

SRI LANKA

State of the Economy

2008



INSTITUTE OF POLICY STUDIES

99, St. Michael's Road, Colombo 3, Sri Lanka

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1. Policy Perspectives

The Sri Lankan economy has grown by 6.9 per cent a year on average over the past three years. While GDP growth in 2007 was lower than the 7.7 per cent recorded in the previous year, published official statistics indicate that Sri Lanka's economy was still growing respectably in 2007 with GDP expanding at an annual rate of 6.8 per cent. Higher growth has also been accompanied by a sustained drop in the rate of unemployment in the country to 6.0 per cent by end 2007, albeit with a marginal decline in the total numbers employed compared to 2006. Absolute poverty levels in the country are estimated to have declined quite sharply with the national poverty rate of 22.7 per cent in 2002 down to 15.2 per cent by 2006. Despite these achievements and the apparent buoyancy in the economy, there are disquieting signs that the country's ability to build on that performance over the coming years may prove to be by no means an easy task.

There are two major areas of concern: external sector developments, and the general state of macroeconomic stability in the country. If a key achievement above all others on the economic front is in delivering stability, not just by maintaining growth but also by keeping inflation down, the country's economic performance in 2007 appears more fragile. With annual inflation hitting 15.8 per cent by end 2007 as per the newly compiled CCPI(N) - or 17.5 per cent according to the old CCPI - the details of Sri Lanka's economic performance in 2007/08 also underscore the complexities facing policymakers, most critically from a recent worldwide surge in the cost of fuels and foodstuffs.

While concerns about the rising cost of living are now being felt across Asia, it has been a primary source of concern in Sri Lanka since mid-2004. There have been sharp differences of opinion on the causes of the jump in inflation to a seventeen-year high by end 2007. But while the debate on what is driving inflation has at times tended to be mired in controversy, what is perhaps clear is that monetary policy - normally best placed to help stabilize the economy - has been playing a much reduced secondary role to counter expansionary fiscal policy impacts. In essence, it underlines the challenges faced by the government as it attempts to walk a tightrope of implementing a public investment drive to ensure that the country's growth momentum remains buoyant in the midst of an escalating conflict, international pressures on aid conditionalities from Sri Lanka's traditional sources of donor assistance, and a fast deteriorating global economic environment.

The initial monetary policy response to mounting inflationary pressures in the Sri Lankan economy from mid-2004 was slow and hesitant. Monetary authorities have a difficult balance to strike - ensuring that policy is not too tight so as to slowdown economic growth, but not too loose that their grip on inflation could slip, as markets and the public cease to believe that prices will remain stable. Sri Lanka, like many other net oil importing developing countries was subject to cost-push pressures from supply-side shocks generated primarily by rising international oil prices. But, more critically, an accommodative monetary policy stance contributed to a surge in demand driven inflationary pressure in the Sri Lankan economy. A moderate policy rate response

saw a sharp increase in monetary aggregates during 2004-06. Not only was the government resorting to heavier borrowing, but cheap credit - fuelled at times by negative real interest rates - saw credit growth to the private sector jump sharply as well. These developments suggested that inflation was likely to prove more persistent than initially anticipated - requiring in turn a much sharper tightening by the Central Bank.

The scope to accommodate a fiscal boost without igniting inflation was already very limited. Sri Lanka has been over spending and over borrowing for far too long without addressing the underlying structural imbalances in public finances. Indeed, the failure to put public finances in order has been an enduring constraint on sustaining a higher growth momentum in the country. Like in many other developing countries, Sri Lanka has seen many ambitious sounding plans to cut the budget deficit and reduce the public debt. Fiscal discipline has been written into law under the Fiscal Management Responsibility Act of 2002 which was expected to help impose budgetary discipline by making policy more transparent and making governments take more account of the future implications of current policies. Unfortunately, convincing details to match the bold aims have either been absent, or such plans have simply faded from the policy discourse.

At first glance, it appears that efforts have been made by the government over the last three years to place public finances on a more stable footing in the medium-term. The overall budget deficit has declined progressively from 8.4 per cent of GDP in 2005 to 7.7 per cent in 2007 while the debt to GDP ratio has declined from 90.6 per cent to 85.8 per cent over the same period. In fact, the ratio of recurrent expenditure to GDP in 2007 has declined relative to 2006, primarily as a result of reduced expenditures

on transfers and subsidies as a percentage of GDP. These efforts - centred on rationalizing and streamlining government subsidies - have to be viewed as a positive development. It is often the case that subsidies are ineffectively targeted, failing to reach the poor for whom they are intended.

However, apart from subsidies and payments, the government spends its money mainly on three other things: on defence and security, servicing public debt, and on transfers to its own bureaucracy by way of salaries and wages. There is limited scope to anticipate any rationalization of expenditures in these areas. Official estimates place defence spending at 3.5 per cent of GDP - with an estimated 20 per cent increase in spending budgeted for 2008 as the government is set to intensify efforts to bring an end to the armed conflict. The chances of progress, if not of a resolution, look better than they have done for years with the establishment of civil and democratic rights in the Eastern Province culminating in the election of the Eastern Provincial Council in May 2008. But in the interim, the government will have the difficult task of meeting defence expenditures while continuing its development work.

In the areas of public sector wages and salaries, despite calls for more independent scrutiny of public programmes and better monitoring of funds handed out by the government, administrative reforms have not gone deeper than that to address core issues of 'down sizing'. In fact, there has been a steady increase of nearly 100,000 persons in public sector employment during 2005-07. The outcome has been a gradual increase in the share of the public sector in total employment in the country from 13.2 per cent to 13.8 per cent over the same period. The staggered implementation of public sector salary revisions will take its inevitable toll on public finances in the future by way

of its wages and pensions expenditures. In such a scenario, Sri Lanka's unreformed public sector can be viewed as a barrier to a faster rate of sustainable growth; it holds adverse implications for government debt and infrastructure spending which sets a lower-than-necessary speed-limit for the economy. Even leaving aside the direct fiscal constraints, a vast administrative machinery - often subject to apathy and corruption - can fail to deliver the services required of it, the most important being to spread the benefits of a growing economy to a country's poor. As demands by trade unions for higher wages to compensate for cost of living gathers steam, the government will have to not only anticipate a further burden on the Treasury but also the possibility of disruption to services being provided.

The scope for reducing Sri Lanka's debt and its debt service obligations are also limited. The dilemma facing the government is clear; an urgent need to raise investment in the face of a debt burden that leaves it short of money for infrastructure. While there is no simple answer to the question of how much a government can safely borrow, there are many reasons why a high level of public debt is to be avoided. A key concern of course is that if government borrowing pushes up interest rates, it can crowd out more productive private-sector investment. But, perhaps, of more concern is the danger of the so-called 'debt trap', in which rising interest payments expand the budget deficit to an extent that total debt continues to grow even when the government is not overspending.

The recent reduction in the debt to GDP ratio that the country has witnessed is in part due to the fact that the high inflationary environment of recent years has eroded the real value of government debt. In the midst of increasing 'conditionalities' tied to aid - human rights being the most visible - the

government has resorted to tap donors for concessional finance that comes relatively free of such strings. It has been fairly successful in this respect - for instance, obtaining assistance from China as a part of the government's infrastructure drive to build roads, ports, power stations, etc. Indeed, China emerged as Sri Lanka's single largest source of bilateral assistance in 2007.

In addition to widening the donor network, the government has also resorted to raising foreign capital through the issuance of sovereign bonds. Sri Lanka raised US\$ 630 million in 2006, US\$ 500 million in 2007 and a further US\$ 200 million in the first half of 2008. In an environment of high and rising domestic interest rates, accessing foreign capital to finance the budget deficit may appear the more prudent course, but there are inherent risks in this strategy. Not only is such borrowing costlier, the risks are high - not only through exposure to exchange rate risks, but also to changes in the country's sovereign credit ratings if the principal has to be rolled over. Sri Lanka's credit outlook has swung from positive to negative since it obtained an initial sovereign rating in December 2005. In fact, the country's credit outlook was downgraded to negative by Standard & Poor's in February 2008 while in April 2008, Fitch Ratings downgraded the credit rating from BB- to B+ on concerns that Sri Lanka's ability to repay debt may be affected by rising inflation, a large fiscal deficit and record oil prices. While the veracity of credit rating agencies have long been subject to query - most recently in the wake of the sub-prime mortgage meltdown - any adverse change in ratings can increase the cost of borrowing, making countries vulnerable, particularly when rolling over existing debt.

In addition, the ability to service higher interest payments will require that the country continues to have sustained foreign

exchange earnings. In 2007, for example, the ratio of total foreign debt service payments to exports of goods and services increased quite sharply to 8.2 per cent of GDP from 7.1 per cent in 2006. Thus, despite the reduction in the overall debt to GDP ratio, in view of a heightened dependence on foreign currency denominated debt raised on more costly commercial terms, the future path of the debt to GDP ratio in Sri Lanka is going to continue to be of major concern.

The government's policy strategy appears to be based on the assumption that productivity gains from infrastructure related spending will spur economic growth, raise additional revenues and allow debt servicing costs to be met in the medium-term without undue risks. This argument has some merit in the context where infrastructure bottlenecks are impeding growth. This may also hold true, for instance, where the government is keen to undertake rapid reconstruction and rehabilitation of the country's conflict affected provinces as a part of an overall political-economy package for development. Indeed, the budgetary outlay on public investment crept up marginally to 6.4 per cent of GDP in 2007 compared to 6.0 per cent in 2006. This has also been accompanied by signs that foreign financing is set to play an increasingly more important role in bridging any resultant increase in expenditures. Already, the share of foreign financing of the budget deficit has increased from 2.5 per cent of GDP in 2006 to 3.7 per cent in 2007, where the bulk of the increase has come by way of loans rather than grants.

The government's strategy to push ahead with increased spending on infrastructure, while balancing its medium-term debt exposure at the same time, is not without potential pitfalls. On the domestic front, uncertainties related to military efforts in the north of the country, and the external risks inherent in a

volatile and weakening global economic environment, add to the risks. The risks can be mitigated, at least in part, if growth-enhancing reforms - aimed at raising overall productivity in the economy - are implemented alongside. At present, the policy focus appears above all to be aimed solely at addressing the significant bottlenecks that have accumulated in the delivery of infrastructure related services. Improvements in infrastructure are needed and will certainly help to raise productivity, but the positive impact will only be partial as other areas - economic stability, regulatory changes to allow factors of production to better respond to market signals, etc. - lag behind.

The imperatives for more managed economy-wide reforms to raise productivity are clear given that some of the things that Sri Lanka needs to do to make the economy more competitive in the long-term are also pushing up prices in the short-term. Infrastructure related investment is needed if the country's continued growth is not to be put at risk, but such investment from additional public spending have inflationary consequences. This underscores the need to rationalize and streamline government expenditure at all other levels. Despite the government's success in holding down current spending as a share of GDP in 2007 vis-à-vis the outcome in 2006, this is unsustainable without convincing medium-term fiscal policy goals. As inflation accelerates, for example, higher prices will mean higher public sector wages - as well as more subsidies to alleviate cost-of-living pressures - further undermining any planned fiscal tightening. The threat in the medium term is that a failure to put public finances on a sounder footing raises the risks of macroeconomic volatility, squeezing policy space to meet any domestic and/or external shocks to the economy.

In the short term, measures to tame inflation and stabilize the economy are the priority. Annual average inflation according to the CCPI(N) had spiralled to 21 per cent by June 2008. With the point-to-point rate increasing steadily from mid-2007 to reach an unprecedented 28.2 per cent in June 2008, it is clear that monetary authorities will continue to grapple with efforts to rein in price increases. The authorities tightened monetary policy significantly in 2007 through a combination of reserve requirements and open market operations, while abandoning adjustments to policy rates. As anticipated, tighter liquidity constraints saw interest rates increasing sharply in the course of the year, squeezing credit growth substantially. The sharp increase in credit growth seen since 2004 had eased, with credit growth to the private sector, for instance, falling to 13.1 per cent by May 2008 from a peak of 25-26 per cent in mid-2007.

While the tighter monetary policy response will rein in aggregate demand to curb inflationary pressures, the impact of various supply side shocks will counteract that to some extent. A key difference is that price increases since mid-2007 have been caused mainly by food prices, which jumped by 20.3 per cent on an annual basis in 2007 compared to increase of only 8.9 per cent in 2006. To the extent that food prices have been pushed up by one-off supply factors, they should flatten, causing inflation to ease. However, food prices are on the rise globally with little signs as yet of a let up. In addition, oil prices have been rising unrelentlessly, with forecasts in early 2008 suggesting a barrel of oil could rise to as much as US\$ 200 by end 2008. These developments are taking place in the backdrop where global growth forecasts have been trimmed, particularly for the US economy. In the past, economic weakness in the US has usually pushed the price of oil and other

commodities down. While there was some easing up of oil prices in August 2008, that relationship has weakened as a result of demand growth in big commodity-intensive emerging economies. Sri Lanka is also bound to start feeling some of the adverse impacts of a slowdown in the global economy - not only through trade flows but also through financial and investment links - while having to continuously grapple with international commodity price increases.

These developments do not bode well for the health of the country's external sector. The trade gap remained a high 11 per cent of GDP in 2007, where only a continued strong inflow of remittances at 7.7 per cent of GDP has allowed a moderation in the external current account deficit to 4.2 per cent of GDP. The injection of foreign capital by way of a US\$ 500 million bond issue averted a continuous depreciation of the rupee against the dollar from Rs. 107.71 at end 2006 to Rs. 113.47 by September 2007. The rupee has since appreciated to Rs. 107.53 by July 2008. While a stronger rupee would do much to curb inflation there are also concerns that it might hurt exports; competitiveness can suffer as wages grow faster than productivity and the currency appreciates. Exporters might of course benefit from a stronger rupee in the backdrop of rising costs of imported fuels and materials, but the persistent appreciation of Sri Lanka's Real Effective Rate of Exchange (REER) during 2007/08 - by as much as 13.5 per cent between April 2007 and April 2008 - suggests otherwise. Despite a high current account deficit - averaging 4.5 per cent of GDP per annum during 2006-07 - the currency has appreciated and held steady, largely on account of inflows of foreign borrowed capital. Such developments need to be watched as they can lead to further distortions in the country's macroeconomic fundamentals.

Persistent and rising current account deficits are a reflection of fundamental economic problems. Sri Lanka has seen a significant widening of its external current account deficits since 2003. Rising inflation has gone hand in hand with widening current account deficits in the ensuing years - a classic symptom of overheating in the economy. As national expenditure outstrips national income, the adjustment has to come via either a cut in expenditure or an increase in income. In practice, income cannot be increased sufficiently in the short term; GDP growth typically increases expenditure at the same time, productivity improvements take time, etc. In the absence of access to foreign capital to finance the deficit, cuts in national expenditure will be required. Either the government and/or private sector (firms and households) must cut expenditure (consumption or investment). If the government does not cut expenditure, and the currency is allowed to float freely, the exchange rate will depreciate to produce price hikes. These price increases are the market mechanism for getting the required cuts in national expenditure. If the exchange rate is not allowed to float freely, then interest rates may become the instrument for getting the required cuts.

In the absence of expenditure cuts by the government, the Sri Lankan economy is seeing cuts occurring in those sectors that are compelled to respond to market signals. High interest rates, for example, are squeezing private investment in the country. Private investment as a ratio of GDP declined from 23.9 per cent in 2006 to 22.5 per cent in 2007 and can be expected to remain subdued in 2008. Sri Lanka can ill afford to see any slackening in its investment rate - which at around 28 per cent of GDP is still lower than what it should be. Although net foreign direct investment (FDI) inflows was an encouraging US\$ 548 million, or about 1.7 per cent of GDP, this was boosted by a

significant share going into the telecommunications sector where profits come through relatively quickly. If Sri Lanka is to ensure that the present near 7 per cent GDP growth is not simply a cyclical upturn around a trend that remains at about 5 per cent a year, it needs to sort out deep-rooted structural imbalances in the economy. Clearly, the country needs to attract much more private investment, both local private investment and FDI. Above all, this means implementing policies to maintain and enhance the competitiveness of the tradeable goods and services sectors, and to retain the capacity for policy flexibility.

The key Chapters of the *Sri Lanka: State of the Economy 2008* report aims to address some of the issues raised above. The central theme of the report examines the political economy dilemma in undertaking reforms. It is recognized that in electoral politics, governments have a difficult task in balancing the often divergent needs of its constituents - a task likely to be made even more complex within coalition governments. State bureaucracies can also resist reform. The perilous consequences of non-action are starkly portrayed in the dismal performance of key public sector entities such as the Ceylon Electricity Board (CEB), the Ceylon Petroleum Corporation (CPC), the Sri Lanka Transport Board (SLTB) and the Sri Lanka Railways (SLR). The financial inefficiencies and the associated drop in the quality of public services are a reflection of deeper, more complex and more pernicious political economy obstacles that stand in the way of progressive reforms. Weaknesses in governance structures - lack of consistency and accountability - create fertile ground for vested interests to engage in rent-seeking activities. Getting to a sustainable solution to the policy dilemma - the dynamics of institutions and institutional change in Sri Lanka - is a recurring theme in the report.

Improving the capacity of the public sector to deliver basic services is the key to bridging the gap between the haves and have-nots. The most recent Household Income and Expenditure Survey (HIES) of 2006/07 suggests that poverty at the national level has declined by 7.5 percentage points to 15.2 per cent from 2002. But the reduction has not been equal across sectors and provinces with the rural and estate sectors continuing to lag behind. Lack of access to economic infrastructure (roads, telecommunication, power, etc.) and poor provision of social infrastructure (education, health, etc.) are factors triggering regional economic disparity.

In education, what are the most effective and efficient ways of delivering education need to be debated. Getting children to school alone is not sufficient; they should also be successfully educated. The evidence to date does not find sufficient support to link high levels of public spending to better education outcomes. Budgetary constraints impose limitations on the equitable provision of public education services. Indeed, the literature appears to suggest that publicly provided education systems can be inefficient due to large overheads and bureaucratic structures that are not accountable to the needs of the students, teachers or parents. Given ongoing efforts to draft an Education Act, it is timely to explore different public-private partnerships in education, and examine the pros and cons of adopting such processes for improving education delivery in Sri Lanka.

Reforms to the energy sector are another area of critical importance in light of escalating international oil prices and concerns regarding climatic change. Current problems in the power and energy sector in Sri Lanka - inadequate supply expansion, losses incurred by state enterprises, price escalation for consumers, etc. - are in part due to the failure

to be attuned to the changing realities transforming the sector globally. Limiting the debate to matters pertaining to inefficiency, poor management, corruption and unsatisfactory performance of the SOEs that dominate the power and energy in Sri Lanka is inadequate. The discussions have to be broadened - to the threat of climate change, the rising demand for and growing scarcity of global energy resources, technological innovations in alternative energy, and the changing structure of energy markets and institutions - to provide a new rationale for reforms in the energy sector in Sri Lanka.

The debate on agriculture reforms has gained a new lease of life with the sharp escalation of food prices globally in 2007/08. An increasingly integrated world economy has either failed to read the price and institutional signals correctly, or has miscalculated the trajectory of such trends in the recent past. Sri Lanka too was not immune, experiencing the worst food price escalation in nearly 30 years. Whilst it is a global phenomenon, the impact is certainly more disastrous in developing countries where the bulk of family income is spent on food. The recent developments raise questions about complacent assumptions that food availability at macro or global levels is adequate to ensure food security for the masses. The underlying objectives of programmes such as "Api Wawamu, Rata Hadamu" - implemented by Sri Lanka well before the onset of the food price debate - becomes more relevant in the current environment. In particular, reforms to encourage investment on improving technology based agricultural productivity growth will have to be given renewed attention by governments and policymakers.

Reforms to ensure the continued dynamism of the services sector - and thus the economy at large - will be critical for Sri Lanka in the coming years. The adequate provision of

services is increasingly recognized as one of the preconditions for - rather than a result of - development. For instance, inadequate infrastructure services, such as poor telecommunications and transport networks or a weak financial system, are perceived as critical bottlenecks on sustainable development. Rapid changes in both the domestic and international environment are likely to bring about opportunities for the economy, but they can also pose challenges which need careful consideration at policy levels. As Sri Lanka readies to enter its first preferential agreement in services under the India-Sri Lanka Comprehensive Economic Partnership Agreement (CEPA) in 2008, the need for an appropriate policy framework to facilitate change and provide ground rules for further progressive reforms is clear.

Finally, as Sri Lanka enters a new political-economy phase of reconstruction of the

Eastern Province after two decades of conflict in the region, challenges of fiscal decentralization to lower tiers of government will assume greater significance. Admittedly, the implementation fiscal decentralization under the 13th Amendment to the Constitution has been less than successful. The provinces have continued to be minor players in the overall fiscal arena in the country - for reasons of institutional weaknesses as well as design issues. Limited assigned revenues to provinces have been a key drawback. As the country embarks on strengthening the system of decentralization, necessary reforms to fiscal and financial aspects must not be overlooked.

The rest of the report draws on these key Chapters to examine related issues of current interest through a series of policy briefs.

2. Economic Outlook

2.1 Overview

Despite a number of adverse domestic and external shocks, the Sri Lankan economy was able to sustain a broad-based growth momentum in 2007. The economy expanded by 6.8 per cent in 2007 compared to 7.7 per cent in 2006. While economic growth slowed in 2007, Sri Lanka has been able to record an annual average growth rate of 6.9 per cent during 2005-07 - a creditable performance in terms of the country's historical growth trends. The number of unemployed has been contracting progressively in recent years with Sri Lanka's rate of unemployment now down to its lowest recorded rate of 6 per cent in 2007. The country's poverty rates are also estimated to have shrunk considerably from 22.7 per cent in 2002 to 15.6 per cent by 2006.

These are no mean achievements for a small economy that has been battling a fiscally costly conflict for over three decades. Scarce resources which otherwise could have been channelled towards socio-economic development have, of necessity, been diverted by successive governments towards defence spending - the volume being dependent on the intensity of the conflict at the time. In addition to dealing with heightened security concerns on the domestic front, the government has also had to deal with the adverse impacts of external supply side shocks. As a small open economy, Sri Lanka remains particularly vulnerable to the effects of international commodity price fluctuations and other global economic conditions. The sharp and sustained increase in oil prices in recent years has been a significant such factor. The country was also not immune to the adverse impacts of an increase in global food prices

in 2007/08. With forecasts suggesting a notable slowdown in global economic growth in 2008, the international environment remains unfavourable for the country.

The fiscal pressures on the government have thus been manifold. Even though the budget deficit has been trimmed progressively to 7.7 per cent of GDP in 2007 (compared to 8.4 per cent in 2006), the expansionary fiscal stimulus continued to undermine efforts to rein in inflation. With the annual rate of inflation at 13.7 per cent at end 2006, a much less accommodative monetary policy stance was adopted in 2007. Nonetheless, abetted by cost-push inflationary pressure of rising oil prices - and higher food prices from mid-2007 - Sri Lanka's annual rate of inflation reached 17.5 per cent by end 2007.

The inability to ensure price stability undermines the achievement in delivering higher economic growth. It suggests that the current growth momentum is unsustainable in the medium to longer term, unless fundamental public expenditure reforms are introduced. In view of committed expenditures on defence, debt servicing and infrastructure development, other areas of government expenditure that continue to be a drain on resources - an expanding public sector cadre, loss making public sector enterprises, etc. - need to be tackled. While the country's debt declined further to 85.8 per cent of GDP in 2007 - from its peak level of 102.3 per cent of GDP in 2004 - the improvement has come partly in response to high nominal GDP growth and not in response to improvements to the underlying debt portfolio of the government. Indeed, non-concessional foreign

debt has been inching upwards, indicative of higher risks to the economy from debt repayment commitments in the future. With annual inflation estimated at 21 per cent in June 2008 even on the basis of a revised consumer price index, fiscal rationalization remains critical if the government is to deliver not only higher GDP growth, but more critically, economic stability.

2.2 Economy and Output

Sri Lanka's GDP growth of 6.8 per cent recorded in 2007 was broad based with all three sectors showing a relatively healthy expansion in output. Growth in the services sector (7.1 per cent) coupled with the industry sector (7.6 per cent) remained robust, providing the main impetus for overall growth in the economy. The agriculture sector saw moderate growth (3.3 per cent) with most of the sub-sectors performing well, with the exception of tea and paddy. Higher medium-term GDP growth outcomes have also seen Sri Lanka's per capita GDP - supported by a stable population growth rate - recording an increase from US\$ 1062 in 2004 to US\$ 1617 in 2007.

2.2.1 Growth and Sector Performance

As of 2007, the compilation of Sri Lanka's National Income Accounts (NIAs) has become the sole responsibility of the Department of Census and Statistics (DCS), replacing the previous practice of similar data com-

pilation by the Central Bank of Sri Lanka (CBSL). Comparative estimates for the period 2003-06 are set out in Table 2.1. Variations in real growth rates - across years as well as across sectors of economic activity - between the two sets of data have been marginal. The differences can, in part, be attributed to methodological and estimation differences of NIAs by the two data collecting agencies. However, there are notable variations in nominal value terms, with DCS data tending to support higher GDP estimates, suggesting differences in price data employed in the two sets of estimates. This has a direct impact when key economic indicators are revised employing DCS data from 2003, particularly instances where GDP at current market prices is used as a denominator.

The Sri Lankan economy has witnessed a relative upturn in its trend growth during 2005-07 compared to 2002-04, from an annual average of 5.1 per cent to 6.9 per cent. The growth momentum in the latter period received a boost from the post-tsunami related reconstruction activities, the generally favourable global economic environment, as well as a stimulus from domestic expansionary fiscal policies and accommodative monetary policies. Nonetheless, the performance in all three key sectors of activity has been notable, with the industry and agriculture sectors showing a marked recovery during 2005-07.

Table 2.1
Comparable Estimates of GDP

	2003		2004		2005		2006	
% growth	CBSL	DCS	CBSL	DCS	CBSL	DCS	CBSL	DCS
GDP	6.0	5.9	5.4	5.4	6.0	6.2	7.4	7.7
Agriculture	1.6	1.7	-0.3	0.0	1.9	1.8	4.7	6.3
Industry	5.5	4.7	5.2	5.4	8.3	8.0	7.2	8.1
Services	7.9	7.6	7.6	6.7	6.2	6.4	8.3	7.7
<i>Rs. billion</i>								
GDP (market prices)	1761	1822	2029	2091	2366	2453	2802	2939

Source: CBSL, *Annual Report*, various issues.

Services sector expansion has been the backbone on which the economy has grown in the last decade.¹ Its contribution to GDP growth during 2002-04 was on average 75 per cent. This declined to 60 per cent in 2005-07 with the gradual recovery of the agriculture and industry sector growth. The services sector has continued to expand at a healthy growth rate of over 7 per cent on average during 2005-07. Growth in the sector has been largely triggered by the dynamic performance of the telecommunication sub-sector. Growth in cargo handling and port services, as well as in financial services, has also been quite strong over the same period. The performance of the cargo handling sub-sector, however, has shown some set-backs recently given capacity constraints of the Colombo port. Capacity limitations and inadequate infrastructure facilities have hindered the growth in the transport sub-sector as a whole. The tourism sector also suffered a set-back with tourist arrivals declining by over 13 per cent in 2007, while earnings contracted by 6 per cent.

The industrial sector has been recovering to grow at a faster pace than the services sector

since 2005, improving its contribution to overall GDP growth significantly from 19 per cent on average during 2002-04 to 33 per cent during 2005-07. The industry sector has registered a robust average growth of 7.9 per cent during 2005-07 compared to 3.9 per cent in 2002-2004. Growth impetus of the sector derives primarily from manufacturing, mining and quarrying and construction sub-sectors. Significant improvement in the performance of textile and clothing, rubber based products, and food products have largely contributed to accelerating growth in the manufacturing sector. The post-tsunami reconstruction related activities and public infrastructure projects have provided impetus for construction sub-sector growth since 2004.

The agriculture sector, despite adverse weather shocks, grew by 3.8 per cent on average during 2005-07, contributing 7.5 per cent to GDP. The growth was mostly visible in rubber, fishery, subsidiary food crops and vegetables and forestry and plantation development. A significant increase in rubber production was mainly driven by the rise in demand - both locally and internationally - and

Table 2.2
Sectoral Performance of GDP at Constant Prices

	Annual Average (%)		Annual (%)		Quarterly (%)	
	2002-04	2005-07	2006	2007	2007(Q1)	2008(Q1)
GDP	5.1	6.9	7.7	6.8	6.1	6.2
Agriculture	1.3	3.8	6.3	3.3	0.0	5.9
Tea	1.5	-0.5	3.4	2.2		
Rubber	2.9	7.7	-2.0	-2.0		
Paddy	-0.8	7.0	2.9	-6.4		
Industry	3.9	7.9	8.1	7.6	7.0	6.0
Manufacturing	3.8	6.0	5.5	6.4		
Construction	3.8	9.0	9.2	9.0		
Services	7.2	7.1	7.7	7.1	7.1	6.4
Post and telecom	24.8	22.6	21.6	21.5		

Note: From 2003, data based on GDP estimates compiled by DCS.

Source: CBSL, *Annual Report*, various issues.

¹ See discussion in this report on "Liberalization of Trade in Services".

attractive prices that prevailed in the international market. A strong revival in the fisheries sector since 2005 is apparent as the industry recovered from the sharp decline in output following the December 2004 tsunami devastation. The tea sector overall recorded a relatively better performance in 2006-07. However, the decline in production reversed towards the end of 2007 with the sector also enjoying higher international prices. Despite the moderate growth recorded in the agriculture sector as a whole, its performance remains far from satisfactory. The relatively poor performance of the sector historically is largely due to a combination of factors such as low investment, poor infrastructure facilities and non-availability of research and development in the sector.

Despite the higher annual average rate of GDP growth witnessed in 2005-07 - admittedly amidst significant challenges on both the domestic and external fronts - the immediate outlook for the Sri Lankan economy to improve on its growth performance in a sustainable fashion remains in doubt. A much tighter monetary policy stance adopted in 2007 to curtail inflationary pressure has already seen the country's growth rate losing some of its momentum. First quarter 2008 GDP estimates suggest that economic growth has remained flat at 6.2 per cent against a growth rate of 6.1 per cent in the first quarter 2007, but slowed sharply from 7.6 per cent growth in the fourth quarter of 2007. As the government continues to grapple with a host of problems - rising fuel prices, continuing domestic inflationary pressure, an anticipated slowdown in the global economy, etc. - efforts to achieve the target 7 per cent GDP growth in 2008 will remain an uphill task.

2.2.2 Labour Force Trends

According to available official statistics, the rate of unemployment in Sri Lanka has been declining steadily in recent years to reach the lowest rate recorded of 6 per cent in 2007. This has come about despite a reduction of 63,000 in total employment in 2007 as compared to 2006.

During 2000-07, the labour force grew by 9.7 per cent. However, yearly labour force growth rates show that the labour force is growing at a declining rate; during 2000-02, the labour force grew at 2.3 per cent a year on average, while during 2006-07 it has declined by 1.4 per cent. The decrease in the labour force over the period 2006-07, despite a 1.4 per cent increase in the working age (15 and over) population, is mainly due to a decrease in the labour force participation rates. In addition, the departures for foreign employment have been increasing over the last couple of decades. In 2006, for instance, 204,000 persons departed for temporary employment abroad. According to the Sri Lanka Bureau of Foreign Employment (SLBFE), the stock of overseas contract workers in 2006 was 1.45 million, which is equivalent to 20 per cent of the workforce in domestic employment.²

Both the number of employed and unemployed has declined between 2006 and 2007. The number of employed declined by 0.9 per cent (by about 63,000 persons), while the number of unemployed declined by 9.4 per cent (by about 46,000 persons). These changes to the labour force have resulted in the unemployment rate declining to 6.0 per cent in 2007,³ but the employment to population ratio has also decreased by 1.1 percentage points from 2006 to 2007.

² These figures are not adjusted for arrival of temporary workers after completing their work contracts. The information on the stock of contract workers abroad is also only available for 2006.

³ As the definition of unemployment has changed somewhat since 2006, unemployment rates are not strictly comparable over the 2004 to 2007 period. As the definition of unemployment has become more stringent since 2006, according to the earlier definition of unemployment, unemployment rate would be slightly higher than the reported value.

By employment status, the largest increase during 2000-07 is seen in the proportion of employers (by 35.9 per cent) and self-employed (by 19.5 per cent). In comparison, the proportion of private sector employees has increased marginally (by 11.1 per cent). Employment in the public sector has also increased by 14.9 per cent. However, encouragingly, the proportion of unpaid family workers has declined by 11.6 per cent. By sector of employment, the employment in industry and services has increased at the expense of employment in agriculture.

At first glance, the labour market statistics look promising, as the unemployment rates are declining. However, the employment to population ratio has increased only marginally during 2000-07, and it has declined from 2006 to 2007. Detailed analysis of employment further shows that employment creation has been mostly in informal types of employment, such as self-employment and

employers (although employment as unpaid family workers has declined). Relatively, employment in the private sector has increased at a lower rate. The data further show that a large number of people are leaving the country for employment abroad. If the current declining trends in the labour force continue, this could lead to a labour shortage situation in the country. Already, some sectors are experiencing labour shortages. As such, policies to aggressively encourage foreign employment overseas should be done with caution, keeping in mind the emerging labour needs of the country. At the same time, there is a need to encourage employment creation in more productive sectors so as to encourage a higher rate of labour force participation.

2.2.3 Investment and Savings

It has long been recognized that Sri Lanka needs to raise its rate of investment substan-

Table 2.3
Key Statistics of Labour Force

	2000	2002	2004	2006	2007
Labour force, '000	6827	7145	8061	7599	7489
Labour force participation rate (%)	50.3	50.3	48.6	51.2	49.8
Male	67.2	67.9	66.7	68.1	67.8
Female	33.9	33.6	31.5	35.7	33.4
Employment status (%)					
Public sector	13.4	13.4	13.0	13.4	13.8
Private sector	42.9	44.5	46.4	42.1	42.7
Employers	2.3	2.8	2.9	3.1	2.8
Self-employed	28.4	28.6	28.3	30.8	30.4
Unpaid family workers	13.0	10.7	9.4	10.5	10.3
Composition by economic activity					
Agriculture (% of total)	36.0	34.5	33.5	32.2	31.3
Industry (% of total)	23.6	20.9	22.8	26.6	26.6
Services (% of total)	40.3	44.7	43.7	41.2	42.1
Unemployment rate (% of labour force)	7.6	8.8	8.3	6.5	6.0
Male	5.8	6.6	6.0	4.7	4.3
Female	11.1	12.9	12.8	9.7	9.0

Source: CBSL, *Annual Report*, various issues.

Table 2.4
Selected Indicators of Investment and Savings

<i>% of GDP</i>	2002-04 Avg	2005-07 Avg	2006	2007
Investment	22.8	27.6	28.0	27.9
Private	19.5	22.9	23.9	22.5
Government	2.5	4.6	4.1	5.4
Domestic savings	15.6	17.5	17.0	17.6
National savings	21.0	23.1	22.3	23.3
FDI (US\$ mn)	190	411	451	548
FDI (% of GDP)	1.0	1.4	1.6	1.7

Source: CBSL, *Annual Report*, various issues.

tially if GDP growth is to be raised in excess of 7-8 per cent, and sustained in that range, over the medium-term. While there has been some improvement in the investment to GDP ratio in recent years, it still remains well below the required rate of 35 per cent and above (Table 2.4).

On average, the investment to GDP ratio has improved during 2005-07 compared to 2002-04, growing incrementally from 21.2 of GDP in 2002 to 28 per cent in 2006. A substantial increase in the public investment ratio was evident following the December 2004 tsunami as the government engaged in the reconstruction drive. In addition, a much more visible public investment drive in capital infrastructure has taken place more recently. These include key infrastructure investments in roads, ports and energy sectors.

However, on a more disconcerting note, it is also evident that private investment has slowed in 2007. Given that it accounts for the overwhelming bulk of total investment, any slowdown in private investment will hold implications for GDP growth. Indeed, the decline in private investment in 2007 is not surprising in view of the sharp increase in interest rates. The 'crowding out' effect of private investment in the face of an expansionary fiscal policy heavily reliant on domestic borrowing is to be expected. Evidence

of economic instability - manifest in high and rising inflation - would also deter private investment. These factors are more likely to impact the investment decision of local entrepreneurs more than heightened concerns over security, which investors are likely to have 'factored in' to an extent over the years.

Despite calls by the government to initiate public-private partnerships (PPPs), it is unlikely that private investors will venture into such arrangements in the required numbers. An environment of uncertainty will raise questions on whether a reasonable return on their investment can be expected. In addition, the absence of regulatory frameworks can also hinder the entry of private investors. Thus, while public capital investment has been increasing incrementally, Sri Lanka's historical savings-investment gap remains a cause of concern in view of the urgent need to raise the country's overall rate of investment.

When looking at savings performance, it is evident that the domestic savings to GDP ratio has been improving; in fact, it has risen from an average of 15.6 per cent in 2002-04 to 17.5 per cent in 2005-07. The improvement in the latter period can be attributed in part to the positive effects of rising per capita income. However, the ratio of domestic savings to GDP dipped in 2006 - as real interest

rates remained low or, at times, negative - while the increase in the ratio to 17.6 per cent of GDP in 2007 is likely to come under threat as inflation imposes severe cost of living pressures on households. By contrast, the country's ratio of national savings to GDP has been rising incrementally - due to the rising inflow of private transfers - to stand at 23.3 per cent of GDP in 2007.

Given domestic resource constraints, Sri Lanka has had to rely on its ability to attract foreign direct investment (FDI) to bolster its investment drive. While it has managed to attract an average annual inflow in the range of 1.5 per cent of GDP in recent years, this is certainly below potential. Undoubtedly, the conflict and the related political uncertainty have played a key role in constraining progress in this area. A lack of policy consistency and predictability governing the environment for FDI is also to be partly blamed. However, despite the upsurge in the conflict since early 2006 - and related political uncertainty - FDI inflows have shown a promising upward trend. Net inflows of FDI have risen from US\$ 234 million in 2005 to US\$ 548 million in 2007. Much of the recent inflow has been concentrated in the more dynamic telecommunication sector, and that too largely investment flows into a handful of companies. For instance, Dialog Telecom, which is the leading service provider in the

telecommunications sector in Sri Lanka, has emerged as the single largest foreign investor in 2007 totalling US\$ 328 million. Overall, however, the increase in foreign investment into infrastructure development - including telecommunication, power generation and construction activities - is to be welcomed.

Even though the overall savings-investment gap has been declining marginally in recent years, domestic resource constraints dictate that the country depends on foreign capital for its investment needs. The potential for raising the current level of FDI substantially to meet the resource gap is limited. While some amount of concessional development assistance has been forthcoming, the government has also increasingly turned to engaging bilateral loans for infrastructure development. In addition, raising foreign currency denominated loans through commercial borrowing has also been resorted to. Investments so financed need to be cost-effective and economically productive given the burden of debt repayments and implications for management of government finances in the medium to long-term.

2.3 Fiscal Policy Management

The medium-term fiscal strategy spelt out by the government aims to increase government revenue, rationalize recurrent expenditure,

Table 2.5
Summary of Fiscal Operations

% of GDP	2004	2005	2006	2007		2008
				Forecast	Actual	Forecast
Total revenue	14.9	15.5	16.3	16.9	15.8	18.0
Tax revenue	13.5	13.7	14.6	15.2	14.2	16.2
Total expenditure	22.8	23.8	24.3	25.3	23.5	25.0
Current	18.6	18.1	18.6	16.8	17.4	17.1
Capital	4.2	5.8	5.6	8.5	6.1	7.9
Deficit	-7.9	-8.4	-8.0	-8.4	-7.7	-7.0

Source: CBSL, *Annual Report*, various issues.

increase public investment, and lower domestic borrowing with the primary objective of creating an enabling economic environment to boost economic growth, productive employment and poverty alleviation. Despite these stated objectives, implementing a prudent and sustainable medium-term fiscal policy has continued to be a challenge.

The upturn since 2004 of total government revenue as a percentage of GDP reversed marginally in 2007 (Table 2.5). While some measures adopted to streamline tax administration was partly responsible for the improved revenue collection, higher nominal GDP growth also contributed towards this end. The dip in tax revenue collection in 2007 can largely be attributed to a lower level of economic activity evident in the slowdown in Sri Lanka's GDP growth. Given the current environment of high operating costs for the private sector - wage pressures from high inflation, high cost of credit, rising energy costs, etc. - as well as cost of living burdens on the general population, the room for the government to raise revenue through tax increases remains very limited. The Budget for 2008 forecasts a total revenue collection of 18 per cent of GDP - a relatively sharp increase of over two percentage points that may not be forthcoming in view of uncertainty related to sustaining a growth momentum of 7 per cent in 2008. Indeed, despite an estimated 33 per cent growth in tax revenue for the year, the *Mid Year Fiscal Position Report*

2008 notes that tax revenue has recorded a growth of only 22 per cent in the first four months of 2008.

By contrast, actual recurrent expenditure for 2007 overran the original target by Rs. 26 billion mainly due to increases in salaries and wages, transfers and subsidies, pension payments and interest payments. Despite such developments, current expenditure as a percentage of GDP was in fact curtailed in 2007 to 17.4 per cent compared to 18.6 per cent recorded in 2006. The adjustment to fuel subsidies whereby price increases have been passed on to consumers has in part allowed the curtailment in transfers and subsidies as a percentage of GDP which declined by 0.8 percentage points in 2007 (Table 2.6). However, containing current expenditure may not be sustainable in 2008. Pressure on current expenditure can be expected to increase in 2008 as wage demands from the public sector, demands for cost of living relief measures for the poor, etc. begin to gather momentum in the current environment of high inflationary expectations. The fertilizer subsidy budget for 2008, for instance, had already been exhausted by May 2008.

It is encouraging to note that there has been a moderate improvement on the capital expenditure front. The initial impetus was largely associated with the tsunami related reconstruction activities in 2005-06. However, capital investment has continued to rise

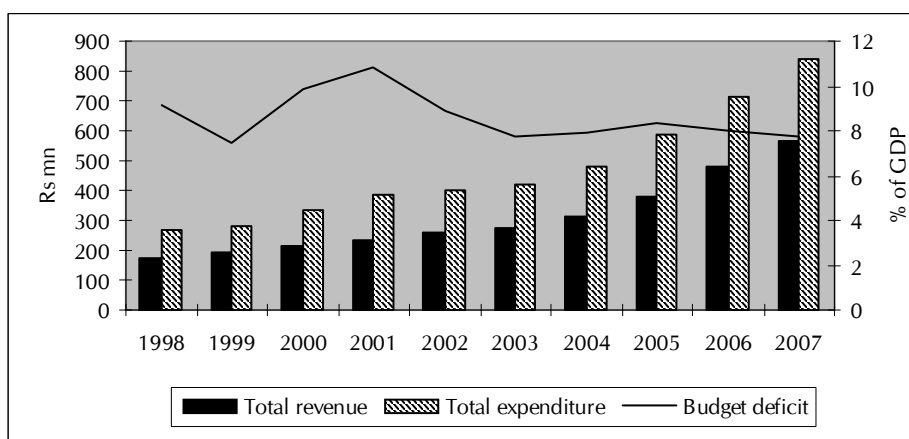
Table 2.6
Selected Items of Recurrent Expenditure

	2004	2005	2006	2007	2008 ^a
1. Salaries and wages (% of GDP)	5.2	5.9	6.0	6.0	5.6
2. Interest payments (% of GDP)	5.9	5.1	5.1	5.1	5.0
3. Transfers and subsidies (% of GDP)	5.2	5.4	4.9	4.1	3.8
4. (1) + (2) + (3) as % of total revenue	106.4	101.9	98.4	96.3	80.2

Note: a: 2008 Budget estimates.

Source: CBSL, *Annual Report*, various issues.

Figure 2.1
Government Fiscal Operations (1998-07)



Source: CBSL, *Annual Report*, various issues.

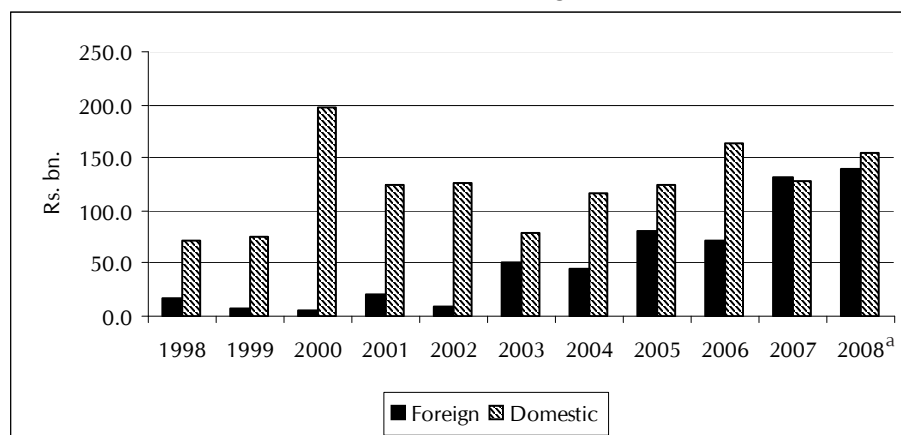
from 5.6 per cent of GDP in 2006 to 6.1 per cent in 2007, despite the fact that actual expenditure has been much lower than initial budgetary outlays (Table 2.5). Increased investment in infrastructure is critical if Sri Lanka's growth momentum in the medium to longer term is not to be compromised. One area of concern that remains, however, is the means of financing increased expenditures. Some part of public infrastructure spending has been raised through the issuance of international bonds. Further such borrowing is anticipated in 2008. While it has been argued that recourse to such borrowing gives the government more freedom and scope for mobilizing funds for domestic policy priorities, the implications on future debt financing obligations, and inherent higher risks, cannot be ignored.

The overall budget deficit for 2007 was estimated at 7.7 per cent of GDP, an improvement on the recorded 8 per cent deficit in 2006. As evident from Figure 2.1, the fiscal deficit has been contracting moderately since 2005. There has also been some improvement in reducing the outlays on key recurrent expenditure items as a percentage of the total revenue raised (Table 2.6). For instance,

current expenditures on wages and salaries of public sector employees, interest payments on debt and on subsidies and transfers as a percentage of total government revenue has declined from 106.4 per cent in 2004 to 96.3 per cent in 2007.

Despite such improvements, however, progress remains too limited. For instance, there has been little progress in providing a workable policy environment to restructure and improve the performance of state owned enterprises which have become a heavy burden on the national budget. Far reaching efforts to rationalize expenditures in a manner that will provide fiscal stability to support long-term growth objectives is needed. This is particularly so in view of the rising expenditure demands in other areas such as defence, reconstruction needs of the Eastern Province, regional infrastructure in other parts of the country, etc. Given that a stable macroeconomic environment is a pre-condition to achieve and sustain higher growth, one of the major areas of concern with fiscal stability in the country remains the means by which the deficit is financed and its implications for the longer term health of the economy.

Figure 2.2
Sources of Deficit Financing (1998-07)



Note: a: 2008 Budget estimates.

Source: CBSL, *Annual Report*, various issues.

2.3.1 Deficit Financing and Public Debt

With a persisting deficit in the government budget over the decades, the financing needs of the government have been largely mobilized domestically, with the bulk from non-bank sources. Captive funds such as the Employees' Provident Fund (EPF) have long provided the government with a source of below market rate funds. A significant departure in more recent years, however, has been the trend to resort to foreign borrowing at commercial rates of interest. Sri Lanka has long been the recipient of foreign development loans on concessional terms. However, with the transition to a middle-income status, access to such concessional loans, in principle, becomes more restricted. While the government is availing itself of concessional loans for infrastructure, particularly from agencies such as the Asian Development Bank (ADB), it has also increasingly sought to access syndicated loans.

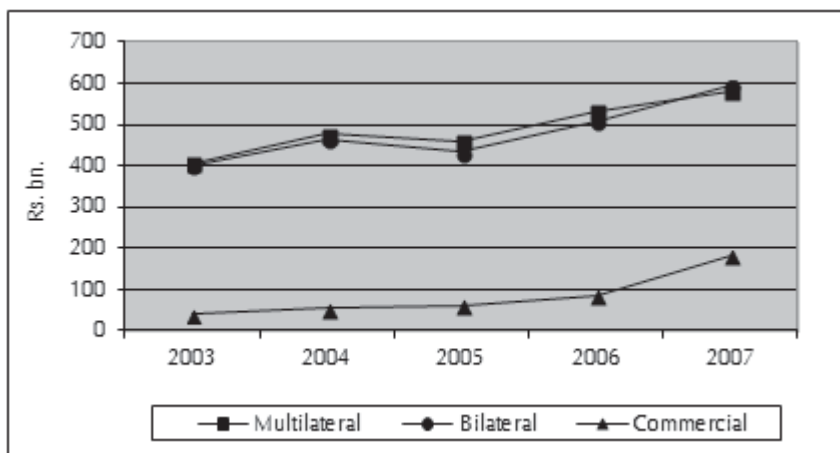
In 2006, for example, the government raised US\$ 680 million by issuing 2-3 year matu-

rity dollar bonds and raising a syndicated loan. In 2007, a further US\$ 500 million sovereign bond was issued. The foreign financing component of the fiscal deficit has risen sharply from 2.5 per cent of GDP in 2006 to 3.7 per cent in 2007 with the bulk of such financing in the form of loans (rising from 1.4 per cent of GDP to 2.8 per cent).⁴

Resorting to foreign borrowing may be cheaper for the government in the current climate of high domestic interest rates. It also has the advantage of lessening pressure on domestic liquidity and thus mitigating further upward pressure on interest rates. However, it has a significant downside in terms of monetary policy conduct as well as the additional risks of foreign currency debt exposure in the medium to longer term. The debt denominated in foreign currencies adds volatility to debt servicing costs as measured in domestic currency owing to exchange rate movements. In addition, it will also require that Sri Lanka repays a large sum of money in one payment at a fixed future date. The

⁴ In addition, the government decided to further expand sources of external finance by allowing foreign purchase of up to 5 per cent of the value of outstanding Treasury bonds in November 2006. Following the removal of further restrictions, such as minimum maturity periods, foreign investment in Treasury bonds took off in January 2007. In December 2007 the limit was expanded from 5 to 10 per cent.

Figure 2.3
Ownership of Foreign Debt



Source: External Resources Department of Sri Lanka, "Overview of Foreign Aid 2007".

risks of a possible rolling over of existing debt is that the costs can increase over time, particularly if the country's sovereign credit rating turns adverse in that time (see Box 2.1).

Large deficit-financing requirements have resulted in the accumulation of a massive

public debt in Sri Lanka. Nevertheless, the debt to GDP ratio which peaked at 102.3 per cent of GDP in 2003/04 has since been on the decline. The ratio stood at 85.8 per cent in 2007. The decline in the debt to GDP ratio in the recent past has been assisted by high nominal GDP growth in

Box 2.1 **Sri Lanka and Sovereign Ratings**

The role, relevance and credibility of credit rating agencies have often been subject to debate. In the aftermath of the East Asian financial crisis of 1997/98, the failure of many rating agencies to anticipate the crisis was criticized. Moreover, the accountability of rating agencies was also subject to some discussion following the financial crisis in emerging markets. A sudden downgrading of a country's credit rating in the midst of such a crisis often aggravates the initial set of problems. More recently, the role of rating agencies has been subject to further criticism following the sub-prime and mortgage related crisis in the US and Europe. Nonetheless, rating agencies are routinely requested by government to issue sovereign ratings in anticipation of borrowing from the international capital market.

In December 2005, Sri Lanka received its first international credit rating from Fitch Ratings of a BB-, three levels lower than investment grade. The escalation of hostilities in the country saw a downgrading of the credit outlook from 'stable' to 'negative' in April 2006. In August 2007, the outlook was revised to 'stable' by Standard and Poor's. In February 2008, Standard and Poor's lowered its outlook on Sri Lanka to 'negative'. In April 2008, Fitch Ratings once again downgraded Sri Lanka's rating from BB- to B+, four levels below investment grade. The downgrading was due to concerns that the country's ability to repay debt may be affected by rising inflation, a large fiscal deficit and record oil prices. However, the Central Bank of Sri Lanka maintained that the downward revision is not consistent with recent improvements in the macroeconomic fundamentals of the country.

Table 2.7
Total Outstanding Public Debt and Debt Service Payments

	2004	2005	2006	2007	2008 ^a
Government debt/GDP	102.3	90.6	88.7	85.8	82.3
Domestic debt/GDP	54.7	51.6	50.3	47.9	44.6
Foreign debt/GDP	47.6	39.0	38.4	37.9	37.7
Total foreign debt/exports ^b	134.8	120.6	127.5	129.5	134.8
Foreign debt service/exports ^b	6.4	3.6	7.1	8.2	11.5
Debt service payments/GDP	14.4	14.1	15.1	14.0	14.4
Debt service payments/government revenue	96.5	90.8	93.0	88.6	80.2

Notes: a: Estimate.

b: Exports of goods and services.

Source: CBSL, *Annual Report*, various issues.

the economy. The weakening of the US dollar has also helped Sri Lanka in its foreign debt repayments.

While efforts are under way to improve debt management in Sri Lanka, including efforts to change the term structure of the debt portfolio, reduce non-marketable debt, increase reliance on longer term Treasury bonds (and foreign participation in the Treasury bond market), there has nonetheless been certain developments in the country's debt portfolio that raises concern on fiscal stability in the longer-term. With the shift towards foreign currency denominated commercial borrowing (with a maturity of 3-5 years on average), there has been a sharp increase in the ratio of foreign debt service to exports of goods and services. Indeed, the ratio has risen from 6.4 per cent in 2004 to 8.2 per cent in 2007 and is anticipated to rise further to 11.5 per cent in 2008. Greater foreign debt exposure can be risky, particularly if a country's ability to generate foreign exchange earnings is subject to some volatility and/or the country remains vulnerable to sudden external supply side shocks that have a bearing on the current account performance on the balance of payments (BOP). At best, it is important to ensure that any such borrowings are used for high priority development activities, infrastructure development projects or

specific development projects that will be productive and generate adequate surpluses to make debt service payments more manageable in the future.

2.4 Monetary Policy Management

Monetary policy management has had to deal with significant challenges arising from domestic policy developments as well as external supply side shocks. On the domestic front, the demands of government expenditures and an accommodative monetary policy stance fuelled demand side inflationary pressures in the economy from mid-2004. A simultaneous external supply side shock in the form of rising international oil prices from early 2004 contributed to fuelling inflationary cost push pressures.

Central banks have a difficult balance to strike, particularly in the face of an economic slowdown. A monetary policy stance that is too tight can choke off growth. The Sri Lankan economy, in the midst of electoral uncertainty, was showing signs of losing its growth momentum in 2004. Despite signs of rising inflationary pressures from mid-2004, the monetary policy response was fairly moderate. Thus, notwithstanding some upward adjustment to policy rates by the Central Bank, real interest rates remained very low, and at times

Box 2.2 Debt Servicing Burden

The most serious concern with regard to large scale borrowing from commercial markets is the higher level of repayments. In the past, the majority of Sri Lanka's borrowing was from concessional sources, primarily the World Bank, ADB and Japan. World Bank (IDA) loans were available free of interest at a service charge of 0.75 per cent with repayment periods of up to 40 years. The Special Fund Resources of the ADB were available at 30 year repayments at 0.5 per cent interest per year. However, lending from multilateral sources is now available at less concessionary rates (e.g., the ADB's Ordinary Capital Resource is LIBOR+0.6 per cent with repayment in 12-20 years). Nonetheless, they are more concessionary than what is available through commercial borrowing. Sri Lanka's recent sovereign debt issue of US\$ 500 million is to be repaid in 5 years at 8.25 per cent. It is interesting to note that in 2008 Sri Lanka's estimated debt repayment shoots above trend to US\$ 707 million, primarily due to a commercial debt repayment due from loans raised in 2005.

Donor	2006	2007	2008	2009	2010
Total	538.1	589.1	707.4	581.8	576.2
Japan	198.0	219.1	219.8	214.6	210.5
Multilateral	135.6	148.4	167.9	182.2	192.5
Commercial	43.1	41.0	139.6	7.4	6.7

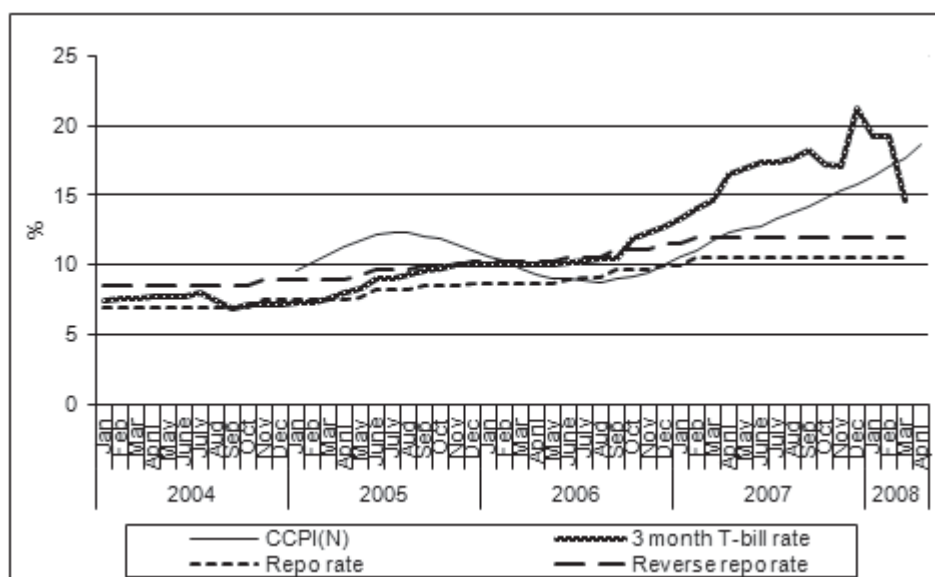
Source: External Resources Department of Sri Lanka.

The concern with increased reliance on commercial borrowing is the impacts it will have through future debt repayment shocks. In 2012, Sri Lanka will face another large repayment when the sovereign debt issue of 2007 matures. Whilst it is expected that a country with increasing per capita income will have to rely less on concessional finance, Sri Lanka's expenditure patterns, particularly by the state, will have to adjust accordingly given the increasing cost of finance. It would not, in this context, be sustainable to continue running large budget deficits as in the past, expecting these to be met by low cost borrowing with long repayment horizons.

negative, as evident from Figure 2.4. There was a significant expansion in money supply growth with credit expansion to both the public and private sectors rising rapidly (Table 2.8). Cost-push pressures contributed further to the inflationary spiral as the government opted for periodic upward revisions to fuel prices. Despite the external factors, Sri Lanka's annual rate of inflation at end 2006 of 13.7 per cent was far in excess of other comparable net oil importing developing economies. It suggests strongly that the prime mover of Sri Lanka's early bout of inflation during 2004-06 was domestic policy responses.

While the growth momentum picked up from 2005/06 - aided in part by tsunami related reconstruction spending - it was accompanied by rising inflation. Once the grip on inflation slips, the more difficult job in hand is to dampen inflationary expectations. The Central Bank gave up adjusting policy rates in February 2007 and instead began to tighten by targeting monetary aggregates through Open Market Operations and through restrictive measures to limit the credit creating capacity of banks. The tighter monetary policy stance saw the point-to-point rate of inflation contract moderately in the first half of 2007.

Figure 2.4
Movement of Interest Rates and Inflation



Note: Data for CCPI(N) is not available for 2004.

Source: CBSL, *Annual Report*, various issues.

From mid-2007, efforts to rein in inflation were further complicated by rising food prices in the country. The newly created Colombo Consumers' Price Index, for instance, shows an annual increase of 20.3 per cent for food and non-alcoholic beverages as opposed to a price increase of 8.9 per cent for that category in the previous year. Rising food prices coupled with steady increases in fuel prices contributed more strongly to the inflationary spiral from mid-2007. Thus, despite a tighter monetary policy stance, the lagged effect of past excesses in monetary aggregates ensured that there was no let-up in the unrelenting increase in the annual average rate of inflation. It peaked at 17.7 per cent in October 2007 to end the year at 17.5 per cent.

Despite the slowdown in the rate of growth of monetary aggregates in 2007 - and continuing into 2008 - there is little evidence to suggest that inflationary pressures will ease substantially in 2008. A new consumer price index was created to counter some of the

key disadvantages of the old CCPI and capture inflationary pressures more accurately (see Box 2.3). The CCPI(N) has also indicated a strong upward movement in inflation with the annual average peaking at 21 per cent in June 2008 with the point-to-point rate at 28 per cent. Any let-up in inflationary pressures resulting from the tighter monetary policy measures will to an extent be countered by rising cost-push inflation. Unlike other countries of South Asia, Sri Lanka has an automatic pricing system for fuel (petrol). The government was compelled to raise the price of fuel by nearly 25 per cent in May 2008 - the single sharpest increase ever - as the price of fuel shot up to US\$ 135 per barrel in the international market. While the global food price increase may moderate towards the end of 2008, there is little evidence to suggest a similar trend in international oil prices. Thus, in 2008 at least, much of the country's inflationary pressures are likely to emanate from developments on the external front.

Table 2.8
Monetary Indicators, 2003-2007

	2003	2004	2005	2006	2007
Reserve money	11.9	20.9	15.8	21.2	10.2
Narrow money supply (M1)	16.0	16.6	22.4	12.6	2.7
Broad money supply (M2b)	15.3	19.6	19.1	17.8	16.6
Net credit to government	-11.0	25.1	11.9	43.1	4.7
Credit to private sector	16.9	22.1	21.5	24.0	19.3
Credit to public corporations	15.8	13.8	-59.5	89.3	55.8

Source: CBSL, *Annual Report*, various issues.

The immediate impact of monetary tightening measures adopted in early 2007 was a rapid increase in interest rates. It is often the case that as inflationary pressure builds and monetary policy response remains moderate, the policy tightening has to be stronger at a latter point. Interest rates peaked in September/October 2007; for instance, the 3 month Treasury bill rate increased steadily to 18.2 per cent in September 2007. It recorded a moderate decline on account of the inflow of US\$ 500 million related to the sovereign bond issue (Figure 2.4). The government has also used other measures to ease liquidity such as further liberalization of the capital account by allowing foreign investors to subscribe up to 10 per cent of outstanding rupee denominated Treasury bonds. This facility was further extended to Treasury bills from May 2008.

The sharp increase in interest rates moderated credit growth in the economy. Credit growth to the private sector, for instance, slowed from 24 per cent in 2006 to 19.3 per cent in 2007 (Table 2.8). The contraction in credit growth has been much stronger in 2008; credit growth to the private sector, for instance, had reduced sharply to 13.1 per cent by end May 2008 from a peak of 25-26 per cent in August 2007. Nonetheless, the slowdown in credit growth - and anticipated lower rates of investment by the private sector - will have an impact in slowing down Sri Lanka's GDP growth in 2008. Of some

concern also is the immediate impact of the recent credit boom on the financial performance of the banking system. Much of the recent increase in credit growth has been mobilized for housing and consumption (Figure 2.5). As interest rates have risen sharply, it also raises the risk potentially of higher non-performing loans in the future.

2.5 External Sector Performance

The main focus on external sector performance in recent years has been Sri Lanka's burgeoning trade deficit. Despite a reasonable rate of growth in export earnings of 12.5 per cent in 2007, continued high expenditure on petroleum imports saw only a slight moderation in the trade deficit. Strong inflows of private transfers - accounting for 7.7 per cent of GDP in 2007 - have allowed Sri Lanka to cushion its current account deficit over the years. However, the external sector performance indicates a marked deterioration in 2006/07 with the current account deficit averaging over 4.5 per cent of GDP. This is likely to continue into 2008. The trade balance has deteriorated sharply in the first half of 2008: the deficit has risen to US\$ 3084 million, compared to a deficit of US\$ 1603 million for the corresponding period in 2007.

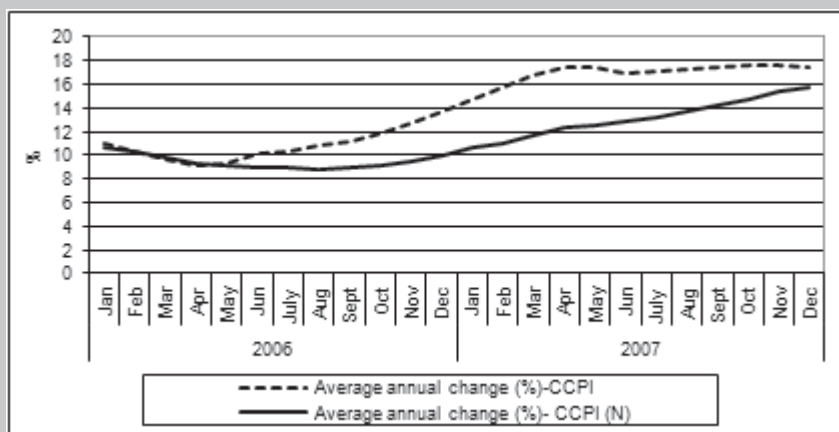
On the capital account, while the performance of FDI has been positive - with net inflows rising from US\$ 451 million in

Box 2.3**New CCPI vs Old CCPI: Pros and Cons**

With recognition of the need for a more representative and accurate measure of inflation, the New Colombo Consumer Price Index-CCPI(N) was introduced by the Department of Census and Statistics (DCS) in November 2007. The old CCPI with a base year of 1952 was widely recognized to contain many weaknesses, not least the relevance of the weights and the composition of key items of expenditure. The CCPI(N) is based on the Household Income and Expenditure Survey of 2002 compiled by the DCS. The weight structure of the new index is based on the expenditure of all urban households in the Colombo district while the base weight is subject to revisions in five year intervals. The CCPI(N) has since replaced the previous CCPI.

The CCPI(N) has been subject to criticism for arbitrarily excluding certain items of expenditure such as alcohol – which is subject to significant upward price movements – while retaining others despite the fact that they constitute the same proportion of household expenditure. Other criticisms levelled against the CCPI(N) are that it does not reflect the actual consumption pattern of the working class and those outside Colombo who spend the bulk of their income on basic food items, unlike those in Colombo who spend the bulk of their income on services.

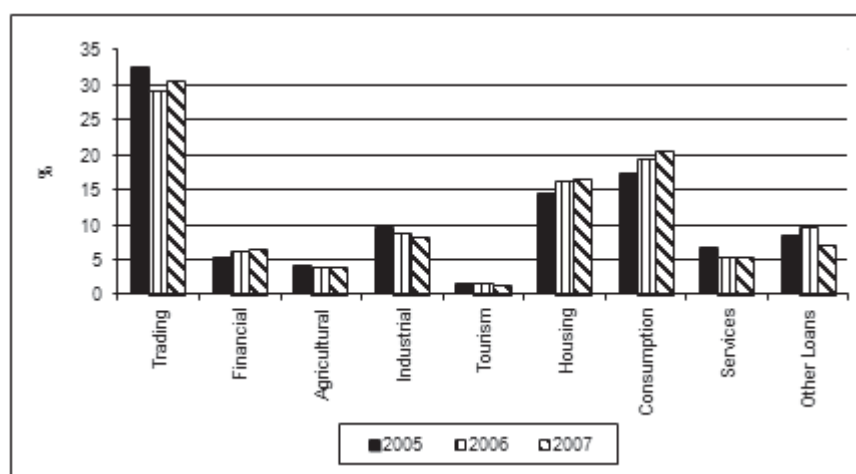
Given the sensitivity of ‘cost of living’ indicators, the credibility of any CCPI also depends on the timing of its introduction. In this respect, despite substantive improvements in the CCPI(N) compared to the previous index, its introduction in an environment of high and rising inflation is perhaps not the most appropriate, particularly in view of the fact that the DCS had already formulated a more comprehensive Sri Lanka Consumer Price Index (SLCPI). However, given that the cost of estimating such an island-wide CPI is high, a revision of the old CCPI is not without merit.

CCPI vs CCPI(N)

Source: CBSL, Annual Report 2007.

The validity of any price index depends on how well it reflects the actual price changes and consumption pattern of the households. Therefore, apart from its wider coverage, the credibility of the CCPI(N) can be further improved by publicizing the prices that are used to construct the index and the methods used to select goods and construct weights, which are to be revised every five years.

Figure 2.5
Sectoral Distribution of Loans of LCBs



Source: CBSL, *Annual Report*, various issues.

2006 to US\$ 548 million in 2007 - other historical sources of long-term financial flows such as concessional loans and grants have been limited. Rather, much of the capital inflow in 2007 was tied into foreign funds mobilized from the international capital market by the issuance of sovereign bonds.

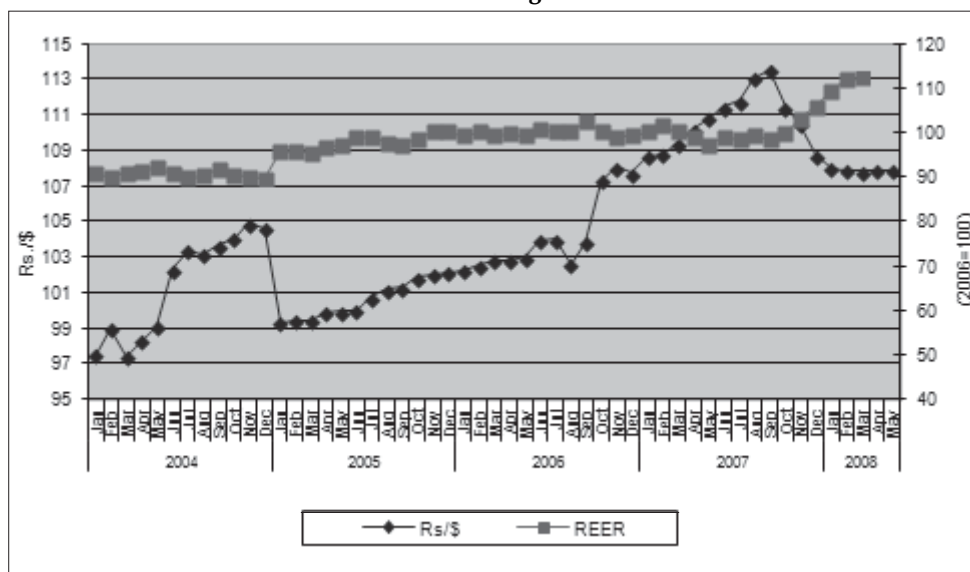
The impact of the foreign capital mobilization on the exchange rate is clear (Figure 2.6). The rupee had been depreciating progressively against the US dollar up to September 2007, but began to appreciate thereafter, and into the first quarter of 2008. Despite the significant burden of a sharply rising oil import bill in 2008, staggered payments arranged via bilateral credit lines

Table 2.9
External Sector Developments

							First Half	
		2003	2004	2005	2006	2007	2007	2008
Export growth	%	9.2	12.2	10.2	8.4	12.5	12.9	9.8
Garments	%	6.3	9.1	3.1	6.4	8.5	14.6	1.5
Import growth	%	9.3	19.9	10.8	15.7	10.2	3.9	35.6
Petroleum		6.2	40.2	36.9	33.0	20.6	-7.8	87.1
Trade balance	% of GDP	-8.4	-11.2	-10.7	-12.5	-11.0		
Private transfers	% of GDP	6.6	6.7	7.4	7.6	7.7		
Current a/c	% of GDP	-0.4	-3.2	-2.8	-4.9	-4.2		
BOP	US\$ mn.	502	-205	501	204	531	192	390
Gross official reserves	US\$ bn.	2.3	2.2	2.7	2.8	3.5	3.1	3.1

Source: CBSL, *Annual Report*, various issues.

Figure 2.6
Nominal and Real Exchange Rate Movements



Source: CBSL.

- for instance, with Iran - prevented major fuel bills from the Ceylon Petroleum Corporation (CPC) coming to the market and further assisted in ensuring exchange rate stability in the first half of 2008.

An appreciation of the rupee of course would help to curb imported inflation. But, there is also concern that it might also hurt exports. However, a currency appreciation can also offer some relief to exporters suffering from rising costs of imported fuels and materials. But, of greater concern is that the domestic inflationary spiral may be impacting adversely on Sri Lanka's external competitiveness. The Real Effective Exchange Rate (REER) calculated against a basket of 24 countries appreciated by 6.5 per cent in 2007 and by a further 8.3 per cent between December 2007 and May 2008. Thus, the inflation differentials between Sri Lanka and its trading partners - in addition to movements in the nominal exchange rates - suggest that Sri Lankan exporters are losing competitiveness overseas.

The nature of capital flows financing an external current account deficit matters. In principle, a high current account deficit suggests that the currency will depreciate to produce the required adjustment. However, the inflow of foreign borrowed funds have ensured that the exchange rate has appreciated (or held steady) which can lead to further distortion in the country's macroeconomic fundamentals.

2.6 Conclusion

The most promising note on Sri Lanka's economic performance in 2005-07 has been an above trend average rate of annual GDP growth of nearly 7 per cent. The higher growth, however, has come amidst signs of increasing weaknesses in the macroeconomic environment, most notably in the form of significant inflationary pressures. The outlook for the country's economy in the medium-term remains shrouded in uncertainty, compounded not only by domestic policy constraints but also a weakening global economic environment.

As widely anticipated, Sri Lanka's growth momentum slowed in 2007 as the monetary authorities took measures to rein in inflation. With limited room to relax a tight monetary policy stance, the macroeconomic indicators point towards a further slowdown in 2008. Even as monetary tightening is showing positive results - for instance through a sharp drop in credit growth in the first half of 2008 - there is no let-up from higher oil prices. While the price of a barrel of oil eased in August 2008 from a peak of US\$ 140 by mid-2008, the signs are that the Sri Lankan economy will continue to be subject to the lagged effects of cost-push pressures with periodic adjustments to the retail price of fuel.

The Sri Lankan economy will be functioning under significantly tighter constraints in 2008, allowing no room for policy errors and safeguards against possible shocks from domestic and/or external sources. Under such constraints, it is all the more critical that the government adopts a prudent management of medium-term fiscal policy that will provide the basis for regaining macroeconomic stability. Given the reality of pressures on expenditure - infrastructure, defence, reconstruction, etc. - the prudent course has to be to restructure spending in other areas in order to minimize Sri Lanka's recourse to costly borrowing.

3. International Economic Environment

3.1 Introduction

After four successive years of above trend global growth, in the second half of 2007 the world economy ran into its first set-back since the end of the 'dot com' bubble in 2000. The reversal in the US housing market coupled with a crisis in financial markets saw a wide ranging credit squeeze in the US which spread through financial markets to Western Europe as well. Thus far, the developing world has been insulated to an extent from the bulk of the problems, driven by continued rapid growth in major emerging economies. Buoyed by the performance of these countries, world GDP grew at 4.9 per cent in 2007.¹ Developing economies grew at 7.9 per cent, led by China (11 per cent), India (9 per cent) and Russia (8 per cent); these three economies accounted for almost half of global growth in 2007. By the end of the first quarter of 2008, much of the financial crisis had been stemmed and governments had taken steps to boost consumption and access to credit. Central Banks in Europe and America infused the global economy with liquidity to mitigate the credit squeeze, and the US government approved a fiscal stimulus package designed to boost consumption. Nonetheless, high commodity prices and more stringent access to credit are likely to curtail global growth through much of 2008 as well, prompting the IMF to project a growth of 3.7 per cent for the global economy in 2008. In this context, this Chapter looks at the implications of global economic outcomes on the Sri Lankan economy and at some specific challenges the country will face on the external economic front.

Given the implications of a global downturn on the prospects for export growth, the Chapter also analyses the recent developments in multilateral and bilateral trade agreements to which Sri Lanka is a party.

3.2 Global Economic Performance and Prospects

3.2.1 The US Downturn

Growth in the US economy slowed to 2.2 per cent in 2007 from 3 per cent in 2006. A long expected housing bubble correction in the US saw inflated house prices fall. This resulted in widespread defaults in the sub-prime mortgage market as borrowers were unable to repay housing loans undertaken on the expectation of rising house prices. The downturn in the sub-prime market spread through financial markets rapidly as debt had been heavily securitized and sold to investors in both the US and Europe. The resultant capital shortfalls spread to inter-bank markets where rates shot up, squeezing credit in general as financial institutions struggled to secure their own liquidity. Central Banks in the US and Europe injected liquidity into financial markets but there remains concern about the possibility of slipping from a credit squeeze to a credit crunch, particularly if there are further losses in financial instruments and institutions. In the first quarter of 2008, there were widespread losses in financial institutions across the US and EU. Results of second quarter earnings will be more revealing in terms of whether sub-prime write downs are indeed coming to an end.² The

¹ IMF, *World Economic Outlook*, April 2008.

² On the back of bleak second quarter 2008 earnings results in US financial markets, Lehman Brothers, Freddie Mac, Fannie May and Morgan Stanley, etc., collapsed in September 2008.

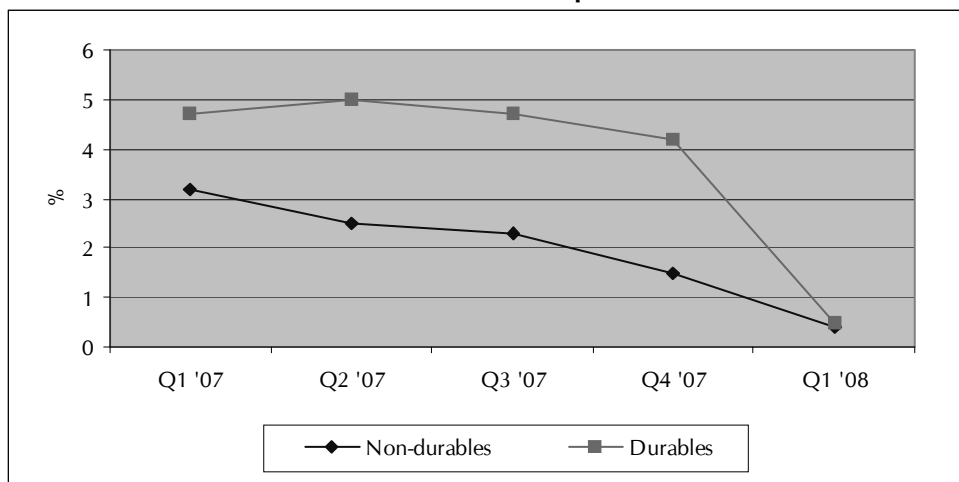
current credit tightening is a necessary re-adjustment following a period of very lax credit growth. The re-pricing of credit will provide a firmer foundation for growth in the medium-term. However, adjustment costs continue to pose a threat to short-term global growth.

A matter of concern that prompted the fiscal stimulus package in the US was the slowdown in consumption. A major cause of this is the reduced ability of consumers to borrow against home equity in the context of falling house prices. Furthermore, declines in equity markets and labour markets in the first quarter of 2008 put further drags on consumption. Employment creation in the US slowed in the 4th quarter of 2007 before levelling off at the end of the year. In the first three months of 2008, the US economy shed 240,000 jobs. Equity markets in advanced economies also fell in early 2008 and remained low at the end of the second quarter of 2008. Equity markets in some developing economies also took intermittent hits as a result. In the past, consumption slowdowns

in the US had major impacts on the rest of the world. However, this has been reduced to an extent with rapid import growth in developing nations, with the US accounting for only about 15 per cent of global imports at present.

For Sri Lanka, the US remains a major market for its exports (25 per cent of total exports in 2007), but from a Sri Lankan perspective, the fall in US consumption is not entirely discouraging. Asset price falls will affect consumption of durable goods to a greater extent than non-durable goods, and the majority of Sri Lanka's exports to the US are non-durable, particularly apparel (81 per cent of Sri Lanka's exports to the US). According to the US Bureau of Economic Analysis statistics, consumption of durable goods fell by 1.5 per cent between the 4th quarter of 2007 and 1st quarter of 2008.³ However, expenditure on non-durables fell by just 0.3 per cent, and expenditure on clothes and shoes increased by 0.2 per cent in the same period. Even though consumption of durables has fallen faster than that of non-durables,

Figure 3.1
Growth of US Consumption



Note: Percent change in quarter from previous year.

Source: United States Bureau of Economic Analysis data.

³ Expenditure on residential investment fell by 7.4 per cent.

there remains concern as non-durables consumption growth has slowed down significantly since the beginning of 2007. Furthermore, consumer confidence fell to a 16 year low in June 2008 according to the US Conference Board Consumer Index.

Concerns about the security of US financial assets have led to declines in foreign investment in such assets since the evolution of the financial crisis in mid-2007. The value of the US dollar has fallen significantly since then, further exacerbated due to rate cuts by the Federal Reserve. The trade weighted average value of the dollar has declined by 9.3 per cent between April 2007 and April 2008. The depreciation of the dollar along with declining US consumption has seen a reduction in the high US current account deficit to below 5 per cent of GDP. The gradual reduction of the US deficit is part of the unwinding of overall global imbalances that have created some uncertainty in the world economy. One threat to this gradual unwinding is the possibility of a sharp movement of capital away from the US in the wake of a depreciating dollar, falling interest rates and reduced confidence in the security of US financial assets.

While the US economy is projected to slow down through much of 2008, a full scale recession is unlikely. The signals continue to be mixed with equity markets stabilizing towards the end of the first quarter of 2008 before declining again in the second quarter - the same applied to the labour market, with unemployment increasing to 5.5 per cent in May 2008 despite stabilizing in April. On a positive note, the US financial institutions entered the crisis with strong financial positions and, therefore, should be able to absorb much of the shock. Furthermore, many financial institutions have benefited from injections of liquidity from sovereign wealth funds (many from emerging markets) and support by the Federal Reserve (the rescue of

the investment bank Bear Stearns and the mortgage institutions Freddie Mac and Fannie Mae). The US government has also taken steps to boost consumption through a fiscal stimulus package and expansionary monetary policy. However, the monetary stimulus may not have the desired impacts on consumption since borrowing will decline due to more stringent credit conditions as much as expense of credit. The overall health of the US economy is likely to be largely influenced by developments in the housing market and resulting shocks in financial markets and consumption.

3.2.2 Transmission to Western Europe

The Euro area grew by 2.6 per cent in 2007 with growth slowing to 1.5 per cent in the 4th quarter. Whilst trade links remain strong between the US and EU (the US remains the largest export market for the EU accounting for 20 per cent of EU exports), the financial link is the main source of transmission of the slowdown. Financial markets in many European countries, particularly British, French and German banks, suffered due to the exposure to sub-prime mortgage backed assets in the US. Inter-bank lending rates in Europe increased as access to credit declined. Thus far, consumption has not been significantly affected as labour markets remained robust. This bodes well for Sri Lanka since Europe has been an increasingly important market for Sri Lankan exports. About 37 per cent of Sri Lankan exports were to the EU in 2007, up from 29 per cent in 2002. The British economy is of particular importance to Sri Lanka since it accounts for more than a third of total exports to the EU.

In the medium-term, there remains uncertainty in the context of continuing revelation of losses made by European financial institutions (especially German and French) in US markets. This could have further implications for access to liquidity and consumption. A more pertinent concern is the

possible downturn in housing markets in Western Europe, particularly England, Spain and Ireland. House prices in these countries have experienced an even larger bubble than in the US, and a correction could have implications for consumption and growth in Europe.

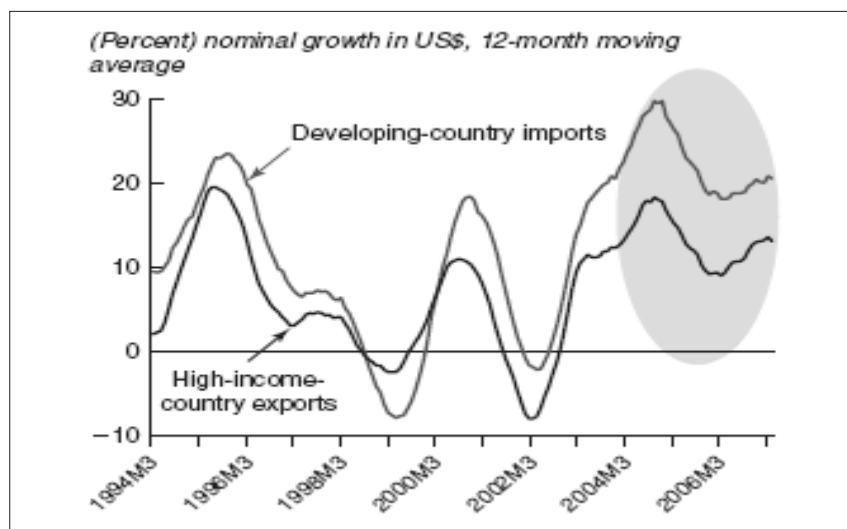
Of the key EU countries of interest to Sri Lanka, the UK economy grew by 3.1 per cent in 2007. Property prices in the UK have been falling since the 4th quarter of 2007,⁴ reflecting more stringent credit conditions, lower household disposable income and weak market sentiment. Thus far, consumption has remained buoyant in the UK but it remains to be seen whether this can be maintained in the event of a prolonged slump in house prices. The financial sector too has been adversely affected, reflected by declining equity prices on major financial institutions. This again is a cause for concern in terms of overall economic performance as the financial sector is the engine of the UK economy

- a decline in which will have ripple effects across the economy. However, in April 2008, the Bank of England cut interest rates and announced a special liquidity scheme to help stabilize financial markets.

3.2.3 Decoupling in Emerging Markets

The major success story in the global slowdown of 2007 has been the resilience of the developing economies. Domestic demand was buoyant in the large emerging markets of China, India, Brazil and Russia, oil revenues boosted economic performance of OPEC countries, and strong commodity prices (metals and agriculture) supported growth in Africa and Latin America. South-south trade has increased significantly, particularly in Asia, with almost 50 per cent of developing nation exports being to other developing nations. As a result, transmission mechanisms between the developed economies and developing economies in trade have weakened. The global linkages between financial markets are dominated by intra-

Figure 3.2
Increasing Developing Country Demand for Imports



Source: World Bank.

⁴ Recording a 3 per cent fall since the 4th quarter of 2007 according to Halifax and Nationwide averages.

developed economy exchanges, particularly with regard to the complex financial instruments that were victims of the financial crisis in 2007. Therefore, developing and emerging economies were to a great extent sheathed from financial market dislocations in the advanced economies. Nonetheless, the major challenge facing developing nations is continued inflationary pressures. This challenge has thus far been exacerbated by reluctance on the part of many developing countries to engage in monetary tightening to curb inflation at the expense of short run growth.

Despite the validity of the overall concept of decoupling, some developing countries continue to rely on the advanced economies for export markets. Sri Lanka is one such country. Financial markets in Sri Lanka are largely unaffected by the sub-prime crisis. FDI could be constrained in the short-term as access to capital has declined and investors appetite for risk will be tempered in the short run. However, encouragingly for Sri Lanka, FDI in the recent past has been dominated by developing nations - particularly Malaysia and India. Given the continued dominance of emerging economies and the down-turn in developed markets, it is possible that inves-

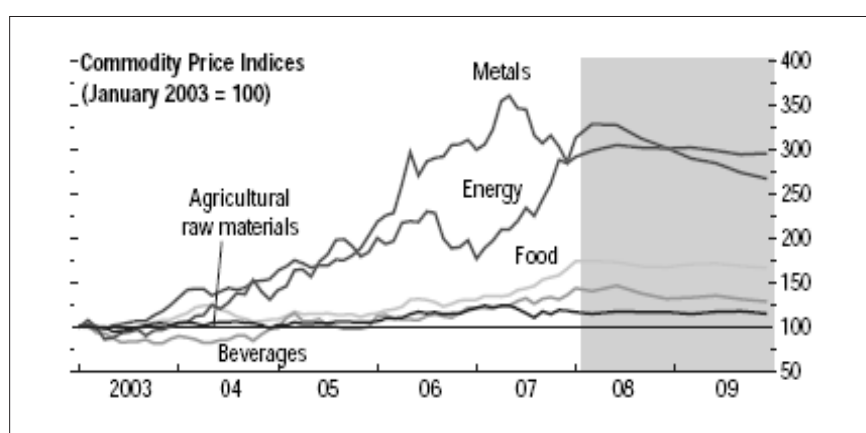
tors will shift away from more advanced markets towards developing economies in the short-term. The major impact of a down-turn in advanced economies is likely to be transmitted through the trade channel.

3.3 Commodity Price Boom

A major development during 2007 was the broad based increases in commodity prices across the energy, food and metal sectors. A range of supply, demand and macroeconomic policy factors contributed to price increases that have persisted in 2008 and are unlikely to abate significantly for some time. The implications of this for Sri Lanka are significant as the import cost of major commodities such as crude oil, wheat and certain other food products have increased. At the same time, Sri Lanka's agricultural commodity exports have benefited from the commodity boom in 2007.

Oil prices increased significantly in 2007 from US\$ 58 per barrel in January 2007 to over US\$ 100 in January 2008. Prices continued to increase through the first quarter of 2008 based on supply concerns in Nigeria and Iran. In June 2008, prices reached US\$ 138 per barrel. The more fundamental

Figure 3.3
Global Commodity Price Increases



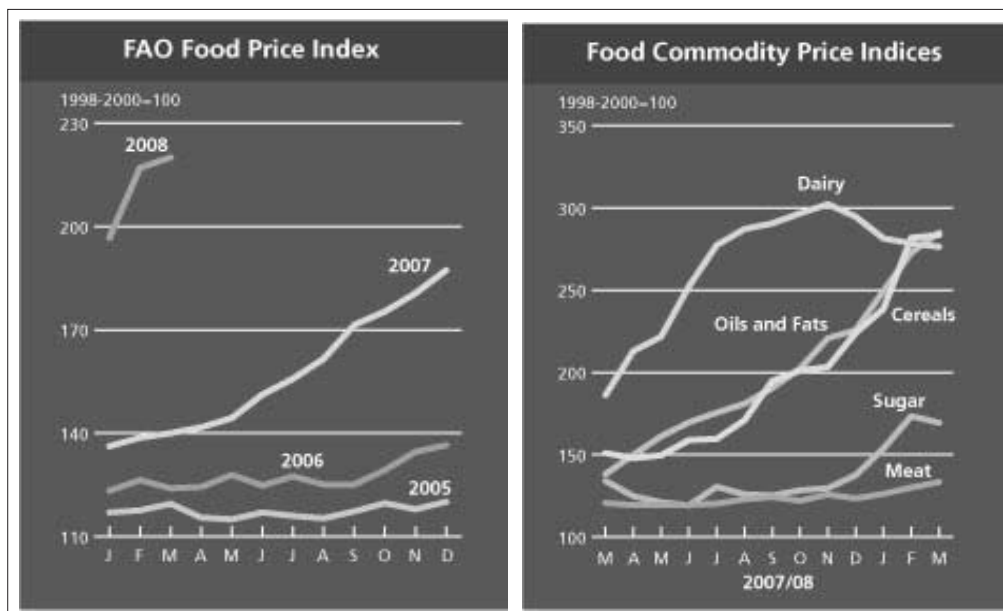
Source: International Monetary Fund.

factors driving oil prices include demand from emerging economies and increasingly challenging supply conditions - particularly with regard to technological and geological constraints.⁵ These supply conditions are expected to remain tight in the medium-term while demand will continue to expand in line with growth in emerging economies, but with some moderation given the outlook in developed economies. As a result of oil price increases, Sri Lanka too recorded a 20.6 per cent increase in import expenditure on petroleum in 2007, contributing 40.7 per cent to total import growth.

The prices of major food products also increased in 2007.⁶ The Food and Agriculture Organization (FAO) food price index in March 2008 recorded a 57 per cent overall increase on the previous year. Food prices increased throughout 2007 and continued to increase sharply in the first quarter of 2008

before showing signs of moderation towards the end of the quarter.⁷ The products of import interest to Sri Lanka include dairy products, wheat and sugar. The increased demand for bio-fuels in the US and Europe has resulted in increased production of corn and other grains at the expense of wheat and other food crops as farmers substituted away from food crops. Bio-fuels accounted for almost half the increase in demand for major food crops in 2006/07. The prices of dairy products and wheat increased significantly through 2007 as increased demand from emerging economies - combined with drought conditions in traditional export countries such as Australia - created supply constraints. Whilst continued demand from emerging economies and the demand for bio-fuel in the wake of increasing oil prices are likely to maintain upward pressure on food commodity prices, a lagged supply response may lead to moderation in prices towards the end of 2008.

Figure 3.4
Food Price Indices in 2007/08



Source: Food and Agricultural Organization.

⁵ See discussion in this report on "Energy Sector: What Factors Govern Successful Reforms?".

⁶ See discussion in this report on "Does 'Foodflation' Call for Agricultural Reforms?".

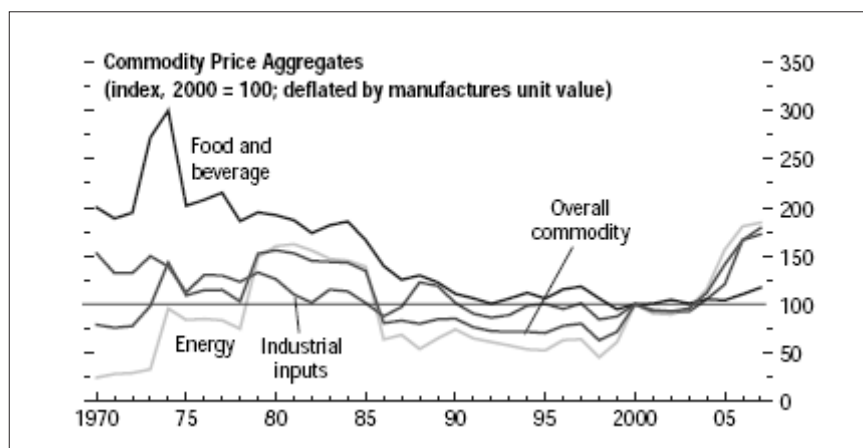
⁷ The Goldman Sachs Commodity Indices showed price declines in cereals and soybeans since March 2008.

Whilst supply and demand shocks have clearly had an important impact on commodity prices, the fact that there have been simultaneous price increases across so many commodities indicates the possibility of a broader causative factor. Demand from emerging economies is one such factor, but as Figure 3.4 shows, the sharpest increases across all commodities have occurred since mid-2007, and this sharp increase cannot be entirely explained by emerging market demand. The behaviour of the US dollar and changes in policy rates by the Federal Reserve and other central banks may provide alternative explanations. The dollar depreciated sharply in the second half of 2007 and the Federal Reserve made successive policy rate cuts that have left real interest rates negative. Low interest rates create incentives for investors to shift from the money market to real assets such as commodities like gold and oil. Low rates in the US and dollar pegged economies (such as the Middle East and China to an extent) stimulate demand for commodities, pushing up their prices. This is particularly the case in dollar pegged economies which attempt to keep up with

expansionary monetary policy in the US despite the fact that domestic demand conditions have not declined as they have in America.

As shown in Figure 3.5, previous broad based commodity price booms in 1973 and 2000 were during periods of US rate cuts (Greenspan's cuts following the end of the 'dot com bubble') and dollar depreciation (return to the floating exchange rate in 1973 following the collapse of Bretton Woods).⁸ IMF research finds that a depreciation of the dollar is closely related to prices of gold and oil, but less so with agricultural commodities. However, the long run price of such commodities is determined by real supply and demand factors - the higher prices will elicit behavioural changes by consumers and supply response by producers - but in the short run such responses are sticky. Given the likelihood of the Federal Reserve maintaining low interest rates through 2008 and the continued demand from emerging economies, it is likely that commodity prices will remain elevated through much of 2008.

Figure 3.5
Historical Commodity Price Booms



Source: International Monetary Fund.

⁸ Whilst 1973 was also the year of the Yom Kippur war, when Arab states placed an oil embargo on the US for supporting Israel during the war, it could be argued that US monetary policy had a significant impact on oil prices since future oil shocks (Gulf War and the second oil crisis of 1979) did not have comparable broad based impacts on commodity prices.

Whilst commodity price increases have adversely affected Sri Lanka's import position, there have been positive impacts on Sri Lanka's agricultural commodity exports. During 2007, the average export price of Sri Lankan tea increased by 31.7 per cent resulting in tea export earnings in 2007 increasing to US\$ 1025.2 million from US\$ 881.2 million in 2006, a growth of 16.3 per cent. This was the first time that tea exports breached the US\$ 1 billion figure. The major markets for Sri Lanka's tea were the Middle East and CIS countries (which together made up 74 per cent). The demand increase in these countries was again spurred by growing export earnings in energy based commodities, particularly oil. The same applies to Sri Lanka's earnings in remittances, the growth of which is influenced by increasing oil revenue in the Middle East. The average export price of rubber also increased in 2007 to Rs. 234.48 per kg from Rs. 189.86 per kg in 2006, an increase of 23.5 per cent. As a result, rubber export earnings also increased by 17.5 per cent to US\$ 109.4 million in 2007. Overall, however, Sri Lanka's terms of trade deteriorated by 1 per cent in 2007 as the increase in export prices lagged behind that of imports.

3.4 Upcoming Challenges for the External Sector in Sri Lanka

Besides the concerns posed by down-turns in Sri Lanka's major export markets, escalating prices of food, energy and other imported commodities, other potential external challenges may have to be faced by Sri Lanka. Two such issues are examined, namely, developments in the international market for garments, and the paradigm shift in Sri Lanka's external financial situation.

3.4.1 Challenges for the Garment Sector Post-2008

The garment industry in Sri Lanka has faced numerous challenges over the last few years - the expiry of the Agreement on Textiles and Clothing (ATC), rising energy costs and increased competition from low cost producers such as China and Vietnam. Sri Lanka's industry has overcome these challenges by evolving and innovating production, marketing, establishing backward linkages and developing human resources.

By the end of 2008, Sri Lanka's garment industry will face two further shocks in the

Box 3.1

Innovations in the Textile and Clothing Sector in Sri Lanka

Technological innovations included the use of modern machines for designing, grading, cutting and dyeing and the use of IT in production. Human resources have been developed by the introduction of a graduate diploma in apparel marketing and a Bachelor of Design programme at the University of Moratuwa. Several other degree programmes and technical courses related to textiles, design and fashion marketing have been introduced in collaboration with major foreign universities such as RMIT University Australia, North Carolina State University and London College of Fashion. A key innovation has been in marketing and projecting Sri Lanka as a high quality, ethical producer under the 'Garments without Guilt' slogan. Firms such as MAS have engaged in extensive corporate social responsibility (CSR) programmes, particularly focused on female workers, while Brandix recently commenced operations in a 'Green Factory' catering to the demands of its major buyer, Marks & Spencer in the UK. These innovations are in response to increasing buyer awareness of labour and environmental standards adopted by producers. Furthermore, Sri Lankan garments have secured certain niche markets such as the market for intimate apparel. As a result, the garment sector has continued to grow in the post ATC era.

form of the expiry of Chinese safeguards and the review of the GSP+ scheme.

Sri Lanka, like all developing nations, gets preferential access to the EU market based on the Generalized System of Preferences (GSP). Under these general arrangements, all developing countries get duty free access on approximately 3300 non-sensitive tariff lines and get preferential access on 3700 sensitive tariff lines. The preferential access accorded to sensitive products is a flat rate reduction of ad valorem Most Favoured Nation (MFN) rate by 3.5 percentage points. However, in the special case of textiles and clothing, the preferential treatment is in the form of a tariff reduction of 20 per cent. Over and above the GSP accorded to all developing countries, special incentives are provided for countries that ratify and implement 16 international conventions with regard to protection of labour and human rights, 7 conventions on environmental protection and good governance or undertake actions to combat drug trafficking and production. This special incentive is what is known as the GSP+

scheme. The GSP+ came into operation on December 31st, 2005 and will apply till December 31st 2008 to 15 countries including eleven South American countries (primarily due to actions combating drug trafficking), Georgia, Mongolia, Moldova and Sri Lanka. The GSP+ provides duty free access to over 7200 products in the European market. The fact that this is enjoyed by only 15 countries gives the beneficiaries a significant competitive advantage over all other developing nations including countries like China. It should, however, be noted that all 44 Least Developed Countries (LDCs) enjoy complete duty free access to the European market based on the Everything But Arms (EBA) initiative.

The GSP+ scheme is due to be reviewed in end 2008 and based on the continued implementation of the said international conventions and demonstration of vulnerability of the economy (determined by level of income and export diversification), the scheme may be renewed. Sri Lanka's exports to the EU have dramatically increased following implementation of the GSP+ scheme - particu-

Table 3.1
Sri Lankan Exports Under the GSP Scheme (2004-2006)

Product	2004		2005		2006	
	•'000	Utilization	•'000	Utilization	•'000	Utilization
Textiles and garments	822,289 (70.4%)	30.4%	819,005 (68.3%)	40.5%	992,988 (66.4%)	57.1%
Plastics and rubber	142,843 (12.2%)	77.7%	166,540 (13.9%)	83.7%	189,135 (12.6%)	83.4%
Live animals and animal products	4,310 (0.4%)	92.9%	4,900 (0.4%)	96.3%	74,644 (5.0%)	98.6%
Machinery and mechanical appliances	33,296 (2.9%)	47.4%	38,409 (3.2%)	54.7%	48,657 (3.3%)	64.3%
Prepared foodstuff	38,529 (3.3%)	25.5%	38,795 (3.2%)	31.3%	43,571 (2.9%)	41.0%
Transport equipment	15,827 (1.4%)	80.0%	26,592 (2.2%)	82.4%	33,388 (2.2%)	69.9%
Total	1,167,979 (100%)	42.1%	1,199,317 (100%)	51.3%	1,495,357 (100%)	64.5%

Source: Department of Commerce, Sri Lanka.

larly in the garment sector where there has been a shift in exports from the US to the EU.

It is clear that during 2006, when Sri Lanka had zero duty access to the EU market, exports increased substantially with a year-on-year growth of 24.7 per cent compared to a growth of 2.7 per cent in 2005. The growth in 2006 was led by exports of garments which grew by 21.2 per cent. It is also encouraging to note that utilization rates for garments in particular have been increasing, aided by regional cumulation under the GSP Rules of Origin criteria.

As can be seen in Figure 3.6, the export of garments to the EU has been gathering pace whilst exports to the US market have been falling. Therefore, a significant loss of market access in the EU is likely to dent Sri Lanka's garment export performance.

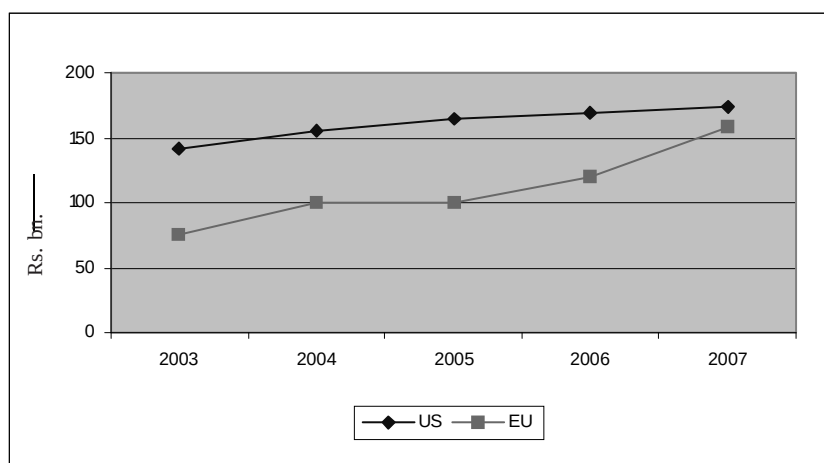
In this context, it is important to understand the implications of the possibility of losing the GSP+ scheme if it is not renewed for Sri Lanka in 2008. In this scenario, Sri Lanka will continue to enjoy the general preferences

under the GSP i.e., a 20 per cent margin of preference on garment exports. LDCs like Bangladesh already receive duty free access under the EBA, therefore Sri Lanka will have to compete on an even footing with countries like China (which already supplies 10 per cent of the total preferential GSP imports into the EU) and Vietnam which receive the normal GSP rate of 20 per cent margin of preference on MFN.

At present, Sri Lanka can export at zero duty, but without GSP+, exporters will be faced with an average tariff of 5.9 per cent and at the highest band a tariff of 9.6 per cent on garment exports into the EU. This would be a significant erosion of preference in the context of the garment industry, particularly as Sri Lanka will face stiffer competition with the expiry of safeguards against China.

As part of China's accession agreement with the World Trade Organization (WTO), member countries were able to impose temporary quotas on imports from China in certain categories, if these imports were deemed to cause market disruption. In November 2005,

Figure 3.6
Sri Lankan Garment Exports to the US and the EU



Source: Joint Apparel Association Forum, Sri Lanka.

Table 3.2
Top Five Exporters of Textiles and Garments to the EU

Country	•'000 (January–August 2007)
China	18,406,325
Turkey	8,679,339
India	4,434,968
Bangladesh	3,167,373
Tunisia	1,985,702
Sri Lanka	724,613

Source: <http://trade.ec.europa.eu>

Table 3.3
Comparison of EU Tariffs on Garments: MFN, GSP and GSP +

	Highest Band ^b	Simple Average Tariff
MFN	12.0%	7.4%
GSP (20% MoP) ^a	9.6%	5.9%
GSP +	0.0%	0.0%

Notes: a: MoP refers to margin of preference

b: The EU average MFN tariff on textiles is 7.4 per cent and ranges up to 12 per cent.

Source: WTO, *EU Trade Policy Review 2007*, EU website.

the US and China entered a three year agreement limiting Chinese imports of 34 categories of textile and apparel products, covering most textile and apparel categories. The agreement stipulates that apparel imported from China can be allowed to grow only by 10 per cent in 2006, 12.5 per cent in 2007, and 15 per cent in 2008.⁹ Some of Sri Lanka's major export items to the US are included in the categories covered under the China safeguards. These include sweaters, men's and boy's cotton trousers, men's and boy's shirts, brassieres and swimwear.

The EU entered into a similar agreement with China in June 2005. However, the EU agreement expired on December 31st 2007. Chinese textile and apparel imports in 10 categories were limited by quotas, allowing

annual growth of between 8 and 12.5 per cent in each category.¹⁰ It is informative to note that between the expiry of the MFA (January 2005) and the agreement to enter into quotas (June 2005), Chinese products entered the EU market in large quantities, particularly in categories such as sweaters (534 per cent growth on the previous year), men's trousers (413 per cent) and blouses (186 per cent). This suggests that the quotas of 8 to 12.5 per cent growth significantly suppressed Chinese export potential.

The expiry of the China safeguards and possible loss of GSP+ will certainly make it harder for Sri Lanka to maintain export markets in the US and the EU after 2008. However, the established Sri Lankan producers have built strong links with buyers and have

⁹ The main apparel categories falling under quotas include; socks, cotton knit shirts, men's and boy's woven shirts, cotton trousers, sweaters, brassieres, underwear, swimwear, towels, men's and boy's wool suits, men's and boy's wool trousers, man made fibre knit shirts and man made fibre trousers.

¹⁰ The categories covered were pullovers, men's trousers, blouses, t-shirts, dresses, bras, flax yarn, cotton fabrics, bed linen, table and kitchen linen.

secured niche markets that will be less prone to price competition. More importantly, Sri Lankan producers have focused on key issues that will shape demand in the coming years. Increased consumer awareness and sensitivity to environmental protection and labour standards will ensure that such issues will play an important role in the sourcing decisions of buyers. Whilst Sri Lanka's main players in the garment industry have taken this message on board, it is essential for others to follow suit in order to remain competitive in an increasingly price competitive market.

3.4.2 Sri Lanka's External Finance Position

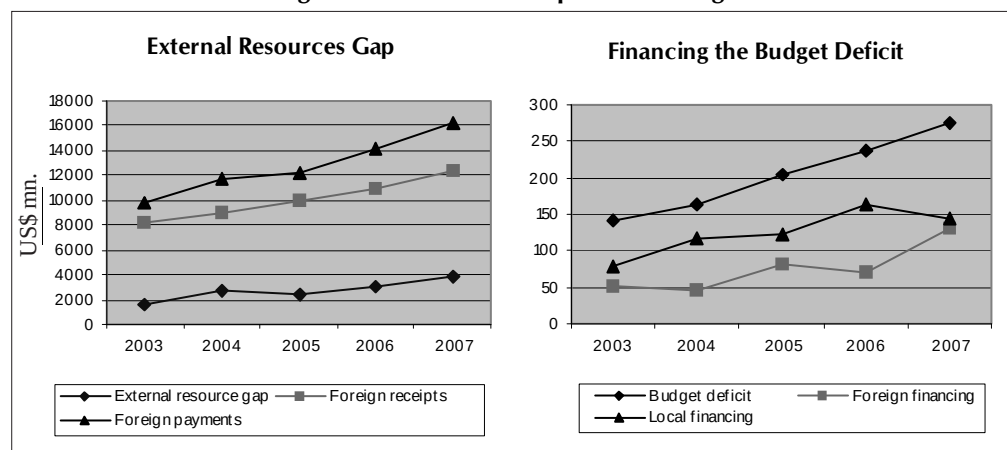
Sri Lanka witnessed a marked change in the sources for financing its external resource gap in 2007. Whilst traditionally, the resource gap has been financed by developmental assistance from international donors, remittances, and foreign direct investment (FDI), the role of commercial borrowing has taken on new significance in 2007.

Traditional financing sources continued to play their role in 2007. Remittances increased

to US\$ 2502 million from US\$ 2161 million in 2006, an increase of 15.8 per cent. The majority of remittances originated in the Middle East (58 per cent) with the next highest being the EU (20 per cent). Several factors contributed to the increase of remittances in 2007. Wages increased due to income growth in the Middle East as a result of strong oil prices, the number of migrant workers also increased by 8 per cent in 2007, and several measures were taken by the banking sector to increase remittances through banking channels.¹¹ Net inflows of FDI in 2007 increased to US\$ 548 million from US\$ 451 million in 2006 with much of the inflows due to re-investment by existing firms, particularly in telecommunications.

Nonetheless, an expanding budget deficit and widening external resource gap has increased the government's need for external finance. At the same time, the government's access to concessional borrowing has declined, forcing the state to seek alternative sources of finance, culminating in the launch of the US\$ 500 million sovereign bond in 2007. This marked a shift in the trend of Sri Lanka's external resource financing by the government.

Figure 3.7
Widening External Resource Gap and the Budget Deficit



Source: CBSL, *Annual Report*, various issues.

¹¹ See discussion in this report on "Money Transfer Systems and the Development Nexus of Migration".

Table 3.4
Multilateral Aid Disbursements to Sri Lanka (US\$ million)

Donor	2006	2007
World Bank	167.7	127.0
ADB	195.0	146.4
UN agencies	92.3	30.0
Total multilateral aid	502.4	355.7

Source: External Resources Department, Disbursements of Foreign Funded Loans/Grants 2006/2007.

As is evident, the growth of the resource gap has been pronounced over the last 4 years, increasing from 8.7 per cent of GDP to 12 per cent during this period, reflecting an expansion of similar magnitude in Sri Lanka's trade deficit. The government has also looked to increase foreign financing of the budget deficit to reduce pressure on local interest rates. At the same time, Sri Lanka's access to concessional loans has declined, led by the decline in concessional multilateral aid available to Sri Lanka as the country's per capita income has increased to that of a middle income country.¹²

Furthermore, aid from Sri Lanka's largest bilateral donor, Japan, also declined from US\$ 284.2 million in 2006 to US\$ 229.5 million in 2007. However, other bilateral donors such as China (US\$ 159 million in 2007 compared to US\$ 9 million in 2006) provided aid to Sri Lanka in 2007.

Therefore, the external resource gap has been to a great extent filled by increases in commercial borrowing. As a result, long term commercial borrowing increased from US\$ 56 million in 2004 to US\$ 630 million in 2007. With increasing pressure on government finances, the government decided to further expand sources of external finance by allowing foreign purchase of up to 5 per cent of the value of outstanding Treasury bonds

in November 2006. Following the removal of further restrictions such as minimum maturity periods, foreign investment in Treasury bonds took off in January 2007. In December 2007, the limit was expanded from 5 per cent to 10 per cent. By the end of 2007, foreign investment in Treasury bonds had reached US\$ 373 million (more than the total multilateral aid received by Sri Lanka in 2007). The maturity for these Treasury bonds was between 2-11 years and the average yield was 14 per cent. Thus, it is clear that there has been a discernible shift in Sri Lanka's external financing regime, raising Sri Lanka's exposure to costlier foreign debt service repayments. This in turn is likely to raise the country's vulnerability to external shocks.

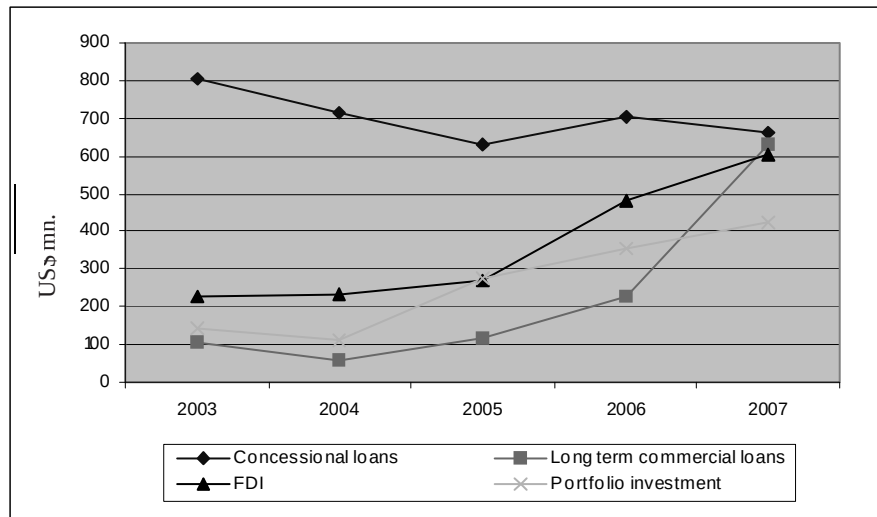
3.5 Sri Lanka in the WTO

Following the collapse of the Doha Round talks in 2006, there have been numerous efforts to get negotiations back on track. Most progress has been made in non-agricultural market access (NAMA) and agriculture negotiations, while services and rules negotiations have been less dynamic. In this context, the following discussion will be confined to NAMA and agriculture only.

In July 2007, draft modalities for negotiations in agriculture and NAMA were put forward by the respective Chairs. These were further deliberated upon by members and

¹² See Kelegama, S., and D. de Mel (2007), "Southern Perspectives on Reform of the International Aid Architecture", available at www.ips.lk/research/highlights.html.

Figure 3.8
Financing the External Resource Gap



Source: CBSL, *Annual Report*, various issues.

revised draft modalities were publicized by the Chairs in May 2008. The draft modalities for agriculture and NAMA are a reflection of the current status of negotiations among members and are not final. The implications for Sri Lanka of these May 2008 modalities will become pertinent if and when the formal Doha Round negotiations get back on track following another collapse of talks in Geneva in July 2008.

3.5.1 NAMA

The May 2008 text retains the principle of a Swiss formula with one coefficient for developed countries and a range of coefficients for developing countries. The Swiss formula entails deeper cuts for higher tariffs, and the higher the coefficient, the lower the tariff cuts. Hence, developing countries will have a larger coefficient than developed countries. The values of the coefficients remain to be negotiated, but they will range between [7-9]¹³ for developed countries and [19-26] for developing countries. The implication of the coefficients would be that the maximum

tariff rate (tariff peak) in a developed country will be less than 7-9 per cent and less than 19-26 per cent in developing countries. However, developing countries are provided certain flexibilities and can choose from a range of coefficients between 19 and 26 per cent. One of three sets of coefficients can be chosen by developing countries - i.e., x [19-21], y [21-23] and z [23-26]. Available safeguards are based on the coefficient chosen. Accordingly, a certain proportion of sensitive industrial tariff lines can be subject to less than formula tariff cuts as specified in Box 3.2.

The tariff cuts will take place over [4 or 5] years for developed countries and [8 or 10] years for developing countries, starting from January 1st following the implementation of the Doha Round.

Many developing countries and all LDCs do not have to undertake Swiss formula cuts in NAMA negotiations. Sri Lanka, due to her low binding coverage of less than 35 per cent

¹³ Square brackets indicate issues that are under negotiation and are yet to be agreed upon.

Box 3.2

Swiss Formula Coefficients and NAMA Negotiations

Coefficient x - [12-14] per cent of NAMA tariff lines can be subject to less than formula cuts, but the cut must be at least half the formula cut. Furthermore, the chosen tariff lines cannot exceed [12-19] per cent of the member's total NAMA imports. Alternatively, the member can maintain [6-7] per cent of tariff lines unbound as long as these tariff lines do not account for more than [6-9] per cent of the member's total NAMA imports.

Coefficient y - [10] per cent of NAMA tariff lines can be subject to less than formula cuts, but the cut must be at least half the formula cut. Furthermore, the chosen tariff lines cannot exceed [10] per cent of the member's total NAMA imports. Alternatively, the member can maintain [5] per cent of tariff lines unbound as long as these tariff lines do not account for more than [5] per cent of the member's total NAMA imports.

Coefficient z - No recourse to safeguards.

of industrial tariff lines (Sri Lanka's binding coverage in industrial products is 28.3 per cent), does not have to undertake Swiss formula cuts, but has to bind [80-90] per cent of industrial tariffs at an average that does not exceed 28.5 per cent. This allows Sri Lanka the flexibility at this stage to maintain tariff peaks in sensitive products. The present simple average applied MFN tariff on industrial products in Sri Lanka is 9.2 per cent and the average bound rate on industrial products is 19.2 per cent. Therefore, the requirement of maintaining average bound rates within 28.5 per cent should not be too taxing on Sri Lanka. The tariff binding will have to take place in [9-11] equal instalments from January 1st of the year following the completion of the Doha Round. All in all, Sri Lanka's defensive interests in the NAMA negotiations will be met to a great extent.

In terms of offensive interests, progress in the NAMA negotiations will provide Sri Lanka with increased market access to her major export markets in the USA and the EU. The Swiss formula will bind developed country tariffs at an average of below 3 per cent and limit tariff peaks to 7 or 9 per cent. This is

beneficial to Sri Lanka, particularly in terms of access to the US market. The US maintains tariff peaks in many garment tariff lines of export interest to Sri Lanka. These include sweaters/pullovers at 16.5 per cent; men's or boys trousers and shorts at 16.6 per cent; women's or girl's suits, blazers, dresses, skirts at 16.6 per cent; men's or boy's shirts at 19.7 per cent; and brassieres at 16.9 per cent.¹⁴ A successful completion of the Doha Round would have seen these tariff peaks being reduced to a maximum of 7-9 per cent - a substantial improvement in market access.

With regard to the EU market, Sri Lanka enjoys trade preferences through the GSP and GSP+ schemes, and reduction in NAMA tariffs could erode these preferences enjoyed by Sri Lanka. For instance, at present Sri Lanka receives duty free access to the EU market for around 7200 products. The EU maintains low simple average MFN tariffs for all industrial products (3.9 per cent) and, therefore, preference erosion is unlikely to be significant. With regard to the garment sector, at present, Sri Lanka can export garments to the EU duty free due to the GSP+ scheme, while average MFN tariffs on garments are

¹⁴ The following tariffs are based on the US 2008 Harmonized Tariff Schedule. Tariffs may differ for different sub-classifications.

around 7.4 per cent with a peak of around 12 per cent.¹⁵ If the Doha Round did come to a successful completion, the only impact it would have had would have been due to erosion of Sri Lanka's GSP+ benefits. However, the impacts of preference erosion would be negligible since Sri Lanka's competitors would anyway be faced with a maximum tariff of around 9 per cent on garments and the NAMA cuts would not change that figure by much. If Sri Lanka's GSP+ status was not renewed, the impact of NAMA would be to provide increased market access - but again this would be negligible since applied rates faced by Sri Lanka under the general GSP scheme¹⁶ would be less than the bound rates that would be affected by NAMA cuts. Therefore, the overall impact of the Doha round in industrial markets in the EU would have been negligible for Sri Lanka.

A matter of greater concern was the proposed extension of NAMA tariff removal time frames in order to mitigate the negative effects of preference erosion on certain LDCs. The extension of liberalization time frames will apply to 25 garment products imported by the US. Accordingly, these 25 tariff lines will be liberalized in [7-9] equal reductions by the preference granting members, beginning on January 1st of the second year following entry into force of the Doha Round. This extension would have adversely affected Sri Lanka, which faces high tariffs in the US market, in relation to competing countries such as Bangladesh which enjoy preferences. Many of Sri Lanka's other competitors in the US market enjoy preferences through regional trade agreements (RTAs) with the USA. These include Mexico (NAFTA), Honduras (CAFTA), El Salvador (CAFTA), Dominican Republic (CAFTA) and Guatemala (CAFTA).¹⁷ Despite not being LDCs, these countries will

continue to enjoy preferential access to the US market at the expense of countries such as Sri Lanka. The 25 tariff lines identified in the May 2008 modalities for delayed tariff removal include major items of export interest to Sri Lanka including lingerie and other intimates, men's and women's trousers and shirts, sweaters and pullovers and T-shirts.

Given the fact that these 25 tariff lines comprise of over 40 per cent of Sri Lanka's exports to the US, Sri Lanka made the case that the country is disproportionately affected by the proposals made to address the concerns of preference receiving countries. Therefore, the Chair took Sri Lanka's position into account and included paragraph 29 in the May 2008 text which identifies 5 of the key tariff lines exported by Sri Lanka to the US and states that the preference granting country (USA) will undertake the Swiss formula cuts without delay in [5-6] equal stages for Sri Lanka beginning January 1st of the year following implementation of the Doha Round. Whilst this does to an extent address Sri Lanka's grievance, the five tariff lines identified by the Chair do not cover all of Sri Lanka's export interests constrained by the 25 tariff lines proposed by the LDCs. It is in Sri Lanka's interest to expand the list of 5 tariff lines to include other such exports.

3.5.2 Agriculture

There is little change in terms of the formulae between the July 2007 negotiating modalities and those put forward by the agriculture Chair in May 2008. The May text spells out the negotiating modalities in domestic support, market access and export competition.

A tiered formula will be used to cut overall trade distorting domestic support (Amber

¹⁵ According to the WTO's latest EU Trade Policy Review.

¹⁶ Even if GSP+ is not renewed, Sri Lanka will continue to receive preferences under the general GSP scheme.

¹⁷ NAFTA refers to the North American Free Trade Agreement and CAFTA refers to the Central America Free Trade Agreement.

Table 3.5
Market Access Formulae

Country	Tariff Range (%)	Percentage Cut
Developed countries	0-20	50
5 years	20-50	57
	50-75	64
	> 75	[66-73]
	0-30	33.3
Developing countries	30-80	38
8 years	80-130	42.7
	> 130	[44.0-48.7]

Source: WTO.

Box, de minimis and Blue Box) along with caps on individual products. Therefore, higher levels of support will face higher cuts. As a result, the EU will cut [75 or 85] per cent, the US and Japan will cut [66 or 73] per cent, and other countries [50 or 60] per cent. The developed nations will make cuts over 5 years while developing nations will do so over 8 years.

Sri Lanka has no reported trade distorting domestic support (no Amber or Blue Box support) and support is limited to Green Box which has minimal or no distorting effects on production and trade (examples include income support programmes such as Samurdhi, fertilizer subsidy, irrigation subsidies, etc.). The May 2008 text proposes increased categories of government development programmes that will fall under Green Box (permitted) support. These include programmes dealing with land reform, rural development, farmer settlement, rural employment, nutritional security, and infrastructural services. This provides countries such as Sri Lanka greater flexibility in supporting agriculture without contravening WTO obligations. Transparency, monitoring and surveillance of Green Box programmes will be increased in order to ensure such programmes are not actually trade distorting.

Whilst Sri Lanka faces no obligations to reduce domestic support for agriculture, a broader concern with regard to the outcomes of negotiations on domestic support is the impact this would have on prices of Sri Lankan food imports. Sri Lanka, being a net food importing country, could in the medium-term face higher prices of imported food when food exporting countries reduce domestic support. This would apply in particular to food substances such as sugar imported from the EU and milk foods from New Zealand. Both will make substantial cuts on bound rates of around 75 per cent. For instance, in the EU, average assistance is bound at US\$ 92 billion, applied rates are around US\$ 64 billion. With a 75 per cent cut, the new bound rate will be US\$ 23 billion, a substantial reduction in support. However, these cuts will take place over a period of 5 years, allowing importing countries such as Sri Lanka to undertake adjustment measures such as finding new import markets. Furthermore, measures have been taken to build domestic production in many food sectors. One such example is the recent programme to reinvigorate domestic milk production.

In terms of market access, a tiered formula for cutting agricultural tariffs was presented in the July 2007 modalities and the same formula and ranges of figures are maintained

in the May 2008 modalities. Developed nations will make tariff cuts in the manner shown in Table 3.5.

These cuts will be made in equal annual instalments over 5 years by developed countries and over 8 years by developing countries. The minimum average cut to be made on final average bound tariffs of developed countries is 54 per cent and developing countries will be subject to a maximum cut of 36 per cent on final average bound tariffs.

Sri Lanka, along with 44 other countries, falls under the category of Small and Vulnerable Economies (SVEs) due to a low share of world agricultural trade. As a result, Sri Lanka can have a further 10 per cent leeway in terms of required ad valorem cuts in each tariff band. LDCs will not be required to make any cuts. As it stands, the majority of Sri Lanka's agricultural tariffs are bound at 50 per cent, thus Sri Lanka falls into the 30-80 per cent category which entails a cut of 38 per cent, with an additional flexibility of 10 per cent on the required cut leading to a cut of 28 per cent. Given that most of Sri Lanka's agricultural tariff lines are bound at 50 per cent, a cut of 28 per cent will lead to final bound tariff of 36 per cent. Sri Lanka's average applied tariffs in agriculture are around 24 per cent. Therefore, whilst this is an improvement on the February 2008 modalities, which stipulated that Sri Lanka's bound tariff would be 28.5 per cent, the new formula reduces Sri Lanka's policy space to deal with import surges.

However, certain further safeguards are provided in the May 2008 modalities. For instance, all countries can identify a certain number of Sensitive Product (SP) tariff lines. Developing countries can identify [5.3 or 8 per cent] of their tariff lines - the final percentage to be negotiated. The tariff cuts on these sensitive products can deviate by 1/3rd, 1/2 or 2/3^{rds} of the standard formula cut. How-

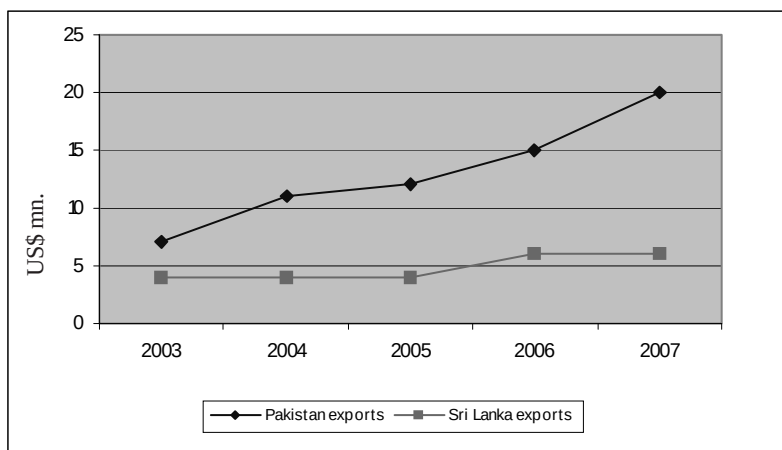
ever, in compensation, the country must allow some market access for the products in the form of tariff rate quotas where the in-quota tariff is at a lower rate. Sri Lanka does not have recourse to the other safeguard, the Special Safeguards Mechanism (SSM), since a ceiling binding was adopted instead.

In terms of market access in agriculture, Sri Lanka's defensive position is somewhat weak. Due to the relatively low bound average tariff of Sri Lanka's agricultural tariffs (50.1 per cent compared to India's 114.2 per cent and Pakistan's 95.6 per cent), there will be limited policy space following the proposed tariff cuts. The SP provision will provide some respite, but as shown above, this applies only to a few tariff lines. If the May 2008 modalities are ultimately agreed upon, it will lead to some challenges for Sri Lanka in the future in terms of protecting domestic producers against import surges. However, it is likely that alternative protection measures such as cesses and various other levies may be imposed in such cases. In terms of increased market access for Sri Lankan agricultural exports, the benefits of the May 2008 modalities on agriculture are likely to be limited. The tariff cuts deal with bound rates while most of Sri Lanka's export markets have high tariff overhang (difference between bound and applied rates). Average applied tariffs are low in developed markets (around 14 per cent) and in developing markets (around 17 per cent), while the bound rates that are being negotiated are much higher, as indicated in the discussion above. Therefore, these cuts are unlikely to have significant impacts on applied rates, thereby reducing the short and medium-term benefits for Sri Lanka's agricultural exports.

3.6 Sri Lanka's Regional Trade Agreements

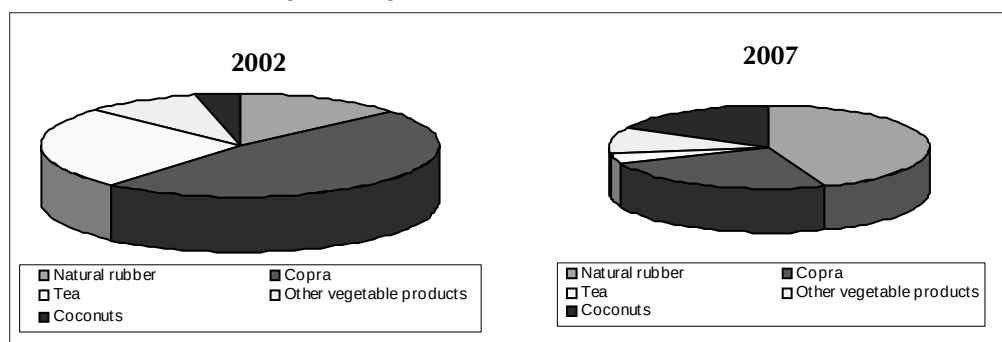
Sri Lanka is a party to three regional trade agreements currently in force - i.e., the Paki-

Figure 3.9
Trade between Sri Lanka and Pakistan (2003-07)



Source: Department of Customs, *External Trade Statistics*, Sri Lanka.

Figure 3.10
Sri Lanka's Top Five Exports to Pakistan 2002 and 2007 (Rs. million)



Source: Department of Customs, *External Trade Statistics*, Sri Lanka.

stan-Sri Lanka Bilateral FTA and India-Sri Lanka Bilateral FTA and the South Asian Free Trade Agreement (SAFTA). The following discussion assesses the performance of these agreements thus far.

3.6.1 Pakistan-Sri Lanka FTA

Sri Lanka's FTA with Pakistan was implemented in June 2005. In the 3 years since, Pakistan completed its tariff phase out in March 2008, except for those under its negative list. However, the impact of the agreement in terms of Sri Lankan exports to Pakistan has been limited. In 2003, Sri Lanka's

exports to Pakistan were US\$ 36 million (0.7 per cent of total exports). Whilst in absolute terms, total exports to Pakistan by 2007 had increased to US\$ 56 million, it still accounted for a mere 0.7 per cent of total exports. Indeed, the expansion of exports in absolute terms has taken off from a small base. Furthermore, it is clear that Pakistan's exports to Sri Lanka have grown at a much faster rate during this period, increasing from US\$ 71 million in 2003 (1 per cent of total imports) to over US\$ 178 million in 2007 (1.6 per cent of total imports).

In terms of Sri Lanka's exports to Pakistan, it is a matter of concern that export diversification has been low and exports continue to be dominated by low value added products.

As can be seen in Figure 3.10, the top 5 export products from Sri Lanka to Pakistan have not changed at all during the implementation of the FTA. The only notable change is the increase in exports of coconuts and decline in exports of tea. The likely cause of the latter is the fact that the price of Ceylon tea increased as global demand (especially from the Middle East and CIS countries) increased substantially, making it less attractive compared to Kenyan tea which did not increase in price to the same extent. It is clear that export diversification has been limited, but it remains early days in the implementation of the agreement and it will take some time for the full impact of Pakistan's complete liberalization of the market to be felt.

Imports from Pakistan have grown significantly since the FTA came into place. The major import item from Pakistan is textiles and fabrics, making up 55 per cent of Sri Lanka's imports from Pakistan in 2007. Other items include medicaments, potatoes, rice and dried fish. It is important to note that the majority of the items imported from Pakistan do not receive benefits under the FTA. Textile and apparel articles receive MFN duty free rates, as do medicaments. Rice and dried fish fall under the negative list and potatoes are imported under a tariff rate quota (TRQ) with the state retail firm Co-Operative Wholesale Establishment (CWE) being allocated the quota. In 2006, the quota was 10,000 metric tonnes (MT) during Sri Lanka's off season, and only 25 MT was imported by the CWE from Pakistan in that year. All in all, the impact of the FTA has been negligible, and it remains to be seen whether Sri Lanka's exports and consumers change their preferences to take advantage of the prefer-

ences accorded in the Pakistani market. In January 2008, the first round of the Sri Lanka Pakistan Comprehensive Economic Partnership Agreement (CEPA) took place in Colombo. The CEPA is scheduled to incorporate trade in services and investment to deepen and broaden the existing FTA in goods.

3.6.2 India-Sri Lanka FTA

The India-Sri Lanka FTA has completed 8 years as of 2008. India already fully liberalized her market to Sri Lanka (except for negative list items) in 2003 and Sri Lanka was scheduled to complete the final stage of liberalization in March 2008. However, since the previous phase was delayed from March 2006 to September 2006, the final phase is likely to be delayed accordingly. As it stands, Sri Lanka's residual list of items to be liberalized in the final stage will have tariffs slashed from 70 per cent to 100 per cent. Whilst aggregate trade between the two countries increased substantially during this period, the results of the FTA have not been entirely positive from a Sri Lankan perspective. Export diversification has been limited, domestic value addition has been low and TRQs have limited the penetration of Sri Lanka's major exports such as tea and garments.

At the aggregate level, exports from Sri Lanka to India have increased substantially since the signing of the FTA. In 2000, total exports to India were just US\$ 58 million (1 per cent of total exports), whereas by 2007 this had increased to US\$ 515 million (6.6 per cent of total exports). India is Sri Lanka's third largest destination for exports and largest source of imports. The trade balance between the two countries narrowed until 2006 (when the import to export ratio was 4:1 compared to 14.3:1 in 1998) as the rate of growth of Sri Lanka's exports was greater than that of imports. Furthermore, FDI from India followed trade as FDI expanded from a cumulative total of Rs. 165 million in 1998

(1.3 per cent of total FDI) to reach Rs. 19.5 billion by 2005 (8.3 per cent of total FDI). India is now the fifth highest investor in Sri Lanka.

Whilst the overall picture appears positive, in reality exports have been dominated by a few products. In 2005, exports of vegetable fats and oils (better known as vanaspathi) and copper and copper related products made up almost 50 per cent of Sri Lanka's exports to India. Excluding these items, Sri Lanka's exports to India have increased only from US \$ 58 million in 2000 to US \$ 278 million in 2006. The concern for Sri Lanka is that production of these items entails little domestic value addition, limited employment creation and has a high imported content. Therefore, little has been achieved in terms of improving Sri Lanka's industrial base. Furthermore, Sri Lanka does not have a comparative advantage in the production of these items - the boom in their export is the result of entrepreneurs taking advantage of tariff differentials between India and Sri Lanka. India maintains high MFN tariffs on products such as vegetable fats and oils but Sri Lanka receives preferential treatment as per the FTA. This is clearly not a viable long-term strategy in terms of improving Sri Lanka's export performance and developing industrial capacity. As soon as tariff differentials are eroded - inevitable in the process of globalization - such arbitrage will no longer be possible.

The benefits of tariff arbitrage had begun to wane since 2007. Copper exports were the first to be hit as earnings fell from US\$ 145 million in 2005 to US\$ 27 million in 2007. A key cause of this was the change in invoicing methods after India insisted that pricing be done according to London Metal Exchange prices. This addressed the issue of under-invoicing by copper exporters to meet Rules of Origin criteria, and eligible exports reduced as a result. Exports of vanaspathi improved

in 2007 following a fall in 2006 due to the imposition of quotas by India. However, this is likely to be all but completely eroded in 2008 with the decision by India to completely slash MFN tariffs on palm oil imports. As a result, exporters from Sri Lanka lose their preferential margin and will not be competitive in the Indian market. The outcome of these changes will be significant in terms of Sri Lanka's trade with India since export earnings were dominated by copper and vanaspathi for the last 3 years. As a result, the trade gap which has been narrowing since the implementation of the agreement, is likely to widen significantly in 2008. This provides an inauspicious beginning for the Indo-Lanka Comprehensive Economic Partnership Agreement (CEPA) which is to be signed in 2008. Nonetheless, despite the short-term set-backs, it is important for Sri Lanka to maintain strong integration with the Indian economy which is well on the way to becoming a major global economic player. With Sri Lanka's small market and limited industrial diversification, access to a large, fast growing market is essential for achieving the economies of scale necessary for growth.

3.6.3 South Asian Free Trade Agreement

The South Asia Free Trade Agreement (SAFTA) came into force in July 2006, and the first phase of tariff liberalization ended on December 31st 2007. Accordingly, Sri Lanka and the other non-LDCs (India and Pakistan) reduced tariffs that were above 20 per cent to 20 per cent among one another. Tariffs below 20 per cent were given a 20 per cent margin of preference to all members. The non-LDCs cut all tariffs to LDCs by a 70 per cent margin of preference by the end of 2007. By the end of 2008, Non-LDCs will provide duty free access to LDCs (except for items on the sensitive list). LDCs brought down tariffs that were above 30 per cent to 30 per cent by the end of 2007 and made a 10 per

cent margin of preference cut on tariffs that were below 30 per cent.

Thus far, intra-regional trade in South Asia has not increased substantially despite the existence of SAPTA since December 1995 and SAFTA since July 2006. Intra-SAARC trade remained a miniscule 5.1 per cent as of 2006, though for smaller countries SAARC is a more significant trading partner. However, this is also due to the dominance of India in intra-SAARC trade. For instance, over 90 per cent of Bangladesh, Sri Lanka, Nepal and Bhutan's trade with SAARC is due to trade with India. Whilst it is too early to judge the performance of SAFTA in improving intra-regional trade, it is possible to identify numerous shortcomings of the agreement that will need to be addressed in order to make the SAFTA viable in terms of increasing intra-regional trade in a meaningful way.

The first major concern is the extent of intra-regional trade that is subject to the negative list, thereby not receiving any preferential tariffs, as per the tariff liberalization programme detailed above. It is estimated that 53 per cent of total intra SAARC imports are subject to the negative list in SAFTA.¹⁸ As it stands, the agreement has no binding provision for reduction of the negative list, whereas successful regional groupings like ASEAN have such binding provisions for systematically reducing the size of sensitive lists. Furthermore, the tariff liberalization programme in SAFTA is highly protracted, and thus is likely to be superseded in importance by other regional bilateral trade agreements such as the India-Sri Lanka FTA and the Pakistan-Sri Lanka FTA which will be fully implemented far earlier (in fact, the India-Lanka FTA is already fully implemented). This concern could be addressed by including a

fast track liberalization programme for some of the most extensively traded tariff lines within the region. Finally, trade within the region will not take off, regardless of tariff liberalization, as long as para tariffs remain unaddressed. Even Sri Lanka, which is widely regarded as the most liberal of all South Asian countries, maintains various cesses and levies (such as the ports and airports development levy and regional infrastructure development levy) which compound the costs of trade.

It is encouraging to note that trade in services will be included into the SAFTA framework based on a regional study commissioned by the SAARC Secretariat. Trade in services occurs extensively within SAARC even today in areas such as health, education, tourism, telecommunications, IT and aviation. There is much room for further co-operation and integration, and it is important to build from current progress in the region. Given the fact that all members of SAARC are either LDCs or developing countries, it is important to adopt innovative measures to encourage scheduling of key sectors by individual countries. In this context, the common sub-sector approach¹⁹ as adopted in ASEAN could be considered for the SAFTA trade in services agreement as well.

The 15th SAARC Summit was held in Colombo in July 2008. The timing of the summit was apt, since many of the member nations' major economic partners (the US and the EU) are facing economic downturns. In this context, the importance of enhanced regional economic cooperation takes on greater significance. The Summit engaged major economic issues affecting the region including food and energy security. The Heads of State welcomed the decision by the Ministerial

¹⁸ Weerakoon, D., and J. Thennakoon (2008), "SAFTA: Which Way Forward?", *Journal of South Asian Development*, Vol. 3, No. 1.

¹⁹ The common sub-sector approach is where if at least 2 developing countries and 3 LDCs make a commitment in a particular sub-sector, all countries must make some commitment in that sub-sector.

Council to commence negotiations on a framework agreement for inclusion of trade in services in SAFTA. Furthermore, they directed that a draft agreement on investment promotion and protection be finalized early. Whilst key issues such as sensitive lists and trade facilitation were discussed at the Summit, more needs to be done to address the major challenges faced in implementing SAFTA, including the need for binding commitments on negative list and NTB reductions.

3.7 Conclusion

The global downturn that began in 2007 is unlikely to be severe due to the shift away from a uni-polar global economy. However, certain threats continue to cause concern, none more important than inflation. Due to improved macroeconomic management and increasing confidence in the capabilities of Central Banks, the world economy grew substantially over the past four years with very limited inflationary pressure. Advanced economies maintained average inflation of 1.8 per cent and developing nations averaged 5.9 per cent. However, inflation has emerged as a concern as demand is increasing in oil exporters and in emerging giants such as China and India. Commodity prices, particularly energy and food, have increased spectacularly in 2007. There is also a threat of inflationary overshoot due to expansionary monetary policy in response to the threat of recession, particularly in the US, and coun-

tries with dollar pegs. The threat of inflation has placed governments in a quandary with regard to addressing growth slowdowns - the outcome of this balancing act will have important implications for the performance of the global economy in 2008.

Between 2005 and 2007, Sri Lanka's economy has enjoyed substantial growth buoyed by a favourable external environment. As the global economy slows down following almost a decade of continued growth, Sri Lanka will have to adapt to this change on the external front, particularly given Sri Lanka's continued reliance on the most affected markets - the USA and Europe. In this context, this Chapter has critically examined Sri Lanka's attempts to diversify exports through regional trade agreements and find that progress has been limited. It is unlikely that the global slowdown will be prolonged and extensive, and related challenges in the garment sector have in the past been effectively met by Sri Lankan exporters. It is encouraging to note that the industry continues to take steps in the right direction - particularly investment in green technology and ensuring security of labour rights. More worrying are the implications of accelerating commodity prices, particularly energy prices, which are unlikely to reverse in the near future. This will undoubtedly pose challenges to Sri Lanka's continued economic progress in the upcoming year or so.

4. Reforming the State-owned Enterprise Sector: The Political Economy Dilemma

4.1 Introduction

The voluminous literature that exists on the challenges to state-owned enterprise (SOE) reforms in Sri Lanka,¹ as well as in other developing countries points to the fact that the dilemma confronting decision-makers is, and has been, a much-debated subject across academic and policy circles. Evidence from around the world, as observed in China, India, Latin America and much of Eastern Europe, for instance, suggests that the need for SOE reforms - in some incarnation - is recognized by political leaders and other key stakeholders in policy circles. The debate, and the practical conundrum, therefore, is on the implementation of reforms - on selecting the optimum modality for improving the performance of SOEs, on sequencing the reform process, and on setting in motion a virtuous policy cycle by strategically identifying winners and compensating losers to get to a sustainable solution.

The essence of the problem afflicting SOEs is broadly similar in developing countries that carry a legacy of state-led growth combined with governance structures that lack consistency and accountability. Extensive public sector involvement in economic activities is a significant feature of Sri Lanka's policy milieu. The SOEs in Sri Lanka are responsible for managing essential services such as electricity, railways and water supply and drainage, and account for over 80 per cent of petroleum products importation

and distribution, 30 per cent of bus transport services, and over 50 per cent of banking services.² However, these entities tend to be managed on non-commercial, soft budget constraint lines, eroding their sustainability as efficient entities and ironically undermining their role as public sector service providers. The perilous consequences of the existing management 'culture' in the SOE sector is starkly portrayed in the dismal performance of key public sector entities such as the Ceylon Electricity Board (CEB), the Ceylon Petroleum Corporation (CPC), the Sri Lanka Transport Board (SLTB) and the Sri Lanka Railways (SLR) - which have been the subject of recent study by the Institute of Policy Studies (IPS). Whilst various examples from these four sectors will be drawn on later in the discussion, to illustrate the problems and prospects for change and improved performance in the SOE sector, a preview of the gravity of the problem from a general equilibrium perspective - what may be seen as one element of the opportunity cost of non-reforms - is evident in the following vicious cycle. As per the IPS research findings, the CEB owes nearly Rs. 28 billion and the SLTB and SLR together owe a sum of Rs. 3 billion to the CPC. As such, the performance of the CEB, SLTB and SLR has a direct impact on the performance of the CPC in terms of revenue collection, which in turn has a significant impact on the country's fiscal deficit and macroeconomic stability.

¹ For instance, see Kelegama, S. (1992), *Privatization: The Sri Lankan Experience*, Public Enterprise Reform Series No.1. Colombo: Institute of Policy Studies; Knight-John, M. (1997), *Performance Contracting: A Strategy for Public Enterprise Reform in Sri Lanka?*, Public Enterprise Reform Series No.2. Colombo: Institute of Policy Studies; *Building the Sri Lankan Knowledge Economy* (2008), Finance and Private Sector Development Unit, South Asian Region, available at: <http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1206318727118/4808>.

² Central Bank of Sri Lanka, *Annual Report 2006*, Colombo.

The financial woes afflicting Sri Lanka's SOE sector has been extensively and thoroughly researched and debated on in and amongst fora ranging from policy, academic, private sector, user, media and donor groups. The objective of this Chapter, therefore, is not to analyse what is perceived as being a symptom of a deeper problem pervading the SOE sector. The downward spiral observed in much of Sri Lanka's SOE sector - unsustainable over-staffing (associated with political nepotism), heavy financial pressures on dwindling state finances (to preserve the status quo in inefficient and unproductive entities) and deteriorating service qualities - needs to be seen in context. The argument put forward is that the financial inefficiencies and the associated drop in the quality of public services are a reflection of deeper, more complex and more pernicious political economy obstacles that stand in the way of progressive reforms. In this Chapter, the attempt is to unpack and highlight these political economy factors.

Section 4.2 of the Chapter provides a brief overview of the evolution and current status of SOE reforms in Sri Lanka. This section also weaves in elements of the country's governance structure as a backdrop to analyzing the political economy challenges that stand in the way of change. The key question that this section deals with is the policy gap - why SOE reforms have not been implemented or are implemented in an ad hoc fashion by successive governments; more precisely to raise the question of what are the political economy obstacles to reforms. The analysis in this section will draw on theoretical constructs from the institutional and regulatory literature, such as principal-agent dynamics, collective action, path dependence and regulatory governance, and will also be interspersed with examples from the four entities in the energy and transportation sectors referred to above, as well as from the telecommunications sector.

Following from the status quo and the political economy constraints identified in the preceding section, Section 4.3 identifies strategies for public enterprise reform based on IPS research and stakeholder interviews in recent months - identifying key stakeholders that would be affected by each reform option and addressing the costs and benefits and trade-offs of each of these options from a political economy perspective. Adhering to the basic persuasion that policy solutions that delve into the political economy and governance realm are necessarily unique - at least from country to country - and that misplaced policy transfer can be potentially more damaging than a non-reform scenario, this section emphasises domestic stakeholder perspectives to illustrate the nuances of the reform process. The concluding section of the Chapter hinges on the policy dilemma facing decision-makers at the helm of the reform process: given the political economy constraints where do we go from here; what are the windows of opportunity for reform; and, what are the necessary and sufficient political ingredients for sustainability of the reform process.

4.2 Political Economy Dynamics of Change

4.2.1 SOE Reforms in Sri Lanka: Evolution, Stagnation or Back-peddalling?

Decades of experimenting with economic reforms in Sri Lanka has seen successive governments coming up with varied strategies for public enterprise reform; and yet, today, Sri Lanka stands at cross-roads with little evidence of progress in terms of SOE reforms. The problems currently plaguing the SOE sector - ranging from financial and allocative inefficiencies to political compromises made - are well-known. In short, what is evident is that in spite of policy rhetoric to the contrary, public enterprise reform in general has been a stagnant - and in some instances a backtracking - process.

The syndrome of a recurring gap between policy statements and practice - addressed in this section - is perhaps best comprehended through the lens of path dependence as defined in the institutional economics literature. Path dependence, in the context of the current analysis, implies that policy outcomes are products not merely of prevalent socio-economic and political conditions; history matters; policy choices have an enduring - 'lock-in' - effect that get embedded in the policy space and persist long after initial conditions change.

The argument being made is that the stagnation in the public enterprise reform process - in spite of decades of experimenting with change in the status quo - is a reflection of historical lock-in. Policy choices made with respect to SOEs, such as, for instance, using these entities to distribute political favours in terms of employment opportunities and assuming a myopic attitude on continuous financial and operational inefficiencies, have resulted in entrenched stakeholder expectations; expectations from public enterprises that have been embedded over time and would require radical and politically risky policy decisions to overturn.

As set out later on in this section, the political incentives underpinning Sri Lanka's governance structure are not conducive to radical policy reform. In short, given the governance milieu and assuming rational decision-making where policy makers maximize political gain (or votes/funding of electoral campaigns/re-election), the opportunity cost of changing the status-quo is perceived as high. With little to gain from change, some regimes have been caught up in a cycle of policy rhetoric and have engaged in futile exercises such as generating masses of consultancy reports and numerous planning

frameworks, mostly to placate donors. On the other hand, regimes that have indeed attempted to implement reforms have backpedalled when faced with stakeholder opposition (a case in point is reneging on CEB reforms despite the enactment of supporting legislation in 2002, consequently losing out on conditional donor - Asian Development Bank - funding) - indicating that strategic, long-term sustainable policy planning has not been the priority of successive governments.

A snapshot of Sri Lanka's public enterprise reform process and the governance structures that have bounded the parameters for policy decision - particularly since the opening up of the economy in 1977 - captures the political economy constraints to implementing change in the SOE sector and illustrates the syndrome of path dependence and policy embeddedness described above.

4.2.2 SOE Reforms: Looking Back to the Future

Sri Lanka's post-independence economic policies were to a large extent nationalistic and inward-looking, reflecting in part a reaction on the part of national leaders to decades of colonial rule. A strong reliance on SOEs, with successive governments creating new public entities, nationalizing a number of private enterprises and fostering state monopolies, was a key feature of economic reforms in these years. Stakeholder support for these changes was secured by appealing to populist sentiments - for instance, by using SOEs as mechanisms for employment creation and imposing price controls on essential goods and services. According to some estimates, the public sector accounted for over one-third of investment and for around 40 per cent of formal sector employment at the time of economic liberalization in 1977.³ A majority

³ Kelegama, S. (1997), 'Privatization: An Overview of the Process and Issues' in W.D.Lakshman (ed.), *Dilemmas of Development: Fifty Years of Economic Change in Sri Lanka*, Colombo: Sri Lanka Association of Economists.

of these SOEs were burdened with issues of overstaffing, mismanagement, corruption, inefficient procurement systems, excessive government intervention, and politicization.

The liberalization of the economy in 1977, and subsequent attempts at reform over the past three decades, have not seen substantial changes in the SOE sector - as evidenced, for example, by the findings of the Central Bank set out in the preceding section of this Chapter. A majority of these enterprises continue to serve as a relatively easy source of rent-seeking and disbursement of political patronage, with stakeholders that lose out from this process displaying a sense of apathy in terms of change - a perplexing attitude perhaps nurtured by the relatively subdued nature of civil society activism in Sri Lanka. The pattern of lock-in and path dependence in the reform process suggests that the political economy incentives that govern decision-making in Sri Lanka - specifically short-term electoral cycles, coalition politics and the general perception amongst voters that there is little or no substantive difference between the different political parties - are inimical to sustainable change in the status quo, resulting in a trend of overall stagnation in public policy.

Whilst public policy in Sri Lanka is divided amongst the executive, the legislature and the judiciary, the extensive powers bestowed on the office of the President under the Constitution of 1978 has tended to undermine principles of good governance based on an effective checks-and-balance mechanism. Executive decisions have judicial immunity (with members of the Supreme Court being appointed by the President) and a two-thirds majority in Parliament is required to impeach the President - a near impossible state of affairs given both the electoral structure and the nature of coalition politics in the coun-

try. To a large extent, the governance framework put in place in 1978, after the opening up of the economy, has only endorsed the tendency towards short-term partisan politics.

The phenomenon of maximizing short-term political gain and transferring the negative ramifications of ad hoc policy decisions to future generations is one that has been common to successive regimes - in spite of declared election manifestos to the contrary. Sri Lanka has been witness to scenarios ranging from one where the executive and the legislature came from different political parties (resulting in disruptive politics), to ones where a single political party dominated these two branches of government (resulting in the concentration of narrow, short-term political interests), to coalition regimes (where decision-making has been hamstrung by the inability to secure collective support).

A pointed message that emerges from this state of affairs, from a governance perspective, is that the options available to move forward are politically challenging. First, as has been extensively discussed and researched,⁴ (and as has been a key feature of the political rhetoric voiced by successive regimes), the status quo as per the Constitution of 1978 - which gives the executive branch of government powers that cannot be matched by a legislature made of up several minor parties and that extends to judicial immunity - needs to be changed. Second, stakeholder groups, such as the media in particular, need to assume a more active role in building the pillars for collective action and informed civil society participation in the reform process. The dilemma, however, lies in the fact that each of these changes requires political will as a necessary and sufficient condition. Political will, as with any phenomenon that deals with choices, can

⁴ De Silva, K.M. (1981), *A History of Sri Lanka*, Delhi: Oxford University Press.

only be created and sustained by strategically establishing the right incentive structures; incentives that would indicate that the benefits of a particular policy choice outweigh its costs - within the constraints of a relatively short-term electoral cycle.

The fallout of misaligned incentive structures on the institutional framework is highlighted in Box 4.1.

In the rest of this section, snapshots of SOE reforms over the last three decades is looked at, to substantiate the core argument that sustainable reforms hinge on an incentive framework that appeals to the 'utility maximization' drive of the political leadership. The next section of this Chapter focuses on identifying elements of an appropriate incentive structure - matching selected strategies with stakeholder perspectives - to get to what is viewed as a sustainable solution to the stagnation and back-peddalling in the SOE reform process.

The United National Party (UNP) government that assumed power with a four-fifths majority in Parliament in 1977 and with executive power centralized in the Presidency under a new Constitution had a strong political mandate for economic reform; and yet, public enterprise reform was placed on the back-burner for over a decade. The lack of progress in SOE sector reforms during this period is perceived as a rational political economy response to the socio-economic conditions that prevailed in those years.⁵ Specifically, the enormous influx of concessional aid that came with the opening up of the economy softened budgetary constraints and made it possible for the government to continue previous practices of political patronage. In short - and particularly

given the fact that this period was also one of mounting political violence - the leadership did not have an incentive to make radical changes to the status quo.

However, by 1989 - at the start of what is termed as the 'second wave of liberalization' - budgetary transfers to loss-making SOEs were at unsustainable levels and the macro-economic fallout of wavering on the reform process could not be ignored for very much longer. Pressures from the donor community - making aid contingent on various liberalization and stabilization measures - saw the proclamation of privatization as a state policy in 1987 and the subsequent implementation of a privatization programme in 1989. Whilst extensive public sector reforms - as evidenced in the partial and full divestiture of around 43 commercial enterprises, with gross receipts of approximately Rs.11.6 billion - was carried out in the 1989-1994 years, the reform process in itself lacked certain crucial elements (such as sound regulatory governance) required for sustainability. In a sense, short-term fiscal pressures surmounted the longer term allocative efficiency and distributional equity concerns that form the bedrock of a virtuous policy cycle.

Although strategies such as dubbing the process 'peoplization' with connotations of transferring public assets to the people - by way of employee share ownership plans, unit trusts and share offers on the stock exchange - and issuing executive directives that retrenchment was not an option to placate trade unions allowed for a relatively smooth reform process in this period, there was little substantive change in terms of the tendency towards maximizing short-term political gains. In fact, ironically, this period lends itself to two depictions:⁶ one which sees these

⁵ Dunham, D. and S. Kelegama (1997), 'A Second Look at the Sri Lankan Experience: 1977-93', *Developing Economies*, 35(2):166-84.

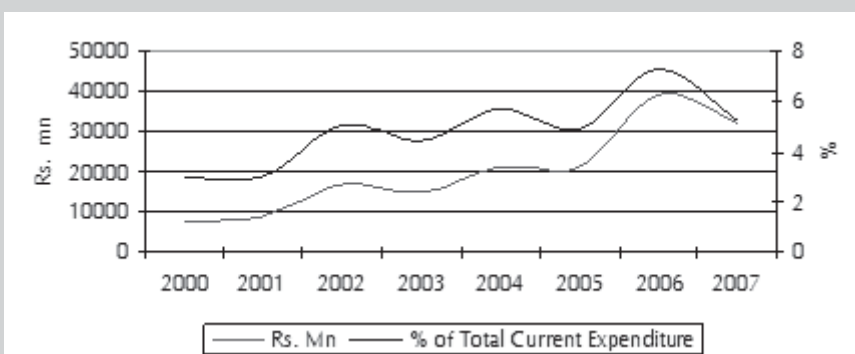
⁶ Knight-John, M. and P. P. A. W. Athukorala, (2005), "Rethinking Privatization in Sri Lanka: Distribution and Governance" in J. Nellis, and N. Birdsall (eds.), *Reality Check: The Distributional Impact of Privatization in Developing Countries*, Washington D.C.: Centre for Global Development.

Box 4.1 Performance of SOEs and the Role of the SEMA and the PUCSL

The Strategic Enterprise Management Agency (SEMA) was established in 2004 with the primary objective of improving the performance of select state owned enterprises (SOEs) by facilitating efficient coordination amongst them under one policy umbrella. Initially, it constituted 12 SOEs. An additional eight agencies were included in 2006. The sectors covered include power and energy, transportation, banking, and agriculture sectors.

Despite several efforts undertaken by SEMA to improve the financial performance of public enterprises, they continue to remain a drain on the government budget. Wage increases and inadequate adjustments to prices to reflect actual costs have weakened the financial performance of these institutions while management inefficiencies have further aggravated the problem. Thus, unsustainable operational losses are covered from the government budget, placing the burden on tax payers of the country. For instance, large operational losses of SLR, CTB and the Postal Department are still met by the government.

Current Transfers to Public Corporations and Institutions

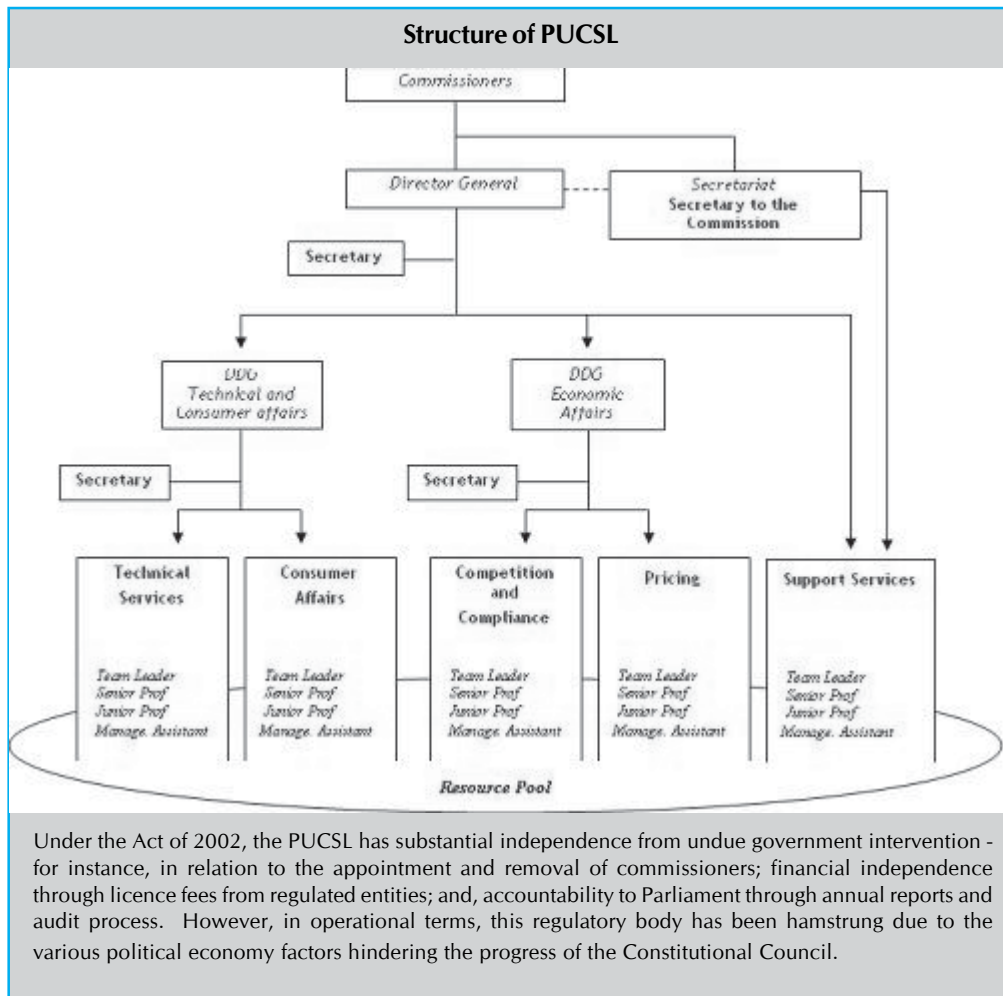


Source: CBSL, *Annual Report*, 2007

SEMA has not been effective in addressing the issue of improving the performance of SOEs. Key factors eroding the efficacy of SEMA include the steadily deteriorating governance structure of Sri Lanka and a lack of careful structuring of incentives under SEMA, taking into account the political economy dimensions of reform. A concrete action plan accompanied by strong political commitment is yet to be formulated in order to restructure these loss making institutions and make them financially viable.

The Public Utilities Commission of Sri Lanka (PUCSL) was established by way of Act No 35 of 2002 as a multi-sector regulator to regulate specific physical infrastructure services in the country. It came into operation in mid-2003. Initially, the PUCSL Act provided for the regulation of electricity and water services; in 2006, petroleum was also added to the list of sectors to be regulated by the PUCSL.

The Commission consists of five members who are appointed by the minister in charge of Policy Development with the concurrence of the Constitutional Council. The composition of the Commission should be such that it consists of at least one member each from the professions of engineering, law and business management, with the members holding a five year term.



years as a reform success story based on fiscal imperatives as well the astute political strategies used to get stakeholder buy-in for the privatization programme. The other more dismal picture hinges on the distributional aspects of the process, with vast opportunities for rent-seeking resulting in an upsurge of crony capitalism and the marginalization of stakeholders that had little or no 'voice' in the new power structure.

The fallout of neglecting to address and institutionalize fundamentals in the reform process - such as robust regulatory governance and equity concerns for instance - grew to politically unsustainable proportions by the 1990s. In late 1994, popular disenchantment over spreading corruption, authoritarian

rule and political violence led to the end of 17 years of UNP rule and to the election of a People's Alliance (PA) government, made up of a coalition of the left-of-centre Sri Lanka Freedom Party (SLFP), the traditional left parties, and splinter groups from the UNP. However, contrary to voter expectations that the ideology of this regime would bring on a reversal of the liberalization process, SOE reforms in the form of complex privatization exercises - in the telecommunications, airlines and gas sectors, for example - were carried out by the government.

Progress in economic reforms, however, started to decline as the political priorities of coalition management began to gradually dominate the policy making process. The

government's ability to take resolute policy decisions was undermined by the fact that it lacked an adequate majority in Parliament and had to cater to the often contradictory view points of the various parties in its coalition. The political climate was one in which numerous interest groups vied for favours and rent-seeking activities - this time on a much larger scale given the size of the enterprises being privatized.

The granting of exclusivity provisions without adequate regulatory arrangements, in the divestiture of key utility and service sector entities such as telecom, gas and airlines for instance and under-pricing of assets was a deliberate policy choice adopted by the government - ironic in a sense in view of the criticism it had levelled against the previous regime for adopting similar practices. Explanations for these policy choices range from what could perhaps be termed 'pragmatic' (speed, lack of committed bidders for these transactions in the midst of a conflict and an unstable political climate, budgetary constraints and a dire need for investment, etc.) A case in point is that of the telecom privatization where the investor set the parameters of what was inherently a political choice of scenarios for the government (with a three year monopoly and an immediate price hike, or a five year monopoly and a phased out price hike) to what is viewed from a 'lock-in' perspective as a continuation of a short-term outlook and a lack of staying power to ensure a sustainable and appropriately sequenced reform process.

A commitment to private sector led growth - including completing the SOE reforms undertaken in previous years - was the hallmark of the new UNP regime that assumed power in 2001. The national policy state-

ment of the government - "Regaining Sri Lanka" - contained in a voluminous document set out an acceleration of the privatization process and reform of the legal foundations of the economy as two of its three main themes. The involvement of donor agencies in the policy making process, both in an advisory capacity as well as in terms of scrutinising progress on the reform front - following from the unsustainable and ever-expanding budget deficit of 9.9 per cent of GDP in 2000 and 10.9 per cent in 2001 and the signing of a Stand-by Arrangement with the International Monetary Fund (IMF) with attached conditionality on structural reforms - was seen as more overt than under any previous regime. Concerted efforts to achieve sound regulatory governance with the setting up of a Constitutional Council and a multi-sector regulatory authority were made by decision-makers during this period. What was lacking, however, was a robust strategy to secure and sustain the political capital vital for the reform process. In a sense, the regime may have focused too heavily on the economic efficiency aspects of reforms whilst neglecting the political fundamentals required to sustain these reforms.⁷ Clearly, the political choices made by this regime, whilst being hailed by text-book economists as being sound, were not tuned to the nuances of real politick, resulting in little tangible progress on the reform front.

The incumbent regime that was elected into power in 2005 has assumed a rather radical stance with respect to SOE reforms, with privatization being ruled out per se as a policy option. The government's national development plan - "Mahinda Chintana: Vision for a New Sri Lanka" - categorically specifies that privatization will not be amongst the menu of public enterprise reform options. However, subsequent statements made by the political leadership suggests that public-private part-

⁷ A case in point is the attempt in July 2003 to revive the Railway Authority Act of 1993 and the railway strike that followed - leading to the abandonment of these reforms.

nerships (and SOE reforms that do not involve ownership change) remain choice variables.

Section 4.3 of this Chapter looks at particular strategies for improving the performance of SOEs with a view to sustainability and political buy-in - setting out the costs and benefits of reform options as perceived by key stakeholders interviewed by IPS for a recent study on public enterprise reforms.

A brief analysis of the regulatory governance and principal-agent dynamics that have played an influential role in shaping the path of public enterprise reform in Sri Lanka is useful at this point to understand the stance that is taken on feasible strategies for change discussed in Section 4.3. The literature on ownership change and SOE performance suggests that there is no conclusive evidence that a change in ownership is a necessary or sufficient remedy for under-performing entities.⁸ Instead, what emerges in the literature, and in examples of SOE reforms in countries ranging from China, South Africa, Singapore and India, is that what matters for enhanced performance is the structuring of incentives in line with principal-agent dynamics. In the case of the SOE sector, where the principal is by definition the general public and the management of the entity the agent, the dilemma lies in institutionalizing incentives that would firm up the line of accountability between the public and the management - a challenging task in view of the fact that the owners in this instance are a varied, non-homogenous group (this classic problem of collective action is compounded by the fact that civil society activism is subdued in Sri Lanka). Whilst ownership change is no longer

a policy option under the current regime, the need to create the right incentives - incentives that would highlight the opportunity costs of reneging or backtracking on planned reforms and 'force' agents to implement change - is key to the development process.

As will be expanded on in the concluding section of the Chapter, a crucial ingredient in firming up the line of accountability, creating transparency and fostering legitimacy in the decision-making and implementation process is the institutionalization of solid regulatory structures. Looking back at the public enterprise reform process over the decades leads to three possible conclusions with respect to the stance adopted by successive governments on regulation. First, that a hands-off policy on regulation was a deliberate, 'pragmatic' decision on the part of the political leadership to attract private investment (the famous "robber barons" hypothesis associated with the 1977 regime). Second, that the vast opportunities for rent-seeking on the part of the more powerful stakeholders that formed the political support base created perverse incentives with respect to regulatory governance (as evidenced in the case of telecommunications privatization), where the regulatory authority became a source of long-term rent extraction. Sri Lanka's telecommunications success story is scarcely a reflection of good regulatory practices, but of global and domestic competitive pressures and technological factors that to a large extent by-passed regulation.⁹ Finally - *albeit* not a very convincing claim despite the fact that politicians often use this explanation to ward off populist pressures - that the pace of SOE reforms/privatization set out for Sri Lanka by donors such as the World Bank and the IMF

⁸ See for example, see Nellis, J. and, N. Birdsall (eds.) (2005), *Reality Check: The Distributional Impact of Privatization in Developing Countries*, Washington D.C: Center for Global Development; Megginson, W. & Netter, J.M. (2001) "From State to Market: A Survey of Empirical Studies on Privatization." *Journal of Economic Literature*, Vol. 39, pp. 321-389; Willner, J. and D. Parker (2002), *The Relative Performance of Public and Private Enterprise Under Conditions of Active and Active Ownership*, Working Paper Series No: 22, Manchester: Institute for Development Policy and Management, University of Manchester, Centre on Regulation and Competition.

⁹ Knight John, M. (2007), *Telecommunications Sector and Regulatory Performance in Sri Lanka: A Tale of Missed Opportunities?*, available at: www.limeasia.net/wp-content/uploads/2008/05/knight-john-2007-6cmcs-sri-lanka.pdf.

did not allow for a proper sequencing of events, where the setting up of an effective regulatory framework preceded divestiture.

4.3 Understanding the Conditions for Change: SOE Reforms from a Stakeholder Perspective

Given the political economy analysis set out above, this section focuses on two crucial policy questions: which stakeholders stand to gain or lose from changes in the status quo; and, how to get to a position of securing the buy-in of 'winners' and compensate 'losers' in a situation of constrained optimization where:

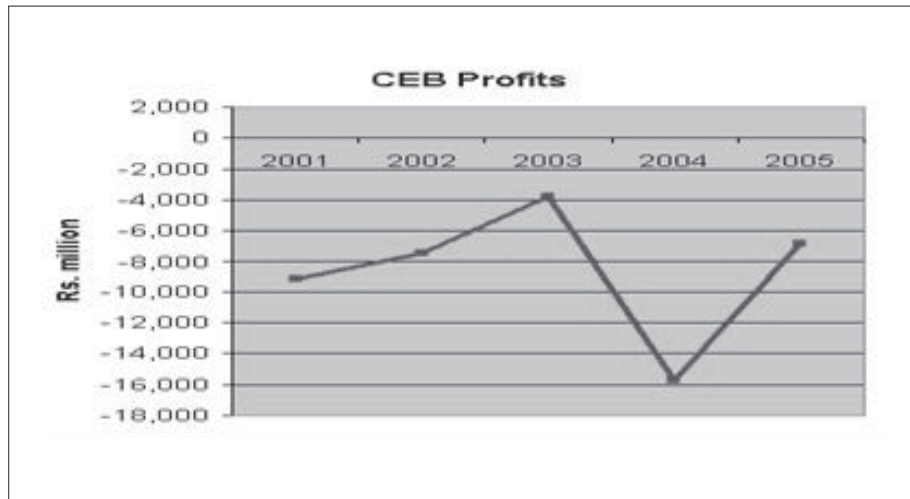
- Privatization is not a policy alternative;
- Perpetuated state subsidization of loss-making public enterprises is an unsustainable option in view of fiscal overcrowding and increasing macroeconomic instability. The realities associated with hard budget constraints have to be recognized by all stakeholders in the policy space; and,
- The crisis in key SOEs has reached intolerable proportions. For instance, the CEB has recorded financial losses for over five years with a further deficit of Rs. 42 billion estimated for 2008, while Sri Lanka's electricity sector tariffs stand out as some of the highest in the region (as illustrated in Figure 4.1 and Table 4.1, respectively). The CPC's performance is negatively impacted upon by the fact that its biggest debtors are 'peer' SOEs such as the CEB, SLTB and the SLR that are themselves in the red. The SLTB faces a chronic problem of overstaffing combined with a lack of skilled workers - specifically, crew to run existing buses - and with labour costs amounting to nearly 50 per cent of total expenditure. The SLR is confronted with the physical dilemma of over-aged infrastructure and rolling stock and the political economy dilemma of not being able to raise rail fares - railway pas-

senger fares in Sri Lanka are the lowest in the region - largely due to stakeholder perceptions that the quality of service does not justify price increases.

The reform strategies identified in this section are based largely on in-depth discussions on the energy and transportation sectors - in the form of one-on-one interviews and focus groups sessions - with key stakeholders in the policy space, specifically public sector managers, regulators, trade unions, academics/consultants, representatives of the private sector, media, donors and users. Given that broad policy options - such as corporatization, performance contracting and management contracting for instance - have already been extensively analysed - this section focuses on what could be viewed as 'micro-level' strategies for enhancing performance in the SOE sector. Whilst the strategies that are set out in this section can be viewed as generic to the extent that the problems that confront a majority of SOEs are broadly similar, specific examples are drawn from the CEB, CPC, SLR and SLTB to illustrate the stakeholder dynamics of change. Figure 4.2 sets out what are seen as possible options for change, given the political economy constraints highlighted above.

The strategies identified below have been slotted into a short, medium and long-term framework with short-term strategies being selected on the basis of minimum resistance from trade unions, the general public, etc. It is argued that the successful implementation of these short-term strategies would create confidence and garner support for the reform process from key stakeholder groups, set in place a process for obtaining the buy-in of 'winners' and compensating the 'losers'; and, pave the way for adopting the relatively more politically controversial medium and long-term strategies.

Figure 4.1
CEB Profits/Losses



Source: Ceylon Electricity Board, *Annual Report*, 2005.

The results of interviews and focus group discussions indicate that most stakeholders are averse to, or misinterpret, the term 'privatization': ("*if your study intends to privatize SOEs we do not want to respond to your questions*"; "*privatization is a curse to this country*"). These findings are similar to those set out in Nellis and Birdsall (2005), where a 2001 World Bank commissioned survey in Sri Lanka found that more than 80 per cent of the respondent group perceived privatization as negatively impacting on poverty and living standards. A key finding emerging from the IPS research is that perceptions are crucial in shaping the direction of the reform process; and in general, perceptions are formed on the basis of what one stands to gain or lose through changes in the status quo.

Not surprisingly, the most neutral promoters of reforms have been the relatively well-connected who have little to gain or lose from changes - given the "votes and election funding in exchange for rent-seeking opportunities and political favouritism" arrangement that exists between this stakeholder group and the political leadership. In general, the

labour force does not look favourably upon reforms - on account of the guarantee of job security in SOEs and the perception, cultivated over years of heavy government intervention in the economy, of a benefactor state - not discounting the presence of vociferous trade unions with strong bargaining power and the ability to create industrial unrest. Consumers tend to be marginalized as the 'silent majority' who lose out (in terms of affordability, access and quality of service) from stagnation and backtracking in reforms - particularly in the services and utilities sectors.

4.3.1 An Overview of Possible Reform Strategies

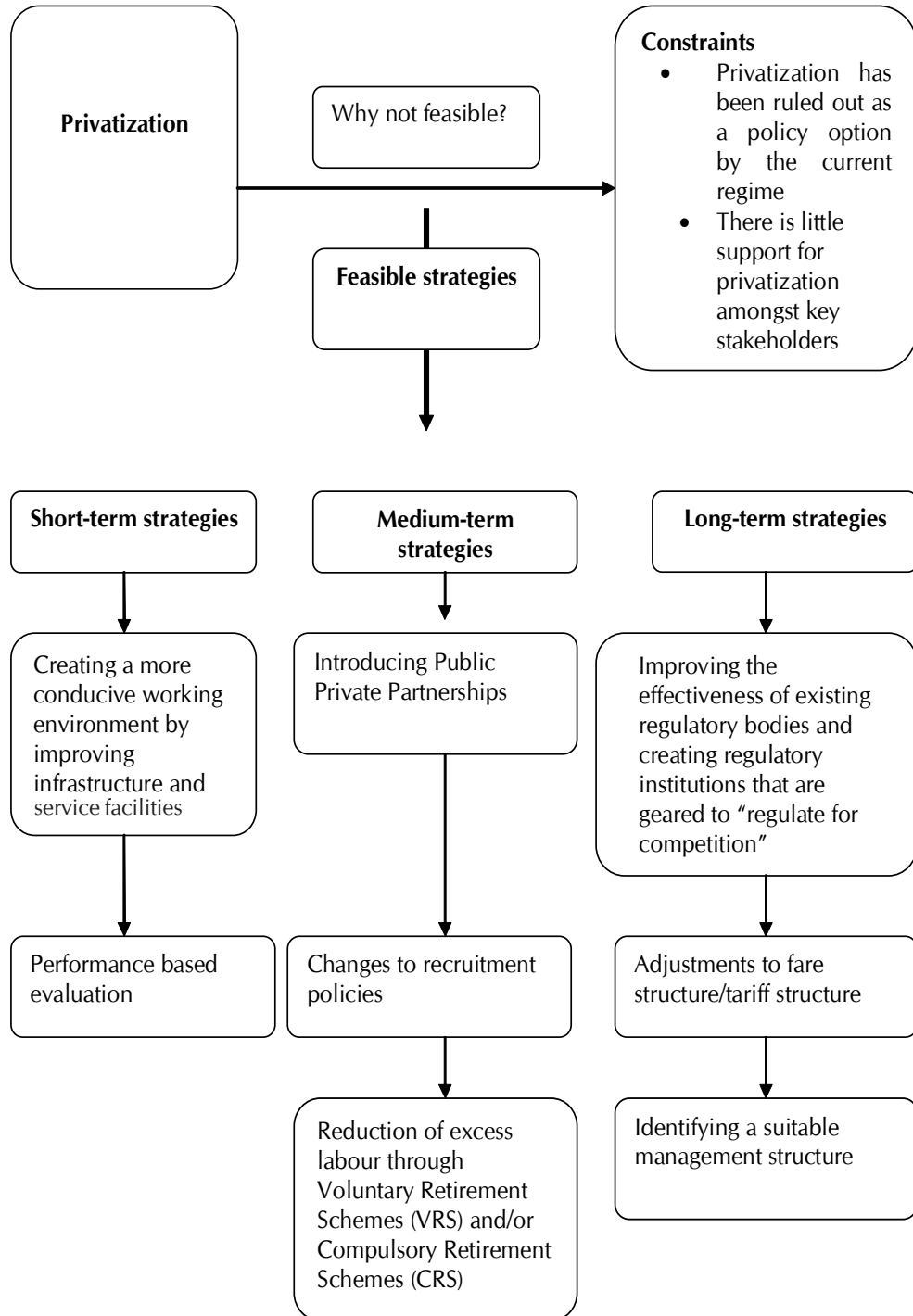
Creating a more conducive working environment by improving in-house infrastructure and service facilities. The findings of the survey suggest that the 'physical' working environment prevalent in most public enterprises is inimical to worker productivity, morale and improved sector performance. Examples from the four entities selected for the study indicated that facilities, ranging from basics such as canteen and sanitation services to modern communication tools such

Table 4.1
Average Price of Electricity in Selected Countries

Customer	Class	Electricity Use 9KWh/ Month	Maximum Demand (KW)	Bangladesh	Tamilnadu India	Kerala India	Maharashtra India	Malaysia	Nepal	Pakistan	Singapore	South Korea	Sri Lanka	Thailand
Household	Small	30	-	5.59	2.55	2.58	7.26	6.17	6.79	2.29	14.02	7.27	4.65	4.21
	Medium	90	-	4.85	4.22	3.64	5.27	6.17	8.74	4.21	14.02	6.38	5.95	5.32
	Large	300	-	5.12	6.70	6.89	7.26	6.83	10.00	5.19	14.02	13.06	15.68	6.64
Commercial	Small	1,000	-	8.46	12.98	11.77	10.97	9.13	12.05	8.16	14.02	11.05	13.50	7.64
	Medium	59,000	180	8.56	13.32	13.78	10.48	9.13	11.01	7.95	14.02	9.33	14.60	5.60
	Large	600,000	1,500	8.54	12.92	9.15	6.80	6.63	10.57	7.73	11.99	8.74	14.13	5.47
Industrial	Small	5,000	-	6.77	6.74	7.58	10.06	8.20	9.44	8.53	14.02	8.49	7.95	8.04
	Medium	65,000	180	6.27	9.73	9.77	7.01	6.29	8.55	7.37	12.11	7.02	8.61	5.53
	Large	270,000	600	6.23	9.36	9.43	6.58	6.29	8.28	6.92	11.81	6.62	8.24	5.41
	Very Large	1,050,000	2,250	5.85	9.31	8.54	6.51	4.09	6.62	6.50	11.21	6.91	8.20	5.39

Source: IPS, Database.

Figure 4.2
SOE Reforms: What is Possible?



as telephones, fax, photocopy and e-mail services, were lacking in these entities. It is argued that herein lies a relatively non-controversial window of opportunity for change, which may well lead to securing the buy-in of stakeholders for more politically challenging reforms - producing a 'win-win' outcome. The argument is supported by citations drawn from stakeholder interviews:

"There is a crying need for proper canteens, toilets and work stations" (SOE management)

"We have not been trained to use computers and we were not given a chance. We believe that we are ill treated" (Trade unions)

Performance based evaluation. Creating incentive structures conducive to improved employee performance is perhaps one of the most fundamental factors in improving the efficiency of any entity/enterprise. In the current, 'non-reform' system, employees in the SOE sector have the luxury of job security and fixed salaries, irrespective of their individual performance or contribution towards the productivity of the entity. The absurdity of this structure and the lack of motivation and lethargy it cultivates were clearly expressed by stakeholders interviewed for the study, suggesting that this may well be another area where reformers can get the necessary 'buy-in' to bring about change in the status-quo:

"Top managers in the SOE sector get huge perks and they are not in the office most of the time; if they lack work ethics, why should clerical staff provide opportunities for them to earn money?" (Media)

"We don't get any incentives, - no performance-based allowances that the private sector gets; do you think it is fair to blame us saying that we are not working full time?" (Trade unions)

Introducing Public Private Partnerships (PPP).

Research carried out by IPS for the recent study on improving the performance of the transportation and energy sectors indicates that PPPs are considered a feasible strategy for reform by a wide spectrum of stakeholders - ranging from the political leadership, to SOE management, to trade unions and the private sector. This is also a strategy that has shown positive results internationally - in India's railway sector for instance - as well as domestically in Sri Lanka's telecommunications sector.

More recently, SLR partnered with Chevron Lubricants to renovate the Kandy railway station, with Sampath Bank to renovate the Aluthgama railway station, and with Colombo Dockyard PLC to renovate the Gampaha railway station. Discussions are also being held between decision-makers in the railways sector and telecom operators to utilize the unlit fibre optic network that lies beneath the railway tracks. There have been no stakeholder protests with regard to the implementation of the PPP in SLR, largely due to the fact that efforts were made by a strong management to convince and successfully obtain the 'buy-in' of interest groups that would in general have been averse to any form of private participation. To cite policy makers interviewed for our study:

"This would be one of the best options to get the involvement of the private sector because we don't have enough capital to carry out each and every task" (Policy makers in the energy and transportation sectors)

Changes to recruitment policies. Clearly set out recruitment policies are essential in creating and sustaining efficient and effective management structures. However, the findings of the IPS research indicate that this is not the case in the SOEs that were studied. What is interesting, however, is that some

of the key stakeholder groups interviewed perceive changes in the current recruitment policies as an important and necessary element, indicating that reformers do have a window of opportunity to implement change in this area.

Examples of stakeholder perspectives on existing recruitment policies:

"It's pathetic, we didn't have clear recruitment policies to appoint top managers till 2005; and still we are not following the new procedures introduced under the SLTB 2005 Act" (SLTB management)

"For the last twenty years we have not considered qualifications or experience for labour recruitment and promotions" (Policy makers)

"There are no Chartered Accountants in Sri Lanka Railways" (SLR management)

4.3.2 Reduction of Excess Labour through Voluntary Retirement Schemes (VRS) and/or Compulsory Retirement Schemes (CRS)

As seen from previous experiments with such schemes in Sri Lanka (for example, in the case of SLTB), this option needs to be strategically implemented as it can create incentives for the outward migration of skilled workers. This approach is best placed in the medium-term horizon of the reform process - after changes viewed as being relatively 'politically benign' are implemented and showcased as having positive spill-over impacts on a majority of the stakeholders. Figure 4.3 illustrates the stakeholder trade-offs associated with a VRS option in the SLTB in an attempt to understand the conditions for change.

Improving the effectiveness of existing regulatory bodies and creating regulatory institutions that are geared to 'regulate for competition'. Contrary to populist thinking, the objective of regulation is not to impose cumbersome rules and regulations that stifle the effectiveness and efficiency of an entity. Whilst excessive regulation is often justified by politicians on the basis of consumer welfare, it is this stakeholder group that tends to lose out the most when regulation lacks dynamism. Instead, the regulatory framework needs to be fine-tuned to enhance performance; to regulate only where there is a clearly demonstrated market failure and to facilitate competition wherever possible. Moreover, in line with international best practices, the setting up of an independent¹⁰ regulatory framework needs to precede other reforms such as liberalization, the introduction of PPPs, etc.

A glaring instance of an ineffective regulator - based on the findings of the IPS study - is that of the National Transport Commission (NTC) which was set up to regulate the transportation sector and is viewed by stakeholders as a 'white elephant'. Moreover, policy makers are yet to establish an independent regulator for the energy sector.

"What is missing in the energy sector is we don't have a regulator, we don't have an institutionalised forum to make complaints" (Media)

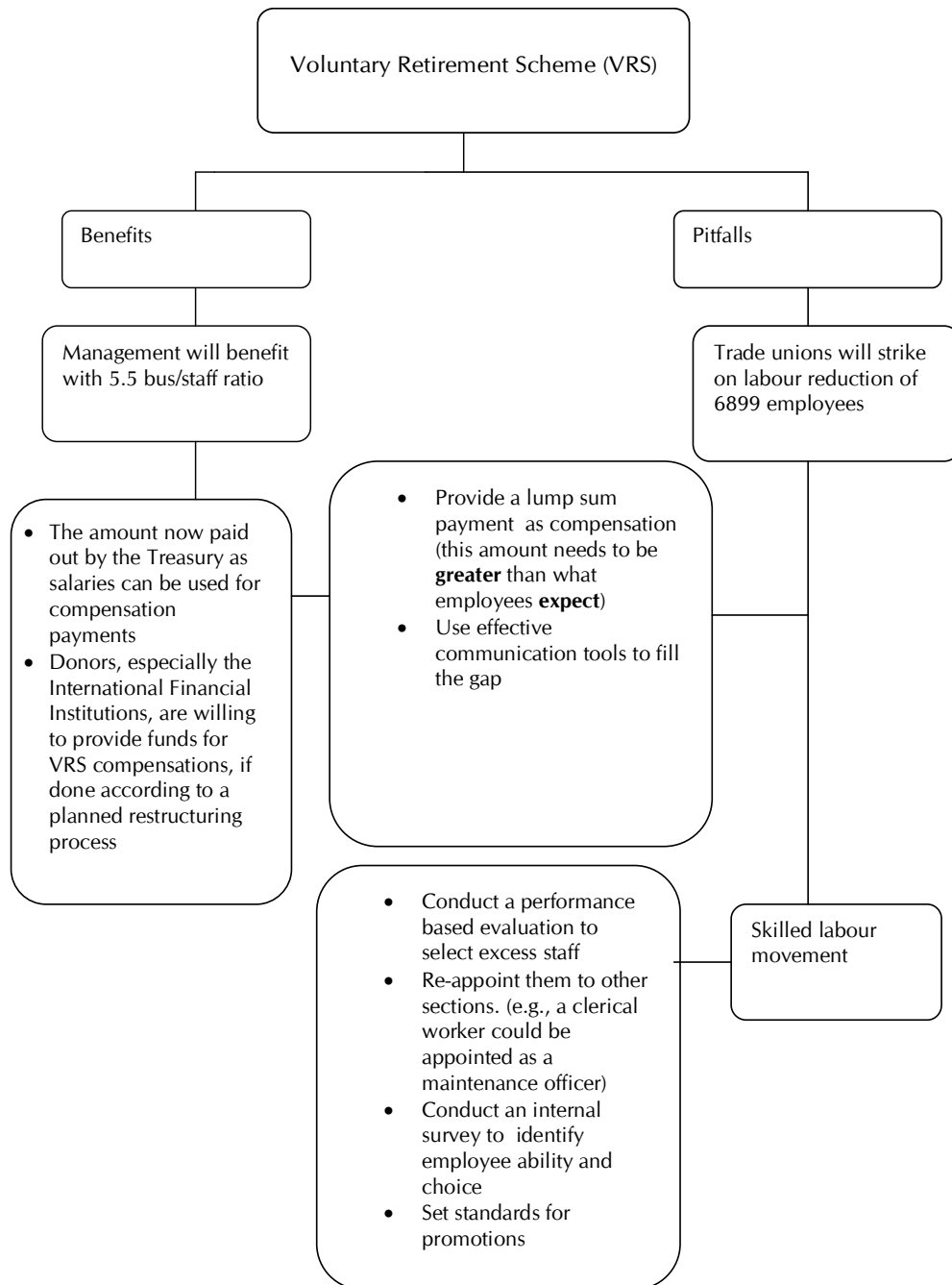
"The NTC is of no use to us or to users. The 13th Amendment has made it a 'white elephant'" (Representative of the private bus sector)

Adjustments to fare structure/tariff structure.

This is a very controversial area (particularly in the current context, where the high cost

¹⁰ 'Independence' in this instance is relative and relates to the day-to-day operational and financial aspects of the regulatory body. Given that regulatory institutions are established by the state, a better and more precise term might be 'workable independence'. The key point here is that legislation governing the regulatory institution needs to be structured so as to minimize both political and regulatory capture.

Figure 4.3
Introducing a VRS Option in SLTB: Costs and Benefits



of living is a huge burden on the general public), which would require strong management and effective policies to ensure that the method adopted by each SOE will benefit the general public in the short and long-term. Robust management and clearly defined and transparent policies, including effective regulatory structures, are essential to create trust and confidence in the reform process amongst the general public and the employees. This strategy would also require an extensive public consultation and media awareness process (focusing for instance on the benefits of price differentiation, improved quality of service, etc.) if it is to be sustainable. The political economy dynamics associated with this strategy are illustrated in Figure 4.4 drawing from the example of the CEB.

Identifying a suitable management structure.

Specific management arrangements are necessarily unique and vary from entity to entity, as each SOE provides different types of services. However, common to all SOEs is the need for flexibility in the decision making process. The need for flexibility in managerial decisions was clearly expressed in the stakeholder interviews:

"It takes nearly two to three months for us to get an approval on seemingly minor things (e.g.: purchase stationery, purchase small parts for a bus engine)"
(SLTB management)

"As an example we need to call for tenders before we purchase a new part for a turbine and it needs to be approved by different heads of the departments; in the private sector an executive could individually decide and order it directly from one person" (CEB management)

The preceding discussion in section 4.3 sets out a possible road-map for change - including key factors for sustainability such as the

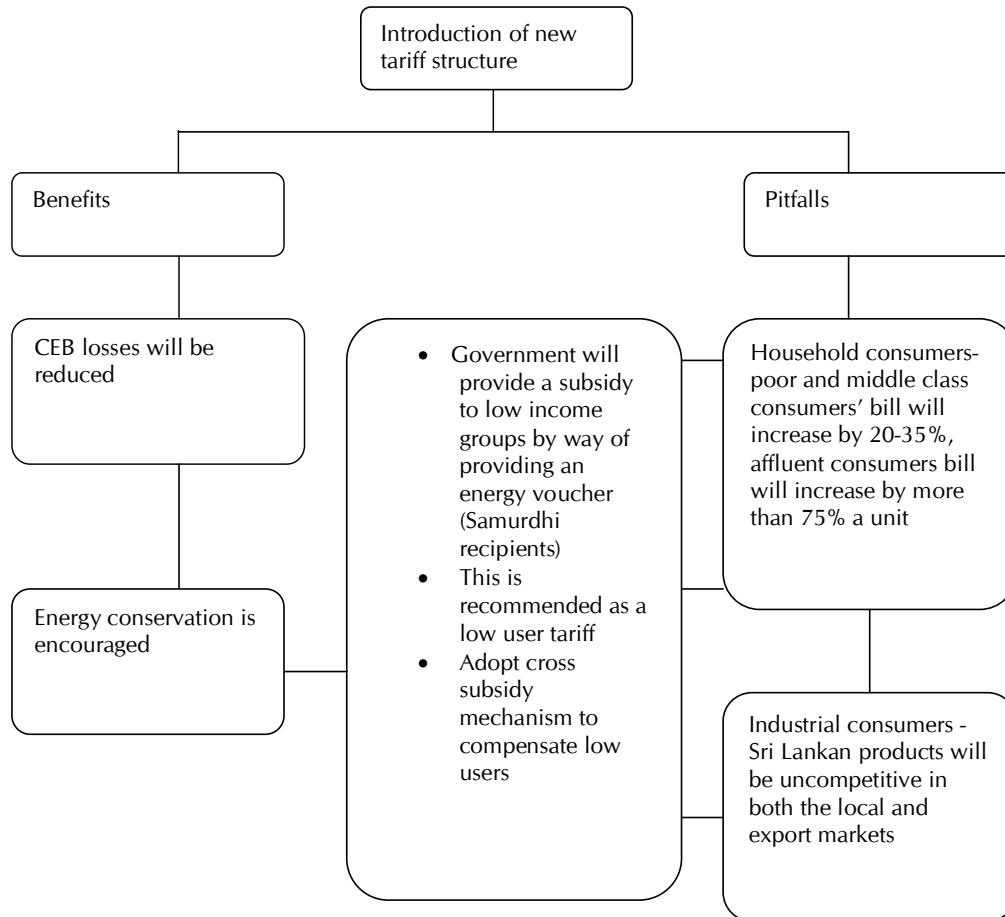
sequencing of strategies and the 'enveloping' of these options to mobilize stakeholder support. The next - and concluding - section of this Chapter steps back from the nuts and bolts of the reform process and addresses the political economy fundamentals required for change.

4.4 SOE Reforms at Crossroads: Where Do We Go from Here?

What emerges as conspicuous when looking back at public sector reforms in Sri Lanka over the years is that it has lacked ownership, with the political leadership either reluctant to take tough decisions due to other political priorities such as the need for coalition building, giving out conflicting signals, or reversing or making ad hoc changes in the process entered into by a predecessor government. Such conditions are fertile ground for vested interests out to engage in rent-seeking activities, particularly in the absence of sound governance practices in general, and weak regulatory governance in particular.

Public debate on policy issues with respect to reforms and regulation has been relatively minimal, compared for example to India, and a number of Latin American and transitional economies that experimented with similar strategies. The relatively subdued response to the reform process is in part due to the fact that the more vocal antagonists such as trade unions are placated by various safeguard measures (such as job security) and have little incentive to push for changes in the status quo. The modest level of discourse on key policy issues is also linked to a more widespread problem in Sri Lanka - the absence of a cohesive civil society that actively participates in the development process. Discussion where it has existed has largely been confined to academic circles (politically marginalizing grassroots stakeholder groups that can actually garner the much-required

Figure 4.4
The Political Economy Dynamics of Tariff Reforms in the CEB



bottom up stimulus for change) with little interaction between decision makers and the academia and a widening gap between policy rhetoric, planning and implementation.

Getting to a sustainable solution to the policy dilemma - where do we go from here - brings back a recurring theme in this discussion - the dynamics of institutions and institutional change in Sri Lanka, which is perceived as being the key obstacle to a sustainable reform process. As conceived in the institutional literature, rent-seeking is a result of policies and institutions that create the wrong incentive structures - for example, ineffective regulation - and the introduction of more

efficient institutions is constrained by the high political transaction costs linked to institutional change. The final outcome of institutional change rests on the distribution of power in society, the relative political leverage of those who are pro-reform and those who resist change, and the nature of patron-client networks.

Applying this analytical framework to the Sri Lankan context provides some useful insights into the reform process. Similar to other countries in South Asia, political power in Sri Lanka is concentrated amongst a small group from the more privileged segments of society. This has resulted in governance struc-

tures that largely discount the interests of a vast majority of the population, with the leadership deriving its support from patron-client networks that serve its narrow political agenda. (For instance, the introduction of the new 2008 CEB Act, which was based on the 2002 CEB Act, was withdrawn due to powerful trade union actions - although these trade unions only represent 10 per cent of the employees of CEB). Successive political regimes have bought the support of groups opposed to the reform process - groups that have the power to resist change that is - as evidenced in the case of privatization. To put it differently, these groups have bought into the rent-seeking process and have become embedded in the prevailing governance structure.

In view of these circumstances, institutional change is only possible if the political leadership is willing to completely overhaul and rebuild the institutions that have perpetuated poor governance over the years and create new structures to support the needs of the reform process. This requires immense political will - as it involves uprooting entrenched vested interests - and political risk, given the nature of the electoral cycle. In an alternative scenario, institutional change could be the natural result of a deep crisis - a situation that may not be too far off given the irregularities that have pervaded the reform process. In the final analysis, the future direction of institutions and institutional change and of the reform process rests on the path chosen by the political leadership: will it be path dependence or will it be a new genre of governance?

History suggests that the state in Sri Lanka appears to have alternated from a captive state (political capacity circumscribed by pressures

from vested interests) to a parasitic state (state actively engages in capturing rents from the reform process) depending on the particular political settlement - the distribution of power between state and society - at the time. This is certainly a far cry from the developmental state that is said to have been the driving factor for the success of the East Asian nations. What then does the nature of the state in Sri Lanka indicate in terms of the capacity for better institutions, better governance, and a development-oriented reform process in the future?

Clearly, it is not feasible and possibly counterproductive to attempt replicating the experience of developmental states elsewhere, given that path dependence and historical factors inevitably play a vital role in shaping the nature of the state. What is required instead is to restructure state-society relations - institutions - to suit Sri Lanka's development needs. It is not sufficient to tinker with economic reforms alone; what is important is to get the political processes right - an effort which requires tremendous political will, given the inevitable loss of political support and hardships in the short-term. The good news, however, as evidenced in a number of countries that have undergone similar processes, is that once the process is right and reforms are on the correct track, support is forthcoming from a broad segment of the population. The key question is whether the current regime will take up this challenge, or whether the opportunity for change will be missed once again.

"The reformer has enemies in all those who profit by the old order and only lukewarm defenders in all those who would profit by the new." Niccolò Machiavelli - "The Prince" (1513)

5. Effective Service Delivery for the Poor

5.1 Introduction

Defining what constitutes poverty is a challenging task given its many dimensions. Nonetheless, poverty certainly involves a lack of physical assets and inadequate material means to acquire food and other basic necessities. Such conditions are also associated with vulnerability to natural disasters, such as floods, droughts, etc., loss of employment, ill health or disability of any member or members of the family, death of the main income earner, violence or conflict, etc. In Sri Lanka, as in most other developing countries, poverty is basically a rural phenomenon. The latest estimates based on the Household Income and Expenditure Survey (HIES) of 2006/07 conducted by the Department of Census and Statistics (DCS) shows that 93 per cent of the 2.8 million poor in Sri Lanka continue to live in rural areas (82 per cent) and in the estate sector areas (11 per cent). One of the main reasons for this disproportionate concentration of the poor in the rural (including the estates) areas is the inadequacy of infrastructure facilities - both economic and social infrastructure, and the inadequacy or weakness in the service delivery mechanisms.

Infrastructure gaps have been one of the factors triggering regional economic disparity. Infrastructure can be used as an instrument for reducing poverty, breaking the isolation of a region and narrowing regional disparities. Inadequacy of both economic and social infrastructure - and ineffective service delivery systems in certain regions - affect almost every aspect of human well-being. If economic growth is limited to more devel-

oped areas of the country and the infrastructure facilities are not developed adequately in less developed regions, the poor in such regions will not have access to the available services and, therefore, may not be able to reap the benefits of growth. It is a truism that "people are poor in the less developed regions, because of very poor services and it is the poorest who get very poor services".

A number of welfare programmes and poverty alleviation programmes have been implemented in Sri Lanka.¹ The Janasaviya and the Samurdhi are two programmes which were especially implemented with the aim of reducing poverty in Sri Lanka. However, there still remains 2.8 million people deemed to be poor (in 2006/07) in the country (excluding those in the Northern Province and in the Trincomalee district). Surveys conducted by the DCS have shown certain weaknesses in implementing these programmes. Some of the most deserving are not receiving the benefits, while some in the higher income groups have received such benefits. Targeting the destitute and the persistent poor should be the main target group for any assistance given.

Alongside such targeted poverty alleviation programmes, a number of major development projects are also being implemented at present with an emphasis on improving rural infrastructure. In addition, there are several other targeted rural infrastructure development programmes, such as 'Gamidiriya' (community development and livelihood improvement), 'Gama Neguma' (village re-

¹ Such as the Food Subsidies Scheme (from 1942 to 1977), the Food Stamp Scheme (from 1979 to 1989), Janasaviya (from 1989 to 1994), and Samurdhi (from 1995 to-date).

vival) and 'Maga Naguma' (road development), designed to develop rural infrastructure with the participation of the local communities.² Initial evidence suggests that the Gamidiriya programme has been found to be effective, mainly because of the community participation and transparency in all its programme activities. While more in-depth assessments may be needed to measure the real impact and effectiveness, the more successful programmes can be extended to cover as many villages as possible where infrastructure facilities are inadequate.

In addition to economic infrastructure, the provision of social infrastructure is essential to provide quality education and access to better healthcare and health services for those living in geographically isolated regions. If schools with necessary facilities and qualified teachers - especially to teach subjects such as mathematics, science and technology, English, etc. - are not available within close proximity to the areas where they live, or do not have access to such schools located in nearby towns due to inadequate access roads and transport, even capable children from these disadvantaged regions are not able to receive a quality education up to GCE (A/L) in a subject area of their choice. Even to receive a reasonably good education in any other subject area may also be difficult due to inadequate facilities or qualified teachers. As a result, poverty may be passed on to the subsequent generation as well.

In the provision of health services, the Demographic and Health Surveys (DHS) conducted by the DCS have shown that the prevalence of under-nutrition among children under 5 years in the geographically isolated areas and in the estates sector is high, com-

pared to the other regions. The DHS results show that there is a direct correlation between the education level of the mother and the nutritional status of the children. This situation could be rectified by educating mothers, especially on how they should look after themselves during pregnancy and lactation period and on proper care of children during the early years of their lives.

Given all these issues, the main focus of this Chapter is on the importance of accessibility and effective service delivery in poverty reduction, especially in the rural and the estate areas, where infrastructure facilities are inadequate or lacking. The Chapter presents an analysis of national trends in poverty and regional disparities in Sri Lanka since 1990. The types of services and the infrastructure facilities which are addressed in this Chapter under economic infrastructure include access to roads, electricity, water, information and communication. Under social infrastructure, the two important subject areas covered are education and health. In education, the discussion addresses issues on providing quality education for all children, especially those from poor families. In health, the discussion addresses the issues of how the poor could be increasingly affected by non-communicable diseases.

5.2 Poverty in Sri Lanka: Trends and Regional Disparities

According to the HIES-2006/07 conducted by the DCS, there are 2.8 million poor persons, including an estimated 100,000 poor in the Batticaloa and Ampara districts in Sri Lanka.³ If the Batticaloa and Ampara districts are excluded (in order to compare the HIES-2006/07 poverty figures with those of

² Gamidiriya was initiated in December 2004 with World Bank assistance. By September 2007, 836 villages in Badulla, Hambantota, Monaragala, Ratnapura, Galle, Matara and Polonnaruwa districts had been covered under this programme (www.gemidiriya.org).

³ The Northern Province and the Trincomalee district in the Eastern Province have not been covered in this survey.

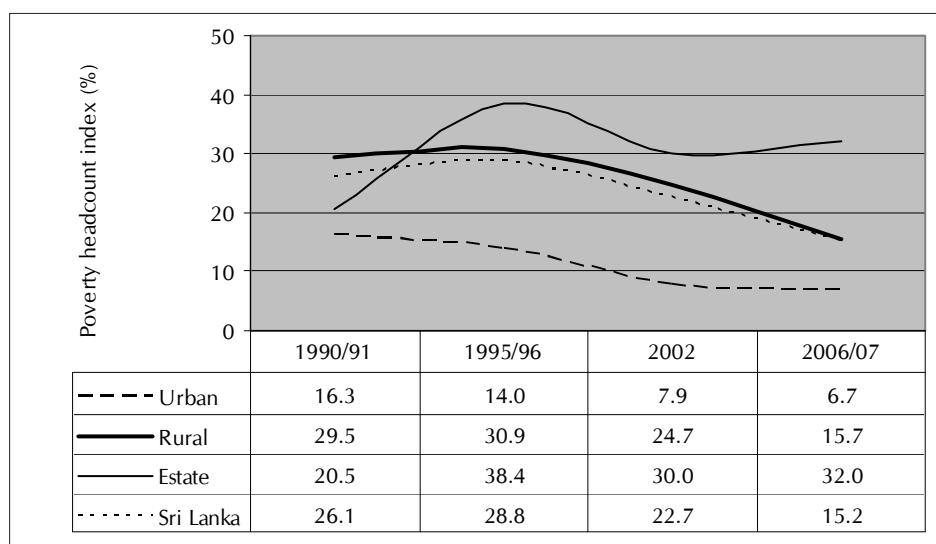
previous surveys),⁴ the total number of poor in the country would be 2.7 million. Compared to 2002, this is a half a million reduction in the number of the poor in areas other than those in the Northern and Eastern provinces, and is an encouraging development.

The Poverty Headcount Index (HCI) values computed by the DCS show a modest decline in the incidence of poverty from 26.1 per cent in 1990/91 to 22.7 per cent in 2002. During 1990/91 to 1995/96, poverty at the national level increased by almost 3 percentage points and then fell by more than 6 percentage points during the 7 year period from 1995/96 to 2002. During the 4 year period from 2002 to 2006/07, poverty at the national level has declined by 7.5 percentage points, which is a remarkable achievement. However, this situation may have since changed due to significant increases in the prices of consumer items more recently. The computations of the incidence of poverty for 2006/07, for example, are based on the Of-

ficial Poverty Line (OPL) of Rs. 2233 real total expenditure per person per month. As of April 2008, the OPL had increased to Rs. 2924. As such, there may be a possibility for some of the non-poor families to have also slipped into poverty due to the increases in prices of most consumer items.

The urban sector shows a continuous reduction in poverty from 16.3 per cent in 1990/91 to 6.7 per cent in 2006/07. This may be due to the relatively higher economic growth in the urbanized Western Province in which around 60 per cent of the urban population of Sri Lanka is located. Most of the major economic activities are still concentrated in the Western Province and the benefits of economic growth are still confined to this province. The HCI values given in Figure 5.1 show that urban poverty has declined by 8.4 percentage points during 1990/01 to 2002. However, during 2002 to 2006/07, poverty has declined only by 1.2 percentage points in the urban sector.

Figure 5.1
Poverty Headcount Index by Sector – 1990/91, 1995/96, 2002 and 2006/07



Source: DCS, Household Income and Expenditure Surveys – 1990/91, 1995/96, 2002 and 2006/07.

⁴ In the HIES-2002, Batticaloa and Ampara districts were not covered.

The rural sector which accounts for nearly 80 per cent of the total population in Sri Lanka is the main contributor to the reduction of poverty at the national level.⁵ The HCI for this sector has reduced from 29.4 per cent in 1990/91 to 15.7 per cent in 2006/07. The reduction during the 12 year period from 1990/91 to 2002 has been very slow (only 4.7 percentage points). However, during the 4 year period from 2002 to 2006/07, poverty in the rural sector has reduced by 9 percentage points. This remarkable achievement in the rural sector may be due to various infrastructure development programmes aimed at providing improved urban-rural connectivity, better access to basic needs - such as health, education, marketing and banking - to reduce poverty levels and contribute to develop self-reliance among rural communities. Another factor may have been the post-tsunami development activities in the districts in the coastal belt, especially those in the Southern Province.

The incidence of poverty in the estate sector (which accounts for around 5.5 per cent of the total population of Sri Lanka) has increased from 20.5 per cent in 1990/91 to 32 per cent in 2006/07 - a 60 per cent increase during the 16 year period. There was a sharp in-

crease in poverty from 20.5 per cent in 1990/91 to 38.4 per cent in 1995/96. From 1995/96 to 2002, poverty in this sector also declined (to 30 per cent) like in the other two sectors. However, when there is an encouraging reduction in poverty throughout the country, especially in the rural sector, poverty in the estate sector has increased further. As such, urgent attention of the relevant authorities is needed to investigate the reasons for such an increase, especially when funds have been allocated to improve the estate infrastructure and other facilities.

The other important measure of poverty, namely the depth of poverty (poverty gap), is used to measure the financial resources (shortfall) needed by a poor person to move out of poverty (or the gap between the total consumption value of a poor person and the value of the poverty line). Table 5.1 shows that the trends are similar to the trends in the HCI. At the national level, the Poverty Gap Index (PGI) has declined by 44.6 per cent between 1990/91 and 2006/07. In the urban and rural sectors, the PGI has declined by 64.9 and 49.2 per cent, respectively. However, in the estate sector, the PGI has increased by 87.9 per cent during this period.

Table 5.1
Poverty Gap Index by Sectors - 1990/91, 1995/96, 2002 and 2006/07

Sector	Poverty Gap Index (%)			
	1990/91	1995/96	2002	2006/07
Sri Lanka	5.6	6.6	5.1	3.1
Urban	3.7	2.9	1.7	1.3
Rural	6.3	7.2	5.6	3.2
Estate	3.3	7.9	6.0	6.2

Source: DCS, *Household Income and Expenditure Surveys - 1990/91, 1995/96, 2002 and 2006/07*.

⁵ The rural sector comprises all areas other than the Municipal Council (MCs) areas, Urban Council (UCs) areas, and the estates.

According to the latest poverty estimates (2006/07) of the DCS, the Nuwara Eliya and Monaragala districts are the poorest districts in Sri Lanka. The incidence of poverty has declined in all the districts except in that of Nuwara Eliya. The HCI for Nuwara Eliya has increased by almost by 50 per cent from 22.6 in 2002 to 33.8 per cent in 2006/07.

The Badulla and Monaragala districts were the poorest districts in 2002 with a HCI value of 37.3 and 37.2 per cent, respectively. The HCI of Badulla has declined by 13.6 percentage points, while the reduction in Monaragala district is only 4 percentage points.⁶ By contrast, the Hambantota district - which was among the poorest districts

with the HCI greater than 30 per cent throughout 1990/91 to 2002 - has made a remarkable improvement by reducing the incidence of poverty by 19.5 percentage points (from 32.2 in 2002 to 12.7 per cent in 2006/07). This achievement in reduction of poverty has brought the Hambantota district even above that of Kalutara in the Western Province. The Puttalam district has also shown a remarkable improvement compared to 2002. The HCI has declined from 31.3 per cent in 2002 to 13.1 per cent in 2006/07.

Table 5.2 and the Figure 5.2 clearly show that poverty in Sri Lanka was highest in 1995/96. This was due to the severe and wide-

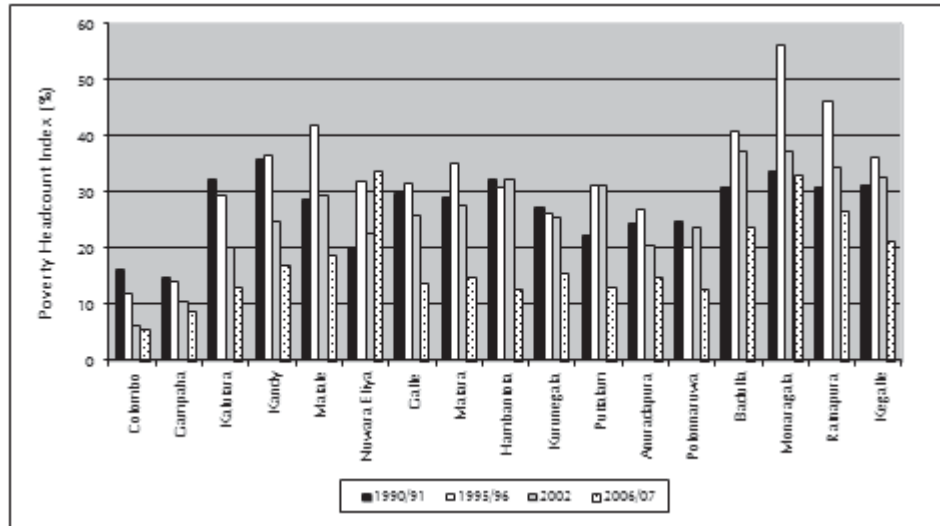
Table 5.2
Poverty Headcount Index by Districts - 1990/91, 1995/96,
2002 and 2006/07

Districts	1990/91	1995/96	2002	2006/07
Colombo	16	12	6	5
Gampaha	15	14	11	9
Kalutara	32	30	20	13
Kandy	36	37	25	17
Matale	29	42	30	19
Nuwara Eliya	20	32	23	34
Galle	30	32	26	14
Matara	29	35	28	15
Hambantota	32	31	32	13
Kurunegala	27	26	25	15
Puttalam	22	31	31	13
Anuradhapura	24	27	20	15
Polonnaruwa	25	20	24	13
Badulla	31	41	37	24
Monaragala	34	56	37	33
Ratnapura	31	46	34	27
Kegalle	31	36	33	21
Batticaloa		11		
Ampara		11		
Sri Lanka	26.1	28.8	22.7	15.2

Source: DCS, *Household Income and Expenditure Surveys 1990/91, 1995/96, 2002 and 2006/07*.

⁶ Ratnapura is another district which needs attention. Although the incidence of poverty has reduced from 34.4 per cent in 2002 to 26.6 per cent in 2006/07, the Ratnapura district records the highest number of poor persons (292,000).

Figure 5.2
Poverty Headcount Index by Districts – 1990/91, 1995/96, 2002 and 2006/07



Source: DCS, Household Income and Expenditure Surveys – 1990/91, 1995/96, 2002 and 2006/07.

spread drought which affected the entire country. After mid-1990s, the incidence of poverty had been declining gradually in all the districts except Nuwara Eliya. Figure 5.2 clearly shows that in 2006/07, there has been a significant reduction in poverty in Kalutara, Kandy, Matale, Galle, Matara, Hambantota, Kurunegala, Puttalam, Anuradhapura, Polonnaruwa, Badulla and Kegalle districts.

When planning and implementing poverty reduction strategies, it is necessary to consider not only the HCI in each region but also the total number of poor persons living in those regions. Out of the total 2.8 million poor persons in the country in 2006/07, 16.8 per cent (471,000 persons) are from the districts in the Western Province, although the province reports the lowest HCI of 8.2 per cent. When considering the number of poor people, the Western Province is second to only the Central Province where 22.3 per cent (or 573,000 persons) are poor. As such, the poor in districts such as Colombo, Gampaha, etc. where the HCI is low cannot be ignored when poverty reduction strategies are implemented. Elsewhere, a total of

467,000 or 16.6 per cent of the total number of poor persons are from the Sabaragamuwa Province. The Ratnapura district has by far the largest number of poor persons (292,000) in the country, which amounts to 10.4 per cent of the total number of poor. The Kurunegala district with a HCI of 15.4 per cent has 238,000 or 8.5 per cent of the poor. It is important, therefore, to consider both HCI and the number of poor persons when planning and implementing poverty reduction strategies and welfare programmes.

In terms of equity, Table 5.3 and Figure 5.3 give the share of household income to total household income by household income deciles for the years 1990/91, 1995/96, 2002 and 2006. Figure 5.3 clearly shows that income inequality has not changed from 1990 to 2006, although income levels have increased. While the share of the richest 10 per cent was fluctuating at around 36 to 40 per cent of total household income, the share of the poorest 10 per cent has remained at less than 2 per cent. The share of the poorest 20 per cent has remained at around 5 per

Table 5.3
Share of Income to Total Household Income by National Household
Income Deciles – 1990/91, 1995/96, 2002 and 2006/07

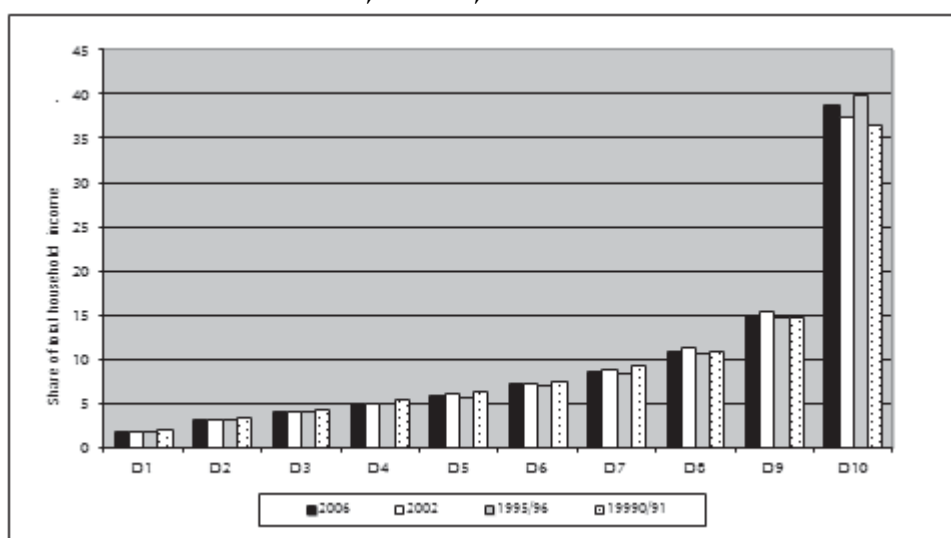
Household Income Decile	Mean Household Income per Month (Rs.)				Percentage Share of Household Income			
	2006/07	2002	1995/96	1990/91	2006	2002	1995/96	1990/91
D1	4412	2123	1139	1661	1.7	1.7	1.8	1.9
D2	7789	3971	1938	1165	3.1	3.1	3.0	3.3
D3	10207	5251	2614	1540	4.0	4.1	4.0	4.3
D4	12472	6444	3210	1900	4.9	5.0	5.0	5.3
D5	14999	7753	3830	2256	5.9	6.0	5.7	6.4
D6	18107	9295	4515	2646	7.1	7.3	6.9	7.5
D7	21898	11319	5535	3176	8.6	8.8	8.4	9.2
D8	27654	14328	7092	3935	10.9	11.2	10.7	10.8
D9	38213	19666	9750	5309	15.0	15.4	14.7	14.8
D10	98500	47569	26187	12963	38.7	37.4	39.8	36.5
All Groups	25414	12804	6579	3549	100.0	100.0	100.0	100.0
First two deciles (D1 and D2)					4.8	4.8	5.4	5.2
Last two deciles (D9 and D10)					53.7	52.8	50.3	51.3
First five deciles (D1 to D5)					19.7	19.9	21.5	21.2
Last five deciles (D6 to D10)					80.3	80.1	78.1	78.8

Source: DCS, Household Income and Expenditure Surveys – 1990/91, 1995/96, 2002 and 2006/07.

cent of total household income. Even though GDP growth rates have been increasing gradually, and the overall incidence of poverty has been reducing throughout the country, in-

come inequality has remained more or less the same throughout the period under consideration. The surveys conducted even in the 1980s show a similar pattern.

Figure 5.3
Share of Household Income by Income Deciles
1990/91, 1995/96, 2002 and 2006/07



Source: DCS, Household Income and Expenditure Surveys - 1990/91, 1995/96, 2002 and 2006/07.

Table 5.4
Inequality: Gini Coefficients for Household Incomes 1980/81 to 2006/07

Year	Sri Lanka	Gini Coefficient for Household Incomes		
		Urban	Rural	Estate
1980/81	0.43	0.44	0.38	0.27
1985/86	0.46	0.48	0.43	0.31
1990/91	0.47	0.62	0.42	0.25
1995/96	0.46	0.47	0.46	0.34
2002	0.47	0.48	0.45	0.34
2006/07	0.48	0.55	0.45	0.41

Source: DCS, *Household Income and Expenditure Surveys – 1990/91, 1995/96, 2002 and 2006/07*.

Table 5.4 gives the Gini coefficients of household incomes for the same period by sectors. The Gini coefficient of the mean household income at national level has been fluctuating between 0.43 and 0.48. The rural sector also shows a similar pattern, except in 1980/81. Income inequality is lowest in the estate sector.

5.3 Inadequate Infrastructure and the Poor

Infrastructure is a key element of poverty reduction. It acts as a catalyst to development and enhances the impact of interventions to improve access to services and available opportunities for the poor. For instance, without proper access roads, the poor are not able to take their produce to the nearby towns or markets, send their children to schools with better facilities, etc. Without electricity, industrial development which provides the poor with opportunities for employment closer to their own areas of living is not likely to take off. Non-availability of safe drinking water may expose the poor to waterborne diseases and thus lower their ability to engage in economic activities. Lack of or inadequacy of water also affects their ability to engage in agricultural and other related activities. Rural infrastructure investments can lead to higher farm and non-farm productivity, employment and income opportunities, in-

creased availability of goods and services, and reduce poverty by raising the mean income and consumption. Investment in rural infrastructure remains critical given that the rural sector is home to the large majority of the poor (93.4 per cent in 2006/07) in Sri Lanka.

5.3.1 Roads

A proper road network, including access roads to rural areas, is a crucial infrastructure requirement to reduce poverty in rural Sri Lanka. There is a significant correlation between accessibility and incidence of poverty as detailed in the World Bank's *Poverty Assessment Report of 2007* for Sri Lanka.⁷ Accessibility in the Colombo district and surrounding regions is high, but declines rapidly with the distance from Colombo. Most of the roads in rural and estate areas have not been properly maintained. Thus, accessibility is very low, especially during rainy seasons.

Inadequate accessibility affects the lives of the people in these regions in many ways. Education of children is affected as it is difficult for parents in these regions to send their children to schools with better facilities, often in distant locations. Access to health services and facilities is also constrained. Although health services in Sri Lanka are pro-

⁷ Regression estimates of poverty headcount (computed by DCS) on accessibility index (computed by the World Bank) have confirmed a significant correlation (of -0.58) between these two indices.

vided free for all, the people in these regions find it difficult and time consuming to reach available facilities. It is especially crucial in an emergency situation. In terms of earning livelihoods, marketing of agricultural and other types of produce is constrained given that transporting the produce to market centres in nearby towns without proper roads is a major problem to most of the poor. Other problems relate to getting access to agricultural extension services, obtaining agricultural and other inputs and services, etc. due to lack of proper roads and transport services.

5.3.2 Electricity

Energy is another vital aspect of infrastructure. Access to electricity is commonly used to measure equitability of infrastructure services in the country. Lack of access to electricity often exacerbates and perpetuates poverty. As such, electricity is an essential component for reduction of poverty. Although 80.4 per cent of households in Sri Lanka have electricity according to the latest HIES-2006/07 data, there are disparities at sectoral levels (urban, 94.2 per cent; rural, 78.8 per cent; and estate, 67.0 per cent).

Electricity contributes significantly to the growth of the rural non-farm sector, leading to poverty reduction. Electricity also raises the use of technology, both in agricultural and non-agricultural activities, which contributes directly to enhance opportunities and incomes of the poor. It is encouraging to note that the country's installed capacity of electricity has increased from 1,575 MW in 1997 to 2,429 MW by 2006 (an increase of 54 per cent). The increase is almost entirely through thermal power. As the growth in the demand for electricity is estimated to be 8-10 per cent annually, it is important to increase the in-

stalled capacity to meet the current and future demand, taking into consideration the additional demand due to new development activities taking place in the regions outside the Western Province.

5.3.3 Water and Access to Safe Drinking Water

Inadequacy of water for agricultural activities, as well as for drinking, is one of the major problems in some areas, especially in the dry zone. Although at the national level 85 per cent of the households have access to safe drinking water, in the estate sector only 58 per cent of the households have this facility. Corresponding percentages for urban and rural sectors are 95.4 and 84.6 per cent, respectively. Adequate irrigation facilities significantly contribute to farm productivity and wages, reducing poverty and income inequality.

5.3.4 Communication

Access to telecommunication services shows a clear increase in recent years. The number of fixed telephone lines has increased from 2 per 100 persons in 1997 to 7.9 per 100 persons in 2006. However, there are significant disparities between sectors and regions (urban, 11.4; rural, 7.6; and estate, 2.4 per 100 persons). The mobile phone subscribers are increasing at a rapid rate. At present, there are 5.4 million subscribers, which is an increase of more than 47 times compared to 1997. However, fixed access line services need to be improved further, because such lines are still a major requirement to access internet and e-mail facilities. The access to such services is still concentrated in urban centres though there is a certain level of penetration to rural areas. Information and communication technology (ICT) based networks

Net enrolment ratio in primary education	-	97.5 %
Literacy rate of 15 - 24 year old persons	-	95.8 %
Proportion of pupils starting Grade 1 who reach Grade 5	-	99.3 %

- such as 'Nenasalas' (Knowledge Centres)⁸
 - have been initiated to serve rural and semi-urban populations. The objective is to empower rural communities with affordable access to such services. Lack of access to timely, accurate and full information is likely to deprive the poor from realizing the full benefits of economic opportunities. Continuous improvement of information infrastructure covering all the regions is critical to the development of all regions.

5.4 Quality Education for All

Sri Lanka has been cited often as having high education achievements and learning when compared to counterparts in South Asia. This reputation has been largely built on the high literacy levels and the high levels of primary enrolment, as well as the gender parity in education access and achievements.

While there is an encouraging improvement in literacy rates, enrolment and educational facilities in numerical terms, a key question is whether the quality of education imparted has been up to the desired level. Education in Sri Lanka is viewed as a basic right and governments from as early as 1943 adopted policies to encourage schooling amongst children. Governments have been committed to supporting "Education for All" adhering to ethics and standards as proclaimed by provisions in international conventions. Accordingly, schooling for 5-14 age groups was made mandatory by Parliament in 1997 and implemented from 1998. Under this legislation, enrolment and attendance of children between the ages of 5-14 years was made compulsory.

The present management structure of education in the country is a shared function between the centre and the provinces. An im-

portant constitutional amendment that led to far reaching effects on the management of the education system has been the 13th Amendment to the Constitution. Free education is given in all government schools. The expansion of the school system to cope with rising demand for education infrastructure development with state funding enabled the system to make significant strides, thereby ensuring universal access to education. Government incentives include free textbooks, material for school uniforms, and subsidized transport. Deserving students from low-income families are also provided with bursaries to meet their other expenses, which are continued up to university.

The public sector dominates the primary and secondary education accounting for nearly 4 million school children, enrolled in about 9,700 public schools. Among these, almost one-third of the schools have classes either up to Grade 5 or Grade 8. More than 50 per cent of schools are small schools with less than 250 students. Science education in grades 12-13 is confined to only 7 per cent of schools with these grades. Information technology education is still in the early stages of development in schools.

Although quantitatively Sri Lanka has creditable achievements at the national level with regard to primary education, there are variations in the system across geographic and socio-economic levels of the population - such as the rural hinterland, conflict affected areas and the estate sector. In the estate sector, the literacy rate of 15-24 year old persons is around 84 per cent which is far below the national level, and the net enrolment ratio in primary education is about 94 per cent.⁹

⁸ Under the 'Vidhartha' programme, ICT centres for the rural youth have also been initiated.

⁹ <http://www.statistics.gov.lk/MDG/Indicators%20New/indica6.pdf>.

An IPS research study examining education participation in Sri Lanka has shown that poverty is one of the major reasons for non-attendance of school.¹⁰ Education is provided by the government as a consequence of the principle of free education. However, in examining how supply side inadequacies affect the schooling of children, the study also finds that it is timely to focus on the ability of the poorest of the poor to make use of free education and on the quality of education provided by these state facilities. In recent years, government and public attention has begun to focus on learning achievements beyond basic literacy. The need for improving the quality of education has been intensified to reduce the mismatch between education and employment.

Given this backdrop, the following discussion attempts to assess existing disparities in service delivery in education to the poor by focusing on current problems in accessibility, quality of education, and issues in administration.

5.4.1 Poor Accessibility

As described in the previous sections, some villages are located in remote areas with poor roads and limited access to services such as schools, transport, electricity, etc. These villagers tend to come from a category at the bottom of the economic ladder. Further, the children of estate workers are also disadvantaged and have limited access to standard education facilities. The key problem faced by children in these regions is the lack of facilities, preventing access to services available outside the village or estate. Poverty in these communities is not merely due to lack of economic assets. Social marginalization, geographical isolation, powerlessness and an

inability to access resources also contributes to this condition.

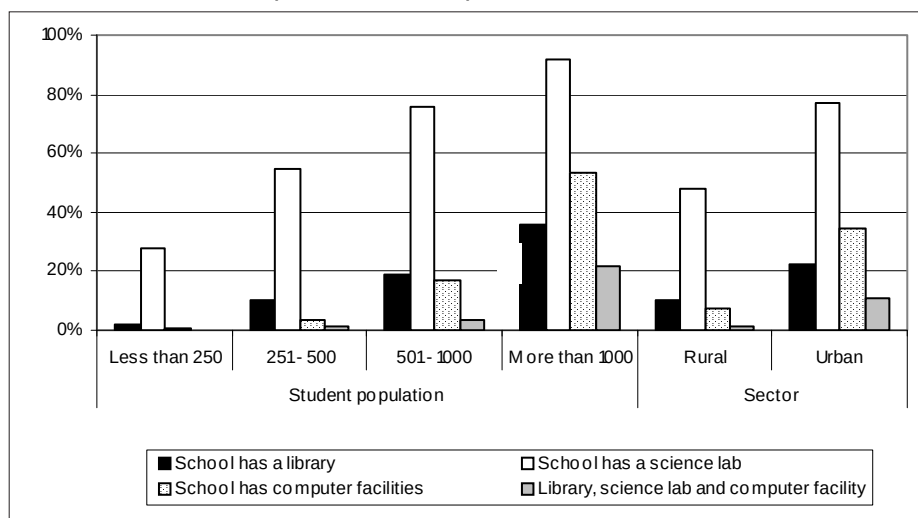
Although the span of compulsory education according to the law is 14 years, the drop-out rate from Grade 6 onwards is higher than the drop-out rate of the primary grades. As evidenced by previous studies, 18 per cent of children do not complete Grade 9, the current level of compulsory education.¹¹ Hence, there still exists a considerable challenge to meet the target of providing all children between ages 5-14 with 9 years of schooling. An equity issue exists as the majority of these children who drop out are from economically disadvantaged groups in society. The reasons for the non-participation are complex, broadly described as socio-economic, with the principal factor being poverty.

In the Northern and Eastern Provinces, several hundred thousands of families have been displaced from their homes, exposed to violence, loss of life and disability, subjected to extended stays in welfare centres, and forced to bear the physical and emotional strains of the long-standing conflict. As a result, mainstream education system in these provinces has been subject to disruption. Children have dropped out of school, or attend irregularly, for a variety of reasons related to the conflict, including displacement, destruction of school buildings, shortages of teachers, poor quality of education, poverty, lack of school infrastructure, unfriendly school environment, and child recruitment into militias. Strong policy action is needed to reach these vulnerable socio-economic groups and achieve the target of universal enrolment and completion in the compulsory education cycle.

¹⁰ Arunatilake, N., (2006), "Education Participation in Sri Lanka: Why All Are Not In School", *International Journal of Educational Research*, 45, 137-152.

¹¹ World Bank (2005), "Treasures of the Education System in Sri Lanka", Colombo, Sri Lanka: The World Bank, Human Resource Development Unit.

Figure 5.4
Availability of Resources, by Size and Location of School



Source: Calculations based on Ministry of Education, *School Census* 2004.

It has been found that schools offering science subjects in GCE (A/L) are not rationally located and a majority of these are to be found in urban areas. The overall ratio of the number of students per school having advanced level science stream is about 5800:1 for the country as a whole. The above ratio is considerably higher for Anuradhapura, Ratnapura, Monaragala, Batticaloa and Polonnaruwa districts, ranging from 7048:1 to 8556:1. This shows that only a limited number of students are privileged to follow the science streams up to GCE (A/L). Rural children from poor families with financial constraints have no options other than to choose a resource-poor secondary school that offers only arts or arts/commerce streams.

5.4.2 Problems with Quality for Poorer Schools

There are significant constraints in physical and human resources in schools. All children should have equal opportunity to successfully complete a basic education. The Compulsory Education Regulations No.

1003/5 of 1997 addresses the issue of the inability of the economically disadvantaged to utilize free education made available by the state. However, these regulations do not go far enough to address the issue of quality compulsory education.

Resource constraints have also led to a decline in the quality of education provided by schools. An IPS study which assessed school level resource showed that the percentage of small schools and rural schools having libraries, science labs and computer facilities are extremely low (Figure 5.4).¹² The majority of small schools are situated in rural areas.

Since 2000, a 'school rationalization programme' has been implemented which aims to absorb smaller schools into nearby bigger schools. The official policy and programme of closing small schools with low student enrolment was to rationalize the distribution of schools and to eliminate wastage of resources. However, the closure of such

¹² Arunatilake, N., and P. Jayawardena, "Will Formula Based Funding and Decentralized Management Improve School Level Resources in Sri Lanka?", Poverty and Economic Policy Research Network Working Paper (forthcoming).

Table 5.5
Proportion of Primary Children Achieving Mastery of Numeracy Skills (2003)

Skills	Sri Lanka	Urban Sector	Rural Sector
Concepts	45	58	42
Procedures	51	56	40
Problem solving	34	39	26
Total	38	52	35

Source: World Bank 2004, *Sri Lanka: Development Policy Review*.

small schools will deprive the children of poor families in these villages of the only opportunity they had for education, even with limited facilities.

On the other hand, lack of qualified teachers and disparities in teacher deployment has lead to a situation where schools which cater to the vulnerable are faced with acute shortages of teachers. Where a teacher is not available for each grade, teachers need to teach across grades or leave pupils without a teacher for some periods of the day. In 2006, 124 schools had only one teacher at each school. These schools are located mainly in economically disadvantaged rural and plantation areas. For example, 48 schools in Vavuniya, 17 schools in Badulla, 10 schools in Anuradhapura, and 10 schools Ratnapura district had one teacher per school.

These figures, bad as they are, do not show the true picture of educational problems, which in reality is even more disturbing. These aggregates do not show the internal disparities within a district. It is clearly seen that within such districts, facilities are concentrated in the urban and suburban centres, leaving out the rural areas. As such, parents - who are the best judges - struggle to get their children into urban schools. It is the economically disadvantaged people who have been forced to send their children unwillingly to village schools.

The realities of educational outcomes are also cause for concern. Sri Lanka's impressive edu-

cation indicators mask serious deficiencies in the quality and efficiency of education. Both activity based learning and teaching as well as personality development have received low priority in rural schools. Cognitive achievement tests among primary schools in Sri Lanka show shortfalls in the mastery of basic language and numeracy skills.

The data show that the primary level students in the rural sector performed poorly compared to those in the urban sector. Only 37 per cent of students mastered language skills (Sinhala or Tamil), while a mere 10 per cent mastered English language skills. While levels of vocabulary (in the first language) are above 60 per cent, written and syntax skills are less than 30 per cent in the rural sector. Only 38 per cent of students have mastered numeracy skills (Table 5.5).¹³

The quality of education in terms of infrastructure, distribution of teaching resources and the learning-teaching process in the classroom is reflected in a low pass rate at the GCE (O/L) examination in Grade 11. In 2006, 59 per cent of students completing Grade 11 failed to obtain 6 passes which included the first language and mathematics. Notwithstanding, or rather because of, the undue emphasis on quantitative expansion in education at the expense of quality, the Colombo district has broken away from other districts and is leading other districts in this field. In the Colombo district, the GCE (A/L) qualifying rate is 66 per cent as against the national average of 51 per cent. In terms of the pass

¹³ World Bank (2005), "Treasures of the Education System in Sri Lanka", The World Bank, Human Resource Development Unit.

rates of mathematics and the first language at the GCE (O/L) exam, it scores 57 per cent against an average of 41 per cent at the national level.

The growth trajectory is best depicted in the nature of education in its urban centres. These schools show a clear dominance over their counterparts in other districts. As explained in the previous sections, the poorest districts of the country such as Monaragala, Nuwara-Eliya and Mulativu, remain well below the national averages. The Monaragala and Nuwara-Eliya districts have the lowest passing rate for GCE (O/L) - 36 per cent and 37 per cent, respectively. Moreover, in the Monaragala district, 17 per cent of children who sat for the GCE (O/L) exam have failed in all subjects. This is consistent with other studies which show that the North-Central Province is one of the most educationally disadvantaged regions of the country.¹⁴ In addition, absenteeism in Uva and North-Central Provinces is close to 20 per cent.

5.4.3 Issues in Administration

The education governance structure in Sri Lanka is complex because it encompasses several aspects of devolution of power. The education sector is one of the most decentralized service sectors in the country. However, despite some excellent institutional foundations for service delivery, there are serious gaps in the education system. Some of these issues in service delivery are opaque teacher recruitment, irrational deployment of teachers, teacher absenteeism, poor motivation, lack of academic empowerment and political interference.

The efficient functioning of decentralized schemes depends largely on the managerial capacity of the principal. The management

of the education system - delivery of services, supervision, administration and monitoring - has been reported to be weak at the local level, underscoring the need for capacity building of educational personnel at all levels and the adoption of effective monitoring mechanisms.¹⁵ The village school is often understaffed, without good and specialized teachers. All efforts of successive Ministers of Education have failed to move out this urban surplus into the deficit areas. The weak quality of educational services for the poor is shown by the refusal of teachers to be deployed into remote areas. Furthermore, there are problems with delivery of free school text books, especially to schools in the less developed regions which need to be streamlined, as many schools do not receive the text books in time. This too affects the education of rural children.

In addition, policy consistency and uninterrupted implementation of reforms is imperative for continuity of best practices. It is often the case that the lift-off to sound educational attainment is preceded by uninterrupted cycles of policy reforms for modernization.

5.4.4 Reaching Out to School Drop-outs

As discussed in the previous sections, the drop-out rate beyond primary education is higher in rural districts, plantation districts, and deprived pockets in urban areas. According to estimates, approximately 10 per cent of school going children in the age group 5-14 years is not attending schools.¹⁶ These include children of poor families, those in rural, plantation and urban deprived pockets, street children, orphans, disabled, children dwelling in coastal areas, in probation centres, and those displaced due to the conflict in the North and East of the country.

¹⁴ Ibid.

¹⁵ Arunatilake, N., and P. Jayawardena, "Will Formula Based Funding and Decentralized Management Improve School Level Resources in Sri Lanka?", Poverty and Economic Policy Research Network Working Paper (forthcoming).

¹⁶ Ministry of Education (2004), "The Development of Education: National Report", Ministry of Education, Sri Lanka.

Various policy measures were introduced to ensure that such children receive formal education and benefit from social welfare programmes. Such programmes range from early childhood care to secondary education, non-formal education and the development of education in conflict affected areas. The Non-formal Education Unit in the Ministry of Education is charged with the responsibility of identifying and providing them alternate opportunities for education.

Disabled children are provided with appropriate educational facilities in normal schools through integration and inclusion. Every effort has been taken to keep a disabled child in the normal class in line with the principles of inclusive education. Disabled children who need special individualized care are admitted to special education units established in schools selected according to the needs. The Special Education Unit at the National Institute of Education (NIE) prepares education materials for children with special needs, and provides training for teachers.

Literacy centres in disadvantaged pockets have been established to address the needs of children who have either dropped out or are not attending schools. A significant number of students are transferred from these centres to formal schools every year. Further, community learning centres have been established to service the education needs of children who drop out from schools and those who cannot be enrolled in formal schools.

Children in conflict affected areas are included in special programmes with the assistance of donor agencies to ensure the inclusion of displaced children, refugee children and orphans in formal education or the provision of alternate educational arrangements. In these areas, targeted programmes

such as Catch-Up-Education (CUE) classes are held for children who have missed several years of schooling and need accelerated learning opportunities to catch up with their peers. The UNICEF and the NIE, alongside the provincial and zonal education authorities have developed standardized materials for CUE. In addition, there are intensive teacher training programmes to ensure a sufficient number of qualified teachers to implement the programme.

On the demand side, a survey on CUE has examined how well CUE programmes are addressing the needs of the children who have difficulties in the mainstream education system.¹⁷ Given that many children involved in CUE programmes are poor, they may need additional support once they are integrated into the school system. The disappointment on implementation of the CUE programme is the seeming lack of recognition of the need to identify and address the particular challenges and problems. The evidence also shows that there are problems in reaching out to children in isolated areas. The types of assistance needed are different from place to place. In some places, the need is to provide affordable transport facilities. In other places, efforts may be needed to take the CUE classes to remote areas.

The implementation of the CUE programme has changed over time. Since 2007, the implementation of CUE programmes has been carried out through the Central Ministry of Education. At present, the provincial non-formal education coordinator is in charge of the CUE in each province. Earlier it was implemented by the Provincial Education Departments or in some cases by the Zonal Education Offices in coordination with local and international NGOs. However, the government has not been able to influence the coordination of different actors in these

¹⁷ Arunatilake, N., and P. Jayawardena, (2008), "Catch Up Education", IPS, mimeo.

provinces and lack of coordination had led to some frustration on the part of the NGOs.

5.5 Health: Non Communicable Diseases, Service Delivery and the Poor

Despite being a relatively low spender on health, Sri Lanka is regarded as a success in achieving most health outcomes much earlier than other regional counterparts. Key health indicators such as Maternal Mortality Rate (MMR) and Infant Mortality Rate (IMR) are almost at the level of developed economies. Further, Sri Lanka's health system has also attained a greater control over many infectious diseases than previously. However, due to economical, demographical and nutritional changes that have taken place during the last few decades, the country is set to face another set of emerging health challenges. The rising trend of Non Communicable Diseases (NCDs) is one such challenge.

The World Health Organization (WHO) distinguishes Communicable Diseases and NCDs by defining chronic NCDs as "diseases that have one or more of the following characteristics: they are permanent, leave residual disability, are caused by non-reversible pathological alterations, require special training of the patient for rehabilitation, or may be expected to require a long period of supervision, observation and care."¹⁸ At present, the world is experiencing a declining trend in the deaths attributable to communicable, maternal, pre-natal and nutritional conditions. This is mainly due to the developments that have taken place in medical science and in health care service delivery channels during the last few decades. In 2002, out of 57

million total reported deaths, 59 per cent were due to the NCDs.¹⁹ According to the WHO projections this will increase up to 65 per cent and 69 per cent by 2015 and 2030, respectively. In many countries, despite their development status, NCDs have become the main cause of the majority of deaths. Other than in the African region, the major proportion of total deaths in the world was due to NCDs in 2005.²⁰

The Sri Lankan situation is no exception to the world situation. In 2002, of a total of 145,500 deaths reported in Sri Lanka, 110,700 were due to the NCDs (i.e., 77 per cent). Cardiovascular disease (34 per cent of the total deaths), cancer (13 per cent), chronic respiratory disease and diabetes are the most common chronic NCDs in Sri Lanka.²¹ In 1980, there were only 6.4 deaths per 100,000 population due to neoplasms, but this had increased up to 14 by 2005.²²

There are many aspects of a person's life that would act as a NCD risk factor. The WHO defines a risk factor as an aspect of personal behaviour or lifestyle, environmental exposure, or inborn or inherited characteristic which, on the basis of epidemiologic evidence, is known to be associated with a health-related condition considered important to prevent. NCDs' risk factors can be broadly identified under four major categories:

- (i) Non-modifiable risk factors,
- (ii) Individual risk factors
- (iii) Health service risk factors
- (iv) Environmental risk factors

¹⁸ See WHO (2007), "Integrating Poverty and Gender into Health Programmes; Module on Non Communicable Diseases". The following diseases – Malignant neoplasms, Other neoplasms, Diabetes mellitus, Endocrine disorders, Neuro-psychiatric conditions, Sense organ diseases, Cardiovascular diseases, Respiratory diseases, Digestive diseases, Genito-urinary diseases, Skin diseases, Musculoskeletal diseases, Congenital anomalies and Oral conditions – have been considered by the WHO as NCDs for the World Health Survey of 2002.

¹⁹ <http://www.who.int/entity/healthinfo/statistics/bodgbdeathdalyestimates.xls>.

²⁰ http://www.who.int/entity/healthinfo/statistics/bod_deathbyregion.xls.

²¹ http://www.who.int/chp/chronic_disease_report/sri_lanka.pdf.

²² Annual Health Bulletin 2004/2005, Department of Health Services, Sri Lanka.

Age, gender, ethnicity, family history and genetic make-up come under the non-modifiable NCD risk factors. Out of these non-modifiable risk factors, ageing has become a critical issue in Sri Lanka. In 2004, life expectancy at birth was 71.7 and 77 for males and females, respectively. On the other hand, the total fertility rate has declined from 5.0 in 1963 to 1.9 during 1995-2000,²³ indicating an increasing trend of elderly in the population. In 1981, the elderly population (60 years and above) was only 6.6 per cent of the total population. This has increased up to 9.4 per cent by 2005. It has been projected that this will increase up to 13.5 per cent and 18.6 per cent by 2011 and 2021, respectively. Nearly one quarter of the total population (23.1 per cent) will be the elderly people by 2031.²⁴

Individual risk factors are mainly caused by biological (obesity, hypertension, protein urea) behavioural (smoking, diet, physical activity and alcohol use), psychological (self-efficacy, self-control, resilience, social support) and early life factors (low birth weight, childhood infection, foetal malnutrition, foetal alcohol syndrome, etc.). During the last few decades, due to rapid socio-economic and demographic changes in Sri Lanka a dramatic transformation has taken place in an average person's lifestyle. Unhealthy dieting patterns, less physical activities, increased smoking and alcohol consumption, and psychological issues have become more evident. For example, per capita consumption of legally produced alcohol was 1.8 litres in 1981, but this has increased up to 7.4 litres by 2003.²⁵ However, the actual per capita alcohol consumption is likely to be much higher as the data on the production and

consumption of illicit alcohol is not available.²⁶

Conditions of the health service also act as a NCDs risk factor. This includes preventive health services and primary care, specialist service and acute care, and ongoing care (rehabilitation and self-management).

In the case of environmental risk factors, there are two main aspects, namely, physical environmental risk factors and social environmental risk factors. Unsafe water, sanitation and hygiene, urban air pollution, indoor smoke from solid fuels, lead exposure and climate change are regarded as major physical environmental risk factors. Cardiovascular diseases, lung cancers, respiratory infections in children and mental retardations are some outcomes of continuous exposure to these environmental risk factors. While 84.7 per cent of Sri Lankan households are estimated to have had access to improved drinking-water sources in 2006 (and 93.9 per cent of households were able to have access to improved sanitation),²⁷ access to safe drinking water is still a challenging issue in some districts of the country. For example, only 46.1 per cent households had access to safe drinking water in the Nuwara Eliya district in 2006 - identified to be the poorest district as per the HIES of 2006/07. The recorded usage of solid fuels is also high in Sri Lanka, especially in the rural and estate sectors. According to the HIES of 2006/07, 86.2 per cent of rural sector households, and 98.1 per cent of estate sector households use firewood as their cooking fuel.

Social environment risk factors include socio-economic conditions, community character-

²³ Annual Health Bulletin 2004/2005, Department of Health Services, Sri Lanka.

²⁴ W. Indralal De Silva (2007), "Beyond Twenty Million: Projecting the Population of Sri Lanka 2001-2081", Demographic Transition and Pension Series No. 6, IPS, Colombo.

²⁵ <http://www.statistics.gov.lk/social/social%20conditions.pdf>.

²⁶ See discussion in this report on "Linkages between Poverty and Alcohol".

²⁷ <http://www.statistics.gov.lk/MDG/MDG%20Indicator1s%20index.htm>.

Table 5.6
Prevalence of Risk Factors in Sri Lanka

Income Quintile	Prevalence of Smoking and Average Daily Tobacco Consumption		Prevalence of Heavy Drinkers		Prevalence of Intake of Fruit and Vegetables		Prevalence of Physical Activity	
	Current	Average	Infrequent	Frequent	Insufficient	Sufficient	Insufficient	Sufficient
Q1 (poorest)	23.2	5.5	2.4	4.7	77.8	22.2	7.7	90.2
Q2	17.9	5.1	1.2	1.6	73.4	26.6	9.8	87.8
Q3	16.1	5.1	1.9	1.5	68.5	31.5	7.2	91.2
Q4	11.6	4.6	1.2	1.5	64.4	35.6	10.6	88.4
Q5 (richest)	9.4	6.0	3.1	2.0	54.8	45.2	14.8	83.7

Notes: Average daily tobacco consumption: Denominator used is current daily smoker.
 Infrequent heavy drinkers: 1-2 days with 5 or more standard drinks per week (last 7 days).
 Frequent heavy drinkers: 3 or more days with 5 or more standard drinks per week (last 7 days).
 Insufficient intake of fruit/vegetables: less than 5 servings of fruit/vegetables per one typical day.
 Insufficient physical activity: less than 150 minutes per week (last 7 days) spent on walking moderate activity/vigorous activity.

Source: WHO, *World Health Survey 2002*.

istics, social capital and public policy over which individuals and households have little direct control. Poor or unfavourable conditions of these social environmental aspects would act as NCD risk factors in the long term.

5.5.1 NCDs and the Poor

For many years, NCDs were regarded as 'lifestyle' diseases and it was believed that only people of affluent social classes faced the risk of getting NCDs. This misconception on NCDs has led the general public, especially the poor, to ignore the gravity of the issue. However, it has now been acknowledged that NCDs are not limited to a certain group of society. When considering NCD risk factors and determinants, it is clear that the poor are the more vulnerable victims. Poor people are exposed to less favourable socio-economic conditions and community characteristics, have less access to social capital, and are marginalized from many community development programmes than the rich. The

WHO also confirms that NCD risk factors are increasingly concentrated in low-income settings and among individuals with the least power to reduce their risk of falling ill.²⁸

Table 5.6 summarizes the prevalence of selected NCD risk factors in each income quintile. The poorest income quintile recorded the highest prevalence rates for most of the risk factors. For example, 23.2 per cent of the poorest were current daily smokers whereas only 9.4 per cent of the richest were daily smokers; 4.7 per cent of the poorest were frequent heavy drinkers, but only 2.0 per cent in the richest quintile were frequent heavy drinkers. Further, 77.8 per cent of the poorest had insufficient fruit and vegetable intake. However, it is worthwhile to note that the majority of every income quintile had insufficient fruit and vegetables intake, including even 54.8 per cent of the richest quintile. In every quintile, more than 80 per cent had sufficient involvement in physical activities. The data also finds that 50.7 per

²⁸ WHO (2007), "Integrating Poverty and Gender into Health Programmes: Module on Non Communicable Diseases", WHO, Manila.

Table 5.7
Dietary Energy Consumption by Poverty Status and Sector in Sri Lanka (2006/07)

Sector	Daily Average Dietary Energy Consumption Per Person			Population Below 20-30 Kcal Level of Dietary Energy Consumption
	Both Poor and Non Poor	Poverty Status		
		Non Poor	Poor	
	Kcal	Kcal	Kcal	%
Sri Lanka	2118	2194	1696	50.7
Urban	1906	1949	1316	65.0
Rural	2138	2222	1686	49.2
Estate	2420	2626	1984	32.7

Source: DCS, *Household Income and Expenditure Survey - 2006/2007*.

cent of the Sri Lankan population had below 2030 kcal level of dietary energy consumption which is the nutritional anchor for the Official Poverty Line in 2006/2007 (Table 5.7). The daily average dietary energy consumption for the non-poor is 2194 kcal, whereas for the poor it is only 1696 kcal. Urban poor had only 1316 kcal per day, indicating the relatively deprived status of the poor.

There is a significant economic burden on the poor from NCDs. Due to any type of disease, three types of costs have to be incurred: direct costs (costs on medication, user fee), indirect costs (food, transportation) and opportunity costs (income that could have been earned if the person was not ill).

A more severe economic strain has to be borne due to a NCD as compared to a communicable disease because of the nature of NCDs. NCDs are permanent in nature and leave residual disabilities. Further, a NCD infected patient requires a longer period of supervision, observation and care. This places a huge economic burden on the poor, especially those who rely on supplying casual labor as their main income source. The situation becomes worse if the patient is the sole breadwinner of the family. Even a household above the poverty line may easily fall below that owing to the economic shock that they have to face with a NCD patient. Economic recovery is also difficult as NCDs are prolonged for a considerable time period and the patient should be looked after with spe-

Table 5.8
Financial Sources Used by Households for Paying for Health Services in Sri Lanka

Income Quintile	Savings	Sold Items	Borrow from Relatives	Borrow from Others	Health Insurance	Current Income	Other
1st (poorest)	2.5	0.9	9.4	3.4	0.0	64.1	8.3
2nd	3.1	1.0	5.8	2.8	0.2	70.9	2.1
3rd	4.6	1.4	2.8	2.7	0.1	75.9	1.5
4th	6.5	0.4	2.7	1.8	0.4	77.2	1.4
5th (richest)	15.6	0.6	1.8	1.4	6.3	76.8	2.1
Total	6.4	0.8	5.2	2.5	1.4	73.0	3.1

Sources: WHO, *World Health Survey 2002*.

<http://www.who.int/healthinfo/survey/whslka-srilanka.pdf>.

<http://www.who.int/healthinfo/survey/whslonghouseholdlow.pdf>.

cial medication, care and attention. This may require the complete dedication of another family member to nurse the patient, forgoing his or her chances of earning an income.

Table 5.8 shows that only 64.1 per cent of the poorest income quintile utilized current income as one means of financing the cost of health services. The data also reveal that 9.4 per cent and 3.4 per cent of the poorest quintile had sought to borrow from relatives and others, respectively. This indicates that the current income of the poorest is not adequate to cover their health expenditures compared to other income quintiles. They face a higher risk of being indebted than other income quintiles. Further, none from the poorest income quintile had utilized health insurance coverage to finance their health expenses.

5.5.2 Service Delivery

Service delivery itself is considered as a NCD risk factor. Therefore, ensuring an effective service delivery in preventive health services and primary care, specialist services and acute care is of vital importance in addressing the problem of NCDs more successfully. Sri Lanka has a well established and organized health service delivery network compared to most other developing countries. The Ministry of Health has the main responsibility of ensuring efficient and effective service delivery in the health sector at the national level, whereas the provincial level responsibility is borne by the Provincial Directors of Health Services (PDHS). There are Deputy Provincial Directors of Health Services (DPDHS) at the regional and district levels to assist the PDHS in each province. In 2005, there were 608 hospitals and 413 central dispensaries all over the country. The total strength of health manpower in 2006 was 104,006. This

included persons attached to both central and provincial institutions.²⁹

The involvement of the private sector in health service delivery is mainly focused on curative care services; their participation in preventive and community health is very limited. During 1990-2004, the number of private hospitals increased from 46 to 72.³⁰ However, there is a high concentration in the Western Province due to the prevalence of various factors such as availability of better infrastructure facilities, a higher population, etc.

There are many issues and challenges in health service delivery. Accessibility is a crucial component in ensuring an efficient service delivery in the health sector. However, accessibility can become a problem due to financial and physical barriers. Although the state health service is provided free of charge to all, there are indirect costs that have to be borne by individuals. In the case of NCDs, unlike communicable diseases, the amount of such costs is much higher, as the patients have to be treated and looked after for a long of period time. Certain medicinal drugs for NCDs are not available in government hospitals. In such a situation, patients are compelled to buy them outside, placing a massive financial burden on the poor. The *World Health Survey 2002* reveals that in Sri Lanka, the poorest income quintile had spent 57.2 per cent of their total out-of-pocket health payments on medicinal drugs, whereas the richest income quintile spent only 36.1 per cent.

Physical barriers arise due to lack of health care institutions with adequate facilities and equipment and health personnel with required skills and competencies. Due to in-

²⁹ Annual Health Bulletin 2004/2005, Department of Health Services, Sri Lanka & <http://www.health.gov.lk>.

³⁰ Census of Private, Co-operative and Estate Hospitals 2006, IPS.

adequate service coverage in rural areas - where the incidence of poverty is high - people have to travel to urban areas to seek health services. Ultimately this increases the total costs of acquiring health services.

There is a wide disparity of service availability of health care facilities across the country. As detailed in Table 5.2, Colombo is the richest district in Sri Lanka having a Pov-

erty Headcount Index (HCI) of 5, while Nuwara Eliya being the poorest district has an HCI of 34. Table 5.9 illustrates how health facilities were distributed among the districts in 2005. The data indicate that 20 per cent of government hospital beds were in the Colombo district with the highest rate of beds (5) per 1000 population. The Colombo district had the privilege of having 128 Medical Officers (MOs) and 230 nurses per 100,000

Table 5.9
Distribution of Health Facilities by District (2005)

District	Government Institutions with Specialties*	Government Hospitals Beds	Government Beds per 1,000 Population	Medical Officers per 100,000 Population	Nurses per 100,000 Population	Public Health Nursing Sisters per 100,000 Population	Public Health Inspectors per 100,000 Population	Specialties in Curative Care
Colombo	9	11,863	5.0	128.2	230.1	2.4	5.5	454
Gampaha	4	4,679	2.2	39.2	73.5	1.8	5.2	159
Kalutara	3	2,707	2.5	40.1	77.1	3.7	8.6	49
Kandy	4	4,482	3.3	90.3	176.2	1.9	6.3	78
Matale	2	1,520	3.3	40.8	82.2	1.9	6.7	19
Nuwara Eliya	1	1,556	2.1	8.8	20.2	0.5	3.3	8
Galle	3	2,982	2.9	68.5	124.0	0.8	7.4	49
Matara	2	2,321	2.9	37.2	84.2	0.6	8.1	18
Hambantota	1	1,466	2.7	29.0	51.1	1.7	10.9	13
Jaffna	2	2,368	3.9	42.1	65.8	0.2	12.1	28
Killinochchi	-	302	2.1	10.3	14.5	0.7	4.1	2
Mannar	1	345	3.5	33.3	40.4	1.0	20.2	7
Vavuniya	1	408	2.8	45.5	58.6	0.7	13.1	15
Mullativu	-	388	2.8	5.0	17.0	0.0	9.9	0
Batticaloa	2	1,258	2.3	26.4	72.5	1.6	7.8	10
Ampara	5	1,989	3.2	41.4	82.5	0.5	14.6	30
Trincomalee	2	924	2.4	36.9	48.5	0.5	10.6	13
Kurunegala	3	4,348	2.9	26.9	93.9	2.5	7.6	44
Puttalam	3	1,714	2.3	54.7	64.9	0.5	5.3	23
Anuradhapura	3	3,060	3.9	43.2	88.0	0.6	10.0	25
Polonnaruwa	2	1,212	3.2	51.2	110.6	1.1	7.7	16
Badulla	3	1,938	2.3	25.5	95.3	1.0	6.9	40
Monaragala	1	1,339	3.2	34.7	53.0	6.0	9.9	6
Ratnapura	4	2,977	2.8	32.9	81.0	0.8	9.6	34
Kegalle	3	2,091	2.6	36.8	52.8	1.3	9.1	23
Sri Lanka	64	60237	3.1	45.6	95.8	1.6	7.7	1163

Note: * Teaching Hospitals, Provincial Hospitals and Base Hospitals.

Source: Department of Health Services, Sri Lanka, *Annual Health Bulletin, 2004/2005*.

population while the national averages were 45.6 and 95.8, respectively. By contrast, Nuwara Eliya had only 2 beds per 1000 population, 9 MOs and 20 nurses per 100,000 population indicating a huge disparity in service delivery across the island. Of the specialists in curative care, 40 per cent were in the Colombo district, while 56 per cent of them were servicing the Western Province. However, the availability of health facilities alone will not ensure an effective service delivery in health. As discussed earlier, other economic infrastructure facilities such as transportation, electricity and telecommunication also influence the access to health services by the people.

Creating awareness on NCDs among the public, especially among the poor, is another challenge. Since the poor are more susceptible to NCDs than the rich, educating them is absolutely necessary. It has been found that better-off persons are more likely to use health related information to reduce their exposure to the health risks factors of NCDs than poorer persons.³¹ Due to the nature of the NCDs, awareness based on behavioural changes has to be created from very early stages. Educating women and other risk groups such as alcohol addicts is essential. Information should be disseminated to every level of society so that the people will have more control over their health risks. Special efforts should be taken to educating the poor since they frequently make themselves more vulnerable to ill health due to ignorance.

5.5.3 Government Initiatives

It is quite clear that NCDs are connected to several aspects of an individual's lifestyle. As such, prevention efforts are also needed as part of an integrated approach. Over the last few decades, health policies and programmes in Sri Lanka have been mainly

concentrated on curative care services, implemented as isolated policies or programmes for the most part. Though NCD risk factors have prevailed for a long time as hidden threats, they have not been paid sufficient attention. However, recent government health initiatives appear to be more focused on NCDs than previously. The Health Master Plan (2007), Mental Health Policy (2005), the draft National Nutrition Policy (2007), National Medicinal Drug Policy (2006) and various legislations on alcohol and tobacco consumption are some examples.

The Health Master Plan (2007-2016) acknowledges that there are gaps still in reaching and servicing the poor in the Sri Lankan health system despite remarkable achievements in many health indicators. It recognizes the epidemiological transition that is taking place in Sri Lanka and identifies three "Problem Groups" that constitute the country's disease burden. These are identified as continuing problems, emerging problems and evolving problems. The NCDs fall under the category of evolving problems. An integrated approach has been adopted by the Health Master Plan to address health issues that will arise due to epidemiological transition. The draft Mental Health Act of 2007 covers many aspects of mental health, including the rights of persons with mental illnesses, availability of care, treatment, continuing care, and rehabilitation facilities. This Act aims to establish a Mental Health Advisory Council, Grievance Committee and District Review Committees. The National Medicinal Drug Policy ensures the availability and affordability of medicinal drugs. It contains 10 major elements to safeguard the patients' rights (selection of essential medicines, affordability and equitable access, financing options, supply systems and donations, etc.). There are a number of laws that regulate alcohol and tobacco consumption.

³¹ WHO (2007), "Integrating Poverty and Gender into Health Programmes: Module on Non Communicable Diseases", WHO, Manila.

Some of these are the National Authority on Tobacco and Alcohol Act No. 27 of 2006, Tobacco Tax Act No. 8 of 1999, and Excise (Special Provisions) Act No. 13 of 1989.

Other than these policy initiatives, the Ministry of Health also operates special programmes and units working on NCD related issues (e.g., the NCD Directorate, Mental Health Directorate, National Cancer Control Programme and the Nutrition Coordination Unit). Further, the Ministry of Health has drafted a National Policy for Prevention and Control of NCDs, with the aim of improving the wellbeing and quality of life of the people by reducing the impact of NCDs and their risk factors on health, economic growth and social development.³²

5.6 Conclusion and Recommendations

While Sri Lanka has managed to see an overall reduction in absolute poverty as shown by the most recent HIES 2006/07 data, the evidence also suggests that significant inequities are emerging across sectors and provinces of the country. Thus, despite Sri Lanka's recognized achievements on social indicators, poverty remains entrenched in rural and estate sectors. The need to check such growing inequities has been rightly identified as a priority in the government's development goals. Investing in infrastructure, health and education, and in improving agricultural productivity are undoubtedly some of the key areas that the government must concentrate on. Improved access to better quality infrastructure, education, health, etc., are essential to empower the rural poor and enhance their opportunities for improving standards of living.

The provision of adequate infrastructure is a powerful tool to lift the rural poor out of poverty. Programmes such as 'Gemidiriya'

appear to have had some success in developing rural infrastructure and effectively improving the service delivery for the poor. In particular, community participation and transparency - that promote wider participation and ownership - have been important elements in contributing to the success of the programme so far. The infrastructure requirements are many, including extension of electricity supply to all rural and estate households, affordable access to Information and Communication Technology (ICT), etc. However, this requires that key ministries - for instance, those involved in infrastructure development, poverty alleviation programmes, development of agriculture and livestock - work together, down to the grassroots level. Coherence between such ministries will ensure effective and efficient delivery of the services.

Besides improvements to capital infrastructure, enhancing the social capital of the poor is necessary to promote participation and accessing the benefits of economic opportunities. Education, for example, is a part and parcel of economic and social development. Schooling is an investment contributing to the wealth and well-being of a nation. It is for these reasons - and the necessity to make opportunities for education available to all alike without discrimination on the basis of wealth, class or creed - that the right of education has been included in the Universal Declaration of Human Rights.

What needs to be done, therefore, is to change the education system to remove any voluntary and involuntary discrimination that exists between the rich and the poor, the rural children and the urban children. As identified in previous studies, poverty has a negative influence on school participation of the poor due to direct and indirect costs of

³² Japan International Cooperation Agency and Ministry of Health, (2007), "Evidence-Based Management for the Health System in Sri Lanka", Ministry of Health, Sri Lanka.

schooling. It requires the establishment of a viable network of schools at each divisional level by creating or restructuring of existing schools to relax constraints on geographically equitable access to good quality education. Further, government school rationalization policy should take precautions when closing primary schools. It should take place only when better quality alternate primary schools are available within close proximity. Opportunities for education in science have to be extended to all, especially in rural areas.

Schools in the North and East of the country need special attention in terms of restoration of physical infrastructure and teacher supply, catering to the special needs of children affected by the conflict as well as school feeding programmes. Furthermore, sound and participatory analysis, information based policy development and proper coordination, formative monitoring and evaluation systems, along with adequate budgeting are necessary to ensure successful service delivery to reach out to school drop-outs. Special catch up programmes as well as non-formal education should also be continued to fill the gap of two decades of exclusion. Further, special attention should be given to reach out to school drop-outs in isolated areas - efforts may be needed to take special classes to remote areas. Particular effort should be given to include children with disabilities, the destitute and abandoned, street and working children into the education system.

The educational outcomes and the benefits from schooling remain low due to poor quality of education delivery. In particular, attention needs to be focused on improving teacher shortage problems in rural areas. Teacher education programmes need to be introduced and incentives provided to teachers to work in rural areas to ensure a more equitable distribution of qualified teachers. To attract qualified teachers and increase retention, measures to motivate them - such

as better salaries and working conditions - should be provided.

The learning achievements of students need to be improved upon. Mastering of basic language, numeric skills and other subject areas need to be improved at the primary level. There is also a need to provide quality secondary education to achieve successful educational outcomes. Reform and expansion of the secondary education system is necessary to widen the skills base and allow greater access. There is also a need to match education to the needs of the labour market to create new opportunities and support future growth.

In the administrative sphere, each layer of administration engaged in the delivery of education must be informed and trained to understand, rationalize and cope with changes to improve the effectiveness of the education system. Education management should be further devolved to the level of individual institutions. Giving more autonomy to the school system by involving communities and parents to monitor and evaluate the school's performance should be given more priority. Further, delays in disbursement of government incentives, including free text books, should be minimized.

Improved health outcomes are also critical in bridging gaps between the rich and the poor. When considering the health care delivery across the country, wide regional disparities can be observed where poorer districts tend to be more underserved. In the past, health issues such as NCDs were regarded as a health risk only of the elite group of society. However, this is not so any more. Indeed, the poor are more susceptible than the rich to NCDs. This is mainly because they are exposed more to NCD risk factors than the rich, while overcoming the financial burden of NCDs is more stressful to the poor.

Efforts to reduce the wide regional disparity in health care service delivery are an essential part of addressing the challenge of NCDs. By improving access to health care, the poor will be protected against having additional financial burdens in seeking health care facilities. However, in order to acquire the full benefits of health services, other economic infrastructure facilities such as transportation, communication and electricity should also be provided and maintained in an effective manner.

Creating awareness is also essential in preventing any diseases. In the context of NCDs, creating awareness on NCDs among the poor

is a more complex issue. It involves many aspects of a person's life and calls for educating the poor in a more organized and cohesive manner. The poor have to be educated about the hidden threats of NCDs and their high vulnerability in catching NCDs. This could be done as a part of the school curriculum where the Ministry of Health and the Ministry of Education can cooperate. Given the increasing role of private health care provision, efforts should also be directed to encourage private health care providers to get involved more effectively in NCD related issues, besides simply providing curative services. They too can play an effective role in creating public awareness on NCDs.

6. Improving Education Service Delivery: Is There a Role for the Private Sector?

6.1 Introduction

In most countries, the public sector dominates the education sector in terms of management and finance. There is evidence to suggest that countries that spend more on education as a percentage of government budgets, have better education outcomes in terms of higher gross enrolment rates and higher primary completion rates. These countries also spend more per child at the primary level in terms of GDP per capita.¹ However, getting children to school alone is not sufficient; they should also be successfully educated. Most research studies carried out to date do not find sufficient evidence to link high levels of public spending to better education outcomes. At the same time, given budget constraints, education has to be delivered efficiently - i.e., using the least amount of resources. The literature shows that publicly provided education systems can be inefficient due to large overheads and bureaucratic structures that are not accountable to the needs of the students, teachers or parents.² Thus, it raises the critical issue of what are the most effective and efficient ways of delivering education. The existing body of research shows that the answer depends, among other things, on the economic and human resource development level of a country.

This Chapter discusses the main challenges for the primary and secondary education sector in Sri Lanka. It draws on international experiences to explore different public-pri-

vate partnerships in education, and examines the pros and cons of adopting such processes for improving education delivery in Sri Lanka.

6.1.1 Defining 'Public' vs. 'Private' Provision of Education

To address the question of private participation in education, a definition of what is meant by 'private' and 'public' providers of education is critical. At first glance, it could be assumed that private providers of education are those that run education facilities 'for-profit'. In reality, however, in most countries, education institutions run by the private sector are subsidized by the government. Educational institutions receiving these subsidies are usually subjected to controls which dictate how different education administration functions – such as, hiring and firing of teachers, and student admission criteria - are carried out. Across the world, and in Sri Lanka, a range of schools that differ according to their share of private finance and level of management autonomy are to be found. In the discussions to follow, 'private' education institutions are defined to be those that are privately founded and managed. They usually have some private funding, although they may receive funding from governments and may be subjected to administration controls by the government. On the other hand, 'public' education institutions are categorized as those that are established by the government and are funded by the government. In reality, many 'public' education providers

¹ UNESCO (2007) Global Education Digest, UNESCO Institute for Statistics, Montreal, Canada.

² Emmanuel Jimenez and Marlaire E. Lockheed, (1995), "Public and Private Secondary Education in Developing Countries - A Comparative Study", World Bank Discussion Papers, No. 309, World Bank.

also receive funding from the private sector, such as from alumnae, parents and other well-wishers affiliated to the institution. They may also influence policies that determine education administration. The actions by alumnae and parent organizations expressing resistance to the recently introduced Grade 1 admission policy in Sri Lanka is an example of how private actors can influence the functioning of public schools.

6.1.2 Different Ways in which the Private Sector Participates in the Education Sector

As discussed in the earlier section, the private sector participates in education in a variety of ways. Table 6.1 summarizes some of these different types of partnerships between the private and public sectors. As shown, in between the pure public sector model and the pure private sector model, there are a number of models where the two sectors interact to provide education services. These integrated models differ according to who chooses the service, who manages the service, and who provides material and human resource inputs. In the pure government

model, all three functions are the responsibility of the government. In the management models, the government chooses the service and provides infrastructure, but the private sector is responsible for the management of the service, and sometimes for recruiting staff. In the service delivery model, the government chooses the service, but the private sector is responsible for management and provision of all inputs. This type of service delivery model is popular for non-core services of education such as supplying food for school canteens or supplying transport for school children. However, in some countries even core education services such as teaching are out-sourced. Hiring private teachers for teaching special subjects is an example of such a delivery model. In the case of the voucher model, a special feature is that the consumers are allowed to choose the service. Typically, parents are given a voucher that can be used as payment to purchase education services from a provider of their choosing. The idea behind the voucher model is to create competition between service providers, so that they will improve their services to attract more customers.

Table 6.1
Choice and Contracting Mechanisms in the Education Sector

Delivery Arrangement	Who Choose Service	Who Manages Service	Who Provides Infrastructure	Who Employs Staff
Government provision	Government	Government	Government	Government
Management model - Pure management contract	Government	Private sector	Government	Government
Management model - Operational contract	Government	Private sector	Government	Private sector
Service delivery model - Core services	Government	Private sector	Private sector	Private sector
Service delivery model - Non-core services	Government	Private sector	Private sector	Private sector
Voucher model	Consumer	Private or public sector	Private or public sector	Private or public sector
Private sector provision	Consumer	Private sector	Private sector	Private sector

Source: World Bank, 2007, "Education Notes: Enhancing Accountability in Schools: What Can Choice and Contracting Contribute", <http://go.worldbank.org/AVTYBMUV80>.

The models that are shown in Table 6.1 only illustrate some of the different types of partnerships models. In addition to these, there are a variety of other types of ways in which the private and public sectors interact to provide education services. These include 'charter schools', which are private initiated and managed schools that receive government funding. These schools give special emphasis to producing good education outcomes and to innovative ways of delivering education services. Also, in many countries, including Sri Lanka, there are other types of government aided private schools that are set up not necessarily as a response to the poor performance of public schools, but to cater to a particular segment of the market. Typically, these private schools are initiated and run by private groups - such as religious organizations. However, given that they provide education services, they are also subjected to government regulation and are sometimes subsidized by governments.

6.2 Public vs. Private Education

6.2.1 Pros and Cons of Public Education

The main argument for public investments in education is the social benefits of education. The private and social benefits of education are widely recognized and well documented. Good quality education improves employability, builds personalities, enhances productivity, and improves social and economic welfare through higher earnings. Education is also well-known to produce numerous other social benefits including better health outcomes, more equitable distribution of incomes across individuals, upward social mobility, and improved social cohesion. Public investment in education is often necessitated, because left alone, the private sector does not invest enough in education. Difficulties in predicting the trends in future labour markets and the associated risks of investing in education, imperfections of

capital markets, and high transaction costs tend to lower private investments in education below socially optimum levels. Education can be considered a merit good as it provides a useful avenue for alleviating poverty, improving economic and social well-being and equity. Lastly, countries invest in education, especially higher education, as a continual workforce competent in skills needed for the current market is an essential requirement for the sustained development of a country in the changing international environment. However, not all public education systems are successful in achieving the education demands of the markets.

The following section discusses the evolution of the private sector involvement in education and the reasons why countries allow the private sector to participate in education provision.

6.2.2 Reasons for Private Participation in Education

There are two main reasons for the evolution of the private sector in many education systems. First, in education systems where the 'public' institutions were capacity constrained, the 'private' participation in education evolved in response to increases in demand for education by the public. This type of private sector involvement in education was common in the 19th century in many developed countries, and at the end of the 20th century in developing countries. Second, in education systems where the public were dissatisfied with the type of education provided by the 'public' institutions, the private sector entered to provide alternate types of education. For example, the 'Federation of Private Schools' Management' based in Hyderabad runs private schools for the poor in India. Although many of the children studying in these schools live in close proximity to public schools, they prefer to go to the private school as there is a lack of effec-

tive teaching taking place in the public schools.³ In Sri Lanka, a good example is Buddhist, Muslim and Hindu schools started by private interest groups in the late 19th century to cater to the demands of the non-Christian population. In multi-ethnic and multi-religious societies, different social groups may demand different types of education, depending on their ethnic and religious backgrounds. Public school systems are often unable to deal adequately with such differentiated demands for various reasons, including lack of information, lack of capacity to identify and initiate change, and lack of resources. Some countries have changed legislation to allow the private sector to enter and cater to these different markets. The charter schools in the US, for example, are initiated by private parties to meet the education demands of different communities. These schools receive funding from the government and must function according to guidelines provided by the state, but they are managed by private groups.

There are several arguments for permitting private participation in education. First, private participation in education can provide avenues for mobilizing funds for education development. Some countries allow private participation to make up for the lack of adequate government funds for education development. For example, in Colombia, the government introduced a voucher system, distributed through a lottery to offer poor students a choice in attending public or private schools. A study on the outcomes of this project shows that the lottery winners were more likely to attend private schools, and that they had better educational outcomes compared to those who did not win

the lottery. The cost to the government of the voucher system was less than what it would have incurred in expanding public schools to absorb additional students.⁴

Second, private participation in education is promoted by some countries to allow for education innovation. This might arise out of a feeling that highly institutionalized public education systems are slow to identify new education challenges and come up with solutions. The charter schools in the US are an example where the private sector is allowed to initiate and manage schools using new innovative ways.

Third, alternate providers of education foster competition, which can result in better performance and more choice for households. Colombia introduced a 'Concession Schools' model at Bogota in 1999, where a number of public schools in low-income areas were turned into high quality private schools. A study that estimated the impact of this programme found that the drop-out rates were lower in the Concession Schools compared to other similar schools.⁵ In addition, the study found evidence that the programme helped to reduce drop-out rates in nearby public schools as well, as they competed to perform better than the Concession Schools.

Fourth, some studies have argued that the main reason for better efficiency and effectiveness in private schools is the difference in management styles. Private schools are autonomous entities that are more accountable to parents and students. As such, they produce education services in a more cost-efficient manner and are more effective than their public sector counterparts.⁶ For ex-

³ James Tooley, (1999), "The Global Education Industry: Lessons from Private Education in Developing Countries", The Institute of Economic Affairs, London.

⁴ World Bank, (2007), "Education Notes: Enhancing Accountability in Schools: What Can Choice and Contracting Contribute", <http://go.worldbank.org/AVTYBMUV80>.

⁵ Ibid.

⁶ Jimenez, E., and M.E. Lockheed, (1995), "Public and Private Secondary Education in Developing Countries: A Comparative Study", World Bank Discussion Papers No. 309, World Bank.

ample, the Delhi Public School Society (DPS) is an educational body which runs a chain of private schools which are relatively cheap, but manage to produce good education outcomes. They are also acclaimed for being service oriented toward poor students under its social responsibility activities. The company has four types of schools - i.e., Core schools, Satellite schools, Village schools and Overseas schools. Core schools are wholly owned and managed by the DPS, while Satellite schools are owned by the public sector, but managed by the DPS. The Village schools are located in underdeveloped areas in close proximity to New Delhi and are cross subsidized by the profits made in Core Schools. In addition to managing schools, the DPS invests in research and development in innovative teaching techniques and trains teachers accordingly.⁷

However, private provision of education can also be disadvantageous for several reasons. Some argue that privately provided education is inequitable as private providers mainly cater to the affluent. This argument is refuted by others who show that there are private education providers catering to all segments of the market, and as such, the idea of private education being elitist is unfounded. A common example given to illustrate this point is the earlier described private schools for the poor in Hyderabad, India. Others point out that as the more affluent buy private education, more opportunities are opened up for the poorer children in the public sector education institutions, thereby releasing public resources for educating poorer students.

Another argument against private provision of education concerns the quality of education. The goals of private education institutions may sometimes differ from the national

education goals, the extent of this variance depending on the level of autonomy given to private institutions. For example, high competition may tempt private education institutions to induce children to cram and perform better in exams, while not giving emphasis to the overall development needs of children. Also, sometimes private institutions are accused of trying to differentiate and market themselves through offering trendy subjects, while not giving due importance to teaching local languages and religions.

Lastly, private schools may not succeed in all socio-economic backgrounds. A controlled experiment done in the Baluchistan Province of Pakistan which examined the effectiveness of creating private schools for poor girls shows that in the urban setting the programme is more sustainable than in the rural setting. The main reasons for this difference is that compared to rural areas, in urban areas parents are more educated and have higher incomes where the schools can easily draw on a large pool of children, in addition to availability of teachers and experienced school operators. Such experiments indicate that private schools are not always viable.⁸

There is also no conclusive evidence that one type of education provision (i.e., 'private' vs. 'public') is better. There is some evidence from the developed world that the student performance is better in private schools as measured by standardized tests for language and mathematical skills, although the actual magnitude of the advantage vary across studies as do the rigour in methods used for controlling selection bias. What is clear in the literature is that different types and combinations of public and private education providers can be effective in providing good

⁷ Tooley, J., (1999), *The Global Education Industry: Lessons from Private Education in Developing Countries*, The Institute of Economic Affairs, London.

⁸ Harold, A., J. Kim, and P.F. Orazem, (2003), "Design, Evaluation, and Sustainability of Private Schools for the Poor: The Pakistan Urban and Rural Fellowship School Experiments", *Economics of Education Review*, 22 (265-274).

quality education in different environments. The structure of the education system and the legal and institutional environments under which different providers operate largely determine the success of different types of education providers.

6.3 Education System in Sri Lanka

6.3.1 Public and Private Composition of the Education System

Since the nationalization of private schools in 1960, successive governments have not allowed the establishment of private schools for providing education from Grades 1-9. Some private schools that were already established before the 1960s were taken over by the government while others were allowed to function as private schools under supervision of the education authorities. However, since the early 1980s, the government has allowed the establishment of new 'schools' under the Companies Act No. 17 of 1982.⁹ These 'schools' - popularly referred to as 'international' schools - are registered as com-

panies and mainly provide English medium education and follow British curriculum in most instances.

At present, there are three types of private schools in the country. These include, aided private schools, un-aided private schools and the earlier mentioned 'international' schools. The first two types of schools are schools established before the early 1960s. Both these types of schools follow the national curriculum and prepare children for government examinations. The only difference between the two types of schools are that the aided private schools receive assistance from the government for payment of teacher salaries, while the un-aided private schools do not receive any assistance from the government. The third type of school is a registered company that provides education services. Unlike the other two types of private schools, 'international' schools are not subjected to any government regulation by the education sector.

Table 6.2
Trends in Private Participation in Education in Sri Lanka, General Education Sector for Selected Years

	1988		2002		2006	
	(No.)	(%)	(No.)	(%)	(No.)	(%)
1. Schools	10,261	100.0	10,508	100.0	10,455	100.0
1.1 Government schools	9,771	95.2	9,829	93.5	9,709	92.9
1.2 Other schools	490	4.8	679	6.5	746	7.1
Private	59	0.6	80	0.8	93	0.9
Pirivenas	431	4.2	599	5.7	653	6.2
2. Students	4,058,843	100.0	4,179,217	100.0	3,999,323	100.0
2.1 Government schools	3,938,062	97.0	4,027,075	96.4	3,836,550	95.9
2.2 Other schools	120,781	2.9	152,142	3.6	162,773	4.1
Private	82,971	2.0	97,174	2.3	107,874	2.7
Pirivenas	37,816	0.9	54,968	1.3	54,899	1.4

Note: Table does not include information on 'international' schools.

Source: CBSL, *Annual Report*, various issues.

⁹ Kulatunga, D. (2006), *Education Guide*, JobsNet, Colombo.

Table 6.2 provides some statistics on private participation in education in Sri Lanka. As seen, the public sector dominates the primary and secondary education sector in the country. However, there is a slow but steady increase in both the number of private schools in the country as well as the number of students enrolled in private schools. Anecdotal evidence suggests that there has been a significant increase in the number of 'international' schools in the recent past, mainly due to the demand for English education in the country and the difficulties in enrolling students in good public schools. Little information is available on these schools. Over 150 international schools are estimated to be operating in the country.¹⁰

In addition to education services provided by private schools, there are many private tuition classes that supplement education provided in schools. Most of these prepare students for highly competitive government examinations. These classes are usually held after school hours by school teachers already teaching in schools. According to estimates based on the Central Bank's Consumer Finance Survey data, the percentage of students attending private tuition classes has increased from 24 per cent in 1986/87 to 50 per cent in 2003/04.

6.3.2 Challenges to the Education System

To answer the question of what the most effective and efficient ways of delivering education are, it is essential to understand the present status of the public education system in Sri Lanka. With this in view, this section discusses the education system in the country to identify the main challenges faced by it. A well planned education system will essentially ensure a good quality education for all. To achieve this, the system must first provide education opportunities to all, and second, it must effectively educate. The following section discusses the performance of the Sri Lankan education system with regard to access and education outcomes.

As shown in Table 6.3, school enrolment rates at the primary level are close to hundred for all levels of consumption quintiles. At the junior secondary level, although the enrolment levels are lower (ranging from 63-71 per cent), the distribution of enrolment rates across consumption quintiles are fairly equitable. Education at the senior secondary and the tertiary levels, however, show large disparities. The literature shows that the most disadvantaged are the children from

Table 6.3
Net Enrolment Rates in Major Education Cycles by Economic Groups

Consumption Quintiles	Net Primary Enrolment (Grades 1-5) %	Net Junior Secondary Enrolment (Grades 6-9) %	Net Enrolment (Grades 10-13) %	Net Tertiary Enrolment %
Lowest 1-20	95	61	31	2
Quintile 21-40	96	66	35	2
Quintile 41-60	95	67	41	4
Quintile 61-80	96	77	47	5
Highest 81-100	97	76	60	13
Sri Lanka	96	68	42	5

Source: World Bank (2005), *Treasures of the Education System in Sri Lanka*, Colombo, Sri Lanka: The World Bank, Human Resource Development Unit.

¹⁰ Ibid.

rural areas, less developed provinces, and the poor and disabled.

School participation rates show high levels of access across all provinces at the primary and the junior secondary school levels. However, the learning outcomes are low in the country. A study by the National Education Research and Evaluation Centre (NEREC) in 2003 of learning achievements of Grade 4 students shows that the proportion of students with first language (Sinhala or Tamil) skills (37 per cent) and numeracy skills (38 per cent) are low. These proportions are lower for the rural sector - where roughly one in three children has mastery in these skills - compared to the urban sector where one in two children have mastery of these skills. The proportion of students with mastery in English language skills are very low (10 per cent), with a wider margin between the urban (23 per cent) and rural (7 per cent) sectors. These proportions also vary across provinces with the Western Province faring better compared to other provinces.¹¹

Similar patterns are seen in examination pass rates at higher levels of education. Pass rates in O-Levels are also low and averages around 37 per cent. These rates are better for the Western Province where the O-Level pass rate averages 48 per cent. The A-Level pass rates are better relatively, and average around 56 per cent for the country. This outcome is partly the result of prior selection. As was shown in Table 6.1, the net enrolment at this level is around 40 per cent.¹²

In order to take advantage of new developments in the global market, there is an urgent need to improve education opportunities and their effectiveness. Technological advances, and the resulting easier and cheaper

access to global labour markets, have driven the demand for skilled workers in the global market. Already Sri Lanka is losing out on economic opportunities that call for better skilled workers, especially in information technology (IT), language and science skills. A recent government initiative to train nurses for temporary employment abroad faced difficulties as there were insufficient numbers of A-Level science qualified students. Business Process Outsourcing (BPO) companies have expressed concerns that the country is losing investments in the BPO industry on account of problems in training workers due to lack of English language skills. Investments in education have long been seen as a necessary, although not a sufficient, condition for development. In the recent past, with the intention of improving the relevance of education to the labour market, the Ministry of Education launched several initiatives to improve IT and English language skills in schools. Although there is some progress in these areas, the changes have been slow to occur.

6.3.3 Sources of Funds for Education

The main source of finance for education in most countries is the state. Other than for the state, the private sector, foreign agents and the households also contribute to education finance. Firms, religious organizations, foundations and private individuals provide private sector contributions to education. Foreign agents include aid - by both multilateral and bilateral agencies - as well as private individuals, organizations, and firms located abroad. In addition, households spend a considerable amount of money on education - on books, uniforms, transport, boarding facilities, etc. - including on private tuition as in the case of many Asian countries.

¹¹ World Bank, (2005), *Treasures of the Education System in Sri Lanka*, Colombo, Sri Lanka: The World Bank, Human Resource Development Unit.

¹² Ibid.

Government expenditure on education in Sri Lanka amounted to Rs. 92,540 million or 2.6 per cent of GDP in 2007. This share of investment in education is low compared to the averages for South Asia, low income countries, middle income countries and upper middle income countries. Low investment in the education sector has resulted in limiting essential investments in improving facilities at schools. The major share of recurrent expenditure is spent on salaries and utilities, leaving very little for investments in teacher training and improving administrative and management capacity of schools, and on maintenance of capital goods. Although recurrent expenditure on primary and secondary schools are distributed fairly across provinces, and discrepancies between similar schools are minimized with the allocation of funds according to a formula based on set norms, historical discrepancies and lack of management of capital assets have resulted in the differences in availability of facilities at schools to persist. Smaller rural schools are more likely to be affected by shortages in both facilities and teachers.¹³

The share of private investments in education in Sri Lanka is substantial. In 2002, 21 per cent of education financing in the country came from households. The largest share (45 per cent) of household expenditure goes to tuition fees, followed by stationery and equipment (28 per cent), school and facility fees (11 per cent). The main reasons for high expenditures in private tuition are due to competition to enter university or 'good' secondary schools, perceived low quality of teaching in public schools, and the culture of attending tuition classes.¹⁴ In addition to these, many households spend money on extracurricular activities for children, such as dancing, swimming, etc.

6.4 How Can Private Participation Improve Education Service Delivery in Sri Lanka?

As the discussion in the previous section shows, there are several challenges to the education system in the country. Although access to education at the primary level is good, it needs to be improved at the higher levels. The education outcomes are low for first language and numeric skills at the primary level. Only two-thirds of the students enter the secondary school cycle. Of these, only a third gets through the O-Levels. English language skills are poor. While these challenges exist, the available investments in public education are low, compared to regional averages. Although the Ministry of Education has recognized the need for modernizing and reorienting the education system to meet the needs of the labour market, the changes are slow to take effect. The increased demand for 'international' schools and the increasing share of students in private schools shows the changing demand for education in the country. Moreover, even children in public schools supplement their education in these schools by attending private tuition classes. As discussed earlier, the largest share of private expenditure on education is on private tuition classes. At the same time, the poorest children have low participation rates due to the relatively high costs of participation and the low quality of education outcomes. These factors suggest that the private sector can contribute to improving the education system in the country in several ways.

6.4.1 Improving Access to 'Good Schools'

As highlighted earlier, there is significant demand for 'good' quality schools in Sri Lanka. The competition for placements in

¹³ Ibid.

¹⁴ Ibid.

good schools at the primary level, and the over-crowding in 'good' schools are evidence of these trends. Studies show that admission rules to good public schools indirectly favour more affluent children. Allowing private schools to operate could reduce the competition for good public schools, making them more accessible for poorer students.

In the competition for 'good schools', children travel long distances to attend schools, which is costly for the parents and time consuming and stressful for children. Allowing the private sector to participate in education provision could bring 'good' schools closer to the homes, saving money and time for children. In areas where there are no 'good' public schools, voucher schemes can be introduced to allow poor students to attend 'good' private schools. As discussed earlier, such a voucher system introduced in Colombia has been successful in keeping poor children in school, and improving their education outcomes.

6.4.2 Improving Education Provision in Areas with Teacher Shortages

Under the present public institutional structure, it is difficult to recruit and retain specialized teachers in rural areas. As deployment of teachers take place centrally, keeping experienced and motivated teachers in rural areas has been a problem. As teachers are compelled to serve in rural areas only for a limited period of time, most experienced teachers transfer out of rural schools. As a result, rural schools are left with inexperienced teachers who are waiting to move out as soon as an opportunity arises. Sometimes, specially trained teachers move to urban areas to teach subjects for which they are not trained. Among other things, unavailability of qualified and motivated teachers in rural areas has lowered the education outcomes of students in these areas. Such teacher shortages are especially apparent for subjects such

as mathematics, science and English. Outsourcing the service delivery for these specialized services to the private sector in rural areas may be a solution to the problem of teacher shortages in rural areas.

The recently launched government initiative on Job-Oriented English Language Programme - 'English as a Life Skill' - seeks to promote private sector investments in English language education through joint ventures between Sri Lankan and Indian investors to train 50,000 persons to serve in the BPO industry. This programme is aimed at school leavers. Similar schemes can be used to improve education service delivery at the school level. The private sector may be more able to mobilize resources in the area to fill vacancies by providing more flexible employment arrangements, or by making use of professionals in the area to teach these types of courses. Households already spend money to send children to tuition classes in order to supplement education received at school. Giving children a better quality education during school hours through outsourced private providers will give them leisure time after school for personal development.

6.4.3 Improving School Performance and Accountability

At present, public schools are not challenged to produce good results. Allowing other types of service providers has the potential to improve the service delivery of public schools as they compete to keep up standards. In the earlier discussed Colombian Concessions School model, the establishment of private schools helped to improve the performance of public schools in rural areas. Proper evaluation of the performance of schools through the introduction of rectification measures, as is done by the Schools Standards and Framework Act of the UK, will also provide incentives for schools to improve their performance.

6.4.4 Improving School Level Resources and their Management

A key threat to the public education system in the country at present is its lack of resources and the inefficient management of resources. Many rural schools still do not have adequate levels of basic resources. Private participation in education can bring much needed resources to the education sector in the country. These can be done through a number of private-public partnership models as spelt out in the introductory section. Which type of model is most appropriate will depend on the nature of the locality where the private participation is solicited, and the education needs of that locality. Examples such as the Concession Schools model in Colombia and the DPS in India show the potential to improve education outcomes in underdeveloped areas through private participation. In the U.K., under the Schools Standard and Framework Act of 1998, the Education Action Zone model allows private companies to take over the management of public schools which are not providing quality education opportunities in some specified relatively deprived zones. These companies are given the funds usually allocated to the public school, to bring in their management expertise to improve the functioning of the public school. The same Act also allows the government to take control over individual schools that are not performing well in order to hand over the management of these schools to reputed private sector companies. The earlier mentioned Satellite schools under the DPS in India are also public schools managed by a private body.

The education sector in Sri Lanka is struggling to improve the management of its resources to produce better results. Hierarchical decision making and highly centralized management structures have exacerbated the problems of resource allocation according to needs. There have been some efforts to improve management of resources by introduc-

ing a 'norm based unit cost resource allocation mechanism' (NBUCRAM) and decentralizing the management of some functions of education to the school level. However, the success of these programmes is hampered by inherent problems in the education system such as teacher shortages, competency of principals and the support received from the education authorities. Allowing the private sector to participate in education delivery can be a learning exercise for the sector. Private participants may come up with innovative ways to overcome some of the problems faced by the sector at present.

6.5 Role for the State

As indicated earlier, the social benefits of education are numerous. As such, it is the responsibility of the government to ensure that all children receive a good quality education, irrespective of who is providing the service. Although the education system can benefit in many ways through private participation in education, if not properly guided, it can also create disparities in the system and bring about social disharmony. Hence, it is the responsibility of the government to safeguard the interests of the children, while profiting from allowing private participation in education.

The main argument against private provision of education is that it creates disparities between the rich and the poor. Although in theory, publicly provided education is more equitable, in practice, the literature shows that the privileged classes benefit more from subsidies on education. Moreover, the existence of 'international' schools and private tuition classes have already allowed the more well-to-do to buy better quality education, improving the employability of children from these households. Experiences in other countries show that private education may not necessarily exacerbate inequality if provisions are made to poorer students to benefit from private education through scholarships and

student loans based on merit, and offering incentives to the private sector to provide education services in a socially responsible manner.

At present, the functioning of 'international' schools and private tuition classes are not regulated in the country. As such, students are unaware of the quality of education services received through them. The government has little control over the values taught in 'international' schools. Many children have little time for leisure and extracurricular activities because of after-school tuition classes. The government has the responsibility to educate the public on the education services provided by these different education institutions, so that households can make wise decisions on choosing education services that best serve their needs. This can be done through publishing information on the quality of teaching staff and facilities available in schools, and publishing information on assessment of student performances and national examination results. Some countries produce league tables which provide comprehensive information on the quality and performance of schools.

Allowing private participation alone is not a guarantee that education service delivery will improve. The Ministry of Education must ensure that schools - both private and public - produce good results. This can be done through monitoring school performance and taking corrective action to improve management of schools that do not perform. The Schools Standards and Framework Act of the U.K., for example, was enacted for the purpose of ensuring that schools produced minimum educational outcomes.

Lastly, the public education system has the responsibility to ensure that all children receive education opportunities. The experiment in Baluchistan Province in Pakistan

shows that private schools may not be successful in achieving education objectives in all environments. Also, studies show that increasing the price of education may reduce the enrolments from poorest households. The government must ensure that education opportunities are available even for children in deprived locations and from poor socio-economic backgrounds by providing either public education opportunities for children in all localities, or by providing financial assistance to students to attend private schools in areas where there is no public education.

6.6 Conclusions

The education system in Sri Lanka is faced with the challenge of improving the quality of education at all levels, and keeping children in school at higher levels of education. To take advantage of new economic opportunities in the global market, it is necessary that the secondary education system in the country is modernized and improved urgently. The education system in the country is faced with these challenges at a time when public investment in education is low. Given current fiscal constraints, it is unlikely that public investment in education will increase substantially in the near future. Although there have been recent attempts to modernize the public education system and improve the management of resources in the public education system, the changes have occurred slowly. Private participation in the delivery of education services has increased over the past decade. The number of 'international' schools and the number of children attending private schools have steadily increased over time. At the same time, the percentage of households sending children to private tuition classes to supplement school education has increased.

Experiences of other countries show that private participation in education can improve education service delivery in several ways.

First, allowing the private sector to participate can bring in much needed resources to the sector. Second, the private sector may serve as a laboratory to experiment innovative ways of delivering education services. There are many established companies that can bring in managerial expertise that will showcase more efficient and effective ways of delivering education services. Third, allowing private participation in education can improve the choices available to households and positively influence the performance of public schools through competition.

The several ways in which the private sector can be allowed to participate in the education system have been discussed. These range from pure private schools to models where the public and private sectors jointly provide education services. The type of model that is suitable for a particular education market will depend on the characteristics of the community served by the education provider. Lastly, the discussion showed the need for regulation and effective monitoring and evaluation in order to safeguard the interests of children.

7. Energy Sector: What Factors Govern Successful Reforms?

7.1 Introduction

The debate on power and energy sector reforms in Sri Lanka has often focused on a few topical issues such as slow growth in investment and supply expansion, the dominance of the market structure by state monopolies, the accumulated fiscal burden due to losses incurred by state enterprises, unsatisfactory service quality, and escalation of price for consumers. While these issues are all relevant, they essentially represent a narrow focus on a fundamental development problem that is likely to have a decisive impact on all sectors of the economy in the years to come. Economic, environmental, political and social realities around the power and energy sector are leading to a rapid transformation of the sector globally. Any intended reforms in the power and energy sector locally will also have to factor in the changing realities at the global level. In a sense, it can be argued that the current problems in the power and energy sector in Sri Lanka are a result largely of the failure to be attuned to the changing realities. In this backdrop, this Chapter reviews the context of reforms in the energy sector in Sri Lanka, with an emphasis on the importance of changes at the global, national and local levels. The power and energy sector is reviewed as a whole, covering electricity, petroleum products, and biomass and alternative energy so that the issues are covered from an overall perspective.

7.2 Role of Power and Energy Sector in the Sri Lankan Economy

Modern economies are dependent on the power and energy sector to a great extent. The degree of dependency may vary accord-

ing to the level of industrialization and modernization, yet even the least developed economies today are highly dependent on industrialized power and energy sectors. As a result, growth of the power and energy sector has become an essential prerequisite for sustainable economic development.

Table 7.1 shows the structure of demand and supply sources of energy in Sri Lanka. Demand for Sri Lanka's power and energy sector comes from five major sources, namely, household (resident), industry, transport, commercial, and agriculture sectors. There are three major types of energy that cater to the demand from end-users, namely, biomass, petroleum, and electricity. Biomass energy from scattered sources such as home gardens, plantations, and natural forests still plays an important role in rural areas, especially in household cooking and small industries. Electricity has a major role to play in domestic lighting/appliances in both urban and rural areas, and in industry and commerce. Petroleum products while playing the main role of energy for transport, fulfills an important supplementary role in industry, commercial establishments and agriculture also. During the last few decades, liquefied petroleum gas (LPG) has become the major source of energy for cooking in urban areas.

Table 7.2 presents the statistics of energy consumption for 2005 by different economic sectors. Accordingly, the largest consumer of energy is the household (residential) sector, which accounts for more consumption than transport and industry sectors together.

Table 7.1
A Broad Outline of the Current Demand and Supply Structure of the Power and Energy Sector in Sri Lanka

End Users Category	Types of Major Uses/Applications/Scales	Types of Energy Sources (Major)	Supply Sources	Operators of Supply Facilities	Remarks
Households	Cooking	Firewood (rural)	Home gardens, forests, plantations, vendors	Private and state-owned sources	Scattered small scale sources
	Lighting	LPG, kerosene (urban) Electricity (all urban & rural)	Retail purchasing Grid and off-grid supply	Shell, Laugfs, CPC, IOC, CEB, LECO & private power producers	All imported fuel Thermal & hydro (major) Mini-hydro, (minor)
	Domestic appliances	Kerosene (un-electrified areas & rural poor)	Retail purchasing	CPC, IOC	All imported fuel
		Electricity (urban & rural upper)	Grid and off-grid supply	CEB, LECO & private power producers	Thermal & hydro (major) Mini-hydro, wind (minor)
Commercial	Other home energy needs	Miscellaneous (solar etc.)	Miscellaneous	Miscellaneous	Miscellaneous
	Power and energy needs of day-to-day running of commercial establishments	Electricity	Grid supply and private generators	CEB, LECO & private power producers	Thermal & hydro (major) Mini-hydro wind (minor)
Industry	Large industries	Electricity	Grid supply and private generators	CEB, LECO & private power producers	Thermal & hydro (major)
	(Boilers, furnaces, kilns, driers, etc.)	Petroleum-based fuels (diesel, heavy fuel oil, kerosene etc.)	Bulk purchasing	CPC, IOC	Mini-hydro, wind (minor) All imported fuel
	Small & medium industries (Boilers, furnaces, kilns, driers, etc.)	Electricity	Grid, off-grid and private generators	CEB, LECO & private power producers	Thermal & hydro (major) Mini-hydro, wind (minor)
		Biomass (firewood)	plantations, vendors (bulk)	Private and state-owned sources	Thermal & hydro (major) Mini-hydro, wind (minor)
Transport	All types of public & private vehicles	Petroleum-based fuels (diesel & petrol)	Retail & bulk purchasing	CPC, IOC	All imported fuel
Agriculture	Water pumping	Petroleum-based fuels (diesel & kerosene)	Retail purchasing	CPC, IOC	All imported fuel

Source: Based on 'Sri Lanka Energy Balance 2003', Energy Conservation Fund and several other sources.

Table 7.2
Energy Consumption by Sector^a (2005)

Consumption by Sector	Coal	Petroleum Products	Combustible Renewables and Waste	Electricity	Total
Industry sector	67	447	1102	210	1826
Transport sector	0	1961	0	0	1961
Other sectors	0	457	3875	413	4746
Residential	0	120	3723	210	4053
Commercial & public services	0	58	151	203	413
Agriculture/forestry	0	9	0	0	9
Non-specified	0	270	0	0	270
Non-energy use	0	54	0	0	54
Total final consumption (TFC)	67	2919	4976	624	8586

Note: a: Thousand tonnes of oil equivalents; ktoe

Source: International Energy Agency.

The main source of energy for the household sector is biomass (combustible renewables), which provides direct primary energy from fuel wood. The industry sector also depends on biomass to a significant extent, in addition to substantial use of petroleum and electricity. The transport sector is the major user of petroleum energy. However, since a majority share of electricity comes from thermal power plants, a significant amount of petroleum energy is used for electricity generation also, which is an intermediate step in fulfilling end-user demand for electricity.

Accordingly, the power and energy sector in Sri Lanka can be classified into two broad segments, namely: (a) informal sector based on rural biomass, and (b) formal sector based on electricity and petroleum-based products. Due to the large rural population which depends heavily on biomass energy, the informal sector has a major share in total energy production. However, the formal sector has an increasing role to play in fast growing productive economic sectors such as industry, transport and commercial activities. While a majority of activities of the formal sector is concentrated in urban areas, rural electrification also has a major role to play in increasing living standards of the rural poor.

An important fact is that the formal sector of power and energy is dominated by a few state enterprises. As a result, the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) are playing a critical role in catering to the energy demands from the poorest rural households to the largest corporations. Hence, the performance of these major state organizations is critical for the sustainable development of the country's economy. In addition, other segments of formal energy markets, such as LPG, are also dominated by a few large-scale private sector companies with concentrated market power.

7.3 Transforming Nature of the Power and Energy Sector

The data indicate that the composition of the power and energy mix in Sri Lanka is transforming gradually (Figure 7.1). This can be observed in primary energy supply, delivery of energy to end-users, and energy use by sectors. The salient features of this transformation can be summarized as follows:

- a) The share of biomass has dropped from over 70 per cent to around 45 per cent of the total primary energy supply during the last three decades. This is a relative change

compared to growth of other sources while the absolute primary energy production from biomass has increased over the time. During the same period, the share of hydro energy peaked at 15 per cent and declined thereafter. Filling the gap created by the drop in shares of biomass and hydro, the primary energy share of petroleum-based fuels has more than doubled from around 20 per cent to 43 per cent.

- b) The same pattern can be observed in the final energy delivered to end-users also. The share of biomass, while increasing in terms of absolute supply, dropped in relative share from 78 per cent to 56 per cent of total supply. This drop has been captured by rising shares of both electricity (2 to 7 per cent) and petroleum-based fuels (19 to 35 per cent).
- c) Energy consumption of different sectors has also changed over the time. The relative shares of transport (10 to 24 per cent) and industry (19 to 24 per cent) sectors have increased, whereas the share of energy consumption by household and commercial sectors has declined from 69 per cent to 51 per cent.

7.4 Reform Experience in the Power and Energy Sector

Energy utilities should be run profitably while also offering reasonable prices for consumers. The formal sector of power and energy in Sri Lanka is a failure on both counts. Electricity tariff rates in Sri Lanka are among the highest in the region and even these high tariff rates are at below cost levels. As a result, the CEB continues to incur losses and public funds are regularly diverted to run the utility. Petroleum-based fuels and LPG prices also have become a major issue for consumers in the country.

The pricing structures in place are also somewhat arbitrary. Certain segments of the power

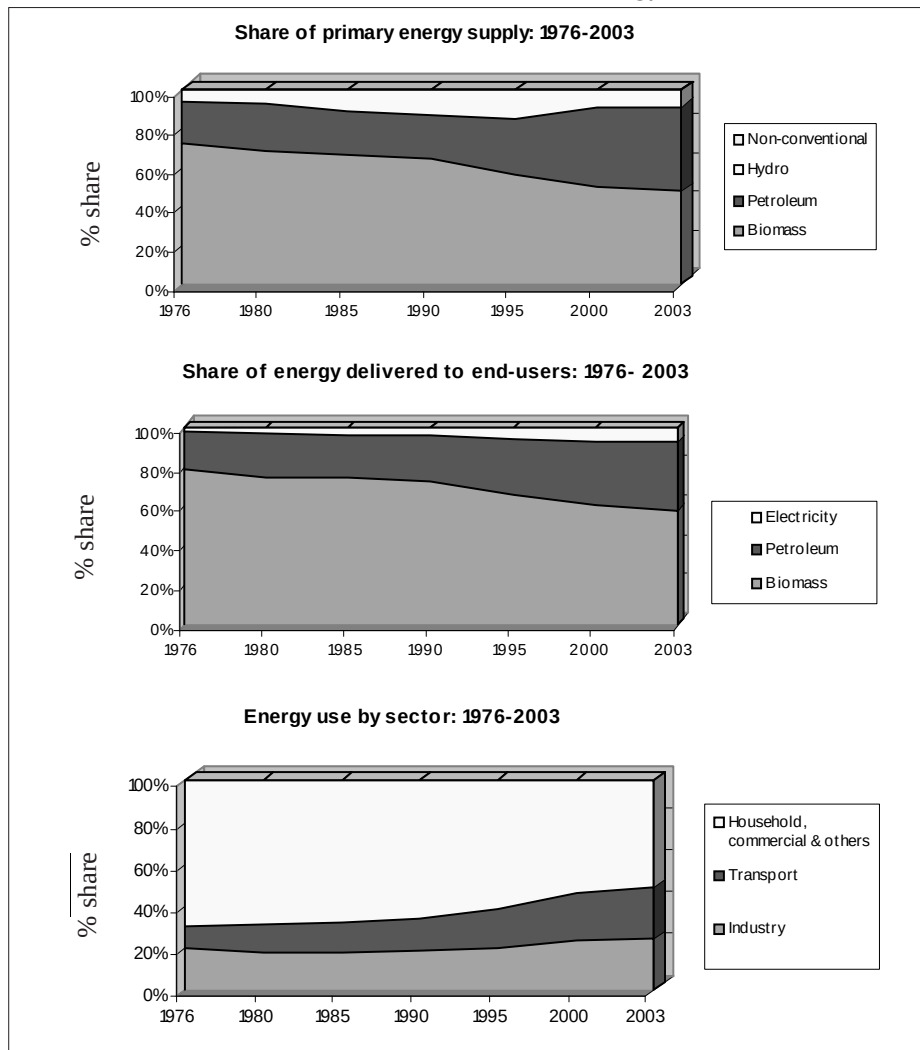
and energy sector in Sri Lanka are indirectly subsidized from other sectors of the economy. While prices are regularly adjusted upwards in line with rising global prices, arbitrary structures are creating extra pressure on public funds. This is hardly a desirable state of affairs and explains the many other failures of the sector, such as scarcity of capital to expand supply, poor service quality, inefficient and poorly maintained facilities/assets, high wastage, etc. These fundamental failures cannot be justified on any alleged socio-political advantages attributed for state ownership.

However, this is not a situation unique to Sri Lanka. Power and energy sectors in many developing countries are dominated by large enterprises which are owned, managed or controlled by the state. This has given rise to utility structures with inherent tendencies towards bureaucracy, inefficiency, corruption and wastage, due largely to the absence of competition and the presence of political patronage. As a result, reducing government involvement through restructuring has become a major thrust of reforms in the power and energy sectors throughout the developing world.

Energy sector reforms in the developing world are closely associated with the structural adjustment programmes facilitated by multilateral donors. The typical path of restructuring usually includes the following major steps:

- *Structural changes of the system:* This implies the vertical and horizontal unbundling of utilities/enterprises. Vertical unbundling deals with unpacking of national power and energy utilities to separate generation (production), storage, transmission and distribution entities, whereas horizontal unbundling implies the unpacking of national utilities into smaller regional or provincial utilities.

Figure 7.1
Transformation of the Power and Energy Sector^a



Note: a. Shares are estimated on the basis of thousand tonnes of oil equivalents; ktoe.

Source: Sri Lanka Energy Balance 2003 and Energy Conservation Fund.

- **Ownership change:** Quite often this has been synonymous to privatization. However, there is a spectrum of ownership structures that can be utilized to bring the state and private sector under partnership arrangements. In essence, some form of privatization is imminent but the total privatization of all assets has rarely been implemented. The path of ownership change usually follows the sequence of corporatization and commercialization of national utilities, contract management and stepwise privatization of unbundled utilities.
- **Regulatory reforms to enhance competition and private sector participation:** Quite often, national power and energy utilities have been established as legally mandated state monopolies, limiting the scope for private sector participation. Hence, bringing private sector investment and creation of competition among service suppliers require legislative reforms. Further, independent regu-

lators have to be introduced to protect consumers as well as investor interests. In addition, various other administrative and managerial reforms have to be introduced to create an enabling environment for private sector operations.

Like many developing countries, Sri Lanka has also taken a few steps along this reform path. Among the expected outcomes of the reforms are:

- ensuring competitive prices and quality services for consumers,
- improving the operational efficiency and management of state utilities,
- reducing the fiscal burden through enhancing the financial viability of utilities,
- generating investments to cater to growing demand, and
- enabling private sector participation.

Predictably, reforms have been focused mainly on the two major state enterprises that have enormous control over the formal sector of power and energy, namely the CEB and the CPC. Accordingly, the following reforms have been introduced in electricity and petroleum sub-sectors during the past few decades:

Electricity reforms

- Corporatization of the former Department of Government Electrical Undertaking (DGEU) into the Ceylon Electricity Board (CEB) for enhancing the commercial operation by an Act of Parliament in 1969.
- Establishment of Lanka Electricity Company (LECO) in 1983 under the Companies Act. The LECO undertakes distribution of electricity in some urban areas.
- Opening of the power generation for private sector large-scale Independent Power Producers (IPP) projects and small-scale Small Power Producers (SPP) projects from the 1990s. The first IPP by Lakdhanavi (Pvt) Ltd commenced operations in 1997.

- Electricity Reforms Act 2002 based on the 'unbundling' model was abandoned due to trade union objections.
- Sri Lanka Electricity (Draft) Bill 2008 based on the 'business unit' model was to be introduced to the Parliament in June 2008, but was withdrawn due to trade union protests.

Petroleum sector reforms

- Nationalization of the liberal petroleum market with the establishment of CPC in 1961. The CPC has since consolidated its activities by diversifying and expanding its operations until the 1990s.
- Spinning off and privatization of certain operations of CPC (Lubricants and LPG) in the 1990s.
- Termination of monopoly in the LPG market and entry of new suppliers (Laugfs).
- Partial unbundling of the distribution network, opening the operations of Lanka Indian Oil Company (LIOC).

One positive result of reforms was the inflow of private capital into electricity generation. Within a period of one decade, private large-scale operators (IPP) established a thermal capacity of over 550MW in 8 generation plants, equal in gross terms to the thermal generation capacity of the CEB. In addition, a large number of mini-hydro operators that helped to enhance the renewable component of energy supply also commenced operations in a short period of time. It has been recorded that about 60 mini-hydro operators have introduced a net capacity of around 100MW during the past few years as grid-connected and off-grid power.

These positive developments, however, have brought little improvement to the system so far as they have not created any cost advantages. The cost of power generated by a few IPP operated thermal plants is continuously rising with fuel prices. The CEB purchases the power from these operators and distrib-

utes at a loss. In the case of LPG and petroleum also, prices are continuously rising at a rapid rate despite government efforts to restrict increases through measures such as declaring LPG as a listed (essential) commodity. While rising international prices do have a direct impact, significant distortions also occur due to lack of competition.

As described above, the motivation for reforms has been driven primarily by concerns relating to the poor performance of the system. At the policy level, reforms are influenced by macro economic policies and associated economy-wide adjustments as well. These issues can be considered as factors internal to the national energy system and the economy. However, the power and energy sector is strongly connected to the global energy market and no single country can take isolated decisions that disregard the dynamics in the global market. The external influence from factors relating to the international market has become stronger over the last few decades due to the process of globalization. Therefore, decisions on energy sector reforms have also to take external factors into consideration. In recent years, significant demand and supply shocks have begun to transform the global energy sector, re-emphasizing the need for such consideration.

Accordingly, factors affecting the power and energy sector reforms in Sri Lanka can be broadly divided into (i) global factors that transform the power and energy sector, and (ii) emerging opportunities and constraints in the national power and energy sector. These two types of factors are essentially interlinked and correspond to each other.

7.5 Global Factors that Transform the Power and Energy Sector

The recent escalation of global energy prices, especially the prices of petroleum products, reflects the sweeping changes that are taking place in the global energy sector. However,

this can be considered as only the tip of the iceberg. Slowly, but steadily, fundamental changes are taking place that are likely to transform the sector significantly in the longer-term. Among the more important forces that are likely to influence these changes are:

- Growing concern over global warming and climate change
- Changing context of resource scarcity in global energy resources and rising demand from emerging economic powers
- Emerging trade-off between global energy and food security issues
- Technological advancements in the energy sector
- Emerging structural changes in energy markets and institutions

7.5.1 Growing Concerns Over Global Warming and Climate Change

Over the past few years, the threat of global warming and climate change has emerged as a major world issue. The Fourth Assessment Report (AR4) of 2007 prepared by the Intergovernmental Panel of Climate Change (IPCC) found evidence of human induced climate change. The rapid growth in emissions of green house gasses (GHG) from fossil-based energy sources have been identified as the major cause for this global phenomenon. It has been projected that the entire world community will have to face dire consequences of climate change unless immediate action is taken to reduce the rate of accumulation of GHG emission in the atmosphere. Scientists and environmentalists have advocated the necessity of creating a low carbon economy by changing the established pattern of energy use. As a result, negotiations for controlling GHG emissions have become a major issue in the international political arena. Despite controversial positions taken by certain Western powers in the global emission control negotiations, it is widely accepted that the world commu-

nity has to initiate some effective measures to face the inevitable reality of global warming and climate change without further delay.

Major implications that emanate from the climate change issue on the power and energy sector can be summed up as follows:

- Over the long-run, the world has no option but to switch to low-carbon intensive energy resources.
- Following from the above, the dependence on fossil-based energy sources should essentially be reduced over the short to medium term horizons.
- Identification, development and promotion of low carbon-intensive alternative energy sources will become the major future challenge for the energy sector.
- Reduction of fossil-energy as well as the development of alternative energy would involve significant costs over the short to medium-term periods. This should be considered as investments to mitigate disastrous economic situations in the long-run.
- Switching to a low-carbon economy would create more pressures on the developing South unless facilitated by the developed world through appropriate mechanisms of assistance.

7.5.2 Issues of Resource Scarcity and Rising Demand

All fossil-based energy resources which make the backbone of the modern global economic system are exhaustible over the long run. Concerns have been raised about rising scarcity of global energy resources,¹ particularly in view of uncertainty regarding economic deposits. These are issues relevant to all fossil-based energy, including petroleum and coal.

The price of petroleum has been rising rapidly over the past few years which in theory signal signs of growing scarcity. However, this signal is largely distorted by conditions found in global energy markets. While petroleum is geographically concentrated in a few developing countries, the industry is mainly controlled by a few inter-connected multi-national companies from the developed world. These companies, largely backed by the respective governments, enjoy significant market power. Therefore, the conditions found in global energy markets are far from competitive and global politics play a major role behind the scene.

Global energy markets, especially petroleum, are being influenced currently by three major economic and political factors, namely:

- Rising demand for available resources from fast growing developing economies such as China and India.
- Mounting contest for control over the resources by resource owning developing nations and the multinational companies, which are politically backed by respective developed countries.
- Disturbances caused by various political reasons in major supply regions.
- Effects of speculations by investors in the global energy industry.

It has been projected that at least four countries are destined to join the world economic superpowers sooner or later, namely, China, Russia, India and Brazil. The pressure on global energy resources from these economic growth centers are identified as one major reason behind the recent escalation of world energy prices, coupled with political disturbances in major oil supply regions.

The current international political arena is dominated by the contest of major political powers over global energy resources, particu-

¹ Hubert's peak oil controversy and Club of Rome projections are two well known examples.

larly for petroleum-based energy. Recent strategic advances of major political powers such as the US, China and Russia in oil rich regions of the world such as the Middle East, Latin America, Central Asia, Caucasus Region, the Far East, as well as the old and new oil regions in Africa, underpin this fact. This has led to various upheavals and confrontations between major political powers as well as oil rich developing economies. There are a few major implications on the power and energy sector due to such emerging global political and economic dynamics as follows:

- Power and energy issues have come to the forefront of the international arena, bearing a strong influence on the direction of global political discourse,
- The demand for global energy resources by major economic powers, emerging economies and oil rich developing countries has reached a heightened level of competition.
- Prospects and alternatives available for less powerful players in the global scene such as non energy-rich developing nations are increasingly more limited.

In this context, countries which are likely to face the greatest difficulties are non-oil producing developing nations. While lacking the necessary resources or capacity to invest on alternative energy sources, these countries will have to face the immense burden of the rising cost of oil imports in the foreseeable future.

7.5.3 Trade-off between Global Energy and Food Security Issues

Many analysts have raised concerns over a possible future trade-off between food security and energy security goals. Many developing countries, already hard-pressed by the problems of feeding their swelling populations, are likely to face further difficulties in meeting food security goals as some potential agricultural lands have to be re-allocated for energy crops. Overall, the issue can be

considered as a potential threat, particularly for Least Developed Countries (LDCs). The growing popularity of ethanol as an alternative fuel in certain countries provides an example. However, this problem has to be addressed cautiously to avoid unnecessary complications. Dubious claims - such as those suggesting that the allocation of lands for energy production was a major reason for the recent food price escalations - could lead to misguided policies.

7.5.4 Technological Advancements on the Energy Front

Not all circumstances surrounding the power and energy sector are negative. Emerging technological advancements can be considered as a promising development. Strong signals of escalating energy prices have prompted the business and scientific communities to explore technological alternatives. With increasing fuel prices, various sources of alternative energy which are at pilot or experimental stages have gradually become economic options. This has been further facilitated by growing concerns over the threat of climate change and rising competition over energy resources. Significant investments have been triggered as a result, especially in developed countries, on various schemes to promote alternative energy applications such as solar, wind, bio-fuel, geo-thermal, wave energy, etc., and in improvements in energy efficiency and reduction of energy waste.

Such improvements have added a new meaning to the concept of energy security. It has opened opportunities to adopt national energy security strategies according to the strengths of a nations' resource ownership and other relevant factors. Key strategies include diversifying energy mix and supply sources, introducing efficiency improvements to the existing systems, reducing the dependence on imported energy sources, and enhancing the environmental outcomes of the energy systems.

However, many such technological improvements have originated in developed countries. Therefore, developing countries need carefully designed policies to reap the maximum benefits from technological developments in the power and energy sector. In this connection, the following steps may have to play a major role:

- Initiation of national research and development capacities to undertake research on local energy resources.
- Introduction of suitable technological developments from other countries on a selective basis.
- Adaptive research on selected technologies to make them locally successful.
- Creating an enabling environment for the successful adoption of new technologies by citizens and businesses.

7.5.5 Emerging Structural Changes in Energy Markets and Institutions

Supplementing the technological advancements, new structural changes have also emerged in the energy markets to facilitate new developments. Traditionally, energy markets were dominated the world over by large oligopolies or state monopolies. In market economies, private oligopolies were usually justified on arguments of 'natural monopolies' and 'economies of scale' whereas the state monopolies in many countries were defended on the grounds of various political, national security and strategic reasons. The large scale nature of technologies that is normally involved in electricity and petroleum industries enhanced these arguments to a certain extent. Despite such justifications, large state and private sector energy organizations have constantly been subjected to heavy criticism over issues such as inefficiency, accumulation of market power, insensitivity to environmental prob-

lems, political patronage, mis-management and corruption.

New energy technologies have opened the opportunity for more competitive, flexible structures that can respond readily to changing realities than the old order structures. While conventional energy industries are still dominated by large enterprises, a new class of energy firms is fast emerging throughout the developed world, especially in the US, EU and Japan, which are aggressively promoting alternative energy technologies such as wind, solar and bio-fuel. For instance, in the US, alternative energy industry firms have become one of the fastest growing businesses supported by venture capital funds.² Overall, these structural changes have produced numerous lessons to be emulated in the power and energy markets globally, and help overcome some of the long standing institutional problems.

7.6 Emerging Opportunities and Constraints in the National Power and Energy Sector

In addition to global factors, there are some important internal factors that hold implications for power and energy sector reforms in Sri Lanka. Among them, oil exploration in the Mannar Basin, promotion of renewable energy options by the Sustainable Energy Authority (SEA), and emerging opportunities in the carbon market are the most important. Even though the government has already initiated certain activities to harness the opportunities presented by them, they have not received due priority in the power and energy reform agenda or policy debate.

7.6.1 Energy Sector Reforms and Oil Exploration: Expectations and Reality

It would be misleading to assume that a successful exploration of oil would provide so-

² This movement has even attracted some pioneers who formerly helped create the 'IT boom' in the Silicon Valley a few decades ago.

lutions to all or many of the economic constraints facing Sri Lanka. Global experience suggests, for example, that none of the oil-rich nations can be categorized as developed countries as yet even though many of them have reached middle-income status. Despite relatively high per capita incomes compared with other developing nations, many of these countries continue to suffer from various economic problems such as wide income inequality, a large share of poor in the population, poor social facilities and low human development conditions, etc., that prevent them from being categorized as success stories of economic development. While oil has no doubt helped small sections of these societies to become wealthy, rampant corruption, abuse of public resources, political instability and violence have worsened conditions for average citizens in some instances. Some groups concerned with the political-economy aspects of the issue argue that the negative influence of neo-imperial machinations by Western economic powers is mainly responsible for such outcomes. However, this does not provide a satisfactory explanation to grasp the complexity of the issues involved. For instance, many newly industrialized economies (NIEs) in South-East Asia have attained far better social achievements without the aid of oil wealth than oil-rich nations. On the other hand, there are examples of countries such as India and Malaysia that have attempted to manage the limited oil wealth more efficiently for the advantage of their citizens than some key oil producing nations. Ultimately, it remains a matter of effective and efficient management of a country's resources.

From the perspective of a long-term energy sector reform agenda, there are a few points that merit special attention as follows:

Management of the oil enterprise: The main lessons to be studied here are Sri Lanka's own experience in the oil industry. Despite the

fact that the country is yet to explore oil as a raw material, Sri Lanka does have the experience of managing a nationalized down-stream oil industry for nearly a half century. Ownership is not the question here since there are examples of successful oil utilities in other countries which are owned by the state. It is the model of management that makes the difference. Sri Lanka has to compare its own model with those of success stories from other developing countries before embarking on the oil exploration venture.

Vision of the oil enterprise: It is apparent that oil, as the key fossil-based energy source, cannot be considered as the main pillar of a sustainable energy strategy over the long run due to rising concerns over climate change mitigation. This means that even if Sri Lanka is successful in its oil venture, it is not going to alter the long-term national interests and objectives of the power and energy sector. Therefore, a successful oil industry in Sri Lanka, at best, has a role to play in short and medium term horizons. The potential wealth from oil should be managed and invested in a far-sighted manner so that it would uphold the long term goals and national interests. In this connection, policymakers should be careful not to become complacent about the long term national interests if oil starts to bring a significant flow of cash resources. There are a few potential pitfalls to be avoided here.

- Avoid creating an over-sized and over-dominant oil industry as usually happens in small economies with abundant cash resources from a prominent single sector.
- Avoid neglecting the importance of various alternative energy sources that can provide cost effective solutions.
- Avoid investing on projects, especially in the area of energy infrastructure, which are overtly dependent on oil.
- Avoid manipulation of economic policy for short-term gains from oil wealth.

Given the emerging realities of the global energy sector and climate change, the potential wealth from oil should be managed to serve the long-term national interests of the country.

7.6.2 Sustainable Energy Authority and Options for Renewable Energy

The Parliament of Sri Lanka passed the Sustainable Energy Authority (SEA) Bill No 236 of 2007 in May, 2007. The Authority is mandated to:

- Identify and develop renewable energy resources to enhance energy security.
- Promote and implement energy conservation programmes and efficiency improvements in different sectors.
- Develop policy, analysis and information management for cost effective, reliable and secure energy delivery.
- Ensure availability of adequate funds for sustainable energy.

Complementing the objective of the SEA, the National Energy Policy envisions generating 10 per cent of the total energy of Sri Lanka from non-conventional sources by 2015. The establishment of the SEA can be considered as a fulfillment of a long felt need of the energy sector. In this context, Sri Lanka lags far behind. India, for example, has a separate Ministry for Non-conventional Energy Sources while the establishment of the Indian Renewable Energy Development Agency (IREDA) dates back to as early as 1987. It would appear that Sri Lanka is at least two decades behind schedule and a jump start is necessary to catch up on lost time. From the perspective of a long-term vision for the power and energy sector, the success of the SEA is critical for the reasons discussed before.

The SEA has ample inputs to draw on given numerous innovations that can be adapted from other countries, as well as some pio-

neering efforts by a few Sri Lankan entities. The SEA has multiple roles to play as a catalyst, facilitator and innovator. The success of its activities will depend on an accurate understanding of its complex role amidst the dynamic changes taking place in the energy sector, nationally and globally. It has to adopt an innovative, practical and business-oriented approach in place of a conventional bureaucratic and administrative approach adopted by many government agencies. Thus, the institutional success of the SEA will hold a crucial role in the future sustainability of the energy sector in Sri Lanka.

7.6.3 Carbon Trade and Energy Sector

Carbon trade offers a good opportunity for integrating sustainable energy and climate change mitigation. What is important here is the Clean Development Mechanism (CDM) initiated under the United Nations Framework Convention for Climate Change (UNFCCC). The CDM provides the opportunity to attract foreign investment on sustainable energy projects from developed countries and earn carbon credits (Certified Emission Reduction or CER) for innovative energy solutions adopted by local enterprises. Both these opportunities can be considered as incentives to expand the share of sustainable energy sources in the national energy balance.

However, these opportunities are competitive and Sri Lanka has to take pro-active measures to develop a competitive advantage in the carbon market. The government as well as the private sector have to play important roles. Significant institutional improvements have to be introduced to create an enabling environment. These include institutional arrangements for processing CER applications, building local expert capacity, creating awareness among the business community about opportunities available, and the promotion of sustainable energy alternatives. The

government has recently launched the Climate Secretariat and Carbon Funds Ltd., under the Ministry of Environment and Natural Resources. This can be considered as an important step forward. The SEA also can make an important contribution by promoting innovative alternative energy solutions. Overall, the success of carbon market initiatives is largely dependent on coordinated efforts of relevant public agencies and the private sector.

7.7 Reality and Challenges of Reforms

The external and internal factors discussed in this Chapter introduce a new dimension to the reform agenda of the power and energy sector. Global energy markets are undergoing a turbulent period of transformation that could lead to major changes in the system. In the short run, it is being strongly affected by fierce global competition for fossil-based energy resources. In the long run, fossil-based energy has become a non-viable option due to the rising threat of global climate change and gradual dwindling of petroleum reserves. There is no other alternative but to switch to a low emission economy, or face the consequences of climate change. Therefore, an alternative global balance of energy with a low emission output has become an essential pre-requisite for sustainable development. This situation calls for the integration of energy policy with policy on climate change mitigation. Further, this integrated energy-climate change policy should be mainstreamed to macro development policies of countries.

Sri Lanka cannot escape the reality of these global challenges. The country should prepare for this challenge by adopting a systematic approach, with realistic planning horizons of short, medium and long-term targets. The long-term target should be to attain a low emission intensive national energy balance that would be capable of self sustained growth. The short and medium

terms should be viewed as transition phases to cater to achieve the long-term objective. The approach should essentially be an evolutionary process of learning and adaptation. The present reform agenda, which is aimed at enhancing the performance of the power and energy sector from the current poor standing, should be the immediate short-term objective of this long-term reform agenda.

A few key elements of this approach may be summarized as follows:

Technological transformation: This should be aimed at diversifying the energy mix while gradually phasing out the dependency on fossil energy sources. It has to be supplemented by constant expansion of the share of alternative clean energy sources. The best way to achieve this goal is to aim for an optimal energy mix for different economic sectors through an integrated strategy.

Policy and enabling environment: Energy policy should be integrated with mitigation of climate change, which would be mainstreamed to the macro-development policy of the country. Attaining the desired technological transformation should be a market driven process where the private sector plays a major role. However, the government has to play dual roles of facilitator and regulator for promotion of innovation, setting up of market based incentives for local and foreign investments, and creating a level playing field.

Institutional innovation: Coordination of the entire policy process should be achieved through innovative institutional arrangements and avoiding bureaucratic structures. The institutional framework should be designed to maximize innovation and economic dynamism. When it comes to productive economic ventures, the government should be the last resort, not the first. When essential, it should be on a public-private partnership basis.

7.8 Conclusion

Power and energy sector reforms have been a controversial issue in Sri Lanka. The current efforts to reform the power and energy sector are mainly motivated by matters pertaining to inefficiency, poor management, corruption and unsatisfactory performance of the state enterprises that dominate the formal sector of power and energy. This can be considered as a narrow approach considering the vast changes that the sector is undergoing at a global scale. Such changes have been mobilized by growing concerns over the threat of climate change, the rising demand for and growing scarcity of global energy resources, technological innovations in alternative energy and the changing structure of energy markets and institutions. These factors have a global influence over the power and energy sectors in the developing as well as the developed countries. They also provide a new rationale for reforms in the power and energy sector in Sri Lanka to lay the foundation for a new agenda that is more comprehensive than the existing one.

The key elements of a new reform agenda should be aimed at facilitating a long-term technological transformation towards a sustainable energy balance, creating an enabling policy environment for adoption of innovative energy applications, integration of energy reforms with policy on climate change mitigation, and institutional innovation that can facilitate private sector participation in the energy sector. This has to be implemented with a long-term vision, with clear short and medium-term objectives. It is necessary to take carefully selected decisions regarding all opportunities open to the energy sector, including that of oil exploration. In this regard, the SEA has the potential to make an immense contribution. In addition, the country should adopt a pro-active strategy to make use of the opportunities available in carbon markets. The success of all these interventions depends on adopting innovative institutional arrangements and achieving proper coordination among key stakeholders, including the private sector.

8. Does 'Foodflation' Call for Agricultural Reforms?

8.1 Background

In 2008, Sri Lanka experienced the worst food price escalation in nearly 30 years. Although 2008 records the peak of food prices so far in the country, this was not a sudden development. The upturn began in 2007 with a near 118 per cent increase in the price of imported milk powder,¹ followed by a 200 per cent hike in wheat flour price in early 2008. This was in turn to be followed by an alarming increase in the price of rice at the end of the first quarter of 2008. The present phenomenon of escalating food prices, however, is not an isolated experience for Sri Lanka, or any particular group of countries. Rather, it is a global development affecting many countries. Nonetheless, the impact is certainly more disastrous in developing countries where the bulk of family income is spent on food, particularly on staple food items.

The current developments in the food sector are neither an end nor a beginning of an era of high prices and scarcity. Fluctuations in food prices have been recurrent. The last such incidence in Sri Lanka, for example, started in 1972 and the one before was in the late 1940s. That too was not the first. Such instances have been recurring since Sri Lanka began to be heavily dependent on the world market for food in the early 20th century. While periodic food shortages are likely to have occurred in earlier times too, the causes of those famines were adverse local conditions. Today, experiences of food shortages and allied food price inflation owe to reasons from within as well as from beyond the national boundaries. For instance, the

price hikes in the early 1970s marked the end of a period of steady agricultural growth in the world. This was triggered by a sharp decline in grain production in the US and the former Soviet Union, diverting world grain stocks to meet the shortfall in these two countries. The situation was further aggravated by the rise in cost of production following the oil price shock that followed the formation of the Organization for Petroleum Exporting Countries (OPEC). The reasons for the present crisis are not exactly the same in spite of some common features. The current developments appear to be different from those relating to periodic food price hikes in the past.

The global economy, in general, has experienced relatively high economic growth, accompanied by decreasing food prices over the last three decades. These developments have been parallel to the increasing measures taken in the direction of freer international trade and economic globalization. Significant technological and institutional advances over this period have not been able to prevent the present global food price hike that may seriously aggravate the already pressing problems of hunger and malnutrition. An increasingly integrated world economy has either failed to read the price and institutional signals correctly, or has miscalculated the trajectory of such trends in the recent past. A close inquiry into the causes and effects of the global food price crisis is, therefore, appropriate.

¹ The CIF price of milk powder and wheat was increased from Rs. 104/kg in 1999 to Rs. 227/kg in 2005 and from Rs. 9,071/Mt in 1999 to Rs. 27,196/Mt in 2007, respectively.

Box 8.1**Food Price Increases: A World of Worries**

In 2007, global wheat prices rose by 77 per cent and rice prices by 16 per cent. These were some of the sharpest rises in food prices ever. In 2008, the speed of change has accelerated even further. Since January 2007, rice prices have soared by 141 per cent; the price of one variety of wheat shot up 25 per cent in a day. Over the last three years, staple food prices have increased by more than 80 per cent, while rice has doubled in price in just twelve months time. A run-up in global food prices in so short a period of time has not been witnessed since 1970.

These food price statistics can no longer remain in the abstract, confined to the realm of economists. The global developments today are such that the numbers mean the difference between worthy living and abject misery, or even death. The development is portrayed in terms of its most disastrous consequences by the assertion that *"famine traditionally means mass starvation. The measures of today's crisis are misery and malnutrition. The middle classes in poor countries are giving up health care and cutting out meat so they can eat three meals a day. The middling poor, those on \$2 a day, are pulling children from school and cutting back on vegetables so they can still afford rice. Those on \$1 a day are cutting back on meat, vegetables and one or two meals, so they can afford one bowl. The desperate – those on 50 cents a day – face disaster"* (The Economist, 17 April, 2008).

Skyrocketing prices of rice, wheat, corn and other staple foods like milk have direct impacts on ordinary people's lives, particularly those in Asia and Africa, where the bulk of income is spent on bare necessities for survival. Soaring food prices have incited unrest in some hard-stricken countries, such as Haiti, Egypt, Bangladesh and the Philippines. According to the FAO, 37 countries currently face food crises.

The turmoil has strong political implications. For instance, the continuing rice riots in Haiti recently have forced the Prime Minister to step down. In Asia, the soaring prices of rice, a staple food in the region, is putting leaders under intense pressure. The Head of the International Food Policy Research Institute (IFPRI) has stated that *"world agriculture has entered a new, unsustainable and politically risky period."* The Director-General of the Food and Agriculture Organization (FAO) has begun an Initiative on Soaring Food Prices (ISFP) in December 2007. Under this initiative, the FAO is offering technical and policy assistance to the most affected countries in an effort to increase local food supplies in the upcoming agricultural seasons and prevent the crisis from deepening further.

However, what is most striking is the reaction to the crisis by the World Bank and the International Monetary Fund (IMF). The President of the World Bank has warned that *"climbing food prices would set back efforts to reduce poverty by about seven years... While many are worried about filling their gas tanks, many others around the world are struggling to fill their stomachs...With little margin for survival, rising prices too often means fewer meals"*.

The Managing Director of the IMF observed that *"hundreds of thousands of people will be starving, leading to disruption of the economic environment, and development gains made in the past 5 or 10 years could be "totally destroyed" as a result...As we know, learning from the past, those kind of questions sometimes end in war"*. If such consequences are to be avoided, measures to tackle rising food prices have to be implemented as a matter of urgency.

8.2 Food Price Movements in General

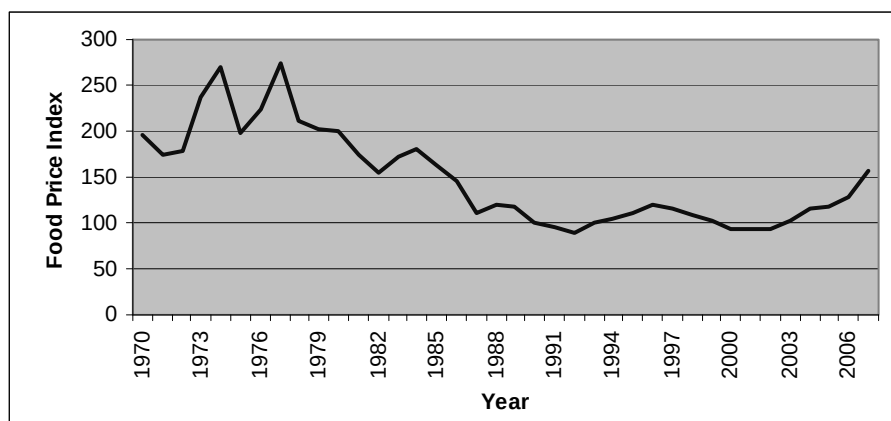
Fluctuation of agricultural prices has been a general phenomenon observed throughout the history of commercial agriculture. This is a result of agriculture being a biological production process, often undertaken by a large number of small producers. These patterns of price changes result from changes in demand and supply for the commodity in question, and they are in turn closely related to changes in biological, economic, institutional and political environments.

In the long run, food prices show general 'trends', either upward or downward. The direction depends on the relative magnitudes of growth in demand and supply. If the growth rate of demand exceeds that of supply, the long-term price trends would be upward and vice versa. Figure 8.1 shows that the real price trend in the global food market has been downwards during the last three decades. Relatively high growth rates of agricultural production following the adoption of green revolution technology from the late 1960s have been the cause of this phenomenon.

Figure 8.1 also shows that, while being on a long-term downward trend, agricultural prices show medium-term 'cyclical' fluctuations which are often related to changes in wider business cycles. The seasonal (or annual) weather dependent nature of agricultural production may cause a third set of changes as supply changes from one season to the other, resulting in short run 'seasonal' price fluctuations.²

The implications of falling real prices of food in the world vary depending on whether a country is a net importer or a net exporter of food. When prices fall, net importers save money on their imports while net exporters lose on their export earnings. Similarly, at the micro level, who benefits from a general food price decrease depends on whether an individual is a net food consumer or a net food producer. Net food consumers gain at times of falling food prices. However, this generalization is not wholly accurate since exporters can gain and importers might lose in times of falling prices, depending on the composition of the food commodity bundle being traded by a particular country.³ Con-

Figure 8.1
Real Food Price Index (1970-07)



Source: World Food Organization, www.fao.org.

² Seasonal price movements occur within the year and, therefore, are not clearly visible in Figure 8.1 which is based on annual averages.

³ Suppose a country is a net food exporter exporting milk and importing other food items. Also, suppose overall food prices fall due to falling prices of non-milk food commodities, while milk prices remain stable or even increase. In this case, the income from milk exports does not fall and expenditure on non-milk imports fall. Consequently, the country gains at a time of an overall food price slump even if it is a net food exporter.

sequently, the losses and gains of changing food prices have to be finally evaluated at the level of individual countries and, at the micro level, by the particular producer and consumer in question.

The food price hike in Sri Lanka in the 21st century coincides well with the global price trends at the time. This may lead to the convenient conclusion that global trends are the cause of the local trend because Sri Lanka is a net food importer. However, the global and Sri Lankan price trends in the past three decades do not suggest such correlations for all products. Further, as would be discussed below, the causes of the world food price rise is still being argued about. Consequently, delineating a cause and effect relationship between the global and SL food prices hikes seems difficult. Irrespective of the causes, the consequences are serious and disruptive for poorer countries, culminating in aggravated hunger, malnutrition, poverty and, possibly, social disorder and political instability. In this backdrop, this Chapter attempts to comparatively review the causes and effects of global and Sri Lankan

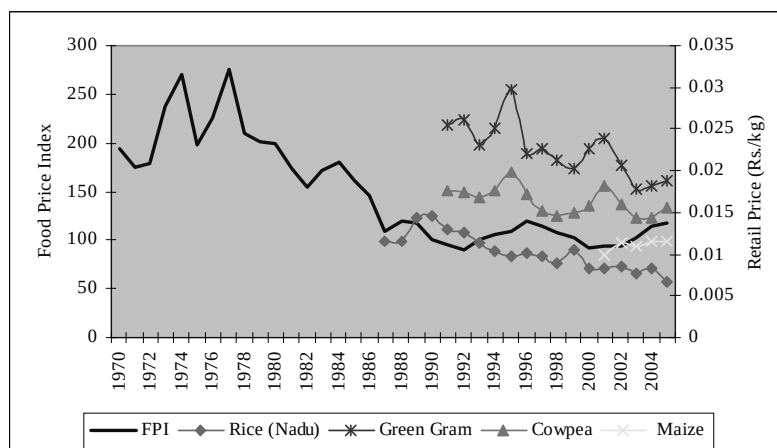
'foodflation' scenarios and, thereby, draw implications for any future efforts to mitigate it.

8.3 Three Decades of Agriculture

It is interesting to compare the global and Sri Lankan price trends over a longer period of time as it helps to understand the medium to long run changes in agricultural development. It also shows how global trends in agriculture have been influencing developments in Sri Lanka. Figure 8.2 compares the medium to long-term changes in global and Sri Lankan food prices.

The world food price index shows a steadily declining trend from the early 1970s to 2000. The real prices of food commodities in Sri Lanka, as presented in Figure 8.2, also follow this general downward trend. This is to be expected as Sri Lanka is an importer of these commodities, with only modest trade protection. It is also important to note that real prices in Sri Lanka have declined faster relative to the world price index, mainly due to the higher rate of depreciation of the Sri Lankan rupee.

Figure 8.2
Relative Movements of Real Annual Average Food Prices in the World and Sri Lanka



Sources: FAO for the World Food Price Index (FPI), and the Hector Kobbekaduwa Agrarian Research and Training Institute (HARTI) for Sri Lankan food prices.

The long term decline of real prices finds its causes on both supply and demand sides. Improvements in the supply side have been impressive during this period, with world food production increasing by 24 per cent between 1970 and 1990. For developing countries as a group, food production increased by 39 per cent over this period.

After increasing steadily during the 1950s, 1960s and 1970s, world grain production per person has been on a downward trend since the mid-1980s. Grain production per person in the developing world has remained constant since the mid-1980s. Corrective actions were needed at this stage to drive up, or at least maintain, per capita food production for the developing regions. This had to be a cause for concern, not just because the additional population needs adequate food, but factors in addition to population growth such as growing income and increased urbanization were pushing up demand for food, particularly grain.⁴

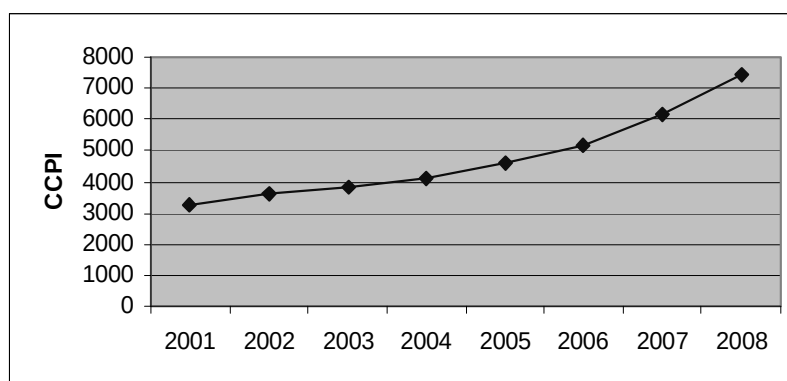
However, the urgency was not perceived by the policy makers of the day. The declining food prices in the world market were taken

too optimistically and the world food problem was perceived as being 'successfully handled'. This rather temporary positive state of affairs was treated with a serious lack of expediency and this led to a "complacency in many quarters regarding the world food situation" according to the International Food Policy Research Institute (IFPRI).

Such complacency in turn led to a reduction in investment in agriculture which is essential for its growth. It is the lack of growth in world agriculture, especially in developing countries in the last three decades that has resulted in the current gap between demand and supply of food, manifesting as global food price inflation starting in early 2000s (Figure 8.2). The food prices in Sri Lanka also followed this change of trend and the food component of the Colombo Consumer Price Index (CCPI) started a steep ascent around this period which continues to the present day (Figure 8.3).

During this period, investment in agricultural research and development by the global donor community lagged behind the requirement. The volume of resources dis-

Figure 8.3
CCPI for Food Items



Note: Base year 1952 = 100, 2008 data is related to the average of first four months.

Source: Department of Census and Statistics.

⁴ Pinstrip-Anderson, Per and Rajul Pandya-Lorch (1995), "The Supply Side of Global Food Security", *Economies et Societe's*. Reprint No. 322, International Food Policy Research Institute, Washington D.C.

bursed by the Consultative Group for International Agricultural Research reduced drastically and the already dwindling budget allocations by national governments of developing countries followed suit. Global economic growth during the last two decades has been centred around the campaign for freer trade, spearheaded by the World Trade Organization (WTO) with the support of developed countries as well as global financial institutions such as the World Bank and the International Monetary Fund (IMF). While there are both proponents and opponents of this move in general, the debate is perhaps most intense in the case of agricultural trade liberalization. Although this debate is not the focus of this discussion, there are a few related points that are imperative to be noted.

The first is the polarization of global food production in developed countries (37 per cent, 52 per cent and 39 per cent of global grain, milk and meat production, respectively).⁵ Based on (revealed) comparative advantage, these countries are justified in specializing in food production. However, it is the protection of their agriculture through heavy subsidies that acts against the interests of the less developed countries.⁶ Subsidization along with dumping of the excess supply in the world market renders the production of basic foodstuff uneconomical for millions of small farmers in developing countries. As a result, these countries have become increasingly dependent on the world market for their food requirement. The direct and indirect pressures from the WTO and the donor community amply contribute to this process. The net result is severe cut-backs of investment in agricultural technology, leading to the gradual erosion of the local food production base. This, in a world

of free trade of the form envisaged, could be harmless and, in fact, be beneficial for all parties. But in a situation of food shortage, this could drive world food prices up, bringing food insecurity to the dependent countries along with civil strife and political instability, as is evident in many parts of the world today.

The message delivered by over-enthusiastic free trade campaigners to the developing countries, directly or indirectly, was that local food production is no longer important and foreign exchange earned through increased exports can purchase their food requirements cheaply from specialized food producer countries. In this global environment of apparent food security, many developing country governments slackened their interest in agriculture. Yield improvements in crops and livestock cannot be achieved in haste, and the time lag between envisioning a new seed and growing it commercially in the field could be 10 to 15 years. Consequently, the solution to sudden developments such as the current increase in food prices lies in years of investment in agricultural technology improvement. This calls for forward vision and careful risk analysis.

Nevertheless, in the 1980s, developing country governments started to reduce green-revolution spending, either out of the aforesaid complacency or because they preferred to involve the private sector. But private developers do not find products with enforceable intellectual property rights in agricultural technology that can be disseminated among small producers, or new varieties of self pollinated crops like rice. Thus, investments in such fields are not attractive to private entrepreneurs. As a result, many private firms brought in to replace state funded re-

⁵ Calculation based on FAO statistics.

⁶ In 2006, for instance, producer support estimates in the US and EU were US\$ 29,289 million and US\$ 137,970 million, respectively, according to the OECD database (1986-2006).

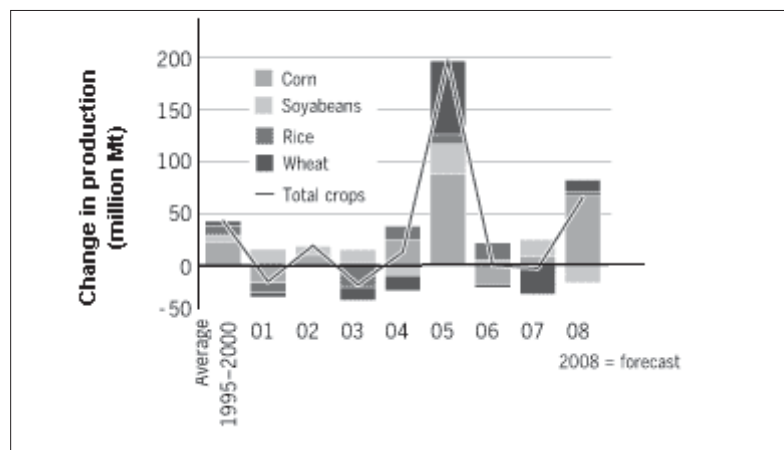
search have turned into rent-seeking monopolists where possible, rather than developers of public goods. Furthermore, in the 1980s and 1990s, large farm surpluses from the developed world were being dumped on markets, depressing prices and returns on investment, and discouraging public support for agricultural investment. Spending on farming as a share of total public spending in developing countries is estimated to have fallen by half between 1980 and 2004.⁷

Alterations in the structure of farming have exacerbated the effects of under-investment. In the past, the end of the chain nearest to consumers was less important. But over the past decade, this end of the chain has come to matter more. Food policy in many developing countries - under the general thrust of economic liberalization and export promotion - concentrated on agribusiness (value addition) and high valued cash crops at the expense of basic food crops in order to increase farm income. Further, the private sector directed their investments towards trade related enterprises with high short run fi-

nancial rates of return. The result of these developments was the slowing down of agricultural (mainly food production) growth rates in many developing countries and in the world at large. Figure 8.4 shows that world grain production has stagnated since the mid-1990s. While it is logical in a free trading environment, it led to a decrease in efforts to increase basic food production in these countries. What matters most in a crisis situation, as at present, is adequate basic food for the majority of the population. The green revolution of the 1960s, for example, provided new seeds and subsidized fertilizers for achieving this goal. The process seen in the global food sector in the last few decades, however, was a complete reversal. Sri Lanka was no exception to this general scenario.

Figure 8.5 depicts public spending on food crop research as a percentage of agricultural GDP in Sri Lanka over the years. The investment in agricultural research had an upward trend during the green revolution starting around 1970s. It is clear that this investment

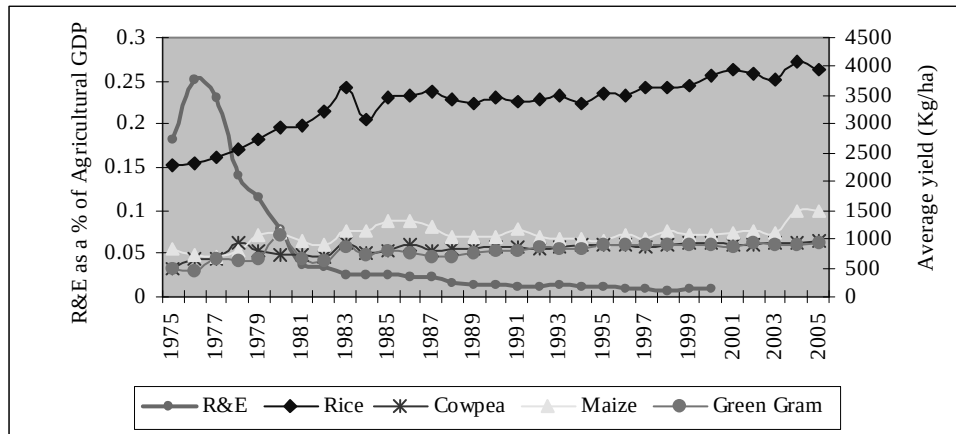
Figure 8.4
Production of Major Crops in the World: Difference from Previous Year



Source: IMF; Thomson Data stream.

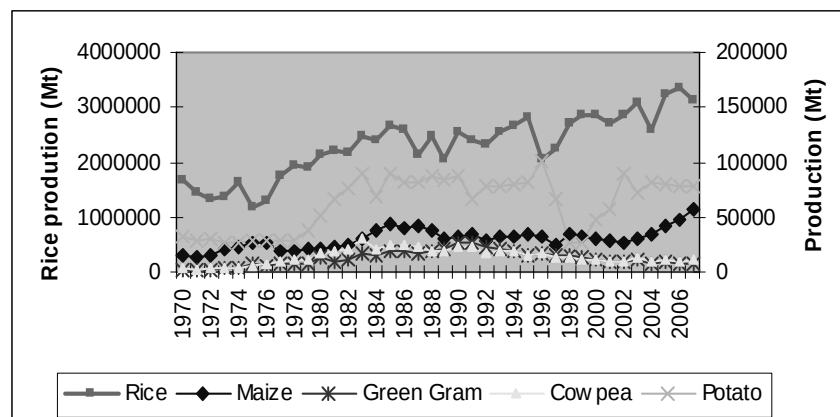
⁷ *The Economist*, 17 April, 2008.

Figure 8.5
Investment in Food Crop Research and Extension in
Sri Lanka and Productivity Growth



Source: Department of Agriculture and HARTI, *Agricultural Commodity Review*, various issues.

Figure 8.6
Food Crop Production Trends in Sri Lanka



Source: HARTI, *Agricultural Commodity Review*, various issues.

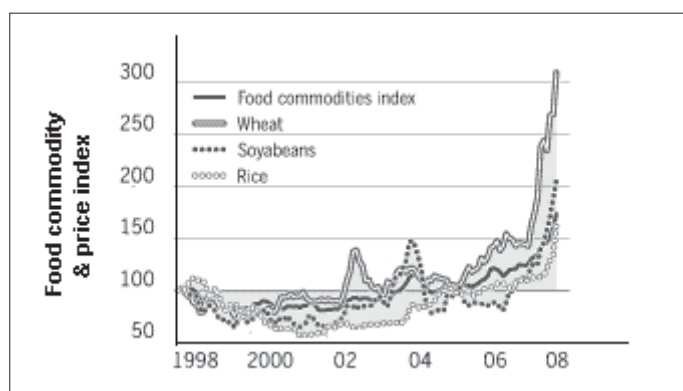
started declining in 1977 and continued on a negative trend thereafter. More importantly, it also shows how the yields of rice and other important food crops have started stagnating following this turn of events, after a long period of impressive growth. This yield stagnation combined with the restriction of area expansion to an apparent maximum at the completion of the accelerated Mahaweli diversion programme, brought the growth of

food crop production sector of Sri Lanka to a halt (Figure 8.6) setting the stage (on the supply side) for the current bout of foodflation being experienced in the country.

8.4 Present Foodflation

The current global food price hike actually started from 2002, but accelerated during 2007, especially from the middle of the year.

Figure 8.7
Changes in World Food Commodity and Price Index



Source: IMF; Thomson Data stream.

In 2007 alone, international grain prices soared by 42 per cent (Figure 8.7). The surge in prices has been led primarily by dairy and grains, but prices of other commodities - with the exception of sugar - have also risen significantly. Along with the price hike has come shrinking grain stocks worldwide. According to the FAO, the current world food reserve has dropped to the lowest level since 1980.

It is widely believed that natural disasters, coupled with market speculation, surging oil prices, and the expansion of bio-fuels, are pushing food prices up from the supply side. According to the World Food Programme (WFP), 57 countries have been hit by catastrophic floods, and harvests have been affected by drought and heatwaves in many others.⁸ A nine-fold increase of US production of ethanol as a bio-fuel within the last five years (at the cost of corn) has added to the problem. These short-term supply constraints superimposed over the long-term growth of demand due to increasing population and income, mainly in developing countries, have given rise to the present food price explosion. Further, after the US sub-

prime mortgage crisis triggered turmoil on the international financial market, a large amount of speculative funds is also estimated to have flowed into the less risky agricultural commodities futures market, pushing food price up along with oil, gold and other commodities. However, there is no consensus on which factor has contributed the most to push up prices.

In spite of the arguments on the role of commodity speculation and the bio-fuel drive on food prices, it is clear nevertheless that inadequate growth in agricultural production in the last two decades, particularly in the face of a rapidly expanding demand for food, is at the root of the current global food crisis and resultant food price inflation engulfing the world. On the demand side, it was obvious that the world's food requirement has been continuously rising due to population growth. Such growth was coming from the developing countries where food consumption is still falling behind acceptable standards. Rapid economic growth experienced in the last 2-3 decades by the majority of Asian countries and of some African countries, therefore, would obviously have

⁸ Global production of maize, rice and soybeans has stagnated during 2000-07 (see Figure 8.7) and according to the WFP, the world has in excess of 854 million hungry today.

led to increased demand for food. This situation has been further aggravated by the fact that these were the countries that accommodate the largest share of the world population.

Despite the impressive growth in the post-1970 period, global food production has barely kept pace with population growth. During this period, the global economy has recorded a growth rate of 2.9 per cent per annum on average while developing countries as a group has grown at an average rate of 5 per cent annually. Rapid growth in India and China were particularly important, as together, they account for 37 per cent of the world's population, spending on average around three-quarter of their per capita income on food.

It is also well known that rising personal incomes result in increased meat consumption and increasing urbanization and 'westernization' of diets in these countries. In China, for example, average per capita consumption of meat is estimated to have reached 50 kg in 2007 as against 20 kg in 1980. This development exerts further pressure on the world food system as, for instance, it takes about 6 kg of grain to produce 1 kg of meat. Nonetheless, such changes in demand for food were gradual; higher meat consumption in Asia was to be anticipated. Even with such expansion in demand for food, as Figure 8.1 depicts, global real food prices declined steadily until the end of the 1990s with only one temporary jump in the mid-1990s. The complacency and the ensuing slackening of development efforts in agriculture were ostensibly justified, but at the cost of the present foodflation and the plethora of social and political problems that followed.

Another key issue is whether food prices are likely to remain high. Two opposing forces are at work. The first is the market, which

will tend to bring prices back down as supplies expand and demand shrinks. But the latter is also what the world wants to avoid, at least in the case of the poor, since reducing their consumption is not so much a solution as a failure. The second force is the current intense pressure exerted by the rapidly rising oil prices on the supply side of the world's food system. The retail prices of food depend on the cost of production in farms as well as the cost of value addition, both of which are heavily energy dependent. As such, food prices are likely to remain relatively elevated, by historical standards, unless (or until) energy prices tumble.

8.5 Impact of Foodflation

As was mentioned earlier, prices do fluctuate in market economies, and it is specially so in the case of agriculture. As such, whether food commodities deserve any special treatment is a question that needs specific attention.

More than the supply side, it is demand side considerations that call for special treatment for food. Aside from clean air and water, food is the only other group of commodities that can be categorized as life sustaining. As such, the availability of nutritious food in adequate quantities at all times, a condition widely known as food security, is a human requirement that cannot be compromised. This is particularly so in the case of staple foods, which provide the basic energy requirement and a bulk of other nutrients essential for healthy and active living. Food security, as a result, is a social necessity that has to be maintained, even at the expense of short run economic costs where necessary, as the long-term social benefits definitely exceed such costs.

An important case in point is that higher food prices have powerful distributional effects; they hurt the poorest the most. In developing countries, three-quarter of income

is spent on food and, therefore, the people in these countries are hurt most in the case of rising food prices. Even among them, the hardest hit are the Low-Income Food Deficit countries (LIFDCs). These countries are particularly vulnerable as they tend to be net staple food importers (and also net importers of petroleum products). The recent price hikes in world food markets would have increased their vulnerability even further. The FAO has already listed 37 countries in substantial need of food assistance. Moreover, according to the World Bank, soaring food prices threaten to make at least 100 million more people hungry.

In the Asia-Pacific region, the poor, and the far larger numbers of those who are near-poor or vulnerable to poverty, suffer from under-nutrition that accumulates and have serious long-term consequences. Those in rural areas, and particularly those in the remote or disaster prone regions of South Asia, remain especially vulnerable to periodic bouts of severe hunger. Female headed households and girls in general, may go hungry even in households with sufficient food supplies. In theory, this rapid increase in food prices should increase the prevalence and depth of hunger, because higher food prices are expected to lead to lower consumption of calories and protein, particularly amongst the families of urban poor and the rural landless labourers. At the same time, net selling farmers should be experiencing windfall earnings, providing for higher levels of consumption and allowing higher levels of real wages to be paid and transfers provided.

Given possible offsetting effects, it is pertinent to raise the issue of what evidence there is that soaring food prices are contributing to increased macro-nutrient deficiencies in the Asia-Pacific region. Whether agricultural wages and private transfers are increasing sufficiently to offset the dramatic rise in staple food prices could be a debatable point.

Nevertheless, in the current context where the developed countries are net food exporters and less developed countries as a group are net food importers, who benefits from global foodflation is not a difficult question to answer.

8.6 The Sri Lankan Case

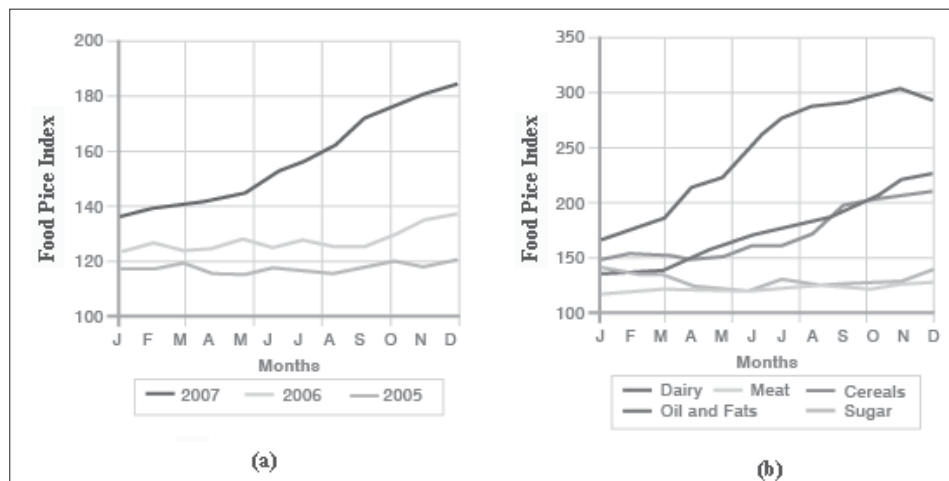
Many would be inclined to rush to the conclusion that Sri Lanka's current foodflation follows directly from the global development discussed above, particularly, the recent escalation in rice prices. However, it is only a partial truth in explaining the cause of the present crisis in Sri Lanka. It is accurate to the extent that it is a result of Sri Lanka being a net food importer, but it is fallacious to believe that the present crisis is a proliferation of a temporary global event. Sri Lanka's major import food commodities are wheat, corn, sugar and milk powder. The traditional and preferred staple food is rice; only 4 per cent of the annual requirement of rice is currently imported. Figure 8.7 clearly shows that rice prices in the world market have been relatively stable till 2004, with only a slight increase during 2004-07. Figure 8.8(a) reveals that the global food price hike started in early 2007 and that was mainly due to the sharp upturn of cereal prices as indicated by Figure 8.8(b). The prices of the other two major food imports of Sri Lanka, sugar and dairy, were comparatively stable. In fact, the price of sugar in particular has not contributed at all to the present crisis. This leaves wheat, corn (maize) and dairy products as the major sources of the present foodflation of Sri Lanka.

Figure 8.9 throws light on the relative contribution of rice, maize and wheat towards the rise of cereal prices. As depicted in Figure 8.8(b), the upturn in cereal prices started in January 2007 while, from amongst the three cereals shown in Figure 8.9, only wheat prices took off early. In fact, the price of

rice started its ascent in January 2008 and the contribution of maize prices was modest and gradual. This is consistent with the contention that, in Sri Lanka, the onset of the foodflation goes back to the early 2000s

and it was not the global price of rice that triggered off the current foodflation - it only took a sharp upturn in 2008 following the sudden jump in the price of rice in the world market.

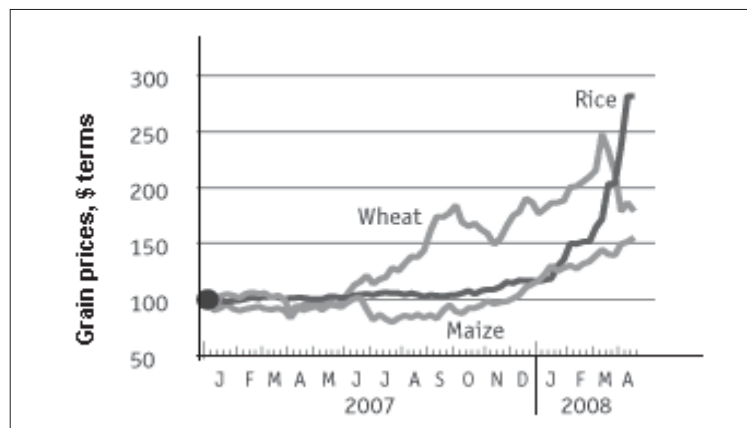
Figure 8.8
(a) Rising Food Prices by Months (2005-07) (b) Monthly Price Rises by Food Type



Note: Changes in price are indexed against the costs dating from 1998-2000 (1998-2000=100).

Source: <http://www.fao.org/worldfoodsituation/en>.

Figure 8.9
Shooting Up of Grain Prices: Wheat, Rice and Maize



Note: January, 2nd 2007 = 100.

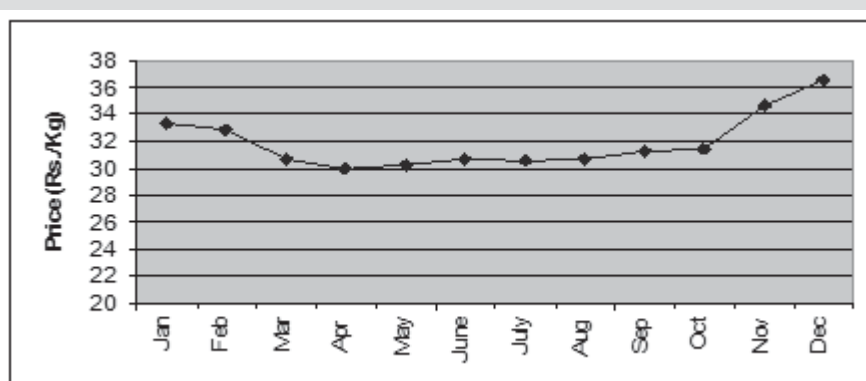
Source: Chicago Board of Trade.

Box 8.2 Rice Price in Sri Lanka

Rising food prices that have been an issue in Sri Lanka for years climaxed with the unprecedented escalation of the price of rice in March/April 2008. Food prices in Sri Lanka since the early 2000s were driven up by imported milk food and wheat flour prices and, rice price in particular, was the channel through which the latter makes its impact. For example, the rise of wheat flour price in 2007 from Rs. 17.23 to Rs. 27.20 per kg immediately jacked up the price of rice from Rs. 38 to Rs. 51 per kg. In effect, the medium-term price movements of rice in Sri Lanka are chiefly governed by wheat prices, while short-term price movements are weather dependent and long-term changes follow cost of production and the state determined producer support price. As Sri Lanka is presently producing over 90 per cent of the annual rice requirement, the impact of world market prices has been minimal. As such, the sudden shooting up of rice price in Sri Lanka in March/April of 2008, although attributed to peaking world price, seems unwarranted.

The retail price of rice in Sri Lanka has a cyclical pattern and this is dependent on the seasonal production patterns (see diagram below). Prices fall in April following the harvest of the Maha season in February/March and remain low till October. Around this time, domestic stocks from both the Maha and Yala seasons start running low and prices tend to increase, with the highest prices in the cycle recorded in December-February. Imported rice makes its major contribution during this period and high prices in the international market, if any, are reflected in local prices during this period.

Monthly Average Retail Rice Price Fluctuation (2000-07)



In 2008, there was an unprecedented 200 per cent increase in the retail price of rice in Sri Lanka. To worsen the situation, this hike came in April, the month of decreasing prices under normal circumstances. Nevertheless, the Maha season of 2007-08 was not a failure. Some rice areas were affected by excessive rains at the harvesting time, but the overall output was not seriously affected, and there was no real reason from the domestic side, for an unusual increase in price on the assumption that the market operates freely. Had the price hike been due to high prices in the world market, reinforced by export restrictions imposed by countries such as India and Thailand, as is widely claimed, the high local price should have come in May or June but not in March/April due to the usual time lag involved in international transactions. Thus, a near doubling of the retail price of rice in the two months ending in April 2008 in Sri Lanka cannot be expected in a well functioning competitive market.

If the observed behaviour deviates from what is expected in a competitive market, the rational conclusion is that there has been an element of market failure involved. In fact, the rice market in Sri Lanka is failing at the present time due to market concentration. Although a clear monopoly situation cannot be seen, an oligopoly of a few rice collector-stockist-miller combined operators is clearly visible. Even though there is a larger number of small processors in the sector, the power – market as well as non-market – of the few large operators prevent them from purchasing paddy at farm level. They have to depend on the large collectors and/or the state run Agricultural Commodity Marketing Authority that collects and stores paddy under the guaranteed price scheme. Both these institutions stand as impediments to the proper functioning of a free market, either due to undue power or inefficiency. The net result is that these organizations enjoy some leverage in controlling the supply and consequently the price of rice, particularly in the lean months of the year.

A possible explanation that follows the rice price hike of 2008 is the presence of an element of speculative behaviour on the part of the oligopolists. With the rapidly increasing rice prices, these agents set their targets to increase the price of not only imported rice, but also the locally produced stock expected to reach the market from March. The stepping in of the government in April 2008 with a controlled maximum price of Rs. 70 per kg foiled this scheme, but the powerful traders reacted by withholding stocks and thereby restricting the supply. The irony is that the state apparently does not have an effective plan or a mechanism to counter this strategy. However, this situation is not likely to persist beyond August 2008 as the upcoming Yala harvest would exert downward pressure on prices in the short run. In the long run, the increased rice prices would encourage producers to increase supply, as the Sri Lankan rice sector possesses a positive supply response elasticity.

A final issue of interest is whether the present resistance staged by the rice traders to the ceiling consumer price of Rs. 70 per kg of rice is in anyway justifiable. Following the increase of the guaranteed minimum price of paddy to Rs. 24 per kg of paddy, the effective private sector price has been around Rs. 30 per kg. The rice sold in April 2008 was bought at this price, or less. Assuming a conservative milling outturn of 68 per cent, a kg of consumer rice costs Rs. 44, net of any milling, transport, storage or retailing margins. Assuming a collecting and milling cost of Rs. 9.50 per kg and Rs. 2.00 and Rs. 2.50 per kg of rice for intercity transport and storage/retailing, respectively, the retail cost comes to Rs.58 per kg. That leaves a profit of Rs.12 per kg, a rate of net return of over 20 per cent within a period of 6 months. Thus, the ceiling price of Rs. 70 per kg does not seem to be without basis, compared to what is possible in a competitive market. However, this price does not cover any rent or speculative gains possible within other market structures and this is an adequate reason for the powerful oligopolists to clamour about.

Further, the almost flat trend of the world price of rice in 2000-07 cannot explain the gradual rise of the general food price index of Sri Lanka within this period (Figure 8.9). It clearly implies, therefore, that the gradual rise of wheat price, supported by the price of milk food, is the root cause of this development. The world price of rice cannot translate into a domestic price of Rs. 90-100 per

kg at a stretch in Sri Lanka given that it is currently producing over 95 per cent of the annual rice requirement. At best, it is an artificial and temporary reaction of the Sri Lankan wholesalers to the global price hike. Further, Sri Lanka has a positive supply response to price in the case of rice, and domestic supply would increase in the medium run to partially counter the price hike. What

is more relevant for a steady jacking up of the price of rice in Sri Lanka is, therefore, the rising cost of production and the support price declared by the state to cushion it.

What is unfortunate, though, is that Sri Lanka has neglected the food production sector for more than two decades for the reasons explained before. Consequently, technology has not developed to a state that permits domestic production to rise and maintain the prices at an affordable level in any of the three locally produced commodities mentioned above. As a result, it is past government policy that is largely responsible for the current predicament. Similarly, it will be the policy decisions of today that will determine the level of vulnerability to global food price fluctuations tomorrow. Wheat, which cannot be grown in Sri Lanka for technical reasons, will remain as an effective conduit of global price fluctuations into Sri Lanka, as long as Sri Lankan people wish to maintain their wheat flour consumption at a high level. In fact, from among the global prices, it is rising wheat prices, not the rice price, that started the sharp upturn of rice price in Sri Lanka in as far back as mid-2007.

8.7 Investment in Agriculture As a Solution

Investment in agriculture has traditionally taken the form of expansion of agricultural area through land development and yield expansion via the development of new technology. In most low-income developing countries, the agricultural sector takes the lead in stimulating overall economic growth and poverty alleviation. In the early 1990s,

it was estimated that an additional dollar in agricultural income increased total income by US\$1.96 to US\$2.75 in a group of least developed countries.⁹ In Asia, one dollar of direct growth in agriculture income was found to result in total income growth ranging from US\$1.46 in Madhya Pradesh, India and US\$1.83 in Malaysia.¹⁰ Of various investments needed to facilitate agricultural growth, yield increasing production technology is of critical importance. Area expansion was no longer feasible or profitable in many parts of the world by the late 20th century, and further increases in cultivated area would result in resource degradation. Besides higher yields, crop varieties that are more tolerant or resistant to pests and droughts, and new varieties and hybrids better suited for various agro-ecological conditions, reduce risks and uncertainty and enhance sustainability in production.

Increasing costs of production due to continuously rising oil prices also calls for new cost reducing technologies. Accelerated investment in agricultural research and technological improvements is the only viable options for meeting future food needs and demands at reasonable prices without irreversible degradation of the natural resource base. Improved rural infrastructure is needed to facilitate access to markets - local, national and international - for both outputs and inputs. Farmers need access to modern inputs such as improved livestock, crop varieties and hybrids, fertilizers and pest control measures, and credit, technical assistance and so forth to meet food production goals. In order to bring all these requirements within the reach of the farmers, the institutional set-up has to be upgraded with ap-

⁹ IFPRI, (1994), "Agricultural Growth Linkages in Sub-Saharan Africa", A report to the United States Agency for International Development, IFPRI, Washington.

¹⁰ Bell, C., P. Hazell and R. Slade, (1982), "Project Evaluation in Regional Perspective: A Study on Irrigation Project in Northwest Malaysia", John Hopkins University Press, Baltimore.

propriate technology to complete the package. There does not seem to be any other alternative or a short cut for this process.¹¹

8.8 Summary and Conclusion

The gradual rise of food prices that started in the early part of the decade was a result of a systematically developing mismatch between the world's demand and supply of food. The present crisis is only an exacerbation caused by other developments such as the diversion of limited resources for bio-fuel production or speculative buying of grain stocks. Gradually, rising prices of inputs such as fertilizer also restricted food supply through increased cost of production. The background for the current situation has been in the making for decades.

Neither the randomly fluctuating global weather patterns nor the volatility of the global economic environment can be held responsible for the current crisis. Such factors do change over time and the market prices of food move up and down accordingly, both randomly and systematically. Prudent economic management should allow for these contingencies or, especially in the case of systematic fluctuations, counter measures should be planned ahead of 'disasters' so that the negative impacts could be minimized. A key cause of the current food price escalation is related to global policy on agriculture, essentially derived from trade centred general development policy that did not read, or ignored, the simple development dynamics during the last three decades. Distortions in the global agriculture market, primarily on account of large agricultural subsidies in developed countries, have also contributed to discouraging poorer countries

from engaging in agricultural pursuits in which they enjoy a comparative advantage.

Notwithstanding the ability of freer trade and specialization to achieve faster economic growth - and even equity and poverty reduction - in a favourable environment, it should also be stressed that this momentum withers away under unfavourable circumstances. Unfortunately, what the world is experiencing today in relation to food security is an emergence of the latter. What is disturbing is that this is not only due to random and unexpected circumstances, but also due to negligence of forewarnings and complacency towards any concerted efforts to avert possible calamity. The negligence or complacency, whether imposed by global economic powers or embraced on free will, resulted in a failure to appreciate the emerging dangers on both demand and supply sides. This is true for the entire world that is food deficit and all the developing countries which are also food deficit, with Sri Lanka being no exception. Consequently, the following synopsis is presented as a common-for-all comment, yet directly transmutable to the Sri Lankan context.

As explained above, the continuous growth in food demand due to rising population - reinforced by increasing income in developing countries during the last three decades - constituted the demand side of the present food crisis, while the deliberate cut-back of investment on improving technology based agricultural productivity growth made up for the supply side. This state of affairs was engendered by the leniency of the assumption that the food availability at macro or global level is adequate to ensure food security for

¹¹ One new development in the field of food economics is the increased attention paid towards "urban agriculture". This paradigm revolves around the two facts that the rate of urbanization has significantly increased in the past 2-3 decades and a substantial proportion of the food requirement of the urban populace can be produced within the urban sector itself. With the right attitudinal change in the urban dwellers, this added production can be realized as near zero added cost. In the case of Sri Lanka, it is encouraging to see that this opportunity has been correctly recognized and given the highest level of political patronage in the urban agricultural drive under the "Api Wawamu Rata Nagamu" initiative.

the masses. The crucial question of distribution rooted in food accessibility and affordability was disregarded. The gradual distancing of the traditional food production bases in developing countries from their food consuming masses in favour of specialized foreign food producers further aggravated the problem. Protectionism practiced by such developed country food exporters worsened the situation further. Moreover, the imminent prospect of a sharp rise in fuel prices and the ensuing implications on the poor majority was also sidelined. What has erupted as global foodflation is nothing but the cumulative outcome of these problems that have been smouldering for more than two decades.

Having looked in to the causes of the problem, the final issue is on what ought to be done to correct it. A food crisis in the short run is a humanitarian problem and relief issues come on top of the agenda. Food aid in adequate quantities, in correct localities, is the immediate requirement. But, for this to be successful, relief programmes have to be backed by efficient stock maintenance and food surveillance which are medium-term rather than short-term undertakings. Relief notwithstanding, the real and sustainable solution to the recurring food shortages lies in managing the demand and supply of food in the long run.

Given population growth rates, which are not likely to come down substantially in the near future, the only remaining demand side manipulation is restricting consumption. This is plainly impossible in today's context of world economic and political affairs, except as a temporary measure to tide over an emergency. Thus, increasing the global food supply and, perhaps more importantly, increasing an individual country's food supply is the only available buffer against future food crises. As stressed before, private entrepreneurs do not find the necessary in-

centives to shoulder this social responsibility and it should be undertaken by national governments supported by international organizations. The past trend of declining public investment in agriculture, especially in research, extension and institution building, has to be reversed. Private sector investment which was mainly in the direction of high value food products, food processing and value addition will have to be rationalized to reflect a sense of social responsibility, in addition to private profit making. This, in fact, could benefit from the present crisis which has jacked up the prices of basic food commodities, particularly grain, making their profitability favourable and, thereby, providing production incentives. The removal of protection on developed country agricultural sectors will further help incentive structures relating to developing country food production to be corrected.

Obviously, a quantum leap in agricultural productivity is the most positive solution to this problem. The closest that modern technology has got towards this goal is the Genetically Modified (GM) food crops (and livestock). Aside from the debatable issue of related health implications, the GM food drive entails a serious political economic consideration, especially in the context of less developed and developing countries. GM crop varieties and livestock breeds are products of modern cutting-edge technology for which the property rights are held by large transnational corporations. If any country adopts GM foods on a large scale, it will have to depend on these global giants for their planting material. This can have far reaching economic and political implications. Further, the current food production based rural economies would lose their prime ownership - i.e., ownership to their indigenous genetic material if they become dependent on an 'alien' genetic base that they could not maintain in their environment. As such, GM foods as a solution to

the global food problem is not yet in the offing and the world will have to depend on more traditional technological and institutional measures to tackle this problem.

All these measures may result in a divergence from high growth rate oriented development mainstream thinking of the day.

However, what is at the centre of all development efforts is human wellbeing and food security as the most fundamental guarantees needed for secure and decent living. As such, even though attaining food security may entail a sacrifice in terms of a slowdown in growth, it is still an option worthy of serious consideration.

9. Liberalization of Trade in Services

9.1 Introduction

Services play a dominant role in countries across the world regardless of their level of economic development, accounting for a substantial proportion of output of a country and employment. Trade in services has also grown in importance, outpacing the growth in merchandise trade, and occupying a substantial share of international trade and investment. Much of this growth has been due to advances made in information and communication technology, coupled with deregulation and privatization of the sector across the world. Developing countries, including those of South Asia, are increasingly participating in trade in services and seeking greater investments in the sector. Sectors such as information technology (IT), business process outsourcing (BPO), tourism, construction, and energy are some of the important services in these countries, with India being a dominant player in the region due to its success in the export of IT and BPO services. Like many labour abundant developing countries, South Asian countries too have an interest in the export of labour intensive exports, as indicated by the sizeable share that remittances play in these economies. They also have an interest on the import side in terms of attracting investments in telecom, banking, insurance and transport services, which are capital and technology intensive. Thus, South Asia stand to gain from liberalization of movement of labour as well as liberalization of foreign direct investment (FDI) which would increase FDI flows to the services sector. However, to date most countries in the region, other than India, have failed to make the most of the opportunities available under trade in services.

In the case of Sri Lanka, the services sector accounts for a substantial share of the economy. The country has not only unilaterally opened up a number of services sectors, but has also engaged in negotiations at both the bilateral and multilateral levels - as it has become increasingly more involved in both the export and import of services. These developments are likely to bring about opportunities for the economy, but they can also pose challenges which need careful consideration at policy levels. In this context, this Chapter looks at the liberalization of trade in services in Sri Lanka, highlighting the opportunities as well as the challenges present. The rest of the Chapter is organized as follows: Section 9.2 provides an overview of the importance of the sector to the Sri Lanka economy. Section 9.3 looks at the liberalization undertaken by the country to date autonomously as well as at the multilateral level through the General Agreement on Trade in Services (GATS) framework of the World Trade Organization (WTO). Section 9.4 discusses modes and sectors in which Sri Lanka has an export/import interest, and the benefits which would flow from their liberalization, while the remainder of the section highlights some of the concerns associated with opening up of the sector in the country. Section 9.5 examines the telecom sector in Sri Lanka as a case study to illustrate the benefits as well as some of the concerns in liberalizing the sector.

9.2. Importance of the Services Sector to the Sri Lankan Economy

The services sector in Sri Lanka has grown to occupy an important position in the economy, contributing more than half the

GDP (59.6 per cent) in 2007 whilst agriculture and industry accounted for about 11.9 and 28.5 per cent of GDP, respectively (Table 9.1). The sector has been growing consistently at a higher rate than GDP growth over the years, much in line with trends in the rest of the world. In 2007, for example, the services sector recorded a growth of 7.1 per cent while the economy as a whole grew at 6.8 per cent. The major drivers of the services sector have been transport and communication (which grew by 10.5 per cent in 2007), and banking, insurance and real estate, etc. (8.7 per cent). The service sector is also a significant generator of employment and accounts for about 42 per cent of total employment in the country, whilst agriculture and industry accounted for 31 and 27 per cent, respectively, in 2007. The largest employers in the services sector were in personal services (41 per cent) and trade and hotels (35 per cent) of total employment generated in the services sector in 2007.

However, the performance of trade in services has been more limited relative to trade in goods, which exceeds trade in services by a significant margin (Table 9.2). Nevertheless, the services account registers a net sur-

plus unlike that of the merchandise goods. In addition, the importance of specific sectors, such as the role of remittances in the export of services cannot be discounted. Remittances brought in US\$ 2.5 billion to the Sri Lankan economy in 2007 (accounting for nearly 8 per cent of GDP) generated by migrant workers, mostly low or unskilled workers going abroad to provide their services. Other important sources of income from trade in services include transportation services provided at the Colombo port and by the national carrier, and information technology services supplied by BPOs.

FDI coming into the country has also been predominantly directed to the services sector over the last decade (Table 9.3). More recently, a substantial inflow of such FDI has been into the telecom sector which has been recording impressive growth rates. If these other contributions of trade in services - which are not entirely captured in the aggregate figures - are added up and taken into account, the importance of trade in services would be much higher than what is currently reported. Thus, the underlying importance of trade in services to the Sri Lankan economy is clear.

Table 9.1
Components and Growth of GDP in Sri Lanka (2007)

Sector	Growth (%)	Contribution to Change (%)	Share of GDP (%)
Agriculture	3.3	6.0	11.9
Industry	7.6	31.7	28.5
Services	7.1	62.4	59.6
Wholesale and retail	6.1	22.3	24.6
Hotels and restaurants	-2.3	-0.1	0.5
Transport and communication	10.5	19.2	12.4
Banking, insurance and real estate	8.7	11.0	8.5
Ownership & dwellings	1.1	0.6	3.4
Government services	6.0	6.8	7.7
Private services	7.8	2.7	2.3

Source: CBSL, *Annual Report 2007*.

Table 9.2
Share of Services in Overall Trade (US\$ million)

Item	2006			2007		
	Credits	Debits	Net	Credits	Debits	Net
Goods	6883	10253	-3370	7740	11301	-3561
Services	1625	1368	257	1711	1473	238
Total (goods and services)	8508	11621	-3113	9451	12774	-3323

Source: CBSL, *Annual Report 2007*.

9.3 Liberalization of the Services Sector to Date

Sri Lanka has undertaken liberalization of its services sector as part of a larger reform process in the economy. Services sector reforms have been done mostly on a unilateral basis with significant modes of services (Box 9.1) and sub-sectors liberalized over the years. In terms of Modes 1 and 2, exchange controls have been removed facilitating cross border trade and consumption abroad. Mode 3 is very liberal with FDI allowed into Sri Lanka in almost all sectors of the economy, with the exception of a few sectors for which there is a ceiling on foreign ownership. But even within these sectors, foreign ownership of

more than 40 per cent is allowed subject to approval by the Board of Investment of Sri Lanka (BOI). Nevertheless, certain sectors such as money lending, pawn broking and retail trade with a capital of less than US\$ one million are reserved for locals. Comparatively, under Mode 4, Sri Lanka is less liberal. For instance, employment of foreign services suppliers require approval from the relevant ministry, except in the case of foreign investments approved by the BOI. Sector-wise, Sri Lanka over the years has unilaterally opened up financial services, insurance, tourism, and telecommunications to name a few.

Table 9.3
FDI Entering Sri Lanka by Sector (2006)

Sector	No. of Projects	FDI (US\$ mn.)
Food, beverages & tobacco	28	34.1
Textile, wearing apparel & leather prod.	64	103.5
Wood and wood products	5	4.4
Paper, paper products, printing & publishing	4	0.8
Chemical, coal, petroleum, coal, plastic	32	43.2
Non-metallic mineral products	8	5.3
Fabricated metal, machinery & transport eq.	20	14.1
Other manufactured products	46	29.5
Agriculture	6	0.7
Services & infrastructure	162	368.2
Total	375	603.7

Source: Board of Investment of Sri Lanka (BOI).

Box 9.1
Four Modes of Supply under GATS

Mode 1	(Cross border supply): neither the producer nor the consumer moves physically but the transaction takes place through telecommunication or some other network.
Mode 2	(Consumption abroad): consumer moves temporarily to supplier's country.
Mode 3	(Commercial presence): commercial organization moves to the consumer's country of residence.
Mode 4	(Presence of natural persons): an individual service supplier moves temporarily to the consumer's country of residence.

At the bilateral level, Sri Lanka is in the process of negotiating a Comprehensive Economic Partnership Agreement (CEPA) with India which includes a chapter on services. The agreement is expected to be signed before the end of 2008 and will deepen economic cooperation with Sri Lanka's largest trading partner in the region by moving beyond trade in goods covered under the India-Sri Lanka Bilateral Free Trade Agreement which was implemented from 2000. Under the proposed agreement, Sri Lanka has requested India to open up tourism, retail, finance, insurance, maritime and aviation services. In turn, India has requested Sri Lanka to open up finance, insurance, audiovisual services, information and communication technology (ICT), transport, tourism, maritime, energy, education, construction, and professional services. Pakistan is also interested in deepening its free trade agreement (FTA) with Sri Lanka along the same lines in the future, and initial negotiations have begun to explore this possibility. Other than the bilateral initiatives, both the South Asian Association for Regional Cooperation (SAARC) and the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC) have expressed their intention to deepen cooperation to include trade in services.¹ It is expected that a frame-

work agreement on services for SAARC would be negotiated soon. With the slow progress under the multilateral framework, many countries, including Sri Lanka, are increasingly looking at regional and bilateral arrangements to liberalize trade in goods and services.

At the multilateral level, Sri Lanka's initial commitments under GATS were limited to tourism and travel related services in 1994. Sectoral commitments were further expanded in 1997 to include financial services and telecommunications. Sri Lanka also tabled a revised offer as part of the Doha Round of trade negotiations in 2003, but no new sectors were offered. Nevertheless, further liberalization of the three sectors previously committed, particularly in Mode 3, were part of the conditional offers. In turn, Sri Lanka has submitted its request list to 18 countries under the GATS negotiations. The requests have been in professional, computer related, communication, transport, health related and social services, and services auxiliary to all modes of transport. Requests are for full commitments in all modes of service supply.

Under the Doha Round of trade negotiations, Sri Lanka, however, has not been particularly active in services negotiations under GATS.

¹ In this regard, a study was undertaken by countries in South Asia to look at the prospects for cooperation in trade in services. The SAFTA Ministerial Council is to commence negotiations on a framework agreement which was welcomed by the Heads of State at the 15th SAARC Summit held in Colombo in August 2008.

Nevertheless, it has engaged in negotiations on a bilateral basis largely on account of the interests of other countries. While there has not been any overt pressure on Sri Lanka at the multilateral level to open its services sectors further, it is important that the country considers and undertakes further commitments at the multilateral level. While Sri Lanka may not need to make any commitments in the services sector under the current Doha Round due to the voluntary nature of negotiations under GATS, it may need to consider how the initial offers made in 1997 could be improved as part of the larger strategic negotiating process to secure Sri Lanka's interests in the ongoing agriculture and non-agriculture market access (NAMA) negotiations. Moreover, making commitments at the multilateral level independent of requests received would benefit the sector in question and the economy as a whole.

It is evident from looking at Sri Lanka's GATS commitments made in 1997 and the Doha Round conditional offers that the sectoral commitments are substantially lower at the multilateral level as compared to the extent of unilateral liberalization that has been undertaken in the country so far. This has generally been the case with other countries as well. Furthermore, the level of commitment by Sri Lanka in the listed sectors under GATS is lower than the actual level of liberalization undertaken in these sectors unilaterally. This of course has given Sri Lanka significant policy space to shift between the committed level of liberalization at the multilateral and unilateral levels.

9.4 Benefits of Services Liberalization and Concerns in Further Opening the Sector

While there are substantial benefits which would flow from further liberalization of the services sector, such as improved and better variety of services at lower prices, there are also a number of concerns and issues which

need to be considered before opening up particular sectors at the bilateral, regional or multilateral levels. While unilateral liberalization allows the country to open up the sectors according to each country's 'comfort level', liberalization at the bilateral/regional or even multilateral levels has the added advantage of enhancing the credibility of the reforms undertaken by binding the reforms through the scheduling of commitments. Moreover, the GATS framework provides a powerful mechanism to address political opposition to liberalization and to carry out reforms by allowing time for domestic services providers to prepare for enhanced competition. In addition, progressive liberalization of certain services sectors can be used to negotiate for technical assistance from the more developed countries in areas such as regulatory reform, implementation of regulations and institutional capacity building. Given the benefits of liberalizing the services sector at the bilateral, regional or multilateral level, the following discussion will highlight the potential modes and sectors in which Sri Lanka has an offensive interest in trade in services. It will then discuss some concerns that would need to be taken on board when considering any moves towards further liberalization.

9.4.1 Mode 4

In multilateral services negotiations, Sri Lanka's main area of interest lies in the liberalization of Mode 4. This holds true for most other South Asian countries as well given the region's comparative advantage in relatively cheap and abundant low skilled labour. The importance of Mode 4 for Sri Lanka can be gathered from the substantial flow of remittances sent by Sri Lankan workers abroad. In 2007, remittance flows to Sri Lanka amounted to US\$2.5 billion, exceeding both FDI and overseas development assistance (ODA) flows to the country. In fact, remittance is the second largest source of foreign exchange to the country after the tex-

tile and clothing sector. Increasing flows of remittances have helped the country to mitigate a weakening balance of payments (BOP) position caused by a rapidly escalating import bill, driven primarily by high international oil prices. In the current global trading environment, however, Mode 4 is the least liberal of all the modes of service delivery.² Furthermore, the commitments in GATS are mainly for temporary migration of higher skilled workers, while restrictions on lower skills workers are more stringent. This is clearly a disadvantage to Sri Lanka since its comparative advantage lies in the export of low skilled workers. Therefore, there is considerable scope to liberalize Mode 4 under GATS given the limited number of commitments made in this mode, which would bring significant benefits to Sri Lanka. While Sri Lanka's temporary migrants are mostly low skilled workers, Sri Lanka also has a potential in the export of high skilled labour as demonstrated by the increasing number of Sri Lankan professionals (doctors, accountants, architects, etc.) working abroad. However, it is unlikely that this mode would be liberalized to a great extent in the foreseeable future given that Mode 4 is linked to sensitive issues such as immigration.

9.4.2 Mode 1

The business process outsourcing (BPO) sector is an emerging sector in Sri Lanka which has tremendous potential for growth. At present, there are about 25 BPOs operating in Sri Lanka and an additional 6 are awaiting approval by the BOI. The total employment in these firms is estimated at slightly over 4000, with total investments of over US\$13.2 million. A majority of firms are engaged in accounting services while others operate as call centres and medical insurance processors. A highly educated labour force with a

good command of the English language combined with relatively low wages makes Sri Lanka an attractive option as an outsourcing hub. Though telecommunication infrastructure remains a constraint on the growth of the industry, this sector is one of the fastest growing sectors in Sri Lanka with technological improvements occurring at a rapid rate. Specific areas where Sri Lanka can benefit under this mode include accountancy, hospital services, architectural services and computer and related services. Most of the trade that occurs under Mode 1 is unregulated at this point in time, especially at the local level. However, laws have been passed in markets abroad that are likely to adversely affect the free flows of services under this mode. For example, a number of US states have sought to introduce measures to control outsourcing of government contracts to foreign services suppliers since 2004. In this context, it is important from Sri Lanka's perspective that Mode 1 is not unnecessarily over-regulated any further.

9.4.3 Specific Sectors

Apart from general strengths in Mode 1 and Mode 4, there are also certain other sectors where Sri Lanka can benefit if there is increased market access abroad, especially in South Asia. More specifically, Sri Lanka would benefit a great deal if other South Asian countries consider liberalizing sectors such as the following:

Tourism and travel related services - Sri Lanka has a highly developed hotel industry and there have been substantial investments by Sri Lankan companies within the region in hotels. Furthermore, travel agency and tour operator services can be supplied by Sri Lankan firms, in particular under Mode 3.

² For example, the EU's GATS commitments are above 50 per cent for Mode 1, Mode 2 and Mode 3 but it has hardly made any commitments in Mode 4. Such bias in the commitment structure is very visible under GATS across developed and developing countries.

Maritime services - Sri Lanka has a well developed maritime sector and interest in exporting these services under several modes. Colombo has one of the best ports in South Asia and can offer a range of services through Mode 2 (i.e., maintenance and repair of ships, supporting services for maritime transport, cargo handling and warehousing services). Sri Lanka also has expertise in Mode 4 in both passenger and freight transport .

Retailing Services - Sri Lanka has many competitive retailing firms in food and non-food retail business and stand to benefit from liberalization in Modes 1, 3, and 4.

Computer and related services - This is a rapidly expanding sector in Sri Lanka and offers significant scope for benefits through liberalization. Sri Lanka has competitive interests in all four modes in this area, particularly in Modes 1 and 4.

Air transport services - Whilst air services are outside the scope of GATS at present, this is an area where Sri Lanka can provide very competitive services, especially within the region. Sri Lanka has been aggressively pursuing greater market access to India and is interested in getting Fifth Freedom Rights from India which would allow a Sri Lankan carrier to pick up passengers at an Indian airport enroute to another country. As it stands, most liberalization in this sector occurs through bilateral air services agreements on a reciprocal basis. Sri Lanka has already concluded Open Skies Policies with some countries such as Singapore, the UAE, Thailand, etc.

Whilst Sri Lanka has areas of offensive interest in the above services, it also stands to benefit a great deal from liberalization of services within the country as well. The major services which have impacts on the rest of the economy, such as telecommunications and finance, are liberal as it stands and the

liberalization undertaken so far have had a positive impact on the sectors, as well as on the rest of the economy. There is also scope for liberalization of other sectors such as transport, construction, maritime, health, and computer and related services.

9.4.4 Concerns Relating to Services Liberalization

It is apparent that Sri Lanka has liberalized only a few sectors to date at the multilateral level, and this is reflected in Sri Lanka's limited participation in GATS negotiations to date. Moreover, the progress to date in services negotiations under the CEPA with India has been slow given the highly complex and information intensive nature of the negotiations, which has involved extensive consultations with the relevant stakeholders in the economy. Some of the concerns relating to services liberalization are due to data limitations, lack of regulatory capacity of the bodies governing various sectors, weakness of certain services sectors to withstand competition, and labour related issues as discussed below.

One of the problems confronting countries in liberalizing the services sector is the lack of available data on trade in services. This is a problem which has hindered the ability of countries, including Sri Lanka, to assess the effects of liberalization and identify sectors which would potentially gain (and lose) from liberalization. The problem has been compounded by concerns on the part of stakeholders who typically tend to view liberalization in terms of opening of floodgates to foreign services suppliers to enter the domestic market and displace local businesses and labour. Not surprisingly, many have resisted opening up of services sectors when, in fact, it could bring substantial benefits to the identified sectors and the economy as a whole. The lack of data compounds the problems. Without sufficient data, it is more difficult to make sound judgments to make efficient

commitments and raises the risks of making arbitrary commitments which could be detrimental at a later date.

In the context of gaps in data, it is important that Sri Lanka takes a cautious approach to services liberalization, especially due to the relative immaturity of some services sectors in the economy. Overexposure to strong foreign competition could potentially undermine the development of these emerging sectors in the country, such as the BPO sector, which has recorded healthy growth over the recent past. Such exposure could be minimized by incorporating safeguard mechanisms into the text of a services agreement. But there are a number of problems in doing this, including defining and measuring what a 'surge' is in imports of services, which is currently under debate at the multilateral level.

Another major problem with liberalization of the services sector arises from a lack of regulatory capacity, especially of professional bodies in the country to monitor and ensure that quality, safety, and health standards are met in the services provided. In fact, some of the professional bodies do not have adequate capacity to regulate; even if they do have the capacity, some of these bodies lack the authority to govern the activities of its members. This has made liberalization of Mode 4 particularly difficult. While the Sri Lanka Institute of Architects (SLIA), for example, has the required regulatory capacity, it lacks the required 'practice registration' which would allow it to regulate the activities of its membership. Even in professional bodies that have parliamentary authority to regulate - such as the Sri Lanka Medical Council (SLMC) - capacity constraints is a problem. For instance, the SLMC lacks the capacity to monitor the functions of foreign practitioners, and at present, relies on complaints by consumers in order to take action. Furthermore, loopholes between the regula-

tory requirements of the BOI and the SLMC have resulted in certain medical practitioners being able to operate in Sri Lanka with minimum assessment of capabilities.

In other sectors such as construction, legislative gaps are a key constraint to liberalization. For example, the Sri Lanka Construction Industry Act - which would have led to the setting up of a Construction Authority - is yet to be implemented. The Act has been in the pipeline to obtain parliamentary approval for several years. As such, Sri Lanka is unable to make commitments in this sector at the bilateral or multilateral levels as any commitments could potentially violate the Act when it comes into effect. With such regulatory and legislative weaknesses, it is not prudent to liberalize these sectors to foreign services suppliers at this stage. Such problems have been compounded by the fact that currently there is almost no regulation of trade through Mode 1, making it difficult to make any commitments in this mode.

Given the above discussed weaknesses, further liberalization of trade in services has been challenging for Sri Lanka despite the numerous benefits that could be obtained through such liberalization. Such problems have contributed to the delay in the conclusion of the CEPA negotiations between India and Sri Lanka. Before liberalization of specific services sectors can be contemplated, a great deal of regulatory capacity needs to be developed in order to effectively regulate the sector once it is liberalized. Pushing forward with liberalization without the required capacity and authority of the regulator may not only diminish, but also undermine, the anticipated benefits from a liberalization process.

Liberalization of professional services also raises sensitive issues with regard to labour and its displacement. Despite the fact that the rate of unemployment in Sri Lanka has

been on the decline in recent years, liberalization of the services sector is a cause of concern as it could potentially contribute towards loss of employment. Nevertheless, liberalization may enable Sri Lanka to fill shortages in the labour market for certain professions such as medical specialists, nurses and midwives, etc. A case-by-case approach can be adopted in such situations. Moreover, liberalization of professional services could be tempered by tying such liberalization to FD1. For instance, Indian doctors may be permitted to work in Sri Lanka, but through Indian investments in the hospital sector.

It has also to be kept in mind that while Sri Lanka - together with other developing countries - has been requesting liberalization under Mode 4, such moves could in turn contribute to perpetuating the 'brain drain' that the country has been experiencing over the last two decades and exacerbate the situation further. Though such export of labour would be temporary in kind, there is a tendency for such migration to become permanent. This is especially so in the case of professionals, who tend to stay abroad after leaving the country on a temporary basis.

9.5 Case Study of Liberalization of the Telecom Sector

Like many other developing countries, Sri Lanka followed a moderate approach in liberalizing the telecommunications market, liberalizing the domestic market initially before introducing competition in the international segment. While reforms in the telecom sector began as far back as in 1980, the real reforms came about with the Telecommunication Act of 1991, which transformed the operator - the Department of Telecommunications - into a government owned corporation - the Sri Lanka Telecom Corporation (SLT) - and created the Office of Di-

rector General of Telecommunications as a regulatory authority. Subsequently in 1996, the Telecommunications Regulatory Commission (TRC) was set up as a more independent and better resourced body with the amendment of the Telecom Act of 1991. At around the same time, SLT was fully converted into a government owned company and 35 per cent of the stake in the company was sold to Nippon Telegraph and Telephone (NTT) of Japan in 1997, which was also given management control of the company.³ The government further divested its shares in the company in 2002, retaining only 49.5 per cent of the company.

Competition in the market was introduced in 1996 with the issuing of licences to two wireless local loop (WLL) operators for the operation of fixed basic telephony, data transmission, payphone, voicemail and facsimile. Sri Lanka Telecom was not only given a monopoly in the domestic fixed wire voice telephone services for a number of years at the time of its privatization, but it was also granted an exclusive licence to provide international telecommunication services till 2002 (when the market was opened up to other operators, including existing market players). In the fixed telephony sector, which now includes fixed wireline, WLL and CDMA operations, the incumbent SLT continues to have a significant market share - currently at about 71 per cent. Since the early 1990s, the number of mobile operators in the country have expanded to four operators (Hutch, Mobitel, Dialog GSM, and Tigo), providing stiff competition to the fixed operators as well as within the mobile market; Dialog has emerged as a dominant player in the mobile market over time, commanding a market share of 57 per cent. With the issuance of a fifth mobile licence to India's Bhatia Airtel in 2007 - which is expected to

³ NTT's shares in SLT were recently bought by Malaysia's Usaha Tegas (UT) group.

start operation towards the end of 2008 - competition in the mobile market is likely to intensify as Airtel is going to compete head-on with Dialog.

Liberalization of the sector undoubtedly has had a positive effect on the industry and, on the Sri Lanka economy, with the telecom sector emerging as an important sector of activity. The sector has recorded consistent growth since its liberalization in the 1990s with significant investments made by foreign service providers, and improvements in the level of prices and services. Before liberalization, consumers were unduly burdened by high prices, low connectivity, and poor quality. Not surprisingly, the number of subscribers has grown rapidly since, surpassing 8 million as of March 2007, of which three-fourths were mobile users. Like in most other countries, the mobile sector surpassed the fixed line sector in 2002, and now dominates the telecom sector (Figure 9.1). Consequently,

the tele-density in Sri Lanka had increased to about 40 per cent by 2007, up from 2.6 per cent recorded in 1997.

Thus, the liberalization of the telecom sector brought about a reduction in prices, improvements in connectivity and quality of services delivered. The share of the mobile sector is expected to increase further as the sector continues to grow, fuelled by large investments by the operators in the sector. For example, Dialog Telecom has made substantial investments towards strengthening the company's mobile and fixed telecommunications, broadband and digital television infrastructure and has been the largest investor in Sri Lanka since 2005. Despite the progress made in opening up the sector, there are a number of challenges confronting the industry such as regional imbalances in terms of penetration and access to telecom facilities, low internet penetration, etc.

Table 9.4
Overview of the Telecommunication Sector

As of March 2007	
Number of system licences	75
Total number of fixed phones	2,086,774
Teledensity (fixed phones per 100 inhabitants)	10
Teledensity (fixed) in Colombo	29
Total switching capacity of fixed operators	2,500,000
Waiting list (fixed) – Dec 2006	77,724
Number of cellular mobile subscribers	5,958,685
Mobile phones per 100 people	30
Total telephone subscribers (fixed & cellular)	8,045,459
Total teledensity (fixed & cellular)	40
Internet & e-mail subscribers	150,000
Number of public pay phones	7,678
Number of paging subscribers	na
Trunk mobile radio subscribers	233

Source: Telecommunications Regulatory Commission of Sri Lanka (TRCSL).

Figure 9.1
Subscriber Growth in Telecom (1992-07)

Box 9.1	
Four Modes of Supply under GATS	
Mode 1	(Cross border supply): neither the producer nor the consumer moves physically but the transaction takes place through telecommunication or some other network.
Mode 2	(Consumption abroad): consumer moves temporarily to supplier's country.
Mode 3	(Commercial presence): commercial organization moves to the consumer's country of residence.
Mode 4	(Presence of natural persons): an individual service supplier moves temporarily to the consumer's country of residence.

Source: TRCSL.

9.6 Liberalization of the Telecom Sector Under GATS

Like many of the developing countries, Sri Lanka did not participate in the initial negotiations on telecommunications under the Uruguay Round but subsequently became a signatory to the Fourth Protocol to the GATS in 1997. Sri Lanka submitted its set of specific commitments as well as fully adopting the regulatory principles outlined in the Telecom Reference Paper as additional commitments (Box 9.2).

Specific commitments in telecom under GATS were made by Sri Lanka in 1997 but these commitments merely re-stated the conditions which prevailed at the time in the telecom sector in the country. Sri Lanka did not make any further commitments beyond the existing levels of liberalization which would have reduced the policy space available to the government to manoeuvre. Thus, the actual impact of GATS schedules on the sector would have been little, if any. Nevertheless, GATS commitments in telecom helped the sector in terms of 'locking-in' the liberalization that had been undertaken up

to 1997. Opening up of the sector to FDI as specified under Sri Lanka's horizontal commitments in GATS would have strengthened the liberal investment regime the country maintained. While it is difficult to assess the real impact of these schedules on investment, the investment that has taken place since 1997 was primarily due to unilateral liberalization undertaken by the government; GATS commitments did not further open up the sector. Since the commitments were made in 1997, the sector has further opened up and gone beyond the commitments initially made. As such, the 1997 GATS commitments have become obsolete now given that they were made more than a decade ago. While the 1997 schedule was updated in 2003 as part of Sri Lanka's Doha Round initial conditional offer on services, these commitments would have also become obsolete due to the dynamic nature of the industry. Therefore, it is in Sri Lanka's best interest to make a more up to date offer at the WTO that would reflect the extent of liberalization undertaken in the sector on a unilateral basis, and thereby provide a positive signal to potential investors. The present commitments provide no

positive signal to potential investors, making the offers redundant from an investment attracting perspective.

Thus, Sri Lanka will need to seriously consider improving its GATS commitments in telecom. However, before opening up the sector further, a number of issues also need to be addressed. The first issue relates to legislature. The current telecom legislation is weak and outdated. For example, not only does Sri Lanka not have an overall competition policy in place, but there are also no specific references in the Telecommunications Act to ensure competition in the industry. At present, individual licences of operators deal with anti-competitive practices and there is a general clause stating that competition must be maintained in the market and, that anti-competitive practices are illegal. However, there is no elaboration on what is meant by anti-competitive practices and what would constitute a breach of competition. Moreover, the legislation in place goes back to the Telecom Act of 1991 which was subsequently amended in 1996 and then in 2003, and as such needs to be updated in due course. An overhaul is necessary if the intention is to attract more investment into the sector, ensure better regulation and increased benefits to the consumer.

The second issue is with regards to the capacity of the regulator - or the lack of capacity to regulate the industry. In the case of the telecom sector, there is an urgent need to strengthen the regulator (TRC) in terms of its independence, transparency of its procedures, and competency of its staff which are weak largely due to financial inadequacies. Currently, the TRC functions very much as a state institution, using state salary structures and requiring approval of the Treasury for spending decisions. As a result, it has been difficult for the TRC to attract qualified personnel based on the salaries that they are able to offer. This has constrained the TRC's ability

to function as an effective regulator due to limitations in technical capacity. This has, for instance, undermined the ability to effectively make and implement determinations on tariffs, interconnection agreements and competition requirements. In this context, it is imperative that the regulator be made financially independent from the government - i.e., it should be taken off the control of the Treasury, and salaries of the employees at TRC should be brought in line with those of operators in the industry which would resolve many of the problems it currently faces. Moreover, the TRC should also be made administratively independent of the government. Currently, the TRC comes under the purview of the President. The President has the powers to not only appoint the regulatory commission and the Director General of the TRC (while the Secretary to the President is the chair of the TRC), but also has the power to overturn licensing decisions of the TRC. The TRC by being closely aligned to the government of the day also compromises its independence, at least in the eyes of the other operators in the industry, since the main player in the fixed line market (SLT) is partially government owned.

The third issue relates to the implementation of existing commitments. Whilst Sri Lanka has met its schedule of specific commitments as noted above, the same cannot be said with regard to Sri Lanka's implementation of additional commitments outlined in the Reference Paper. Sri Lanka has failed to implement many of these commitments in full largely due to regulatory and institutional weaknesses as highlighted above. For the most part, the TRC has been unable to implement these additional commitments. Thus, it would be prudent to implement the Reference Paper requirements before tabling any new commitments. It is noteworthy that additional commitments made under GATS have helped to strengthen (to some extent) the regulatory framework governing the

telecom sector by encouraging improvements in the Telecommunications Act. For example, the Telecommunication Act was amended with the promulgation of interconnection rules in 2003, which not only fulfilled Sri Lanka's GATS Reference Paper requirement but also addressed the shortcoming of the 1996 Act in which interconnection was not mandatory.

9.7 Conclusion

Sri Lanka stands to benefit from liberalization in services of specific modes and sectors, particularly if there is increased foreign participation which would provide greater access to foreign expertise and technology. At the same time, competition and investments in such sectors hold out potential benefits to consumers in the country. However,

Box 9.2 Sri Lanka's GATS Commitments

Sri Lanka's *specific* commitments under 1997 GATS included:

- incumbent SLT was given a monopoly in international basic voice telecommunication services till 2000, when the sector would be opened up for competition subject to meeting certain conditions
- 4 licences were issued to four mobile cellular operators to provide domestic local and long distance basic telephone services, and further licences would be taken up for review in 2000
- 2 licences were issued to Wireless Local Loop (WLL) operators for basic telephony, data transmission, payphone, voicemail and fax and a duopoly was guaranteed for 5 years
- 5 licences were given for the operations of public payphone and radio paging services, with additional licences subjected to economic needs criteria
- In data communication services, licenses were issued to 6 operators while no licences would be issued to facilities based operators till 1998
- For Global Mobile Person Communications by Satellite (GMPCs), issuing of licences would be under consideration
- For all suppliers other than SLT, foreign equity participation was permitted up to 40 per cent while investments over this limit was subjected to case-by-case approval
- Presence of natural persons was kept unbound except as indicated by the horizontal commitments.

Sri Lanka also undertook *additional* commitments outlined in the Reference Paper which included:

- competitive safeguards: countries are required to undertake measures to prevent major suppliers from engaging in anti-competitive practices
- interconnection: countries are required that interconnection with a major supplier is provided under non-discriminatory terms, timely fashion and on unbundled basis
- universal services: countries are allowed to define universal service obligations as long as they are transparent, non-discriminatory and not burdensome
- public availability of licensing criteria: countries are required to make public the licensing criteria, the period of time to process the licence application and terms and conditions of individual licences
- independent regulators: countries are required to ensure that the regulator is independent of any supplier
- allocation and use of scarce resources: allocation of frequencies, numbers, etc., will be made objectively, timely, transparently and non-discriminatorily.

there are a number of concerns that need to be addressed before undertaking further reforms. To fully benefit from liberalization, reforms are needed at the domestic level, especially in establishing and building capacity to regulate the services sector. The efficacy of the regulator is a key factor to consider when liberalizing a service sector as was demonstrated in the telecommunication sector in Sri Lanka. A weak regulator will be unable to create an effective regulatory environment, which could in certain cases make liberalization efforts counter-productive. Moreover, a weak regulator will not be able to manage competition effectively and would, therefore, not necessarily be able to

respond effectively to market changes resulting from liberalization.

The implications to be drawn from the discussion is that Sri Lanka should focus on tightening up domestic regulatory frameworks and improve the capacity of the regulators where these are weak, prior to liberalizing the sector. In this regard, much work still remains to be done to improve domestic preparedness for the liberalization of services. As highlighted, many professional service associations lack regulatory and legislative capacity to effectively regulate even local service providers.

10. Fiscal Decentralization and the Thirteenth Amendment

10.1 Introduction

There has been a trend towards decentralization in many parts of the world in recent times and many countries have experimented with devolving political, administrative and fiscal responsibilities to lower levels of government. The reasons for such decentralization include dissatisfaction with the prevailing system of governance and service delivery, transition from a centralized planned economy to a market economy and the accommodation of ethnic, linguistic and cultural diversities.

In Sri Lanka, a system of decentralization in the form of Village Councils or Gam Sabhas existed from ancient times. In 1973, under the District Political Authority (DPA) system and, in 1980, under the District Development Councils, some attempts at decentralization were made but they were not major departures from the prevailing system, which was essentially administrative decentralization with the main authority being the central government. In 1987, under the Thirteenth Amendment to the Constitution an attempt was made for the first time for the effective decentralization of administration by a process of devolution. It was a hastily drawn-up exercise imposed externally with the object of resolving a political problem. It offered powers to newly established Provincial Councils (PCs) to plan, execute, and manage a totality of selected functions. However, in the case of Sri Lanka as compared to other countries where multi-level systems of government prevail, the system is unique in that the sub-national units were introduced into a state explicitly unitary in character.

The performance of the devolved system in Sri Lanka, however, is yet to be considered satisfactory. Rather, it has been deemed a failure. The provinces have continued to be minor players in the overall fiscal arena in the country. Several reasons can be adduced for the unsatisfactory progress of fiscal devolution in Sri Lanka. While some of the reasons are institutional, others relate to design issues whereby a serious imbalance between decentralization of expenditure and revenues at the provincial level continues to exist. The devolution design did not envisage any significant revenue sharing, and with limited assigned revenues, the vertical fiscal imbalances have been addressed solely by a system of provincial grants from the Centre.

A number of recommendations have been mooted to remedy these difficulties and make the provincial devolved system more equitable and meaningful in fulfilling the objectives for which it was introduced. These include such elements as (a) total revenue sharing, (b) need-based, performance linked, normative expenditure assessment, (c) normative revenue estimation, and (d) equalization grants.

The most recent of the proposals made to make the Thirteenth Amendment more meaningful in solving the problems it was designed for, was the set of proposals formulated by the All Party Representatives Committee (APRC) in January 2008 (see Box 10.1). These proposals are not considered final and only provide a basis for appropriate constitutional arrangements, some of which may require constitutional amendments and others, approval by a referendum. The APRC proposals are, in effect, the implementation

Box 10.1
The APRC Proposals

The All Party Representatives Committee (APRC) was mandated in 2006 to prepare a set of proposals that would form the basis for a solution to the problem of minority rights or what is called the national question. After 63 sittings over a period of one and a half years, a set of proposals was handed over to the President on 23 January 2008.

These proposals are not final and only provide a basis or framework for appropriate constitutional arrangements, some of which would require amendments to the present Constitution and others, approval by a referendum. Their current aim is to achieve maximum and effective devolution of power to the provinces in the short-term within the framework of the existing Constitution and which could be implemented with immediate effect.

The APRC proposals are in effect the implementation in full of the existing provisions of the Thirteenth Amendment in respect of legislative, executive and administrative powers while overcoming its existing shortcomings. The proposals also envisage the following:

- (i) An Interim Council for the Northern Province in terms of the Constitution, which will function until Provincial Council elections are held in that Province.
- (ii) Implementation of the Official Languages Provision of the Constitution – i.e., the full implementation of Chapter IV of the Constitution on Language.
- (iii) The routing of all finances in respect of special projects undertaken by the Centre and within the purview of the provinces, through the respective provincial administrations.

The full implementation of the Thirteenth Amendment would involve the devolution of all matters in List I in the Provincial List. This would presumably include police powers, land and land settlement, health and education (to the extent provided). These are critical and sensitive issues which have to be handled with care and circumspection and a viable arrangement has to be reached as to the sharing, coordination and exercise of these powers by the provinces and the Centre.

in full of the existing provisions of the Thirteenth Amendment in respect of legislative, executive and administrative powers while overcoming its existing shortcomings.

This Chapter is divided as follows. Section 10.2 describes the main features of the Thirteenth Amendment. Section 10.3 examines the sources and performance of provincial revenue while Section 10.4 analyses the reasons for its weak performance. Section 10.5 examines the nature of provincial expenditure and its budgeting process. Section 10.6 attempts to analyse the relationship between the provincial administrations and the centre with its attendant consequences. Section 10.7 examines the role and functions of the

Finance Commission while Section 10.8 describes the prevailing grants system and its weaknesses. Section 10.9 has some concluding remarks.

10.2 Main Features of the Thirteenth Amendment

The legislative provisions are contained basically in the Thirteenth Amendment to the Constitution certified on 14 November 1987, the Provincial Councils Act No. 42 of 1987 and Provincial Councils (Consequential Provisions) Act No. 12 of 1989. Under the Eighth Schedule, the country was divided into nine provinces. However, with the temporary merger of the Northern and Eastern Provinces the system effectively functioned as eight till

2007 when, under a Supreme Court decision on the validity of the merger, the number of provinces was again restored to nine.

Under the Ninth Schedule, the functions were allocated under three Lists - the Provincial List (List I), the Reserved List (List II) and the Concurrent List (List III). This followed the general trend of allocating matters of national importance to the central government and those of regional or local interest to local governments. The Concurrent List which follows the Indian model has overriding powers, and also a proviso that the residual powers belong to the Centre. This has, admittedly, created many problems and much confusion. Some of the main responsibilities assigned to the PCs related to education, health, energy, transport, roads and waterways and local government. Some new establishments and institutions were also created under the aegis of the PCs such as Council Secretariats, Governors' Offices and Provincial Public Service Commissions.

The Finance Commission established under Section 154 R (3) of the Constitution has the primary function of allocating grants to the provinces. It also enunciates the principles under which these grants are allocated and administers them for apportionment between the provinces. It reports directly to the President and is granted immunity in its determinations and recommendations.

10.3 Provincial Revenue

The revenue sources devolved to the provinces are enumerated in sections 36.1 to 36.20 of List I of the Ninth Schedule of the Thirteenth Amendment. While at first glance, these sources appear formidable, a closer scrutiny reveals that the main sources consist only of the turnover taxes (44 per cent), stamp duties (28 per cent) and licence fees (13 per cent). All others bring only 15 per cent of total provincial revenue. Under Section 4.3 of the Ninth Schedule, stamp du-

ties and court fines are devolved to the local bodies who are legally entitled to them. Table 10.1 gives the provincial revenue in relation to total government revenue for the period 2001-07.

As indicated, the sources devolved on the PCs account on average for only 4 per cent of total central government revenue while provincial tax revenue also averages about 4 per cent of such tax revenue. In terms of GDP, the total provincial revenue is only 0.6 per cent of GDP and provincial tax revenue is only 0.5 per cent of GDP.

It is thus seen that only a relatively insignificant proportion of the country's revenue has been devolved to the sub-national units. This is in contrast to such countries as Australia, India, Brazil and the US where the sub-national revenue is over 50 per cent of central government revenue. Even in countries such as Malaysia and Thailand, it is over 15 per cent. This poor revenue performance of the provinces in relation to its expenditure needs has created a serious budgetary imbalance. Some vertical imbalance is generally unavoidable in any devolved system of government, but in Sri Lanka, the imbalance is severe.

Source-wise, provincial revenue can be divided into three broad categories.

- i. Taxes on production and expenditure. These consist mainly of the turnover taxes on wholesale and retail sales, licence fees on liquor, betting taxes, taxes on lotteries and prize competitions, stamp duties, motor vehicle licence fees and fines.
- ii. Receipts from property and investment consisting largely of rents from land and buildings, interest and dividends.
- iii. Sales and charges including profits from commercial activities, court fees and fines, fees under the Motor Traffic Act, etc.

Table 10.1
Provincial Revenue in Relation to Government Revenue (Rs. million)

	2001	2002	2003	2004	2005	2006	2007
Central government total revenue	234,296 (16.6)	261,887 (16.5)	276,465 (15.1)	311,473 (14.8)	379,747 (15.4)	477,833 (16.3)	565,051 (15.8)
Provincial total revenue	8,674 (0.6)	9,366 (0.6)	11,625 (0.6)	13,522 (0.6)	16,132 (0.6)	19,481 (0.6)	25,868 (0.7)
Provincial total/government total revenue	3.7%	3.7%	4.2%	4.3%	4.2%	4.0%	4.5%
Central government tax revenue	205,840 (14.6)	221,837 (14.0)	231,597 (12.7)	281,552 (11.4)	336,828 (13.7)	428,378 (14.6)	508,947 (14.2)
Provincial tax revenue	7,539 (0.5)	7,922 (0.5)	9,968 (0.5)	11,544 (0.5)	13,818 (0.5)	16,586 (0.5)	21,473 (0.6)
Provincial tax/government tax revenue	3.6%	3.6%	4.3%	4.1%	4.1%	3.8%	4.2%

Note: Figures in parenthesis denote percentage/GDP.

Source: Compiled from CBSL, *Annual Report*, various issues.

Most of the provincial revenue collected is credited to the Provincial Fund itself. In accordance with Section 4.3 of the List 1 of the Ninth Schedule, collection from stamp duties, and court fees and fines have to be transferred to the local authorities.

Looking at the revenue performance province-wise, the most striking feature is the dominance of the Western Province which col-

lects over 65 per cent of the total provincial revenue (Table 10.2). Of the other provinces, the Central, Southern and North-Western Provinces collect around 7-8 per cent each, while provinces like the North-Central and Uva collect less than 3 per cent each.

A similar pattern to that of province-wise revenue performance is observed in the distribution of provincial GDP where the West-

Table 10.2
Provincial Revenue Performance (2007)

Province	Amount Rs. million	Share %
Western	16,986	65.6
Central	2,035	7.8
Southern	2,149	8.3
North-East	108	0.4
North-West	2,066	7.9
North-Central	755	2.9
Uva	626	2.4
Sabaragamuwa	1,140	4.4
Total	25,868	

Sources: Ministry of Provincial Councils, and Local Government; Finance Commission.

Table 10.3
Gross Domestic Product by Province at Current Factor Cost Prices (2006)

Province	Amount Rs. million	%
Western	1,243	50.1
Southern	230	9.3
Central	217	8.8
North-Western	231	9.3
North-Central	102	4.1
Northern	72	2.9
Eastern	117	4.7
Uva	114	4.6
Sabaragamuwa	153	6.2
Total	2,484	100.0

Source: CBSL, *Annual Report 2007*.

ern Province dominates with over 50 per cent of GDP while others like the Central, Southern and North-Western have between 8-9 per cent of GDP, while Sabaragamuwa, North-Central and Uva varies between 6-4 per cent (Table 10.3).

10.4 Reasons for the Weak Revenue Performance

Notwithstanding the constraints imposed by the size of the provincial economy, there are several other reasons for the weak performance of provincial revenue. The limited nature of the tax base is one such key factor. As stated earlier, though items 36.1 to 36.20 enumerate a whole list of revenue sources devolved to the provinces, in reality, the major portion of revenue comes only from the turnover taxes (44 per cent), stamp duty (28 per cent), and licence fees, including motor vehicle and excises (13 per cent). All others in the formidable list of revenue brings in only a paltry 15 per cent of total provincial revenue.

The base of the turnover tax is limited by three factors, namely: (i) exemptions of certain commodities and items gazetted; (ii) it is limited purely to wholesale and retail sales

and precludes other activities such as manufacturing and services (these are subject to VAT by the central government), and; (iii) it is subject to the limitations and exemptions prescribed by Parliament and legislated under the Provincial Councils' Turnover Tax (Limits and Exemptions) Act No. 25 of 1995. For example, the maximum turnover tax rate permitted is limited to 5 per cent and no more.

Another weakness is the non-use or inadequate use of the sources devolved. A number of the sources devolved have not been adequately used or sometimes not used at all by the provincial administrations. Such sources include fees under the Medical Ordinance; fees under the Fauna and Flora Protection Ordinance; toll collections; taxes on mineral rights; taxes on prize competitions and lotteries; charges under the Weights and Measures Ordinance, etc.

The ability to raise revenue is also inhibited by legal constraints and lack of statutory legislation or gazetted regulations. There are basically two legal constraints in the existing legislation inhibiting the potential collection of additional revenue. One is that

under item 36.20 of List 1 of the Ninth Schedule, any additional taxation within the Province should be "to the extent permitted by or under any law made by Parliament." The other is that in the Reserved List relating to national revenue, monetary policy, external resources and customs, "any other tax or fee not specified in List 1" is the preserve of the central government. This constraint could, however, be overcome according to the Attorney General's ruling, by Parliament enacting by a simple majority to give PCs the right to levy additional taxation, provided they do not conflict with those included in the Reserved List.

Apart from the above factors, there also appears to be a lack of motivation at the provincial administration level to putting in greater effort at enhancing revenue capacity. The provinces have continued to be minor players in the overall fiscal arena. There is a lack of motivation to promote imaginative and innovative schemes and methods at enhancing provincial revenue. This stems largely from the fact that the current system of grants provided by the central government appears to fulfil most of the recurrent expenditure needs, resulting in the lack of a need for any extra effort.

Finally, administrative weaknesses and inadequate technical skills continue to be a problem. The provincial revenue system lacks adequate personnel and sufficient training and skills development in the complex task of tax collection. These pertain to procedural weaknesses, examination of returns and audits, surveys and inspections, and inadequate computerization among others. An incentive scheme introduced to motivate officers to enhance revenue collection and lessen corruption has, in practice, turned into an automatic salary increase.

Measures to improve revenue performance need attention. Apart from rectifying the de-

ficiencies relating to the above areas, a number of other recommendations have been made by various programmes and projects to improve provincial revenue performance. These include, among others, the following:

- (i) Introducing a full scale VAT by the central government to include the wholesale and retail sector together with a 'piggy back' levy to be retained by the provinces.
- (ii) A multi-rate structure for provincial turnover tax.
- (iii) A 'piggy-back' levy on income tax by the provinces.
- (iv) Stamp duty reforms to prevent undervaluation.
- (v) Closer coordination and sharing of information between the Centre and the provinces.

10.5 Provincial Expenditure and Budgets

As stated, provincial revenue to central government revenue is only around 4 per cent (or 0.6 per cent of GDP). By contrast, provincial expenditure is around 20 per cent of total central government revenue (or 3 per cent of GDP). This leads to a situation of continuous budget deficits at the provincial level and vertical fiscal imbalances.

Of total expenditure undertaken by the provinces, over 80 per cent is for recurrent expenditure and less than 20 per cent for capital expenditure, and of the recurrent expenditure almost 90 per cent goes for personal emoluments such as wages, salaries and overtime payments (Table 10.4). Only about 10 per cent of recurrent expenditure is used for economic services such as infrastructure, agriculture and industries.

Province-wise, the largest share of total expenditure is incurred by the Western Province followed by the Central and Southern Provinces while the lowest shares are indi-

Table 10.4
Provincial Expenditure (2007)

	Amount Rs. million	Share
Recurrent	92,721	82 %
Capital	20,346	18 %
Total	113,067	
Breakdown of recurrent expenditure		
i) Personal emoluments(salaries, wages, overtime, etc.)	82,110	89 %
ii) Others	10,611	11 %
Total	92,721	

Sources: Ministry of Provincial Councils and Local Government, CBSL, *Annual Report 2007*.

cated in the Uva, North-Central and Sabaragamuwa Provinces. This is true both for recurrent and capital expenditure. The paucity of capital expenditure in the provinces, where such expenditure on infrastructure is most required, compromises the declared objective of balanced regional development.

In terms of monitoring expenditure, provincial budgets are historically determined and are allocated by the relevant sector in the central government. The proceeds of own revenues, grants, loans and other receipts are credited to the Provincial Fund and an annual financial statement of estimated receipts and expenditure is laid before the PC by the Governor. The withdrawal of the moneys out of the Fund is, however, only by a warrant under the hand of the Chief Minister. While these provisions of the Constitution and the law serve to secure the functional autonomy of a PC in respect of finances, it has its weaknesses. Not only does the system lead to waste and corruption, but to diversion of the different grants and funds allocated under various programmes for uses other than their allocated purposes.

In Sri Lanka, the PCs are almost solely engaged in maintaining the existing services and paying for the personnel and administration in areas assigned to them. Any development work seems largely to be the responsibility of the central government. This is also due partly to the weakness at the design level. The pattern of expenditure assignments has led to fragmentation of responsibilities over many line ministries and over-lapping departmental functions between central and provincial departments of administration, both in the areas of concurrent and devolved subjects. Such fragmentation is most evident in the major areas of education, health and roads. The co-existence of the PCs with the Ministry of Provincial Councils and Local Government as well as the Finance Commission, has led to a system of detailed central control over provincial use of funds, far beyond monitoring and overseeing of fiscal performance, thus retarding the progress of meaningful fiscal devolution.

It has been suggested that the current system of provincial budgeting and budget preparation be entirely changed to a system of Results Based Budgeting (RBB). This involves identification of key components such as

objectives, inputs, expected results, and outputs, and the use of performance indicators and performance measurement.¹

10.6 Provincial Administration and Services

One of the institutional reasons for the inadequate progress of fiscal devolution is the relationship existing between the provincial and central administrations. While in the legislative sphere, the existence of the Concurrent List provides a handle and mechanism for the Centre to legislate, execute, and administer a host of functions which are the prerogative of the provinces, the existence of a parallel administrative system erodes to a considerable extent, the scope and effectiveness of provincial administration even within its own boundaries.

The establishment of the Provincial Public Service in 1987 under the aegis of the Provincial Public Service Commission was critical for providing the PCs their functional autonomy and quality of service. However, the system of centrally appointed Divisional Secretaries and line ministries at the Centre, even on devolved subjects, together with the Ministry of Provincial Councils and Local Government have contributed to hinder the scope and effectiveness of provincial administrations.

At the design level, the fragmentation of responsibilities over many ministries and overlapping departmental functions of administration, are seen at all levels of both concurrent and devolved subjects. Such duplication exists especially in the spheres of health, education, roads, agriculture, livestock, cooperatives, etc. These have created not only unnecessary duplication and overlap between the central and provincial functions, but also led to ambiguities and friction between the Centre and the provinces.

In any fiscal devolved system, the central government has a legitimate and useful role to play in supervising, overseeing and monitoring the fiscal performance of the lower tiers of government. This is also important to control the deficit behaviour of provincial governments. However, in Sri Lanka, the current system has led to detailed control over provincial use of funds far beyond the normal monitoring and overseeing functions. This has led to retarding the progress of meaningful fiscal devolution.

10.7 The Finance Commission

The Finance Commission is established under Section 154R (1) of the Constitution. It constitutes a key institutional arrangement for the regulation of the system of devolving power to the provinces. It also constitutes a key policy instrument for regulating centre-province relations in the area of provincial finance. Its main purpose is to enunciate the principles under which grants are allocated to the provinces. This is similar to the Finance Commission in India or the Commonwealth Grants Commission of Australia.

The Finance Commission is an autonomous body consisting of five members, namely: (i) Governor of the Central Bank; (ii) Secretary to the Treasury, and; (iii) Three other members to represent the three major communities, each of whom shall be a person who has distinguished himself, or held high office, in the field of finance, law, administration, business or learning.

The Constitution has assigned the Finance Commission with the following responsibilities:

- (i) Consult with and recommend to the government such funds as are adequate for the purpose of meeting the needs of the provinces from the annual Budget.

¹ In this connection, several workshops to educate Provincial Council authorities and relevant personnel were conducted by the IPS in 2007 in collaboration with the World Bank Institute.

- (ii) Make recommendations to the President as to the principles on which funds granted annually by the government for the use of the provinces should be apportioned between them; and any other matter referred to the Commission by the President relating to provincial finance.
- (iii) Formulate principles for achieving balanced regional development in the country taking into account the population, per capita income of the provinces, the social and economic disparities, and the difference in per capita income of the provinces.

The Commission reports directly to the President and is granted immunity in its determinations and recommendations. While this immunity safeguards the independence of the Commission, it also casts an obligation on it to discharge its responsibilities with care and impartiality.

There have been a number of contentions made in respect of the construction, functions and performance of the Finance Commission. One is that unlike in India, where it is appointed for a period of five years, the Finance Commission in Sri Lanka is a permanent body. This, while giving it continuity, has both strengths and weaknesses. Second, the advisability of having ex-officio members in the Commission is sometimes called into question and it is contended that it should be fully independent. Thirdly, the emphasis on community-based 'proportional representation' in a small country denies the Commission of the chance to have the best possible talent to deal with the complex issues of fiscal devolution.

There is very little documentation of the workings of the Commission. While its annual

recommendations submitted to the President have been tabled in Parliament, there have been no official records pertaining to the Commission, the fiscal devolution system and its operation. It was only in 2004 that the Commission was able for the first time to bring out an Annual Report and make available to the public an official record of the work of the Commission in the discharge of its constitutional mandate on fiscal devolution. This, however, should be made an annual feature mandatorily, if necessary, for the information of Parliament, the PCs and the public at large.

Other steps that need to be taken to improve the performance of the Finance Commission include: (i) strengthening the capacity and technical capability of its staff, especially the professional personnel, and; (ii) establishment of a Finance Commission Act as recommended by the Salgado Report² providing for necessary operational powers and procedures. This would enable the Finance Commission to be legally empowered to perform its role and functions.

10.8 The Grants System

The wide discrepancy between provincial expenditure and provincial revenue has been addressed solely by a system of government grants. These grants are of four types.

- (i) Block grants: These are needs-oriented grants based on the difference between the estimated current expenditure and estimated revenue collection of each province. Block grants constitute on average 80 per cent of total grants.
- (ii) Matching grants: These represent an incentive measure to enhance efforts to generate additional revenue by better enforcement or through new measures. These are, however, limited and represent less than 1 per cent of total grants.

² M. Ranjit P. Salgado (1989), Report on "Fiscal Aspects of the Public Sector Restructuring Project (Financial Devolution to the Provinces)", World Bank.

Table 10.5
Grants Released to Provincial Councils (Rs. million)

	2006		2007	
Total provincial expenditure	94,471		113,067	
Grants				
Block grants	62,342	79.0%	70,742	80.0%
Criteria based grants	790	1.0%	1,208	1.3%
Matching grants	221	0.2%	205	0.2%
Province specific development grant (PSDG)	7,345	9.2%	6,995	7.9%
Grants for specific projects	8,331	10.5%	9,167	10.4%
Total grants	79,029		88,317	
% of expenditure	84%		78%	

Sources: Finance Commission; and CBSL, *Annual Report 2007*.

- (iii) Criteria-based grants: These are based on a formula and constitute an instrument to achieve balanced regional development. They take into account differences in per capita income and social and economic disparities in the various provinces. They represent about 2 per cent of total grants.
- (iv) Provincial Specific Development Grants (PSDG) and other special grants made for various projects. These constitute about 15 per cent of total grants.
- the provinces receive between 8-10 per cent of the grants provided.
- (ii) The block grants constitute about 80 per cent of the total grants while the others are relatively insignificant.
- (iii) The criteria-based grants are also provided mainly to the Western, Central and Southern Provinces while the others, particularly the North-Central, Uva and Sabaragamuwa Provinces receive relatively paltry amounts.
- (iv) The matching grants are also allocated mainly to the Western and Central Provinces.

The prevalence of 'block grants' and 'criteria-based grants' in the allocation system ensures a degree of predictability in the Sri Lankan grants system and prevents control of the periphery by the Centre. The introduction of 'matching grants' in 1995 provided the PCs with the incentive to realize their actual potential.

Table 10.5 shows the grants released to PCs for 2006 and 2007. There are a number of notable features in the existing grants systems, including the following:

- (i) The bulk of the grants are provided to the Western, Central, Southern, North-Western and North-East Provinces. These account for between 11-16 per cent each of the total grants. The rest of

It is clear that the present grants system has a number of weaknesses. They tend to promote a lack of motivation to increase provincial revenue while overestimating their revenue needs. There are defects in the delivery mechanism resulting in cash flow and liquidity problems.

The block grants merely fill the gap between the pre-determined portion of the recurrent expenditure of a province and the devolved revenue of the province. They are, therefore, needs-oriented than principles-based and are largely used for meeting the administrative expenses and personnel emoluments. They tend to encourage wasteful expenditure and

discourage revenue effort at the provincial level. Similarly, in the case of criteria-based grants, the methodology used in computing these grants is both limited and outdated. They are based on the Central Bank's Consumer and Finance Survey of 2003/04 and need updating and change. They have to be allocated on a more realistic basis and be more capable of achieving the desired objective of balanced regional development. In the case of matching grants, the small quantum of these grants has significantly reduced the matching ratios, defeating the purpose of these grants. These amounts can be merged with the criteria-based grants and, in fact, have been done so from 2008.

In fact, the entire scheme of grants allocation needs revision and re-consideration because it is evident that effectively, the objective of devolved fiscal management has not been achieved. It may also be time to reconsider the entire concept of revenue grants as a means of fiscal transfer and to consider alternative measures.

10.9 Concluding Remarks

It is obvious that the present system of fiscal decentralization has, both in concept and practice, serious inherent deficiencies and contradictions. Beset with institutional and

financial constraints, it is neither a purely administrative and decentralized system nor a fully devolved system of government. The Thirteenth Amendment was not a home grown solution to the problems facing the country, but a hastily drawn-up document imposed externally with the object of solving a political problem rather than a well thought out scheme of decentralized governance within the Sri Lankan context.

Little attention has been paid to the fiscal and financial aspects, monitoring and supervising mechanisms or inter-governmental relations that underpin a multi-level system of government. The current system of grants has no devolutionary character being merely a system of decentralized grants.

The APRC proposals aimed at solving these problems are only basic guidelines and do not yet constitute detailed arrangements at solving specific and concrete issues that need examination and solution if the Thirteenth Amendment is to be effectively implemented in full measure as envisaged. Its progress depends on a number of evolving factors including military progress in combating separatism and the balance of political forces that would arise in the future.

11. Conserving Coconut Lands: The Way Forward

11.1 Introduction

Sri Lanka has been experiencing the adverse impacts of unsystematic land use for a long time despite the fact that conserving and planning the use agricultural lands has long been a topic of policy discussion, with coconut lands too not being an exception. The history of formulating a land use policy for Sri Lanka dates back to the early 1950s, but the country was able to table it as a legal document only in 2006. Notwithstanding the slow implementation of the land use policy document, management of the country's land resource, under numerous uses and tenure status, is quite challenging.

According to the Agricultural Census (2002), agricultural lands cover 30 per cent of the total land area (1,973,840 ha) of the country and coconut cultivation which accounts for 21 per cent of agricultural lands and the largest coverage out of all plantations spreads over 394,836 ha. In 2007, coconut production of 2,869 million nuts accounted for 1.3 per cent of GDP and 2 per cent of export earnings. Moreover, the sector provides 5 per cent of employment and 22 per cent of per capita calorie intake of the diet for Sri Lankans, being second only to rice.

In spite of the substantial contribution to the overall growth of the country's economy, the coconut industry is in a crisis situation today due to high cost of production, poor maintenance of plantations, heavy fragmentation of coconut holdings and conversion into other uses. The conversion of prime coconut lands into other uses has been aggravated by the increasing demand for land from competing uses and rapid urbanization in major coconut growing areas during the past

two decades. It is noteworthy that not only the urban coconut lands but also lands in rural areas are subjected to threats of fragmentation and being converted to other uses. Low income from second and third generation palms, high replantation cost, high cost of production, land degradation due to poor soil and land management, and adverse weather impacts which are beyond the control of the growers have made coconut farming an economically unattractive option, compared to other potential investments. This has led to the rapid conversion of coconut lands into other uses.

As a result, both the extent and the production of coconut have been decreasing continuously. According to the Coconut Research Institute, 1075 ha of coconut lands are lost per year (or 250 coconut palms are lost per day) in Sri Lanka, irrespective of the location and type of the sector (i.e., small holdings or estate). The rate of decline in coconut palms is highest in the North-Western and Western Provinces and the highest rate of decline has occurred in the Kurunegala and Gampaha districts. Moreover, due to severe fragmentation, more than 82 per cent of coconut extent is presently under the small holding sector (less than 8 ha) while the area under the estate sector accounts for only 18 per cent. According to the Agriculture Census (2002), the extent under small holding and estate sectors has declined by 3.9 per cent and 26 per cent, respectively, of the base values in 1962. Further, large extents of coconut holdings are currently out of production or are underutilized.

Policies and tools employed by the government to prevent fragmentation and conversion of coconut lands have often been subject to much debate on the grounds that they are likely to limit the effective allocation of land. The argument put forward is that underutilized coconut lands yielding marginal incomes should be put to their best possible economic use. Others are of the view that such practices adversely affect the growth of the coconut sector and should be immediately prevented by bringing in necessary rules and regulations.

The market mechanism, with its inherent imperfections, has often been ineffective in allocating natural resources such as land and putting land to the best economic use. Nevertheless, the state too has not proved to be effective in optimally allocating land resources of the country. The state has ownership of a major percentage of the country's land area. As such, it has been influencing changes in ownership and allocation of land, including that of coconut lands in the past. The dilemma that the coconut industry is facing at present can be largely attributed to such state interventions as explained in the next section.

11.2 Changes in Ownership of Coconut Lands

Policies on coconut lands date back to the colonial regime in which the growth of plantation agriculture was promoted. Since then, the ownership and allocation of coconut lands have been influenced by state policies. When Sri Lanka gained independence in 1948, coconut along with the other two major export crops - tea and rubber - occupied an aggregate extent of about two million acres. A marked change in the agrarian structure of independent Sri Lanka was the transformation of the pattern of ownership of agricultural lands in 1975, converting a considerable share of land under plantation crops from foreign to local ownership. This was mainly

due to the economic policies pursued by the government during this period. As a result, the percentage extent of coconut held by the companies registered in the U.K and by non-Sri Lankans fell from 11 to 4 per cent. With the setting up of the State Plantation Corporation (SPC) in 1958, the government entered into commercial agriculture production by gradually gaining ownership of 38,000 acres of plantation lands. The Divisional Development Council (DDC) programme begun in 1971 can be considered as one of the major arms of decentralization of agricultural planning and rural development of the country. It led to a change in the pattern of land ownership by promoting cooperative farming in Sri Lanka. This distributive alienation of lands led to a change in the size-composition in agricultural holdings. It led to a decline in the large units of plantations with the estate acreage of coconut dropping from 34 per cent to 25 per cent between 1948 and 1972.

The Estate (Control and Transfer) Act, No.2 of 1972 imposed government controls over land transfers from proprietors owning over 100 acres in extent. Under the Land Reform Laws of 1972 and 1975, private ownership of land was subjected to a ceiling and large extents of plantations, including coconut, was nationalized and vested with two state companies, Janatha Estate Development Board (JEDB) and SPC. The extent of coconut lands acquired under the Land Reform Law of 1972 was 112,523 acres with a further acquisition of 6,406 acres under the Land Reform Law of 1975, accounting in total to 10 per cent of the coconut acreage of the country. Under the acquisition programme, large plantations were vested with public sector agencies to operate as government estates, while medium scale holdings - which fall below the generally recognized size-optima for management under an estate system - were leased to government-sponsored agencies for setting up cooperative farms. Small

allotments accounting for about 12 per cent of the total area acquired were distributed to farmers to operate as family farms.

The expected benefits of alienating land to cooperative farming and rural people were alleviation of acute land hunger of the peasantry and increasing production and employment through agricultural intensification and crop diversification. However, its contribution to an expansion in individual peasant proprietorship has been minimal, while political influences undermined the egalitarianism expected from the programme. Moreover, the land alienation programme was followed by a serious drop in production of all the plantation crops, mainly due to fragmentation into small units and management inefficiencies resulting from the conversion of ownership from commercial plantations to cooperative farms.

The SPC and the JEDB, which were under the purview of the Ministry of Plantation Industry were separated and put under the supervision of the Ministry of State Plantations and the Ministry of Janatha Estate Development, respectively, in 1980. They were once again brought back under the control of the Ministry of Plantation Industry in 1989. In 1992, with the motive of removing management inefficiencies, plantations under state corporations were privatized, where 450 of the 525 state owned estates were clustered into 22 Regional Plantation Companies (RPCs) with their management contracted out to private firms on 5-year terms. In 1995, with the objective of encouraging more RPC investment on plantations, the government divested the controlling interest in 20 of the 22 RPCs, but retained the ownership of land.

The evidence suggests that the decline of the coconut industry commenced after nationalization, even though there had been an improvement initially. Ignorance of issues faced

by stakeholders involved in the industry and frequent management reorganizations seem to have seriously affected the performance of the sector. Despite the fact that ownership of almost all the coconut plantations is held by the private sector at present, the growers have been unable to make efficient use of the lands. This can be largely attributed to inappropriate policies implemented in the past.

11.3 Policy Interventions for Protecting and Improving Coconut Lands

Even though an Act of Parliament for the control of fragmentation of tea and rubber estates was passed in 1958, no provisions were in place to control the fragmentation of coconut estates. Taking the adverse impacts of severe fragmentation of coconut lands into consideration, the Control of Fragmentation Act No. 02 of 1958 was amended by the Control of Fragmentation Act No. 20 of 2005. Under the provisions of this Act, the approval of the Tea, Rubber and Coconut Estates (Control of Fragmentation) Board has to be obtained to divide or transfer ownership of coconut estates which are over 4 hectares in extent.

A number of institutions have also been established under various legislations to promote coconut production and prevent the conversion of coconut lands to other uses. However, they have not yet been able to produce the intended results. Under the provisions of the Coconut Development Act No. 46 of 1971 and amendments, the Coconut Development Authority (CDA) was established for the development and regulation of the coconut industry and the utilization of land for coconut plantations. The Coconut Cultivation Board (CCB) was established under the Coconut Development Act of 1972 with the objective of promoting coconut growers to establish systematic coconut plantations and maintain them properly to ob-

tain optimum yield. The Coconut Research Institute (CRI) was established in 1929 with the objective of serving the coconut industry in the fields of coconut production, crop protection and processing technologies for the sustainable development of the industry.

In 2007, the Cabinet granted approval to amend the Coconut Development Act to formulate a structure to levy a tax on fragmentation of any coconut land authorized by the Tea, Rubber and Coconut Estates (Control of Fragmentation) Board. Under this amendment, a tax per acre of coconut land authorized for fragmentation was proposed. This tax is expected to reduce further fragmentation of coconut lands. A law on felling coconut trees is also expected to be amended in future so that the owners felling trees will also be taxed.

Under the National Coconut Home Garden Cash Programme, the Cabinet approved Rs. 269 million for 2008 and 2009 to promote home gardening. In 2008, the UNDP agreed to grant US\$ 22 million to develop the coconut industry, mainly the small and medium coconut businesses. In addition to all these measures, successive governments have continued with the fertilizer subsidy for coconut plantations. However, coconut growers claim that the fertilizer application has dropped due to non-attractiveness of the subsidy. They also claim further that since the subsidy scheme is supported by a cess fund,¹ the benefits should reach the growers without hampering their activities.

However, the effectiveness of such intervention and support needs to be further analysed since it appears that they do not sufficiently encourage the coconut cultivators to reinvest in their lands. Instead, cultivators are continuing to devise various means to sell their

lands or use them for alternative crops. This trend has seriously affected coconut based industries. Many of them are at a critical stage today, making it clear that there are gaps at the policy level that need to be addressed.

Making the trade-off between conserving and converting coconut lands to other profitable ventures is not an easy task since the costs and benefits of conserving an agricultural land extend beyond normal economic boundaries. However, channelling scarce resources of the country to protect an unproductive sector should also not be the case. Hence, a detailed analysis based on economic rationale is needed to justify the conservation efforts, in particular, in the prime urban lands.

11.4 Conclusions and Policy Suggestions

Complementing measures taken by successive governments to expand and protect the coconut industry, the present government too has implemented several regulatory measures and enforcement strategies for the development of coconut farming. Loopholes in the institutional and regulatory framework are unlikely to make the regulatory mechanisms (i.e., imposing land tax, enforcing penalties, etc.) as effective as expected. Hence, providing a favourable environment for the growers and businesses is likely to be more effective than imposing restrictive measures to pressurize them to continue in the industry. Therefore, immediate interventions by the government should be directed towards facilitative measures, requiring a coordinated effort by all the institutions related to the coconut industry. Some policy recommendations in this regard include the following:

- Abide by the present law of land fragmentation; measures need to be taken to protect the coconut lands belonging to

¹ A coconut cess is a tax charged on exported coconut products and selected coconut related imports (i.e., vegetable oil in 2008) and distributed among the coconut sector for development purposes.

the best land suitability classes. In harmonizing such actions towards conserving coconut lands, it is vital to undertake an island-wide zoning exercise and identify the lands best suited for agricultural uses and develop a concrete land use plan for the country to prevent possible future conflicts. Further, in the context of land scarcity and increasing urban development needs, conversion and fragmentation of less productive coconut lands are inevitable; hence, marginal coconut lands, in particular in prime urban areas, can be released for development purposes.

- Promote the present trend of growth of coconut farming in non-traditional coconut growing areas. Identifying potential coconut growing areas based on detailed analysis of soils and climate are crucial to offset the loss of prime coconut lands from traditional coconut growing areas. Research and extension should be geared to cater to the farmer's needs and to provide technical know-how and other support services to expand cultivation in areas out of the coconut triangle.
- Execute a favourable trade policy to promote local production as well as to remove discriminating measures in order to have a balanced approach to promote key coconut exports. It is claimed that at present, the coconut oil industry is heavily protected at the expense of other coconut exports, in particular desiccated coconut. The collapse of some of the coconut industries (i.e., closure of desiccated coconut and oil mills) has had numerous direct and indirect adverse impacts on the economy, while seriously affecting rural income generation. Hence, government intervention in implementing a favourable trade policy and export promotion strategies is crucial.²
- Move away from heavy dependency on chemical fertilizer. Application of organic fertilizer is likely to reduce the cost of production while re-establishing soil conditions. Moreover, growers need to be educated on the present trends of organic farming which allows supplying products for niche markets (e.g., Virgin coconut oil). The other major obstacle in coconut farming, the unfavourable weather conditions, in particular, water stress can be overcome by educating on water conservation methods and introducing drip irrigation methods at cost effective rates in the more progressive coconut growing areas.
- Focus immediate strategies of the government towards motivating the growers and investors who are not willing to give up the industry. At present, coconut growers are deprived of inducements to continue in the coconut industry. Strengthening long term credit programmes (i.e., replantation, new plantation) which are in operation at present and introducing micro credit programmes through grower associations are imperative in promoting immediate investments. Revising the fertilizer subsidy, which is supported by a coconut cess, can also provide short-term incentives to depressed growers. However, such strategies can only provide limited support towards sustained growth in the country. Long-term strategies should essentially be aimed at crop intensification and product diversification measures which will enable investors to be self sustaining.

² See IPS, *Sri Lanka: State of the Economy 2002* report.

12. Co-management for Sustainability of the Coastal Fishery Sector

12.1 Introduction

Coastal fisheries in Sri Lanka are generally open access except a few traditional, community based fishing operations such as beach seine and stake net fisheries. Therefore, coastal fisheries share the two main characteristics of a common property resource; non-excludability (difficulty in exclusion of potential users accessing the resource) and subtractability (consumption of the resource by one user reduces its availability for other users). Coastal fishing in Sri Lanka is a small scale industry which is characterized by multi-species and multi-gear fishing. The sector has been experiencing an increase in fishing pressure due to several reasons such as population growth, and lack of alternative income generating activities in coastal areas. This situation, together with unregulated open access conditions, has inevitably led to an increase in total fishing effort that threatens certain vulnerable fisheries with depletion of stocks. From a resource management point of view, the unmanaged open access condition has the potential to cause permanent damages to fisheries with limited opportunity of a recovery. The main challenge the coastal fishery sector is currently facing is low catch per unit effort and low profits.

There are three main types of management regimes that exist globally to address resource management and socio-economic issues in the fisheries sector. They are centralized (command and control) management, community based management, and co-management. Apart from a few instances, a centralized (top-down) approach has been used to manage fishery resources in Sri Lanka. This method, however, has not been able to meet

growing challenges impacting the sector - such as reversing stock depletion, solving conflicts among resource users, and increasing profitability - due to implementation and enforcement difficulties. Evidences from different countries suggest similar problems, with the underlying causes having social, economic, institutional and political origins. This implies that the management of fishery resources and policy interventions should focus mainly on the relationship of fishery resources to human welfare, and the conservation of such resources for the use of future generations. The current management regime provides very limited (or no room) for the participation of fishers, thereby sidelining the wealth of local and indigenous knowledge available to supplement scientific information in order to improve overall management. A centralized management regime often fails to address core concerns of the fishing communities, is insensitive to local conditions, and lacks backing from fisher communities. It can also be inefficient in achieving its own set of development objectives. Thus, fishery experts, particularly in South Asia, recognize that the cooperation of fishers/local community as a necessary condition for effective and sustainable fishery management.

Community based management has gained greater attention as a mean of a sustainable approach to coastal resource management. In this instance, the local community has the ability to manage fishery resources in a sustainable manner, regulating access and enforcing rules through community institutions and social practices. However, except for a few traditional long-enduring arrangements, community based management has

not been always successful in addressing broader issues over which the community has very little control.

Co-management is focused not only on community participation but also on the active participation of governments. Therefore, the concept of co-management of fisheries is seen as the most appropriate management tool as it provides a strong institutional structure to address fisheries and other coastal resource management issues.

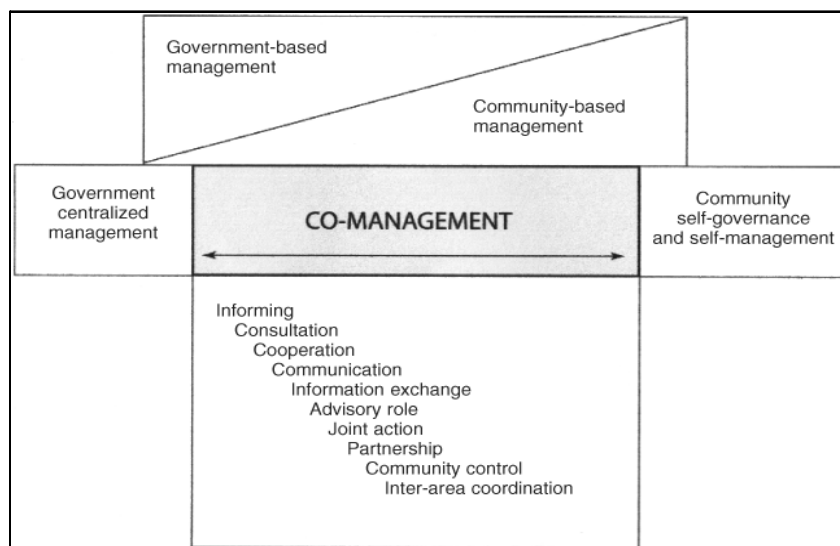
12.2 What is Fisheries Co-management?

Co-management has been widely accepted as an evolutionary tool for participatory fishery management by several governments, development agencies, and researchers. It is essentially a partnership arrangement to share the responsibility and authority between the government and local resource users. The underlying hypothesis in co-management is that the involvement of local resource user groups creates incentives for cooperation in

order to formulate and implement efficient and sustainable resource management schemes. This management regime provides some sense of ownership to the fishery resource as user groups are involved actively in decision making and implementation of fishery management. The emergence of co-management has been based on concerns of both democracy and efficacy. Democracy refers to the involvement of local fishers into the decision making process of fishery management, and efficacy refers to the expected reduction in implementation cost and improvements in compliance with resource management rules.

Figure 12.1 shows different types of co-management arrangements. There can be five broad categories - instructive, consultative, cooperative, advisory and informative - depending on the degree of partnership between the government and resource users. The instructive type involves a minimum exchange of information between the government and user group. In the case of consultative, the

Figure 12.1
Hierarchy of Fishery Co-management Arrangements



Source: Pomeroy, R.S., and R. Rivera-Guieb, 2006, *Fishery Co-Management: A Practical Handbook*, CAB International, IDRC.

government consults more actively with the fisher group, but keeps the responsibility of decision making. The cooperative management occurs where the government and fisher group equally share power in decision making processes. The advisory type is found where the user group advises the government of decisions to be taken and seeks the government's approval of their own decisions. The informative type occurs when the government delegates the authority to make decisions to the fisher group and the fisher group is responsible in informing these decisions to the government.

It is very important to note that the implementation of co-management is costly, complex and lengthy. A comparison of the transaction cost of centralized management with co-management regime shows that the cost of co-management is comparatively high in the initial stage of implementation.¹ However, over time, these costs tend to decline.

12.3 Fishery Management in Sri Lanka

With the promulgation of the Fisheries Ordinance in 1940, fisheries management in Sri Lanka became a centrally controlled top-down approach. During 1940-1996, the objectives of fishery management were development oriented, such as policies to promote fishing by introducing new fishing technologies, providing subsidies to buy fishing equipment, and providing welfare facilities for the fishers. Fishery management during this period had been limited to inquiring into fishing disputes among fishers by retired judges. The demand for a comprehensive legal framework to address the complex needs of the fishery industry was fulfilled in 1996 with the introduction of the Fisheries and Aquatic Resource Act No.2 of 1996 which is the prin-

cipal legal Act pertaining to the fishery industry in Sri Lanka. After 1996, fisheries management has been focusing mainly on sustainable resource management. Licensing of fishing operations and registration of boats, prohibition of destructive fishing gear and fishing method were started under the provisions of the Act. However, controlling access to fishery resources or completely preventing illegal fishing has not been successful. The Act also has provisions to make fishery management more community oriented. Development of fishery management areas, establishment of fisheries committees and fisheries management authorities are allowed. This can be viewed as the first initiative towards co-management. The functions of fishery committees are formulating fisheries programmes for their own areas, assisting members with fishing equipment, and carrying out welfare activities beneficial to the fishing communities. However, the establishment of such management areas and committees are carried out under the authority of the Minister of Fisheries.

The Ten Year Development Policy Framework (2007-2017) of the Ministry of Fisheries and Aquatic Resources (MFAR) highlights the fact that fisheries management has been weak and that there is an urgent need for an innovative way of managing fisheries to address the current problems. It emphasizes the importance of shifting the current command and control centralized management system to a more fisher oriented co-management approach.²

12.4 International Experience of Co-management

International experience suggests that the main reason behind the change towards a co-management regime is the recognition of

¹ Jahan K. M., et. al., (1999), "Transaction Cost in Fisheries Co-management at Oxbow Lake in Bangladesh", Proceedings of the international workshop on Fisheries Co-management, Penang, Malaysia.

² Ministry of Fisheries and Aquatic Resources (2007), "Ten Year Development Policy Framework of the Fisheries and Aquatic Resources Sector, 2007-2016", Colombo.

a resource management problem. The problems can be related to deterioration of the resource (e.g., in the Philippines and Tanzanian marine protected areas), conflicts amongst stakeholders such as competition between different fishing gear (Africa), conflicts between management agencies and local fishers (e.g., Atlantic coastal fishery in Canada), problems of exclusion of outsiders (e.g., Laos, Malawi, Thailand, Zambia) and governance problems in general.³

In Southeast Asia, countries such as Thailand, the Philippines, Indonesia, Malaysia and Vietnam have been moving the fishery management regimes to co-management by raising the commitment of governments to policies and programmes aimed at developing new legal, administrative, and institutional arrangements in varying degrees.⁴ The Philippines is one of the best examples of a country with a long history of traditional community based fishery management and one that has also been working on co-management processes for over two decades. In 1991, under the Local Government Code (LGC), the Philippines government recognized the importance of participation of the fisher community and developed a Fisher Sector Programme (FSP) to decentralize authority and simplify procedures for clearance of local fishery management ordinances, strengthen the implementation of national fishery enforcement laws, and promote community based initiatives to conserve, rehabilitate and protect coastal resources, etc. The changes in administrative arrangements that resulted from the LGC created a supportive environment to promote co-management. The FSP was also supported by other national initiatives to promote co-management. Co-

management has been embodied in the Philippines development plans and the legislative branch of the Philippines' government has made a substantial contribution towards co-management. The integration of national, local level policies and plans enhanced the co-management efforts and was further strengthened by the Fisheries Code of 1998.

Bangladesh also initiated a new Fisheries Management Policy in 1986 aimed at sustaining inland fisheries and improving equity (Beel fisheries). The main policy instrument used was the provision of direct access rights to fishermen instead of the former method of leasing public water bodies. The co-management arrangement between fisher groups and the government was initially instructive rather than cooperative as the user groups were insufficiently prepared, unorganized, poorly educated, etc. The government has since been getting the help of NGOs to take a central role in organizing and representing fishers until the group is sufficiently able to represent themselves.⁵

Although many countries are keen to adopt co-management, evidence from some other countries indicates a lack of support by governments for co management initiatives. This can be mainly due to lack of adaptation of organizational structures of government departments to cope with a new management regime. On the other hand, efforts by governments to initiate co-management without addressing necessary changes required in the enabling environment, combined with a lack of capacity and lack of empowerment at community and households levels, have resulted in frustrating local level experiences when expectations created by such initiatives

³ Pomeroy, R. S., and F. Berkes (1997), "Two to Tango: The Role of Government on Fisheries Co-management", *Marine Policy*, Vol 21, No 5, pp 465-480.

⁴ Pomeroy, R. S., (1995), "Community based and Co-management Institutions for Sustainable Coastal Fisheries Management in Southeast Asia", *Ocean & Coastal Management*, Vol 27, No.3, pp 143-162.

⁵ Ahmed M., A.D. Capistrano and M. Hossain (1997), "Experience for Partnership Models for the Co-management of Bangladesh Fisheries", *Fisheries Management and Ecology*, Vol. 4, 233-248.

fail to be realized. This, in turn can result in undermining the legitimacy of the management system and thereby lead to a worse situation than in centralized management.⁶

12.5 Conclusion and Policy Recommendations

Shifting from the current management system to a proposed co-management regime demands two main prerequisites. The challenge for any government in implementing the new management regime is related to these two prerequisites; an enabling policy, legal/ regulatory and administrative framework, and empowerment of individuals and communities to participate in fishery management. At the national level, there should be an integrated effort and commitment to facilitate co-management by changing legislation, creating an enabling policy environment, integrating development plans, and making changes in the administrative framework to support the implementation of such management regimes. The Philippines is a good example of where such arrangements at the national level have helped in the successful implementation of co-management. In addition, the role of external change agents such as NGOs, academic or research institutions, religious organizations, government agencies and project teams is also very important at national level to expedite the co-management process (for e.g., Bangladesh).

At the community level, various factors affect the success of co-management. These are local leadership, appropriate scale and defined boundaries of the resource, property rights over the resource, clearly defined user group membership, clear objectives from a well defined set of issues, socio-cultural homogeneity of the user group, active participation of group members, existence of

community based organizations, long-term support by local government units, accountability, ability to enforce management rules, mechanisms for conflict management, adequate financial resources, and empowerment of communities. Apart from successful community based arrangements, some local communities lack different factors mentioned above. Therefore, empowerment at the individual and collective level - the central element of co-management - can be achieved via capacity building through education and various types of targeted training efforts.

Sri Lanka has taken an initial step towards co-management of the fishery sector by changing its legislative framework with the introduction of the Fisheries and Aquatic Resource Act No.2 of 1996. In addition, the current development policy framework related to the sector mentions the importance of changing the central management regime to co-management, especially in the coastal fishery sector. However, apart from the above mentioned Act, there has to be a strong commitment and an integrated effort to make the enabling policy and administrative arrangements for the proper implementation of fishery co-management at the national level.

In addition, Sri Lanka has to work on empowerment of communities and individuals in the coastal fishery sector to facilitate the co-management process, and to enable them to participate in the decision making process. Empowerment should be done not only for local communities and individuals, but also for the relevant officials in the fishery authorities. This is needed to change the mind-set from command and control management to accept the fishers' right to make decisions on sustainable use of their collectively owned resources.

⁶ Neilson J. R., et. al., (2002), "Fisheries Co-management: An Institutional Innovation, Perspectives and Challenges", *Ahead*, IIFET, 216.

In the case of local communities, certain community based organizations such as some fishery cooperatives in Sri Lanka have been able to perform certain management functions required for the sustainable use of fishery resources. This does not mean that fishery cooperatives alone can manage the fishery resources, but they do show an alternative approach of solving some fishery management problems through collective action with low transaction costs. However, this is not a common feature in all the coastal fishery ar-

reas. Areas where such social capital is available have greater potential to be successful in co-management. Therefore, strategies to empower communities should be customized according to the availability of local level capacities. Moreover, the communities that lag behind in terms of collective action towards fishery management need help from change agents such as NGOs to change their attitudes towards a new management regime as well as to develop their capacities to participate effectively in decision making.

13. Ecotourism for Sustainable Forest Management in Sri Lanka

13.1 Introduction

The Sri Lankan forestry sector has faced a host of problems over the past few decades. While rapid forest degradation has been the most visible outcome, there are many other issues in the sector which have implications on the sustainability of forest resources. The inability of the present policy and legal framework to adequately address issues of forest conservation and economic development is seen as a major obstacle in this regard. The traditional 'command and control' method of forest management has not been able to successfully conserve forests and provide benefits to society. Critically, the present system has failed to consider local communities as important stakeholders in forest conservation.

Given the inefficiencies in conventional command and control forest management, market based approaches are emerging as alternative tools of forest management today. In this regard, ecotourism is viewed as an important approach for sustainable forest management. As defined by the International Ecotourism Society (TIES), ecotourism is responsible travel to natural areas that conserves the environment and improves the well-being of local people. The definition encompasses seven major principles as follows:

- Contributes to conservation of biodiversity
- Sustains the well-being of local communities and people
- Interpretation and education aspects
- Involves responsible travel from both the tourists and the tourism industry
- Primarily small-scale

- Lowest possible consumption of non-renewable resources
- Active community participation in planning, management and benefit sharing.

Accordingly, the sustainability principles of ecotourism fit into aspects of sustainable forest management. Moreover, it has the potential to address issues in the present forest management system in the country, wherever potential exists. Ecotourism, being a fast growing market segment in the global tourism industry, provides ample opportunities for positive gains from engaging in it. Thus, ecotourism could be undertaken as a functional tool to capitalize on the potential and prospects that Sri Lanka possesses as a future ecotourism destination.

13.2 Prospects and Potential in Forest-based Ecotourism

Sri Lanka is endowed with rich and diverse natural forest resources, which include a number of national heritage sites as well as world heritage forests. Given the high degree of biodiversity in a small land area, it is considered as one of the top 25 biodiversity hotspots in the world. In addition, being a small island, the places can be visited within a short time period. The potential for ecotourism is also enhanced by the distinct culture that Sri Lanka possesses.

Ecotourism could also be seen as a potential source of income diversification in forest peripheral villages, where poverty is a significant issue. In most of the cases, households living in the peripheral villages are dependent on agriculture as their main live-

lihood. Such areas are characterized by lack of alternative income sources, poorly developed infrastructure, and high unemployment and underemployment rates. Thus, from a socio-economic point of view, there are prospects for ecotourism to generate economic benefits to the forest peripheral communities by providing alternative employment opportunities, and by actively contributing towards infrastructure development in the areas.

13.3 Changing Focus of Sri Lanka's Tourism Sector

Historically, Sri Lanka's tourism activities have been focused on mass tourism. However, due to frequent fluctuations in mass tourist arrivals - due both to external and domestic events - product differentiation has been identified as an important step forward by the Sri Lankan tourism industry today. With the new slogan "Beyond Beaches, Culture, Nature, Adventure", the Sri Lankan tourism sector is in the process of attracting tourists for nature and cultural sites, and to capitalize on it, while retaining its competitive advantage in beach tourism. This initiative can provide significant opportunities for the development of the ecotourism sector in Sri Lanka.

On the other hand, the world's tourism industry now is driving towards 'sustainable tourism', where environmental concerns of growing tourism activities receive greater emphasis. It is estimated that ecotourism has been growing by 20-34 per cent per year at the beginning of the 1990s,¹ as opposed to a 7 per cent rate of overall growth in the global tourism industry in the 1990s.

In line with this, the Sri Lanka Tourist Board (SLTB) has taken the initiative to promote green tourism, with a view of promoting Sri

Lanka as a 'Tourism Earth Lung' destination. Through this initiative, the SLTB aims to establish codes of practice for each of the sub-sectors in the tourism industry in Sri Lanka. Meantime, efforts are also to be made to stop deforestation, ensure reforestation to encourage the use of alternative energy sources, mitigate pollution at their sources through local and regional efforts, and thus to create an 'Earth Lung Community'. This initiative can fit well into the process of promoting ecotourism, since ecotourism by definition is a 'green' initiative.

13.4 Present Situation of Forest-based Ecotourism in Sri Lanka

Despite the fact that Sri Lanka possesses a strong potential for forest-based ecotourism, it is nonetheless, still being operated at a primary level. Sri Lanka's present forest cover, which includes both dense and sparse forests, is around 29 per cent of the total land area of the country. The Forest Department (FD) and the Department of Wildlife Conservation (DWLC) are the main forest resource owners. The total land area owned by the DWLC is around 982,587 ha while the FD owns around 1,582,756 ha. The areas collectively account for over 98 per cent of Sri Lanka's natural forests. As such, almost 98 per cent of Sri Lanka's natural forest lands are under state management. Of the lands owned by the DWLC, only the national parks are open for undertaking tourism activities, which amounts to 59 per cent of the total land owned by the DWLC.

The two main forest managing institutes in Sri Lanka, the FD and the DWLC, have been carrying out forest-based tourism activities over a long period of time. However, lack of community involvement in management and benefit sharing is a significant problem in the state managed forest-based tourism ac-

¹ Cited in *The International Ecotourism Society, Fact Sheet: Global Ecotourism*, based on a World Tourism Organization, press release, June 2004.

tivities. Moreover, the FD is not legally provisioned to invest the tourism income it generates back in conservation activities. Education and interpretation services are also not up to standard. In addition, the resource owners do not have the required potential and capability to invest in forest-based ecotourism businesses in the country.

More recently, the private sector has been showing growing interest in ecotourism investments given emerging market opportunities in the global tourism industry. However, lack of coordination between the private sector and resource owners in Sri Lanka has meant the absence of a more conducive environment for the private sector to invest in ecotourism. On the other hand, the actual ecotourism product that is offered is a major factor in capitalizing on emerging market opportunities. Mismatches between what is being marketed and the products offered can be an issue. Many private sector players tend to use the 'ecotourism' label without complying with at least the basic criteria of ecotourism. This is viewed as a significant constraint in developing Sri Lanka as an ecotourism destination. At present, however, there are a few private sector players offering genuine ecotourism products and earning high profits in the Sri Lankan tourism sector. Successful stories of private sector involvement in ecotourism projects are heard from other countries that have reached high levels of ecotourism development (see Box 13.1). Sri Lanka can learn lessons from such experiences and apply them appropriately to the local set-up.

On the other hand, the private sector in Sri Lanka is not well aware of the present forestry regulations. Identification of forest areas which could be developed as ecotourism sites in the future has to be done on the basis of socio-economic and biological aspects, where the FD has a special role. This type of data and information are not available at

present, which leads to conflicts between environment agencies and private sector entrepreneurs.

On the other hand, not all stakeholders - including the state agencies, private sector and local communities - in the ecotourism sector in Sri Lanka have the necessary knowledge and awareness of the principles of ecotourism. Often, the term ecotourism is referred to mean traditional nature tourism activities due to lack of understanding on the sustainability principles of ecotourism. Such constraints also contribute to limit the ability to attract the genuine ecotourists.

In addition to state and private sector participation, a few community-based ecotourism projects are also emerging sporadically in several areas. Since rural communities lack necessary funds to invest in ecotourism businesses, the private sector will have to play a vital role in making the business investments in ecotourism, while partnering with the state resource managing agencies and rural communities. It is important to get the rural communities involved in ecotourism at all stages. This is seen as a challenging task in the Sri Lankan context since rural communities are not well-recognized as an important stakeholder in the existing forestry policies and legislations.

Most importantly, the absence of a coordinated effort between the stakeholders is seen as a major drawback in moving forward. The environment and tourism agencies operate within their boundaries, and necessary collaboration required for ecotourism is missing. This has been the main reason for slow progress in ecotourism in the country.

13.5 Enabling Policy Environment for Forest-based Ecotourism in Sri Lanka

Ensuring the establishment of a sound policy and legal framework is a key to the successful implementation of ecotourism in any

Box 13.1**Sustainable Ecotourism in Costa Rica**

Ecotourism in Monteverde forest reserve is known as the most popular tourist destination for both local and foreign tourists, which could be presented as a model for sustainable ecotourism. The forest reserve is privately managed by a non-profit organization dedicated towards conservation and research. The site is well-known for providing good interpretational services. Well-trained tour guides – who are mostly biology graduates – provide quality education and awareness raising services to the tourists, particularly on the wildlife and ecological functions of the living components of the forest. It is interesting that guides are bilingual and carry high-power binoculars and bird encyclopedias to provide the best possible services to the ecotourists.

Revisions on entry fees are made timely, in order to ensure that it is a self-sustaining entity. It charges higher fees for tourists on the assumption that they are willing and able to pay. The revenue generated is utilized for education and provision of information, in addition to sustaining efforts of the forest administration. The latter accounts for nearly 17 per cent of total expenditure, while costs of preserving the forest and providing education collectively amounts to 30 per cent of total expenditure. The members of the local community are not charged entry fees as an appreciation of their role in supporting the development of the preserve, and to generate a sense of ownership and interest in sustaining the preserve. With the tourism income, an endowment fund has been created to support the integrity of the forest reserve in the future.

The ecological balance is also maintained well with timely revised policies. The carrying capacity of the forest, in particular, is taken into account, especially during the peak season. When the number of visitors exceeds the capacity, some nature trails are kept closed and the number of entries is controlled. Large numbers of volunteers who arrive during the peak seasons also help maintain trails and facilities. Over-expansion of infrastructure and other facilities are avoided, particularly due to the involvement of the community, who are the main owners of the infrastructure. Also, only a section of the park is allowed for tourism activities, indicating that the forest is intended to be a reserve meant for nature protection and biological reserve, while generating economic benefits. This feature has minimized conflicts that might arise due to competing uses of the forest.

On the other hand, local communities are also encouraged to get involved in the planning process. The reserve has a substantial economic impact on the local communities through various income generating activities such as local hotels and restaurants, outfits offering horseback riding, souvenir shops, tours to local manufacturing plants, art galleries, butterfly farms, etc. Accordingly, Monteverde reserve provides an example of a sustainable ecotourism project, since it has to a greater extent fulfilled the sustainable principles. Moreover, this is a case of a private reserve setting that could feed lessons for privately managed ecotourism businesses in other countries.

Source: Aylward, B. *et al.*, 1996, Sustainable Ecotourism in Costa Rica: The Monteverde Cloud Forest Preserve *Biodiversity and Conservation*, Vol. 5, 315-343.

country. In this regard, it is important to have both tourism and environmental policies mainstreamed in order to develop a common vision towards ecotourism.

Although the future focus of tourism provides space for ecotourism development, the tourism policy which is in existence is primarily on mass tourism with no mention of ecotourism. However, having understood the increasing opportunities in global ecotourism, three documents presenting the national ecotourism policy, regulations, strategy and action plans have been formulated by the SLTB under the direction of the Ministry of Tourism in 2003. Although nearly five years have passed, the policy is yet to be implemented. The delay in preparing the necessary legislation stands as a barrier towards implementation. Although the above policy documents have been published in order to get comments from relevant stakeholders, they have not been given the intended publicity. As a result, awareness on the policy documents among the resource managing organizations is limited.

In the case of forest policies, forest-based tourism has been identified as a means of generating income from forest resources. However, the policies have not adequately responded to the sustainable principles of ecotourism. Primarily, the FD at present does not have provisions to invest the forest-based tourism income it generates in conservation activities, and the entire revenue earned by the FD is sent directly to the Treasury. On the other hand, the Forest Ordinance does not have provisions for the creation of legal partnerships with either the private sector or communities. This is a significant issue in forest-based ecotourism. However, the FD is in the process of making necessary amendments to the present Forest Ordinance to accommodate the said provisions. It is important that the DWLC identify communi-

ties as an important stakeholder in managing, implementation and benefit sharing.

Therefore, it is evident that the current policy framework does not adequately present a conducive environment for the development of ecotourism in Sri Lanka. There are conflicts between tourism and environment policies and legislations, constraining relevant stakeholders from working towards a common vision in ecotourism. It is important that the resource managers - the DWLC and the FD - should have control over the resource to ensure that it is open for sustainable utilization by the private ecotourism operators and service providers.

13.6 Conclusion and Policy Suggestions

Despite the presence of strong potential for substantial benefits to be had out of forest based ecotourism, Sri Lanka has not yet paid adequate attention to the issues involved in order to reap the expected benefits. Ecotourism is an approach that encourages environmental conservation and generates economic benefits out of environmental resources. Thus, it is necessary to have strong policy and legislative support for ecotourism. The future policy reforms should focus on the following key areas:

- Establishing a well-coordinated mechanism amongst the tourist agencies and environment agencies should receive a high policy priority. This could be facilitated through an inter-ministerial committee to identify the existing conflicts between tourism policies and initiatives on environment policies. The SLTB could play the lead role in this regard.
- Legalization and implementation of the draft ecotourism policy, strategies and action plan should not be delayed any further.

- Guidelines should be developed by the FD and the DWLC to include regulations for other stakeholders, specifically for the private sector. In addition, it is necessary to prepare a database on selected forest-based sites (and other ecotourism sites which can be developed as ecotourism sites) regarding the socio-cultural, physical and market characteristics of a particular site.
- Establishing ecotourism certification and monitoring mechanism would ensure that the ecotourism service providers and operators actually fulfill the elements of ecotourism and thus maintain the trust of ecotourists.
- Ecotourism should be viewed as an integral part of both development plans and conservation plans. This is primarily because ecotourism is a small-scale business, and thus cannot operate in isolation.

14. Money Transfer Systems and the Development Nexus of Migration

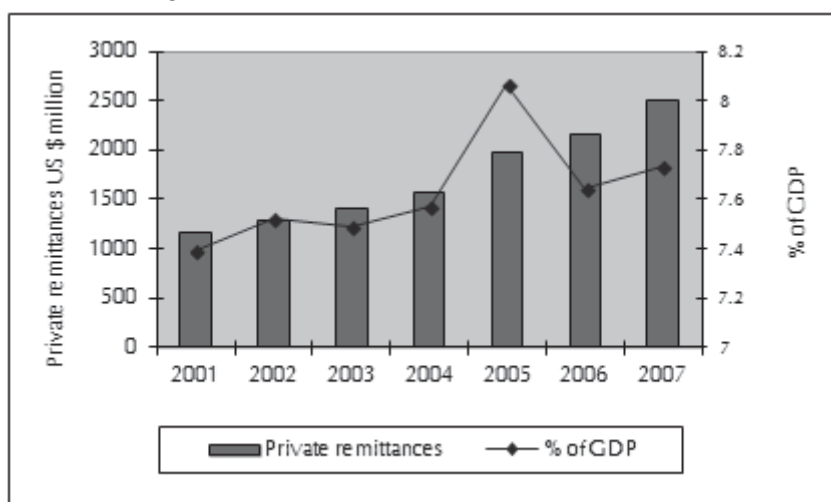
14.1 Introduction

The development dimension of migration has taken centre stage in the research and policy agenda of developing countries in recent years in view of a sharp increase in the volume of remittance flows globally. International remittances received by developing countries have doubled in the past five years as a result of several factors, including increased monitoring of remittance flows, growth in the national income of oil producing countries which host large numbers of migrant workers, and growth in the number of migrants itself. Sri Lanka which has been a recipient of remittances inflows over the last three decades has also benefited from the recent increase in global remittance flows (Figure 14.1). At present, over one million Sri Lankan citizens are estimated to have migrated for foreign employment. Around 90

per cent of such migrant workers continue to send remittances on a regular basis.

The main source of inflows to Sri Lanka remains the Middle East, accounting for 58 per cent of total inflows in 2007, followed by 20 per cent from the EU. Remittance inflows have come to account for nearly 8 per cent of Sri Lanka's GDP in 2007 (US\$ 2.5 billion), second only to export earnings from goods (US\$ 7.7 billion) and far above that of average FDI inflows of 1.5-1.7 per cent of GDP. Recognizing that migrant remittance flows into Sri Lanka are significant and rising, the government has placed particular emphasis on improving the policy framework to generate higher inflows. The government hopes to raise workers' remittances to around US\$ 4 billion by 2010.¹ As part of the initia-

Figure 14.1
Migrant Remittance Flows into Sri Lanka (2001-07)



Source: CBSL, *Annual Report*, various issues.

¹ GOSL (2006), *Mahinda Chinthana: Vision for a New Sri Lanka*, Colombo.

tive to raise the volume of remittance inflows, the government has also proposed to increase migration of skilled workers in anticipation that they will generate higher inflows through higher wages.

Details on the actual volume of remittance flows - in Sri Lanka and globally - remain imprecise. Indeed, the actual figures on remittance flows may be much higher because there are under-recorded remittances due to imprecise accounting, as well as a preference to remit through informal channels. Econometric analysis and available household surveys suggest that unrecorded flows through informal channels may conservatively add as much as 50 per cent or more to recorded remittances.² Available estimates for Sri Lanka suggest that the share of private remittances channelled through informal dealers could have been close to 45 per cent in the mid-1990s.³ This could partly be explained by the fact that the bulk of migrants from Sri Lanka are unskilled labour migrants, where evidence suggests that such migrants typically prefer to utilize informal money transfer systems.

There is little doubt that migrant remittances can provide governments with an important source of finance for development purposes. As in the case of Sri Lanka, remittances often have significant macroeconomic impacts. At the micro level, remittances are an important flow of income for poorer households. However, given that there are many associated socio-economic costs - and increasingly costs associated with the migration of more skilled workers in terms of 'brain drain' - it is imperative that countries fully exploit the development opportunities provided by mi-

gration. To this end, improving the infrastructure for channelling remittance flows is critical. This policy brief analyzes the different approaches that can be adopted to transfer remittances through formal channels and discusses possible policies which need to be put in place to best achieve such an outcome.

14.2 Money Transfer Systems

The propensity to remit from an available resource pool depends on the characteristics of the migrant and their country of origin (Figure 14.2). If the migrant worker is unskilled and the country of origin does not make any attempt to enhance its remittance infrastructure, the flow of remittance may be hindered.

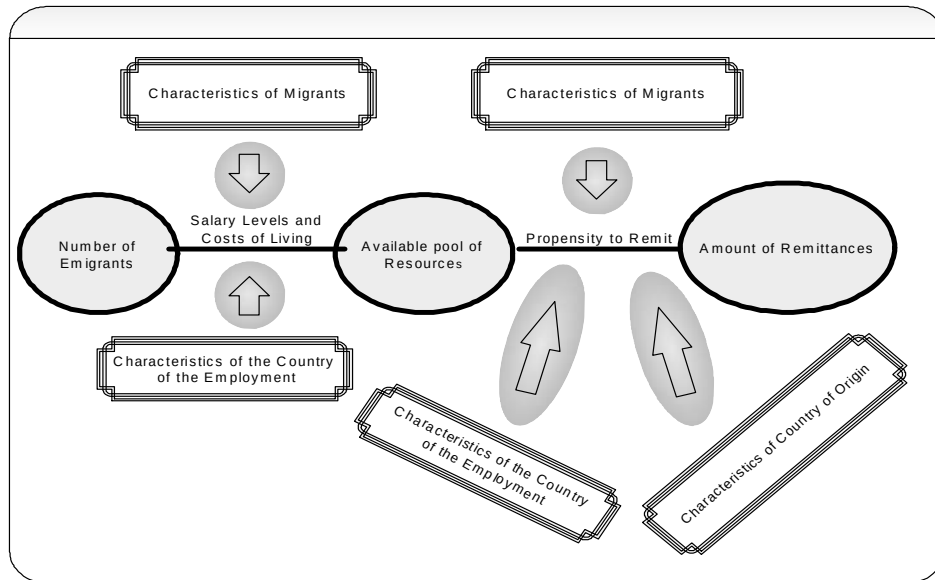
There are two money transfer systems, namely, formal and informal. Authorized dealers or registered mechanisms for foreign exchange transaction can be identified as formal money transfer systems. Commercial banks and Money Transfer Businesses (MTBs) such as Western Union are examples. Informal money transfer systems - which are sometimes referred to as the 'poor man's private banking vehicle' - are formed when conventional formal financial infrastructure has not been fully maximized, or when unskilled migrants are not familiar with formal channels. Informal channels can also be the outcome when skilled people seek ways to evade taxation and foreign exchange controls. Typically, informal channels operate outside and in parallel to the conventional formal channels.⁴ Such money transfer systems are similar in terms of their operational mechanism as can be seen in the Figure 14.3.

² World Bank (2006), "Global Economic Prospects: Economic Implication of Remittances and Migration", World Bank, Washington D.C.

³ World Bank (2005), "Sri Lanka's Migrant Worker Remittances: Enhancing the Quality and Outreach of the Rural Remittance Infrastructure", World Bank Policy Research Working Paper 3789.

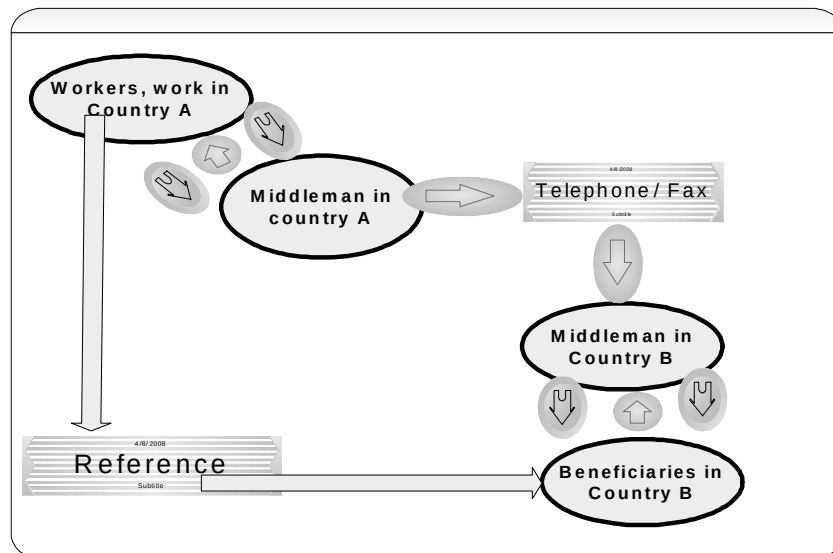
⁴ Examples include: *fei ch'ien* in China, *hundi* in South Asia (Pakistan and Bangladesh), *hawala* in North Africa, Middle East and South Asia, *padala* in Philippines, *hui kuan* in Hong Kong, and *phei kwan* in Thailand.

Figure 14.2
A Basic Model of Remittance Flow



Source: Carling, J., 2005, *Migrant Remittances and Development Cooperation*, Oslo: International Peace Research Institute.

Figure 14.3
The Basic Informal Remittance Transaction



Source: Maimbo, S.M., 2004, "The Regulation and Supervision of Informal Remittance System", proceedings of a seminar on "Current Developments in Monetary and Financial Law", November 2004, Washington, D.C.

The use of informal channels is prevalent in countries where there is high incidence of unskilled labour migration as they have poor knowledge about the formal financial sector as well as required documents to carry out transactions. In addition, the technological gap between origin and destination country can be another reason for the continued use of informal transfer systems.

Sri Lanka has a well connected network of institutions which provide financial services to migrants. These include 22 Licensed Commercial Banks (LCBs), the state owned National Savings Bank (NSB) and the Bank of Ceylon (BOC), the Sri Lanka Post Office Network and Money Transfer Businesses (MTBs). Some of the LCBs provide specialized services targeting remittance inflows. For example, the Commercial Bank of Ceylon provides an instant money transfer service named 'Combank e-Exchange'. Migrants can transfer remittance through network agents in over 50 countries and receivers can collect money either from on-line connected bank branches or from related centres.⁵ The Inward Remittance Department of the Bank of Ceylon transfers remittances through swifts, telexes and faxes. In addition, 'BOC e-Cash', 'Xpress Money Service' and 'EZ Remit' are internet based remittance schemes. The Seylan Bank has designed a 'FastCash' remittance service for Sri Lankan workers in Saudi Arabia and Lebanon. This service is generally more expensive. The leading MTB in Sri Lanka is Western Union.

However, as mentioned earlier, nearly 45 per cent of private remittances were estimated to be channelled through informal sector systems in Sri Lanka in the mid-1990s. While more recent estimates are not available, it is likely that the percentage would have low-

ered with the improvements in formal infrastructure channels over time. Nonetheless, global estimates suggests informal channels continue to account for a significant share of remittance flows and this too is likely to be the case for Sri Lanka. Informal remittance systems are preferred due to lack of bureaucracy and reliability. Migrants in areas of conflict are also more likely to be linked to informal channels due to language and cultural convenience.

However, the key issue in the remittance transfer market in Sri Lanka is that the potential for conventional formal remittance infrastructure is not being maximized. High transaction cost, less outreach, slow services and highly document based services are the major reasons behind this drawback. Some areas of the country are more adversely affected. Even to date, LCBs have provided only a limited range of banking facilities in a few townships in the Northern and Eastern regions of the country. Other financial organizations such as microfinance institutions (MFIs) which have greater outreach in such regions are not licensed to provide remittance services.

14.3 Costs and Benefits of Money Transfer Systems

Transaction fees of the formal channel are very high. Transaction cost of a migrant's remittances can amount to as much as 20 per cent of the transferred money.⁶ Furthermore, the outreach of the formal financial infrastructure is limited and, therefore, many recipients have to travel considerable distance and spend significant amounts of time to collect their remittances. Nonetheless, even though individual costs are incurred in the use of formal remittance channels, they offer some benefits to their clients. Formal re-

⁵ For example, MiniCom Centres at Cargills Food City Super Markets and Service Points at Arpico Super Centres.

⁶ Usher, E. (2005), "The Role of Migration in Achieving the Millennium Development Goals" in M. Morocco (ed.) *International Migration and the Millennium Development Goals: Selected Papers of the UNFPA Expert Group Meeting*, United Nations Publication Fund, New York.

mittance systems open up sources of financial services for the recipients such as savings and investments. For example, when remittances are channelled through formal banking systems, they may encourage savings as required accounts are opened. In addition, remittances can be used to obtain business loans and other financial products such as insurance. Remittances also have greater local investment potential where there are modern and flexible infrastructure facilities.

At the country level, formal channels lead to economic growth through savings and investments as formal channels open up paths to savings and investments. In addition, formalized remittances enhance foreign exchange reserves which are extremely vital for developing countries. The development potential of such remittances can be more effectively maximized when remittances are channelled through formal financial institutions. Formal channels also help in reducing illegal activities such as money laundering which is increasingly receiving global attention in the context of rising international terrorist networks.

With regard to informal channels, the disadvantages outnumber the advantages. Remittances channelled through informal transfer systems are highly vulnerable to risks of exploitation. Anonymity is possible through informal remittances and there is thus a concern that financial flows are much more vulnerable to illegal activities. Further, at the household level, in contrast to the formal system, money channelled through the informal sector is likely to be used for immediate consumption as there is no motivation, guidance and opportunity to save and invest. Individuals may also seek informal channels as they want to avoid income tax, leading to a loss of potential revenue for a government. Informal remittance transfer channels, there-

fore, can be identified as a barrier to making full use of such resources for development. Even though there are significant costs associated with informal channels at individual level as well as at the country level, a few benefits can be recognized. Most of the migrant workers try to send money through informal channels as the cost of transactions borne by them is low. In addition, the outreach of informal sector is wider and, therefore, people do not need to waste valuable time which can be spent on other productive activities. Also, most unskilled migrants are attracted by cultural affinity and language conveniences that informal transfer systems offer.

14.4 Policy Options for Enhancing Formal Channels

As a result of informal transfer systems, the impact of remittances on development might be muted. Therefore, policies that seek to improve the development impacts of remittances should also encourage formal money transfer systems and access to formal financial infrastructure. Policies which enhance the formal channels can be divided into three major components, namely; migrant specific policies, macroeconomic incentives and improving the conventional financial sector. These three policy instruments are also interrelated.

14.4.1 Migrant Specific Policies

Migrant specific policies should enhance the access of poor remittance senders and receivers to formal financial services for sending and receiving remittances. To realize this objective, public policies should encourage expansion of domestic banking networks and should allow domestic banks to operate overseas. In addition, other institutions with a better outreach to rural communities should also be considered. Microfinance institutions (MFIs) and credit unions at the receivers end

can potentially make formal transfers more attractive with their superior accessibility and greater outreach. Without compromising their primary focus on poverty alleviation, remittance transfer services may become extra sources of revenue to MFIs. In addition, supportive trainings and marketing programmes offered by MFIs can be used to enhance the productive use of income received from abroad. It can be a more realistic means of capturing migrant remittances as deposits and channelling them to small and micro enterprises, rather than introducing migrant specific investment programmes. In addition, MFIs can also help in overcoming migrant's cultural and language problems in the money transfer market. The staff in most MFIs is from the same locational areas with knowledge of local conditions and persons. This can create a familiar environment at financial institutions for low income groups who may otherwise be reluctant to access them. MFIs can also keep past remittance records and thereby limit any liquidity constraints. For instance, they can convince migrants to send large amounts of money on a single transaction as it reduces the transaction fee. In addition, MFIs can provide pre-departure financial education to unskilled migrants parallel to other training that is received.

However, a key constraint to engage MFIs is that many do not have sufficient strength in manpower and capital to enter international money transfer services. In this context, governments can encourage MFIs to deal with money transferring activities by providing human resource facilities and financial support. Governments can also provide support in terms of linking them with international donors to finance the cost of developing such infrastructure know-how.

14.4.2 Improving the Conventional Financial Sector

Competition in the remittance transfer market should be improved to lower existing high transaction costs, considered to be a major weakness in the formal money transfer market. Competition can be enhanced by lowering the capital requirement on remittance services and opening up non-exclusive partnerships with remittance agencies by reducing bureaucratic barriers. To this effect, Sri Lanka Post has started a partnership with Western Union. However, the transactions are highly dependent on documentation. Undocumented migrants, particularly from the North and East of the country and migrants based in countries such as Italy still have to remit their money through informal remittance mechanisms.

Box 14.1 Remittances and MFIs

The Fondasyon Kole Zepol (Fonkoze) in Haiti can be cited as an MFI which exemplifies how an undercapitalized grassroots organization can tap into the remittances market. Fonkoze offers an international deposit service called Ayiti Direk (Direct to Haiti) in addition to its microfinance services such as microcredit and savings. This MFI has formed a mutually beneficial relationship with the City National Bank of New Jersey (CNB). A remittance sender can deposit money in Fonkoze's CNB account and the corresponding amount of money is deposited in the recipient's Fonkoze account at a flat fee of US\$ 10. The CNB has identified that there is potential for attracting clients and transfer money at a very low cost. The number of migrants transferring money through this system is growing, indicating that there are benefits to be had from the system to all parties.

Disseminating data on remittance transfer fees would help in improving transparency and thereby market competition. The fee for remittance transactions includes a fee charged by the sending agency and a fee of currency conversion. In addition, some agencies charge a fee to account for unexpected exchange rate movements and an indirect fee in the form of interest. The fee for remittance depends on the business model used by the remittance service and on the amount of remittance. The remittance fee is, therefore, complex and a client is rarely informed about the precise fee of the transaction. With greater transparency, migrants will be able to compare the cost of transferring money and select the most cost effective method. This indirectly helps financial institutions to enhance their products as well.

The other option is to invest money to strengthen electronic payment systems and thereby lower transaction costs and improve the speed and distributional reach. Card based instruments such as stored value cards (representing money on deposit with the issuer while name of individual account holder is anonymous) can be initiated. Sampath Bank in Sri Lanka has introduced pre-paid card named "WEBCARD" to make payments via internet. This kind of facility can be introduced for money transferring. Local banks together with their international networks can introduce pre-paid card systems which allow migrant workers to send money through Automated Teller Machines (ATMs). Migrant workers can credit monthly salaries to the local bank operated in the foreign country and the bank can issue a card which can be topped up according to each transaction. Migrant worker can use ATMs to send money

to an account in the same bank in the home country with the receiver in the home country collecting money from an ATM. With a well improved banking network and a data base, this system can be implemented. The 'Smart Phone' based remittance system provided by the Smart Communication mobile phone Company in the Philippines is a good example.⁷

International banks too can expand their electronic services to rural areas. It would also require that local banks in rural areas connect to such electronic networks. Electronic interconnectivity in banks creates the opportunity to the recipient to receive money at any bank branch. Payments system linkages with non-bank financial institutions can also be created. The costs of providing such facilities can be reduced by partnering with microfinance institutions. For instance, the Federal Reserve Automated Clearing House (FedACH) is a notable example of efficient sharing of an electronic payment system, not only within a country but also across international borders.⁸ FedACH also publishes foreign exchange rates, adding market transparency which is not available in most other services.

14.4.3 Macroeconomic Incentives

The government can assist remittance service providers by permitting them to hold foreign currency deposits which will increase the volume of remittances channelled through formal institutions as they are not subject to foreign currency regulations. In Sri Lanka, resident foreign currency (RFC) deposits can be opened with LCBs or state owned banks such as the Bank of Ceylon. However, the initial amount required to open an account

⁷ A Filipino abroad can deposit money to be remitted with a remittance partner of Smart's and send a text message to the receiver. The money is then credited to Smart Money Electronic Wallet and the receiver can withdraw money from an ATM using a Smart Cash card.

⁸ The US and Mexico established an Automated Clearing House (ACH) to reduce the cost of remittance transfers between the two countries. The monetary authorities of these countries have linked their automated clearing house system (FedACH) operated by the Federal Reserve System and the Central Bank of Mexico (Banco de Mexico). Under the system, the US bank processes client transfers and sends a file to FedACH, which in turn transfers the funds to Banco de Mexico. The latter sends information to the Cecoban (image clearing system) and forwards the money to banks in Mexico.

is high. For example, the required amount to open an RFC account is US\$ 500 at the Bank of Ceylon. This is more than one month's salary of an unskilled migrant worker. It is, therefore, better to reduce the initial amount of money so that more migrants are encouraged to open an account and receive the benefits of using formal transfer channels.

Foreign currency bonds also operate in the same way and can be more effective in encouraging longer-term flows than foreign currency deposits. The Sri Lankan government has already initiated foreign currency bonds named 'Sri Lanka Nation Building Bond'. Citizens of Sri Lanka who have taken up foreign employment are identified as eligible investors. However, the minimum investment requirement level is US\$ 500 which may be beyond the reach of many unskilled migrants as in the case of foreign currency deposits.

Such instruments typically target the more skilled migrants. Whilst the bulk of migrants from Sri Lanka at present fall into the category of 'unskilled migrants',⁹ the skills profile and composition of migrant workers have been changing progressively over time. With more recent government initiatives to encourage more skilled migrants, such instruments will complement efforts to raise the total volume of remittance inflows to the country.

Governments can initiate bilateral negotiations for financial activities between sending and receiving countries as a better alternative. Examples of such partnerships include the US-Mexico Partnership for Prosperity which is a private-public agreement launched in 2001. Under this partnership, the issue of streamlining remittances was the area that received most attention. There has reportedly

been a dramatic decline in the cost of remittance transfers due to the alliance.¹⁰

In Sri Lanka, the government has permitted domestic banks to operate overseas and provide services to migrant workers abroad. For example, the People's Bank has opened branches in Saudi Arabia, United Arab Emirates, and Kuwait. The Commercial Bank of Ceylon has also opened networks in several Middle East countries such as Kuwait, Qatar, Oman, Jordan, and Bahrain. This encourages remittance senders to use formal channels to remit money as they do not face cultural and language barriers when they use financial institutions from their own country. This particular macroeconomic incentive, therefore, relates to the migrant specific policies at the sender's end. However, migrants should be informed about this financial network before they leave the country. This will mitigate the tendency of first time migrants to remit money through informal channels due to lack of prior information.

In addition to the above mentioned macro-economic incentives, mandatory requirements can be used as an effective tool for attracting remittances to the formal channels. For example, the Korean government stipulates that 80 per cent of migrant workers' earning should be channelled through the Korean banking system as a condition for issuing exit permits.

14.5 Conclusion

The analysis of the impact of remittances on the domestic economies of labour sending countries is mainly focused on officially recorded remittances. Formal remittance services reduce the risks of money laundering, open up opportunities to save and invest and, thereby, hold the potential to support higher

⁹ In 2007, housemaids and unskilled labour migration represented around 71 per cent of total migrants (47 per cent constituted housemaids with a further 24 per cent as unskilled labour).

¹⁰ Lasagabaster, E., et. al., (2005), "Sri Lanka's Migrant Labour Remittances: Enhancing the Quality and Outreach of the Rural Remittance Infrastructure", World Bank Policy Research Working Paper 3789.

rates of economic growth and development. In Sri Lanka, the government has taken initiatives to improve the remittance infrastructure in line with its stated policy of increasing the volume of remittance inflows in the medium-term. However, a significant share of remittances is still likely being channelled through the informal sector given that housemaids and unskilled labour - with a preference for informal transfers - dominates the composition of migrant patterns. In reviewing various policy measures to strengthen the formal remittance transfer system in Sri Lanka, a possible option is to promote microfinance

institutions to engage in this area of activity. The conventional financial sector can also initiate further innovative instruments targeting migrant workers. Finally, the government can also consider the imposition of mandatory requirements for the issuance of exit permits. However, in order for such schemes to be effective - and not prove counter-productive - sufficient numbers of local financial institutions should be easily accessible to migrants. In this respect, promotion of microfinance institutions in remittance transfers can also be useful.

15. Linkages between Poverty and Alcohol

15.1 Introduction

Alcohol related issues can be considered as one of the more controversial topics in the world due to different cultural values and its often negative social and health outcomes. Given its addictive nature, alcohol is viewed as different from many other consumer products. For governments, taxes on alcohol can be an easy means of revenue generation. Nonetheless, given that excessive alcohol consumption is associated with a plethora of health, social, legal and economic issues, the costs often outweigh any positive revenue related issues. Many countries, including Sri Lanka, are increasingly looking to restrict consumption of alcohol through various measures such as prohibitive taxes, bans on alcohol related advertising, etc.

Although some studies have shown that moderate consumption of alcohol can be good for health, many other studies suggest that alcohol consumption is harmful. On the one hand, non-health related studies have suggested that alcohol consumption is associated with celebration and pleasure, relaxation and reward. On the other hand, other related studies argue that alcohol consumption is associated with health issues and criminal offences. In particular, excessive alcohol consumption has direct and indirect effects on poverty. In Sri Lanka, health activists point out that the country's third biggest health issue is related directly to alcohol consumption. In addition, it is found to be positively correlated with crimes, domestic violence, low labour productivity, injuries and accidents. These consequences of alcohol consumption are particularly severe for the poor people in the country.

15.2 Key Issues of Poverty

Poverty is clearly a complex economic, social and cultural phenomenon. It is not just an inadequacy of direct income to meet basic needs or the inability to spend. In most cases, it is associated with numerous characteristics such as lack of assets, landlessness, unemployment or underemployment, illiteracy, malnutrition, high infant mortality, large family size, low productivity, low position in the social hierarchy, low access to publicly provided goods and services, poor infrastructure facilities and extreme vulnerability to natural calamities, disease and social conflicts. Some of the key factors related to poverty in Sri Lanka are as follows:

- There is evidence to suggest that free education and efficient health care delivery have positive impacts on the population and on reducing overall poverty.
- To deal with high levels of inequality, of income, land and other assets, and to reduce poverty effectively, it is necessary to have sound macro-economic policies to promote growth coupled with pro-poor delivery.
- Poverty reduction also requires effective safety nets to mitigate the impact of personal and natural calamities like droughts, floods, landslides, etc.
- Inappropriate targeting of welfare benefits is also one of the major reasons for persistent high incidence of poverty in the country.
- Insufficient infrastructure development facilities and lack of access to services (such as proper road network, water resources and electricity) in many parts of rural Sri

Lanka is one of the major issues which hamper poverty reduction.

15.3 Links between Alcohol and Poverty

In addition to the above, excessive use of alcohol has also contributed to the incidence of poverty in Sri Lanka. Sri Lanka is estimated to have one of the highest per capita levels of alcohol consumption in the world. Excessive alcohol consumption has both a direct and an indirect effect on the poverty status of individuals, families, and the entire community. Excessive consumption has negative impacts on the achievement of key human development outcomes in health and education, and is a key driver for poverty in the long run. In Sri Lanka, alcohol consumption is found to be higher among poor families compared to non-poor families.¹ In rural areas, people who drink do so heavily - consuming locally produced alcohol for the most part. Thus, poor households tend to spend a larger percentage of their income on alcohol, while the government is providing financial support to the same target group.

Apart from the money which is spent on drink, excessive alcohol consumers often suffer many economic problems such as indebtedness, lost employment opportunities and reduced wages, increased medical expenses, and decreased eligibility for development opportunities which are available at local levels (e.g., microfinance loans, incentives, etc.). Normally, a heavy drinker's expenditure on alcohol takes up a large share of the income, implying that the household will get affected by indebtedness. This usually affects the education of the children of such households as well. When parents are addicted to alcohol, the mental and social development of children may also get af-

fected as a result of being exposed to in-family violence, etc.

Alcohol addiction in adults can also affect the education of children as well as the nutritional status of the entire family. One of the reasons for poor families to be persistently poor is due to such reasons.

15.4 Availability of Alcohol

There are two types of easily identifiable alcohol sectors in Sri Lanka, namely, the legal and illegal (*kasippu*)² sectors. Home based brewing of alcohol in Sri Lanka is illegal. However, this illegal brewing is a lucrative business in most parts of the country. After any increase in taxes on alcohol, alcohol prices rise and products of the illegal industry become more and more attractive to consumers. Illegal alcohol is more harmful to consumers. Anecdotal evidence suggests that many people have faced severe health problems - loss of eyesight, brain damage, paralysis, etc. - due to the consumption of *kasippu*. Thus, free availability of cheap alcohol - aggravated by unemployment and underemployment - is a major reason for addiction to alcohol, particularly in the rural sector. In the plantation sector, women also consume large quantities of alcohol due to the harsh nature of the work, climatic conditions, as well as due to cultural factors. All these contribute to aggravating poverty conditions in these vulnerable sectors and segments of society.

A study by the World Health Organization (WHO) highlights that *kasippu* makes up 92 per cent of total alcohol consumption in Sri Lanka, amounting to 625 million litres, while legal alcohol consumption amounts to only 55 million litres.³ Thus, per capita consumption of hard liquor is about 36 litres and this

¹ Jayathilaka, R. (2007), "Alcohol and Poverty: Are they Related? Empirical Study from Sri Lanka", *Sri Lanka Economic Journal*, Vol. 8, No. 1.

² This is the most common and accepted name of illicit brewing in Sri Lanka.

³ WHO (2004), *Global Status Report on Alcohol*, World Health Organization, Geneva.

is considered a high level of consumption. According to industry sources, in the last five years, the legal alcohol sector has grown by 10-12 per cent while the illegal liquor sector has also been growing at a much faster pace. Nevertheless, soft liquor consumption in Sri Lanka has been declining over the last five years while hard liquor consumption has been increasing. Therefore, in Sri Lanka, hard liquor contributes more towards alcohol consumption at an increasing rate. This is exactly the opposite trend to movements in world-wide alcohol consumption.

In recognition of the growing problem of alcohol consumption in Sri Lanka, the government has recently initiated certain measures to regulate the industry.⁴ Two Bills related to control of sales of alcohol for young adults, banning of advertisement, and 1 km alcohol-free distance from religious places were passed in Parliament in 2006. The expected positive impact of these approved two Bills still remains to be seen.

The existing uniform taxation of soft and hard alcohol in Sri Lanka also has some serious shortcomings that impact adversely on high risk sub-sets of the population who are mainly in the poorer groups. The overall level of alcohol taxation, and hence price, is likely to be one factor underlining the increasing consumption of illicit alcohol, and the related adverse effects.

However, there is no unique solution to the kasippu threat in Sri Lanka. Whilst it is recognized that kasippu dealers and supporters of kasippu sellers are engaged in illegal activities, enforcing the laws has been difficult, and often ineffective. In many instances,

there is collusion among kasippu dealers, the law enforcing authorities and some politicians. Such an undesirable situation needs to be changed to control the kasippu threat effectively in Sri Lanka given the significant downside effects on health, particularly on the vulnerable poor in the country.

15.5 Health Issues

Alcohol has been identified as one of the most harmful products to human health. Studies have found that around 4 per cent of the burden of disease worldwide is due to alcohol.⁵ In addition, alcohol consumption is estimated to contribute to more than 60 health related problems. These include chronic diseases such as cirrhosis of the liver and certain cancers, as well as poor health resulting from trauma, violence, and accidental injuries. Therefore, most governments try to control the consumption of alcohol through laws, although very few countries ban alcohol entirely. On the other hand, the World Health Organization (WHO) has recommended that its member countries should develop national control policies to prevent excessive alcohol use. Nonetheless, there are significant variations to be found between national alcohol policies.

Many studies in Sri Lanka have documented that alcohol is an important factor in the persistence of poverty in the country.⁶ Many families are found to be unable to escape from poverty because of the alcohol - and tobacco - use of one or more of their members. Once influenced by alcohol use, poverty itself may be exacerbated by absenteeism, lack of motivation, ill-health and lack of a family unity.⁷ It is a leading risk contributor to the burden

⁴ The government has spelt out its policy towards alcohol under the 'Mathata Thitha' programme.

⁵ See Rodgers A., et. al. (2004), "Distribution of Major Health Risks: Findings from the Global Burden of Disease"; Room, R., et. al. (2005), *Alcohol and Public Health*, *Lancet*, 365: 519-30.

⁶ Room, R. et al. (2002), "Alcohol in Developing Societies: A Public Health Approach", Finnish Foundation for Alcohol Studies in collaboration with the World Health Organization.

⁷ Baklien, B. and D. Samarasinghe (2003), "Alcohol and Poverty in Sri Lanka", FORUT, Norway.

of disease and a key cause of disability, especially among men. Thus, excessive alcohol consumption generates a wide range of interrelated negative effects and outcomes, some primary and others secondary. Most common primary consequences are domestic violence, violence against women, injuries and accidents, petty crime, violence, and declines in labour productivity.

From a health activists' point of view, alcohol consumption has resulted in serious health and safety issues that adversely affect society. The WHO highlights that the effect of alcohol consumption on the health of the population is the third biggest issue in Sri Lanka, followed by premature death caused by tobacco, and high blood pressure.⁸ While there is no guarantee that abstaining from alcohol consumption will reduce poverty levels it will certainly help to reduce the health hazards, violence, and indebtedness of individuals and households - indirectly helping to sustain income levels of affected households.

15.6 Community Level Intervention

Alcohol and related problems - especially among the rural population - is a community based activity which is perhaps best tackled at the community level. Generally, a community is guided by leaders of religious places, respected elders of the community, government servants, law enforcement authorities, etc. Such community leaders are in a position to guide the community more effectively and, therefore, their contribution at the community level to eradicate the menace of alcohol abuse will be more productive.

Community level programmes focus on changing the environment in which a person consumes alcohol, rather than the behaviour of the individual drinker. There are several

community activities which can be adopted to discourage alcohol consumption. First, the use of media to target policy makers, as opposed to the general public, in support of programme goals. Secondly, building an environment to focus on mobilizing the community to make structural and system changes, rather than on persuading individuals to change their behaviour. Finally, community and environment activities can generally target the supply of alcohol through social and market systems as opposed to the demand for alcohol by individuals. Such environmentally based community prevention programmes represent an important and promising approach to the reduction of alcohol problems.

In the current environment of reduced state involvement in social and economic activities, the community emerges as the natural vehicle for taking action against alcohol related problems - as long as the freedom of the community to act is not constrained or diluted by political regimes. Communities need to be supported in this task and lasting change is most likely when the people who are affected are part of the change process. The complexity of how a community functions also has to be taken into consideration and harnessed. The most positive change is likely to be achieved by operating at the level of the overall community system so that the structure and operation of the whole community are geared to ways that support safer drinking, avoiding illicit brew. This can best be implemented only when community intervention is free of politics.

15.7 Conclusion

Sri Lanka's alcohol policy has to take into consideration issues of illegal alcohol, legal alcohol, pricing and quantities as determining factors when formulating policy within the context of cultural and religious values.

⁸ WHO (2004), *Global Status Report on Alcohol*, World Health Organization, Geneva.

However, effective alcohol policies are those that control access to alcohol, determine how alcohol is being distributed and influence various high-risk activities. An effective approach may include efforts to implement multiple policies, including policies aimed at discouraging illicit and illegal alcohol. Availability of cheap illicit alcohol is a society-wide problem which has to be tackled at both the national and grassroots levels. Other measures include ensuring that there is no

police/political interference in the enforcement of laws and regulations. Educating the younger generation in society about the harmful effects of excessive alcohol consumption could also be a major component in an effective alcohol policy. The problem of alcohol consumption should be tackled through a well coordinated education programme at the national level through the school education system.

16. 'Negenahira Udanaya': Reconstruction of the Eastern Province

16.1 Introduction

Reconstruction of the Eastern Province of Sri Lanka is a 'political-economic issue' rather than a mere regional development plan. This implies that any political mistake in the process could lead to heavy economic losses while any political gain has the potential to create multiplier effects in the country's economic development. Similarly, poor planning and economic policies could lead to political costs too. Due to this reason, the reconstruction of the Eastern Province invariably becomes a strong balancing act of political and economic interests. Hence, any policy analysis of reconstruction challenges of the province should essentially be a political-economic analysis.

16.2 Political Economics of the 'Eastern Revival'

In the current context, the Eastern Province assumes a great significance in the national political scenario. It has been a major battleground where national sovereignty and the territorial integrity of the sovereign state of Sri Lanka has been contested by separatist forces led by the Liberation Tigers of Tamil Eelam (LTTE). The claims of separatist elements have been based on the concept of a 'traditional Tamil homeland' where the Eastern Province becomes an 'integral part' of a territory that is argued to hold over two-thirds of 'Tamil speaking people'. Given the ethnic diversity of the Eastern Province, such a definition permits the inclusion of the Muslim community on linguistic grounds.

Behind these ethno-political claims, the real political-economic value of the Eastern Province to any separatist movement lies in the richness of economic resources and the strategic

location of the province. In the absence of a claim to such territory, the political and economic platform to sustain the notion of separatism becomes significantly diluted. In this backdrop, the reconstruction of the Eastern Province assumes an overwhelmingly important position in the agenda of the government to safeguard the national sovereignty and territorial integrity of the country. It cannot merely be an ordinary plan for 'regional development', but rather one that will generate not only economic development but ethnic harmony in the development process.

There are three main pillars that bear the weight of 'Negenahira Udanaya' - the popular title given for the reconstruction plan for the Eastern Province. These three pillars are national security, economic development, and communal harmony. The strategic objectives to be achieved by the programme include the following:

- Nullify the separatists' claims of discrimination of minorities by creating conditions for equitable growth of all communities
- Win the masses back to the democratic process who have been denied participation in political decision making over two decades
- Consolidate ethnic harmony among Tamil, Muslim and Sinhala communities, which has been disturbed for a long period of time
- Ensure meaningful participation of all communal groups, social strata and gender groups in the decision making of the development process

- Bring the relatively backward province into the mainstream of the national economic development agenda by efficient utilization of numerous resources for the economic well-being of residents in the area.

In the above list of objectives, the last objective would have been the 'standard main objective' in any other less politically complicated regional development effort. However, in the case of the Eastern Province, the first four objectives become necessary conditions for achieving this ultimate final objective. This explains why the 'Negenahira Udanaya' is essentially a political-economic plan than a mere regional economic development plan. Unless gains are made in the directions demarcated by these four objectives, it is highly unlikely to make positive gains in terms of the final objective also. This situation makes the rehabilitation programme a major challenge for the government as well as the people of the region.

16.3 A Brief Profile of the Eastern Province

To assess the situation properly, an understanding of the physical and socio-economic realities involved is required. Therefore, a brief profile of the province in terms of demography, resources and economy is discussed below.

16.3.1 Demography and Population

The Eastern Province consists of three districts - Trincomalee, Batticaloa and Ampara.

Some of the key statistics of the province are given in the Tables 16.1 and 16.2. As the last Census of Population conducted in 2001 could not fully cover the Eastern Province due to the security situation, the population figures given are based on estimates.

Compared with other provinces where one ethnic group usually dominates (Sinhalese in seven provinces and Tamils in the Northern Province), the Eastern Province has a more or less equitable distribution of population amongst the three major ethnic groups. Hence, the province is unique in ethnic composition. However, since there is no accurate information on the demographic data of the province, the current ethnic composition is quite controversial. The last reliable account on the ethnic composition of the province was the Census of Population of 1981 (Table 16.2). It is understood that there may be certain changes in the ethnic composition due to the conflict and related shifts in population such as out-migration.

16.3.2 Physical Resources

The Eastern Province is a resource-rich province in the country. It has the longest beach (over 400 km) among all provinces with numerous white sand stretches suitable for tourism and recreation. Therefore, the potential for beach tourism in the province is immense. It has significant mineral sand deposits such as ilmenite and monazite that are of exportable quality. The long coastal belt and numerous lagoons/bays, etc., provide a strong

Table 16.1
Eastern Province: Area and Population

District	Land Area (km ²)	% National	Population (Thousands)	% National	Pop. Density (Pop/km ²)
Trincomalee	2,727	4.2	395	1.98	144.8
Batticaloa	2,854	4.3	556	2.80	194.8
Ampara	4,415	6.7	627	3.15	142.0
Total	9,996	15.2	1,578	7.94	164.4

Source: Department of Census and Statistics.

Table 16.2
Eastern Province: Ethnic Composition

District	Sinhala (%)	Tamil (%)	Muslim (%)	Other (%)
Trincomalee	33.4	36.4	29.3	0.9
Batticaloa	3.43	72	23.9	0.7
Amapara	7.82	20.4	41.5	0.3
Total	4.99	42.05	32.34	0.6

Source: Department of Census and Statistics.

resource base for coastal fisheries and aquaculture as well.

In addition, inland areas of the province have fertile soils with very high agricultural productivity. As a result, the province remains the main paddy producing area even after 25 years of conflict. Sri Lanka's two major sugar production facilities (Kantale and Hingurana) have also been established in the province, although neither of them are currently functioning. Among other strategic resources is the Trincomalee harbour, one of the finest natural harbours in the world.

16.3.3 Economy

Table 16.3 provides a snapshot of the comparative position of the provincial economy. Accordingly, despite the rich profile of resource and the pre-eminent position in paddy production, the province has underperformed in all other sectors, lagging significantly behind (ranking sixth to eighth) among other provinces. The activities with most potential in the provinces, such as tourism and fisheries, are highly vulnerable to conflict situations. With the escalation of the conflict, the momentum for economic progress was lost due to security concerns, leaving

Table 16.3
Economic Fact Sheet of the Eastern Province

Parameter	Value	% of National	Rank Among Other Provinces	Remarks
Provincial GDP (Rs.mn) - 2006	117,192	4.7	6	Low agriculture GDP despite high paddy production
♦ Agriculture	26,821	6.6	8	
♦ Industry	31,976	4.8	6	
♦ Services	58,395	4.2	6	
Paddy production (000'mt)				
♦ 2005/06 Maha	491,000	23.0	1	Ampara is the main paddy producing district
♦ 2006 Yala	348,000	28.9	1	
Marine fish production (mt)				
♦ 2006	27,130	12.6	NA	Drastic drop of production due to security restrictions
♦ 2001	74,930	29.4	NA	
Industry (2003)				
♦ No. establishments	7,143	5.6	7	Indusrially backward province despite high profile of resources
♦ No. engaged	23,518	2.2	8	
♦ Value added (Rs. mn)	3,508	0.8	8	

Source: Department of Census and Statistics.

little room for upholding economic development activities. Before the conflict had begun, the area seemed to have attracted significant economic development projects such as sugar factories in Kantale and Hingurana, a paper factory in Valachchanai, a mineral sands project in Pulmodai, major hydro-electric and irrigation projects such as Galoya and Maduru Oya, cement and wheat processing facilities at Trincomalee harbour, etc. Hence, the Eastern Province showcases an example of lost economic potential due to a long drawn conflict.

16.4 'Negenahira Udanaya': Programme in Brief

The government has drawn a strategic plan for revival of the Eastern Province with a time horizon of four years, starting from 2007. The total estimated funds required is Rs. 197 billion. Table 16.4 indicates the six major strategies identified under the plan and the budget requirements under the respective strategies in each planning year.

Accordingly, the major weight has been given to improving the economic infrastructure,

followed by human settlement development. This is logical, as much of the essential economic infrastructure and human settlement facilities have been damaged by the long drawn conflict. The damage was further worsened by the December 2004 tsunami, which affected the coastal zone in particular. The government's plan also has provisions for revitalizing productive sectors based on the foundation laid by infrastructure development. Among the key economic sectors identified for revival are agriculture and livestock, fisheries, tourism, and minor, small and medium enterprises (MSME).

The logical path for achieving the success in 'Negenahira Udanaya' and key issues to be addressed in the each step can be summarized as follows:

Restoring normalcy as early as possible: The government has militarily wrested control of the Eastern Province. However, as a region long involved in the conflict, it may take some time to return to normal economic life. This has to be expedited through the following major steps.

Table 16.4
Key Strategies and Budget (Rs. million)

Strategy	2007	2008	2009	2010	Total	%
Resettlement of returnees	3,666	4,800	6,000	7,000	21,466	10.88
Revitalizing productive sectors and regional economy	2,075	8,703	10,919	12,154	33,850	17.16
Improving economic infrastructure	11,823	21,309	25,787	24,909	83,807	42.49
Strengthening social infrastructure and fostering social services	1,999	6,404	5,304	5,400	17,895	9.07
Human settlement development	6,541	9,290	11,122	11,094	38,047	19.29
Public institution capacity building	457	527	569	601	2,154	1.09
Total	26,561	51,032	59,700	61,157	197,219	100.00

Source: Ministry of Nation Building and Estate Infrastructure Development.

- ⇒ Resettling the internally displaced as early as possible
- ⇒ Opening up avenues for normal economic life:
 - Ensure the protection for livelihoods from terrorism related disturbances
 - Minimize the security related restrictions on livelihoods
 - Transferring the civil administration to democratically elected representatives

Linking economic activities with the rest of the country: The success of the revival programme depends heavily on how quickly the economic activities in the province will be connected to the rest of the country, as well as the global economy. One of the core reasons that make any conflict-ridden area economically backward is the disconnection from other areas. This imposes more poverty and hardships on the people in the area, thereby worsening the conditions further in a vicious downward spiral linked with conflict dynamics. The government gaining administrative control over the entire area is a turning point that can reverse this cycle. However, military gains can be converted into political and economic gains only if necessary measures are taken to integrate the province to the economy of the rest of the country. This involves the difficult task of rebuilding at least essential transport and communication infrastructure during a short period of time so that it can support the commencement of normal economic linkages with other areas.

Setting into a path of rapid economic progress: Setting the province into a path of progress is a challenging task. This is complicated by a number of factors that have negative as well as positive features. In the first place, mobilization of funds, human resources and expertise in required scale is a difficult task. This can be exacerbated by the

scepticism of potential investors until they are convinced that the system will survive without falling back to the conflict regime once more. Finally, a long drawn conflict has effectively drawn out productive resources, especially skilled human resources from the area. On the positive side, there is some potential for seeking funds from donor sources by highlighting the urgent needs of post-conflict rehabilitation.

16.5 Challenges of Rehabilitation

The success of 'Negenahira Udanaya' will depend on how effectively it will overcome major political, economic and social challenges. In the first place, gaining political acceptance of an ethnically divided community for the revival programme is the most important factor. It is necessary to pursue a path of action which is unbiased to any ethnic group, while simultaneously addressing major concerns of all ethnic groups as well. This requires a difficult balancing act, especially in the current context of mistrust built up over decades of conflict. The best way to achieve this is by handing over the decision making powers of the revival programme to democratically elected representatives from all ethnic groups of the area. The government's decision to revive the hitherto unfunctional Provincial Council can be considered as a positive step towards this direction.

It is also necessary to improve the situation of ethnic harmony among major communities from the current context of strained relationships. Otherwise, implementation of the government's plan could lead to further divisions rather than overcoming them. The government's decision to hold early elections for the Eastern Provincial Council in May 2008, allowing people of the province to elect their own representatives can be considered as a positive strategic move to achieve this objective. This strategy paid off as a group of electoral members that is represen-

tative of the ethnic composition of the province has been elected as a result. In this context, elected representatives from all community groups have a responsibility to think beyond narrow political gains and along communal lines. They have to concentrate on the common good rather than on individual or communal gains.

Achieving the mass political support of major ethnic groups alone would not overcome the challenges. It is a necessary but not a sufficient condition. Another key challenge faced by the revival programme is mobilization of resources in sufficient scale. This has two major aspects; firstly, mobilizing funds for public investments for rehabilitation of infrastructure, human settlement facilities and capacity building measures; and secondly, attracting investments for development

of resources from potential investors, especially from the private sector. Both of these aspects are highly dependent on maintaining security and ensuring a stable environment for investment.

Another important challenge is ensuring good governance of the revival programme. Efficiency, public accountability and transparency are key parameters that can affect the success of the programme. A high level of efficiency is necessary to yield the maximum outcome from limited available funds. Public accountability and transparency should be maintained at all levels to raise public support/acceptability and to minimize waste and corruption. In an enterprise of this magnitude and complexity, adopting good governance practices is an essential pre-requisite for success.

17. Prospects

The most encouraging note of Sri Lanka's economic performance in 2006/07 was that the country continued to achieve a satisfactory GDP growth rate of 6.7 per cent. While it signalled a slowdown in the growth momentum achieved from 2004, a near 7 per cent output expansion per annum during 2005-07, nonetheless, is creditable in view of significant domestic and external challenges the country has had to face in that time. On the domestic front, the government has been engaged in fighting a heightened conflict since early 2006. On the external front, Sri Lanka has been facing the adverse impacts of a crippling increase in oil prices, which rose sharply from US\$ 30 per barrel in early 2004 to over US\$ 100 per barrel by end 2007.

Despite the relatively healthy growth performance, the economy has not escaped unscathed. Inflationary pressures that began to build up from mid-2004 were fuelled further in 2005 by reconstruction related activities in the aftermath of the December 2004 tsunami. As the growth momentum picked up, a relatively relaxed monetary policy stance was adopted for fear of 'choking off' the growth stimulus. Thus, despite some upward adjustments to policy rates by the monetary authorities, faster inflation caused real interest rates to be generally low - or even negative at times - in turn encouraging a rapid expansion in credit. As pressure on government expenditure mounted - from the post-tsunami reconstruction effort, higher defence spending, improvements to infrastructure, etc. - the expansionary fiscal policy stance offered no let-up on the inflationary spiral.

Cost-push inflationary pressures - primarily from external supply side shocks of high glo-

bal oil prices - contributed to the inflationary spiral. Nonetheless, Sri Lanka's rate of inflation which has been far above comparable inflation rates of other oil importing developing economies suggest that domestic policies have had a greater bearing on fuelling inflation. Concerted efforts by monetary authorities to tighten monetary policy from early 2007 - with monetary policy being much less accommodating - did bear some results in reining in inflation in the first half of 2008. However, a rapid rise in global food prices from mid-2007 - in addition to continuing increases in oil prices - saw the country's rate of inflation picking up sharply. While the global food price increases are expected to ease by the end of the year, the outlook for oil prices remains less optimistic. By mid-2008, the price of a barrel of oil had increased sharply to over US\$ 140. Although oil prices dipped in August 2008, particularly as a result of weak demand in the US - the world's largest consumer of energy - the long-term outlook is that high energy prices will continue to persist.

The spiralling 'cost of living' has become the most critical issue on the economic front for the government. The newly constructed Colombo Consumer Price Index - CCPI(N) - indicates a sharp increase in the annual rate of inflation from 15.8 per cent at end 2007 to 21 per cent by June 2008. Reining in inflation will be that much harder in the current environment of high inflationary expectations. As businesses and workers factor in inflationary expectations, it will increase the risk of a further spiral in wages and prices. Unrelenting price increases, if unchecked, could also threaten to escalate into social unrest.

The options for the government to address the issue of rising cost of living pressures are limited. The government has taken necessary steps to partially adjust petroleum prices in line with increases in the international market. For instance, the price of fuel was increased by nearly 30 per cent in June 2008. Such price revisions can no longer be viewed as contributing to a 'one-off' adjustment. Rather, they have become a series of adjustments that will inevitably have ripple effects throughout the economy - on costs of transportation, energy, etc. - increasing costs across a wide range of industries. Thus, despite monetary tightening efforts to curb demand-pull inflation, the counter-forces of cost-push price pressure from the latter half of 2008 will be quite significant.

Subsidizing and manipulating petroleum prices are no longer a luxury that the government can afford. The country's fiscal situation is beset with an overload of competing demands for limited resources and there is little scope to provide relief. While the narrowing of the fiscal deficit over the last three years - from 8.4 per cent of GDP in 2005 to 7.7 per cent in 2007 - and progressive reduction of the debt to GDP ratio - from 90.6 per cent to 85.8 per cent - might suggest otherwise, the medium-term health of public finances remains unsound. Much of the concern centres around the public debt financing strategy that can undermine fiscal stability in the future.

The shift to greater exposure to foreign financing of the deficit at relatively costly rates of commercial borrowing makes the economy more vulnerable to hits from domestic and/or external shocks. Not only does it raise interest servicing costs, repayment of the principal within relatively short time periods raises the possibility of having to roll over the debt, possibly at a higher rate of borrowing. The government made its initial offer of Sri Lanka Development Bonds (SLDBs) in June

2006 to raise US\$ 300 million with a mix of 2 and 3 year maturity. In June 2008, the debt was rolled over in part with a fresh issue of SLDBs amounting to US\$ 125 million for a two year maturity period, US\$ 50 million for a three year maturity period and US\$ 25 million for a five year maturity period.

Some of the money raised is argued to be earmarked towards infrastructure spending. The expectation would be that improved infrastructure can result in efficiency gains to the economy and to higher rates of growth - and government revenue - that can cushion the repayment obligations. The strategy carries inherent risks; productivity and efficiency gains take time, while the economy could also be subject to unforeseen domestic and/or external shocks. In the Sri Lankan context at present, these risks are more pronounced due to two factors, namely that productivity enhancing reforms are absent or lagging and secondly, that the global economic environment is likely to remain unfavourable, at least in the foreseeable future.

Global economic growth is projected to slow sharply to 3.7 per cent in 2008 from 4.9 per cent in 2007, with only a mild recovery forecast for 2009 (at 3.9 per cent). In Asia, soaring inflation is expected to hurt the outlook for emerging economies as monetary tightening measures are adopted. While food prices may ease by end 2008, the forecast for similar price movements in oil remain less optimistic. Even if oil prices ease in the world market, they are unlikely to settle at levels seen prior to the current upward spiral. Thus, the threat of continued external supply side pressures on the Sri Lankan economy remains very real.

Sri Lanka's trade balance has deteriorated sharply from 8 per cent of GDP in 2003 to over 11 per cent of GDP in 2007 as the oil import bill kept rising. With a current account deficit on the BOP of 4.2 per cent of

GDP in 2007, the exchange rate would have come under severe pressure if not for the inflow of borrowed capital. Indeed, a persistent depreciation of the rupee from January-August 2007 reversed in September 2007 with the inflow of US\$ 500 million on an international sovereign bond issue. It allowed the country to register an overall surplus of US\$ 530 on the BOP as opposed to a previous target of US\$ 200 million by end 2007.

The total oil expenditure bill in 2007 stood at US\$ 2.5 billion. In the first half of 2008 alone, the oil import bill stood at US\$ 1792 million - a near 100 per cent increase on the first half of 2007 (US\$ 957 million). The deficit on the trade balance has widened sharply to US\$ 3083 million in the first half of 2008 compared to US\$ 1602 million in the corresponding period of 2007. The pressure on external payments is, thus, likely to heighten in the coming months.

The Sri Lankan rupee has held steady in 2008 despite the weakening in the trade balance. Inflows of private remittances - estimated at US\$ 1460 million in the first half of 2008, compared to US\$ 1313 in the corresponding period of 2007 - and other capital inflows have helped cushion the current account and allowed Sri Lanka to register a surplus of US\$ 390 on the BOP. While the government is likely to favour a steady exchange rate to combat inflation, there are other risks. Sri Lanka's Real Effective Exchange rate (REER) has already appreciated by 8.3 per cent between December 2007 and May 2008, which could adversely impact on the competitiveness of the country's export sector. Already, there has been a slowdown in the growth of export earnings in the first of 2008 to 9.8 per cent compared to a rate of 12.9 per cent in the first half of 2007.

On the domestic front, pressure on government expenditures will tighten in 2008. Es-

timated expenditure on fertilizer subsidy has been increased to around Rs. 40 billion from the allocated amount of Rs. 15 billion. Moreover, despite the periodic adjustments to fuel, the subsidies still remain significant, particularly in diesel fuel. Thus, there is likely little let-up on the drain to the Treasury from transfers to public corporations especially in view of the lack of progress in tackling issues related to rationalization of government entities. Related to that is also the issue of public sector wages and salaries. As inflation accelerates - and inflationary expectations build - higher prices will mean growing demands for higher public-sector wages as demonstrated by the call for a general strike in July 2008. The government may also come under pressure to offer targeted cost of living relief to the poor. In addition, unbudgeted election related expenditures in 2008 for Provincial Councils will also have to be absorbed.

In these circumstances, relying on relatively short-term and costly foreign borrowing to tide over the fiscal needs - in the absence of attempts to rationalize expenditures - can impose significant downside risks. The assumption that infrastructure improvements over time will lead to productivity improvements presupposes that there will be efficiency gains in the economy overall. In the absence of reforms aimed at optimizing fiscal expenditures, as well as other institutional and regulatory reforms - in areas such as education, labour, etc. - to provide a conducive environment for private actors, misallocation of resource will yield only a sub-optimal outcome. Indeed, even today, instability in the macroeconomic environment is acting as a deterrent to private investment. As the Sri Lankan economy shows signs of a sharper slowdown in growth in 2008, it is even more critical that the policy response is governed by a viable longer-term outlook to achieve economic stability.

Appendix A: Macroeconomic Indicators (Statistical Base)

Table A1: Socio-Economic Indicators

1. Indicator	Unit					
Area:	Sq. km.	65,610				
Mid Year Population (2007)	('000)	20,010				
Population growth rate (2007)	%	1.1				
Life expectancy at birth (2005)	years	71.6				
Infant mortality rate (2005)	per 1000 live births	12				
Gross school enrolment ratio (2005)(a)	%	62.7				
Adult literacy rate (2005)	%	90.7				
Human development index (HDI) (2005)	Value	0.74				
Human poverty index (HPI) (2005)	Value	17.8				
		2003 (g)	2004	2005	2006	2007(e)
2. Output, labour force and employment						
GNP at current market prices	Rs. bn.	1,806.0	2,070.0	2,423.0	2,898.0	3,540.0
GDP at current market prices	Rs. bn.	1,822.0	2,091.0	2,453.0	2,939.0	3,578.0
GDP at current factor cost prices	Rs. bn.	1,562.0	1,800.7	2,098.0	2,484.2	-
GDP per capita at current market prices	US\$	981.0	1,062.0	1,241.0	1,421.0	1,617.0
Labour force(b)	mn.	7.6	8.1	7.3	7.6	7.5 (c)
Labour force participation (b)	%	48.9	48.6	49.3	51.2	49.8 (c)
Unemployment (b)	%	8.4	8.3	7.2	6.5	6.0 (c)
3. Real output growth						
GDP	%	5.9	5.4	6.2	7.7	6.8
Agriculture, forestry, and fishing	%	1.7	0.0	1.8	6.3	3.3
Mining and quarrying	%	5.7	7.9	14.1	24.2	19.2
Manufacturing	%	4.2	5.1	6.0	5.5	6.4
Construction	%	5.5	6.6	8.9	9.2	9.0
Services	%	7.6	6.7	6.4	7.7	7.1
4. Prices and wages						
CCPI (1952 = 100)	% change	6.3	7.6	11.6	13.7	17.5
CCPI (2002 = 100)	% change	-	9.0	11.0	10.0	15.8
WPI (1974 = 100)	% change	3.1	12.5	11.5	11.7	24.4
Implicit GNP deflator	% change	5.1	8.8	10.4	11.2	14.0
Real wage rates						
Workers in wages boards trades	% change	0.7	-4.8	-3.5	-9.9	2.7
Government employees	% change	-6.0	2.9	-7.0	-11.8	14.5
5. Consumption, investment, and savings						
Consumption	% of GDP	84.0	83.6	82.1	83.0	82.4
Gross domestic capital formation	% of GDP	22.0	25.3	26.8	28.0	27.9
Gross domestic savings	% of GDP	16.0	16.4	17.9	17.0	17.6
Gross national savings	% of GDP	21.5	22.0	23.8	22.3	23.3
Net imports of goods and services	% of GDP	-6.0	-8.8	-8.9	-11.0	-10.3
6. Government finance						
Revenue	% of GDP	15.2	14.9	15.5	16.3	15.8
Expenditure and net lending	% of GDP	22.9	22.8	23.8	24.3	23.5
Current expenditure	% of GDP	18.4	18.6	18.1	18.6	17.4
Capital expenditure & net lending	% of GDP	4.6	4.2	5.8	5.6	6.1
Current a/c balance	% of GDP	-3.2	-3.7	-2.6	-2.4	-1.6
Budget deficit						
Primary deficit	% of GDP	-0.9	-2.2	-3.6	-2.9	-2.6
Overall deficit (before grants)	% of GDP	-7.7	-7.9	-8.4	-8.0	-7.7
Public debt						
External	% of GDP	46.3	47.6	39.0	38.4	37.9
Domestic	% of GDP	56.0	54.7	51.6	50.3	47.9

Contd..../-

	Unit	2003	2004	2005	2006	2007(e)
7. External trade						
Terms of trade	% change	7.4	-5.2	-4.2	-3.5	-1.0
Import price index	% change	-1.8	9.7	7.8	8.0	5.9
Export price index	% change	5.5	4.0	3.3	4.2	4.8
Import volume index	% change	11.2	9.0	2.7	7.1	4.1
Export volume index	% change	3.5	7.8	6.6	4.1	7.3
8. External finance						
Trade balance	% of GDP	-8.4	-11.2	-10.7	-11.5	11.0
Current account balance	% of GDP	-0.4	-3.2	-2.8	-5.3	-4.2
Capital & financial account balance	% of GDP	3.9	3.1	2.8	6.7	6.5
Foreign direct investment	% of GDP	1.1	1.1	1.0	1.7	1.7
Foreign portfolio investment	% of GDP	0.01	0.05	0.03	0.19	0.13
Import capacity	months of imports (d)	5.8	5.2	5.7	4.7	5.3
External debt	% of GDP	62.4	61.8	53.3	50.3	51.8
Debt-service ratio	% of exports	11.6	11.6	7.9	12.7	13.0
9. Exchange rates (year end)						
U.S.A.	Rs./US\$	96.74	104.61	102.1	107.7	108.7
U.K.	Rs./UK Pound	172.19	201.37	175.9	211.3	217.1
Japan	Rs./Yen	0.90	1.02	0.86	0.90	0.97
European Union	Rs./Euro	121.60	142.32	120.96	141.58	160.27
India	Rs./Rs. Indian	2.12	2.40	2.27	2.40	2.76
SDR	Rs./SDR	143.75	161.60	145.90	162.00	171.60
10. Money supply						
Narrow money supply (M1)	% change	16.0	16.6	22.4	12.6	2.6
Broad money supply (M2)	% change	15.3	19.6	19.1	17.8	16.6
Domestic credit	% change	7.6	25.0	18.7	25.9	13.8
External banking assets	% change	51.0	1.9	20.3	-15.0	33.2
11. Interest rates						
Treasury bills						
3 month	% per annum	7.3	7.2	10.1	12.8	21.3
12 month	% per annum	7.2	7.6	10.4	12.9	19.9
Call money rate	% per annum	8.5	9.0	10.3	11.5	12.0
Average prime lending rate	% per annum	9.3	10.2	12.2	15.2	17.9
Commercial banks saving	% per annum	7.2	7.7	10.2	10.5	16.5
NSB saving	% per annum	5.0	5.0	5.0	5.0	5.0
Commercial banks fixed deposits	% per annum	7.7	9.8	11.5	14.0	20.0
NSB fixed deposits	% per annum	7.0	8.0	9.0	11.0	15.0
12. Share market indicators						
Annual turnover	Rs. bn.	73.6	59.0	114.6	105.1	104.9
Companies listed	No.	244	242	239	237	235
Market capitalization	Rs. bn.	263.0	382.1	584.0	835.0	821.0
Net purchases by non-nationals	Rs. mn.	209.3	1109	6,143.0	5,377.0	11,254.0
Share price indices						
CSE share	(1985 = 100)	1,062.1	1506.9	1,922.2	2,722.4	2,541.0
CSE sensitive (f)	(1985 = 100)	1,897.8	2073.7	2,451.1	3,711.8	3,291.9

Notes: (a): Combined first, second, and third level gross enrolment ratio.
(b): Excluding Northern and Eastern Provinces.
(c): Average of four quarters.
(d): Months of same year imports.
(e): Provisional.
(f): The Milanka Price Index (MPI) was introduced in January 1999, (1998 December = 1000) to replace the Sensitive Price Index.
(g): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

Sources: IPS database.

Central Bank of Sri Lanka, *Annual Report*, various issues.

Colombo Stock Exchange, *Annual Report*, various issues.

UNDP, *Human Development Report*, various issues.

Dept. of Census and Statistics, *Quarterly Report of the Sri Lanka Labour Force Survey*, various issues.

Table A2: Gross Domestic Product (GDP), Mid-year Population (POP), Per Capita GDP (PGDP), and their Growth Rates, 1986-2007

	Constant Prices (c)		POP(b) (‘000)	Growth Rates		POP
	GDP	PGDP		GDP	PGDP	
	Rs. mn.	Rs.mn.				
1986	456,316.2	28,312.7	16,117	4.3	2.5	1.8
1987	462,949.6	28,295.9	16,361	1.5	-0.1	1.5
1988	475,441.7	28,665.2	16,586	2.7	1.3	1.4
1989	486,140.6	28,926.6	16,806	2.3	0.9	1.3
1990	516,152.7	30,335.2	17,015	6.2	4.9	1.2
1991	539,954.8	31,270.9	17,267	4.6	3.1	1.5
1992	563,061.9	32,311.6	17,426	4.3	3.3	0.9
1993	602,171.5	34,125.1	17,646	6.9	5.6	1.3
1994	636,061.5	35,571.9	17,891	5.6	4.2	1.3
1995	670,742.2	36,984.0	18,136	5.5	4.0	1.4
1996	695,934.0	37,954.5	18,336	3.8	2.6	1.1
1997	739,763.0	39,875.1	18,552	6.3	5.1	1.2
1998	774,796.0	41,225.7	18,794	4.7	3.4	1.3
1999	808,340.0	42,448.1	19,043	4.3	3.0	1.3
2000	857,035.0	44,270.6	19,359	6.0	4.3	1.7
2001	843,794.0	45,045.6	18,732	-1.5	1.8	1.4
2002	877,284.0	46,155.8	19,007	4.0	2.5	1.5
2003(d)	1,733,222.0	90,028.2	19,252	5.9	4.6	1.3
2004	1,827,597.0	93,905.9	19,462	5.4	4.3	1.1
2005	1,947,671.0	99,027.4	19,668	6.2	5.5	1.0
2006	2,090,548.0	105,126.6	19,886	7.7	6.2	1.1
2007(a)	2,232,387.0	111,563.6	20,010	6.8	6.1	0.6

Notes: (a): Provisional.

(b): From 2001 figures are based on Department of Census and Statistics, *Population and Housing 2001*.

(c): Up to 2002 data are based on 1996 prices and 2003 onwards data are based on 2002 prices

(d): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A3: Structure and Growth of Output, 1998-2007

Unit	1998	1999	2000	2001	2002	2003(c)	2004	2005	2006	2007(a)	1998-2007(b)
1. Structure of output											
Agriculture, forestry, and fishing	21.3	21.3	20.4	20.1	20.5	13.2	12.5	11.8	11.3	11.7	16.4
Agriculture	16.6	16.6	15.9	16.0	16.6	14.7	14.3	14.3	13.4	15.5	15.4
Tea	8.7	8.5	8.9	9.0	7.2	10.9	11.6	11.4	10.5	11.8	9.9
Rubber	2.7	2.6	2.3	2.4	1.2	2.6	3.2	3.8	6.1	5.9	3.3
Coconut	10.0	10.4	11.1	10.0	8.4	13.4	11.9	11.3	10.1	11.0	10.8
Paddy	20.4	20.8	20.4	20.1	18.0	14.8	13.7	14.8	13.1	12.3	16.8
Mining and quarrying	1.8	1.8	1.7	-1.8	1.8	1.4	1.4	1.5	1.6	1.6	1.3
Manufacturing	16.9	16.8	17.4	-16.9	15.8	18.6	18.7	19.5	19.2	18.5	14.5
Export processing	12.7	12.6	12.0	11.7	11.3	4.2	4.0	3.4	3.1	3.3	7.8
Factory industry	79.7	79.7	80.6	80.8	77.2	89.6	89.8	90.9	91.4	91.5	85.1
Small industry	7.6	7.7	7.4	7.5	7.6	6.3	6.2	5.7	5.5	5.3	6.7
Construction	7.6	7.6	7.3	7.6	7.2	6.0	6.1	6.8	7.4	7.4	7.1
Services	51.4	52.0	53.3	53.9	54.9	58.3	58.8	58.0	58.0	58.4	55.7
2. Real output growth											
Agriculture, forestry, and fishing	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007(a)	1998-2007(b)
Agriculture	2.5	4.5	1.8	-3.5	2.5	-54.9	-5.5	-6.1	-4.3	3.1	-6.0
Tea	1.8	4.4	1.7	-4.3	1.9	-12.9	-2.8	0.0	-6.7	13.8	-0.3
Rubber	1.1	1.3	7.8	-3.5	5.1	33.9	6.4	-2.3	-8.7	11.5	5.3
Coconut	-9.0	1.0	-9.7	-1.5	5.0	53.2	20.5	15.8	37.7	-3.7	10.9
Paddy	-3.2	9.1	8.0	-13.5	-13.6	37.3	-12.4	-5.2	-12.1	7.9	0.2
Mining and quarrying	18.3	6.6	-0.3	-5.7	5.1	-21.9	-7.6	7.4	-13.2	-6.8	-1.8
Manufacturing	-5.4	4.1	4.8	0.7	-1.1	-28.5	2.8	1.6	6.8	0.7	-1.3
Export processing	6.3	4.4	9.2	-4.2	2.1	15.0	0.7	4.1	-1.5	-3.9	3.2
Factory industry	-1.2	3.8	4.2	-6.7	-0.9	-170.6	-3.4	-19.3	-7.9	3.7	-19.8
Small industry	7.6	4.5	10.4	-3.9	2.5	13.8	0.3	1.2	0.6	0.1	3.7
Construction	6.5	4.8	5.5	-3.5	2.1	-21.3	-1.8	-7.4	-4.8	-3.8	-2.4
Services	7.1	4.8	4.8	2.5	-0.8	-19.2	1.1	10.8	7.2	0.1	1.8
GDP	3.7	9.8	2.3	-0.5	6.1	5.9	0.8	-1.5	0.1	0.6	2.7
	6.3	4.3	6.0	-1.5	4.0	5.9	6.9	7.9	8.9	9.9	6.7

Notes: (a): Provisional.

(b): Average annual growth rate.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A4: Value Added in Industry and Industrial Production, 1995-2007

	1995	1996	1997	1998	1999	2000	2001	2002	2003(b)	2004	2005	2006	2007(a)
1. Value added, current prices (Rs. mn.)													
Food, beverages and tobacco	29,507	32,891	35,585	40,452	44,503	49,031	54,282	61,550	136,058	158,229	202,785	241,854	282,843
Textile, wearing apparel and leather products	24,895	31,148	40,581	47,482	55,263	69,451	71,263	77,028	76,511	85,179	103,198	113,956	131,522
Wood and wood products (including furniture)	1,177	1,250	1,258	1,313	1,390	1,554	1,639	1,736	1,085	1,121	1,143	1,245	1,353
Paper and paper products	2,458	2,580	2,633	2,578	2,664	2,808	3,103	3,124	1,669	2,079	2,963	3,998	4,883
Chemicals, petroleum, coal, rubber and plastic products	6,898	8,957	10,745	14,274	13,832	17,771	19,245	22,653	46,133	58,912	72,089	95,346	112,915
Non-metallic mineral products (except petroleum and coal)	9,726	10,537	11,600	12,463	13,817	14,240	16,010	17,273	11,388	13,432	15,805	17,930	20,351
Basic metal products	347	450	598	710	777	959	1,131	1,306	970	998	1,061	1,292	1,521
Fabricated metal products, machinery and transport equipment	4,547	4,809	5,924	6,779	7,367	7,714	8,731	9,698	28,339	30,217	34,480	38,872	47,947
Manufactured products n.e.s.	2,319	2,763	3,157	3,426	3,799	3,965	4,154	4,695	1,307	1,350	1,446	1,879	2,209
Total	81,368	95,385	112,011	129,477	143,412	167,493	179,559	199,063	303,460	351,517	434,970	516,372	605,544
2. Composition of industrial production, %													
Food, beverages and tobacco	35.6	34.5	31.7	31.2	31.0	29.3	30.2	30.9	44.8	45.0	46.6	46.8	46.7
Textile, wearing apparel and leather products	30.6	32.7	36.2	36.7	38.5	41.5	39.7	38.7	25.2	24.2	23.7	22.1	21.7
Wood and wood products (including furniture)	1.4	1.3	1.1	1.0	1.0	1.0	0.9	0.9	0.4	0.3	0.3	0.2	0.2
Paper and paper products	3.0	2.7	2.4	2.0	2.0	1.7	1.7	1.6	0.5	0.6	0.7	0.8	0.8
Chemicals, petroleum, coal, rubber and plastic products	8.5	9.4	9.6	11.0	9.6	10.6	10.7	11.4	15.2	16.8	16.6	18.5	18.6
Non-metallic mineral products (except petroleum and coal)	12.0	11.0	10.4	9.6	9.6	8.5	8.9	8.7	3.8	3.8	3.6	3.5	3.4
Basic metal products	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.7	0.3	0.3	0.2	0.3	0.3
Fabricated metal products, machinery and transport equipment	5.6	5.0	5.3	5.2	5.1	4.6	4.9	4.9	9.3	8.6	7.9	7.5	7.9
Manufactured products n.e.s.	2.9	2.9	2.8	2.6	2.6	2.4	2.3	2.4	0.4	0.4	0.3	0.4	0.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Notes: (a) Provisional.

(b): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A5: Major Agricultural Crops, Production and Prices, 1985-2007

	Tea		Rubber		Coconut		Paddy	
	Production Mn.kg.	Price Colombo (net) Rs/kg.	Export (f.o.b.) Rs/kg.	Production Mn.kg.	Price Colombo (RSS 1) Rs/kg.	Export (f.o.b.) Rs/kg.	Production Mn.nut	Price (a) Rs./nut
							Production '000 Mt	Price (b) Rs./bushel (c)
1985	214.0	35.39	60.62	137.5	15.90	21.34	2,958	2.55
1986	211.0	30.28	44.52	137.8	16.62	23.83	3,039	1.46
1987	213.0	38.06	52.97	121.8	19.87	27.63	2,291	2.64
1988	227.0	41.59	55.95	122.4	24.40	37.33	1,936	4.00
1989	207.0	52.16	66.91	110.7	22.63	36.18	2,484	3.36
1990	233.0	65.72	91.78	113.1	22.93	35.50	2,532	3.63
1991	241.0	57.13	84.12	103.9	23.59	34.55	2,184	4.82
1992	179.0	60.51	81.98	106.1	29.28	37.65	2,296	6.47
1993	231.9	68.88	91.16	104.2	35.48	44.34	2,164	6.31
1994	242.2	65.12	91.32	105.3	50.36	51.81	2,622	5.67
1995	245.9	72.21	102.31	105.7	72.04	83.69	2,755	6.08
1996	258.4	103.88	139.56	112.5	67.85	79.78	2,561	9.42
1997	276.9	119.40	158.40	105.8	56.70	75.40	2,631	9.60
1998	280.1	134.30	184.90	95.7	49.70	67.70	2,552	8.30
1999	283.7	115.30	162.40	96.6	45.30	54.00	2,828	9.90
2000	305.8	135.50	184.40	87.6	55.00	66.90	3,096	7.40
2001	295.1	143.90	208.90	86.2	55.00	66.40	2,796	7.10
2002	310.0	149.30	216.30	90.5	68.80	69.50	2,392	12.10
2003	303.2	149.05	221.01	92.0	102.50	105.25	2,562	9.98
2004	309.5	180.74	248.92	94.7	127.20	128.51	2,591	11.00
2005(d)	317.2	185.84	263.31	104.4	147.41	147.73	2,515	13.00
2006	310.8	198.87	279.97	109.2	202.50	189.90	2,785	24.30
2007(e)	304.6	279.10	364.30	117.6	234.20	234.50	2,869	27.70

Notes: (a): Average export price of the three major coconut products only.

(b): Guaranteed price.

(c): 20.9 kg. of paddy = 1 bushel of paddy.

(d): Revised.

(e): Provisional.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

**Table A6: Labour Force Participation of the Household Population
All Island, 1997-2007**

		Household population (10 yrs. & over) No. mn.	Labour force No. mn.	Labour force participation rate (%)	Labour force			
					Employed		Unemployed	
					No. mn.	Rate	No. mn.	Rate
1997								
	q1	12.9	6.2	48.5	5.6	89.3	0.7	10.7
	q2	12.9	6.2	48.4	5.6	89.8	0.6	10.2
	q3	12.9	6.2	48.3	5.6	89.6	0.6	10.4
	q4	12.9	6.2	48.5	5.6	89.6	0.6	10.3
1998								
	q1	12.9	6.6	51.6	5.9	89.5	0.7	10.5
	q2	12.9	6.6	51.0	6.0	90.5	0.6	9.5
	q3	12.9	6.7	51.9	6.1	90.9	0.6	9.1
	q4	12.9	6.6	51.4	6.0	91.2	0.6	8.8
1999								
	q1	12.9	6.7	52.3	6.2	91.4	0.6	8.6
	q2	13.1	6.5	49.5	5.9	91.5	0.6	8.5
	q3	13.2	6.7	50.8	6.1	90.9	0.6	9.1
	q4	13.5	6.8	50.2	6.1	90.8	0.6	9.2
2000								
	q1	13.5	6.9	50.8	6.3	92.0	0.5	8.0
	q2	13.5	7.0	52.0	6.5	93.0	0.5	7.0
	q3	13.5	6.7	49.4	6.2	92.0	0.5	8.0
	q4	13.6	6.7	49.2	6.2	92.6	0.5	7.4
2001								
	q1	13.7	6.7	49.2	6.2	92.3	0.5	7.7
	q2	14.0	6.9	49.0	6.3	91.7	0.6	8.3
	q3	13.9	6.7	48.3	6.2	92.2	0.5	7.8
	q4	14.1	6.8	48.9	6.2	91.7	0.5	8.3
2002								
	q1	14.1	7.2	51.7	6.7	91.3	0.6	8.7
	q2	14.2	7.0	49.5	6.3	90.2	0.7	9.8
	q3	14.2	7.1	49.4	6.4	90.9	0.6	9.1
	q4	14.3	7.2	50.6	6.7	92.5	0.5	7.5
2003								
	q1	15.6	7.6	49.1	6.9	90.8	0.7	9.2
	q2	15.6	7.5	48.3	6.9	91.9	0.6	8.0
	q3	15.7	7.6	48.6	7.0	91.6	0.6	8.4
	q4	15.8	7.8	49.6	7.2	92.1	0.6	7.9
2004(a)								
	q1	16.3	7.9	49.0	7.3	91.9	0.6	8.1
	q2	16.5	8.0	48.6	7.3	91.0	0.7	9.0
	q3	16.7	8.0	47.8	7.3	91.5	0.7	8.5
	q4	16.7	8.1	47.8	7.4	91.8	0.7	8.2
2005(b)		16.9	8.1	48.3	7.5	92.3	0.6	7.7
2006								
	q1	14.8	7.6	51.7	7.1	92.8	0.5	7.2
	q2	14.8	7.6	51.1	7.1	93.7	0.5	6.3
	q3	15.0	7.6	50.7	7.1	93.5	0.5	6.5
	q4	15.0	7.6	51.0	7.1	93.7	0.5	6.3
2007								
	q1	15.0	7.5	49.8	7.0	93.3	0.5	7.1
	q2	15.0	7.4	49.0	7.0	94.6	0.5	7.1
	q3	15.0	7.5	50.2	7.1	94.7	0.4	5.6
	q4	15.1	7.6	50.1	7.2	94.7	0.4	5.6

Notes: (a) Up to 4th quarter 2002, data excludes both Northern and Eastern Provinces. Commencing from 1st quarter 2003, Eastern Province is included and only the Northern Province is excluded from the survey.
(b) Quarterly labour force survey was conducted as a one-off survey in August 2005.

Source: Department of Census and Statistics, *Quarterly Report of the Sri Lanka Labour Force*.

Table A7: Gross Domestic Fixed Capital Formation, 1985-2007

	Private(a)	Public(b)	Private(a)	Public(b)	Private(a)	Public(b)	Private(a)	Public(b)
	(Rs. mn., current market prices)		(As % of GDP)		(at constant prices(c)(e))		(Growth in real terms)	
1985	30,690	7,767	18.9	4.8	90,542.8	22,914.5	-6.4	8.8
1986	32,692	9,634	18.2	5.4	91,122.2	26,852.8	0.6	17.2
1987	34,536	11,216	17.6	5.7	89,958.6	29,215.2	-1.3	8.8
1988	37,156	12,805	16.7	5.8	86,801.6	29,914.3	-3.5	2.4
1989	39,943	14,306	15.9	5.7	85,114.8	30,484.7	-1.9	1.9
1990	57,910	12,507	18.0	3.9	102,852.2	22,213.3	20.8	-27.1
1991	68,368	15,838	18.4	4.3	109,412.4	25,346.3	6.4	14.1
1992	86,407	13,632	20.3	3.2	125,717.4	19,833.8	13.0	-27.8
1993	105,305	20,570	21.1	4.1	139,953.2	27,338.1	10.2	27.4
1994	136,649	17,611	23.6	3.0	166,094.3	21,405.8	15.7	-27.7
1995	147,280	23,595	22.1	3.5	165,105.2	26,450.7	-0.6	19.1
1996	160,181	23,328	20.9	3.0	160,181.0	23,328.0	-3.1	-13.4
1997	186,950	29,923	21.0	3.4	172,145.0	27,553.4	6.9	15.3
1998	221,754	33,960	21.9	3.3	188,246.2	28,828.5	9.4	4.6
1999	266,518	35,210	24.1	3.2	216,505.3	28,602.7	15.0	-2.6
2000	311,460	41,132	24.8	3.3	237,212.5	31,326.7	9.6	9.5
2001	267,298	42,346	19.0	3.0	181,058.0	28,683.6	-23.7	-8.4
2002	298,731	31,812	19.1	2.0	188,863.2	19,913.6	4.1	-44.1
2003(f)	318,909	46,285	17.5	2.5	325,998.0	47,784.0	42.1	58.3
2004	422,060	51,262	20.2	2.5	390,940.0	49,540.0	16.6	3.5
2005	478,917	94,347	19.5	3.8	393,561.0	90,138.0	0.7	45.0
2006	624,972	105,938	21.3	3.6	454,050.0	91,905.0	13.3	1.9
2007(d)	714,084	170,604	20.0	4.8	469,690.0	127,914.0	3.3	28.2

Notes: (a): Private sector and public corporations.
 (b): Government and public enterprises.
 (c): Current series deflated by GDP deflator.
 (d): Provisional.
 (e): Up to 2002 data are based on 1996 prices and 2003 onwards data are based on 2002 prices.
 (f): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A8: Saving and Investment, 1993-2007

(As % of GDP)	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003(c)	2004	2005	2006	2007(a)
Gross domestic capital formation	25.5	27.0	25.7	24.2	24.4	25.1	27.3	28.0	22.0	21.3	20.0	22.6	23.4	24.9	24.7
Gross domestic savings	16.0	15.2	15.2	15.3	17.3	19.1	19.5	17.4	15.8	14.5	16.0	16.4	17.9	17.0	17.6
Net imports of goods and non-factor services (b)	9.5	11.8	10.4	8.9	7.1	6.0	7.8	10.6	6.2	6.8	6.4	6.6	7.1	6.7	6.8
Net factor income from abroad	-1.2	-1.4	-1.0	-1.5	-1.1	-1.1	-1.6	-2.1	-1.7	-1.6	-0.9	-1.0	-1.2	-1.4	-1.1
Net private transfers	5.4	5.4	5.2	5.1	5.2	5.4	5.6	5.9	6.2	6.6	6.4	6.5	7.1	6.7	6.8
Gross national savings	20.2	19.1	19.5	19.0	21.5	23.4	23.5	21.5	20.3	19.5	21.5	22.0	23.8	22.3	23.3
Foreign savings	5.3	7.9	6.2	5.2	5.2	1.7	3.8	6.5	1.7	1.8	-1.5	0.6	-0.4	2.6	1.4

Notes:

(a): Provisional.
(b): Also referred to as external inflow or the resources gap.

(c): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

Sources: IPS database; Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A9: Summary of Government Fiscal Operations, 1995-2007

(As % of GDP)	1995	1996	1997	1998	1999	2000	2001	2002	2003(c)	2004	2005	2006	2007(b)
Revenue	20.4	19.0	18.5	17.3	17.7	16.8	16.7	16.5	15.7	15.4	16.1	16.3	15.8
Grants	1.4	1.0	0.8	0.7	0.6	0.4	0.4	0.4	0.5	0.4	1.5	1.7	1.6
Expenditure													
Current expenditure	23.1	22.8	20.8	19.6	18.7	20.2	21.6	20.8	19.0	19.2	18.7	18.6	17.4
Capital & net lending	7.4	5.7	5.7	6.7	6.5	6.5	5.9	4.5	4.7	4.3	6.0	5.6	6.1
Current account balance	-2.7	-3.8	-2.2	-2.4	-1.0	-3.4	-4.9	-4.4	-3.3	-3.9	-2.7	-2.4	-1.6
Primary deficit	-4.3	-3.1	-1.7	-3.8	-1.9	-4.2	-4.1	-1.6	-0.9	-2.2	-3.6	-2.9	-2.6
Overall deficit (before grants)	-10.1	-9.4	-7.9	-9.2	-7.5	-9.9	-10.8	-8.9	-8.0	-8.2	-8.7	-8.0	-7.7
Financing budget deficit													
Foreign financing	4.5	2.3	1.9	1.7	0.7	0.4	1.4	0.6	2.9	8.2	3.4	2.5	3.7
Net borrowings	3.2	1.3	1.1	1.0	0.1	0	1.0	0.1	2.4	1.8	2.0	1.4	2.8
Grants	1.4	1.0	0.8	0.7	0.6	0.4	0.4	0.4	0.5	0.4	1.4	1.0	0.9
Domestic financing	5.1	6.5	3.4	7.1	6.8	9.4	8.8	8.0	4.5	5.8	5.2	5.6	3.6
Market borrowings	5.0	5.1	4.5	7.1	6.8	9.2	8.7	8.0	4.5	5.5	5.0	5.6	3.6
Bank	1.1	1.7	-0.2	1.9	2.5	4.5	3.5	-0.3	-1.2	2.1	1.1	2.7	0.4
Non-bank	3.9	3.4	4.7	5.2	4.4	4.7	5.3	8.3	5.7	3.4	3.9	2.9	3.1
Other borrowings	0.1	1.3	-1.1	-0.1	-0.1	0.3	0.1	-0.1	-	0.2	0.2	-	-
Privatization proceeds(a)	0.4	0.6	2.5	0.4	-	-	0.6	0.4	0.6	0.1	-	-	-

Notes: (a): Since 1994, privatization proceeds have been shifted from the capital expenditure and net lending category to the financing section.

(b): Provisional.

(c): From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A10: Money Supply and Underlying Factors, 1988-2007

	Unit	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
1. Financial depth											
Narrow money supply	M1/GDP	14.6	14.0	12.3	12.5	11.8	11.9	12.2	11.3	10.2	10.7
Broad money supply	M2/GDP	30.6	30.3	28.1	29.7	30.5	32.1	33.1	34.2	33.0	35.9
2. Monetary expansion/contraction											
Narrow money supply	% growth	29.1	9.1	12.1	17.7	7.4	18.6	18.7	6.7	4.0	9.8
Broad money supply	% growth	16.5	12.5	18.5	22.1	17.4	23.4	19.7	19.2	10.8	13.8
3. Causal factors											
3.1 External banking assets	Rs. mn.	7,058.5	4,732.0	3,419.0	12,258.0	20,940.0	48,119.0	64,467.0	66,532.0	61,861.0	89,292.0
	% growth	-24.0	-33.0	-27.7	258.5	70.8	129.8	34.0	3.2	-7.0	44.3
3.2 Domestic credit	Rs. mn.	96,867.0	102,321.2	115,964.3	127,751.2	144,003.0	150,696.9	173,795.6	223,798.3	252,317.0	272,733.0
	% growth	28.2	5.6	13.3	10.2	12.7	4.6	15.3	28.8	12.7	8.1
3.2.1 Government	Rs. mn.	36,064.5	36,118.0	35,358.0	35,392.0	33,065.0	26,993.0	28,148.0	35,214.0	48,537.0	46,365.0
	% growth	33.3	0.1	-2.1	0.1	-6.6	-18.4	4.3	25.1	37.8	-4.5
3.2.2 Private sector	Rs. mn.	60,802.5	66,203.2	80,606.3	92,359.2	110,938.0	123,703.9	145,647.6	188,582.0	203,780.0	226,368.0
	% growth	25.3	8.9	21.8	14.6	20.1	11.5	17.7	29.3	8.2	11.1
3.3 Other liabilities	Rs. mn.	-35,979.6	-30,619.8	-28,838.0	-29,435.0	-35,150.0	-38,679.0	-46,590.0	-61,794.0	-60,978.0	-73,768.0
	% growth	35.7	-14.9	-5.8	2.1	19.4	10.0	20.5	32.6	-1.3	21.0
Contd...											
	Unit	1998	1999	2000	2001	2002	2003(b)	2004	2005	2006	2007
1. Financial depth											
Narrow money supply	M1/GDP	10.5	10.9	10.5	9.8	8.8	8.9	9.0	9.4	8.8	7.5
Broad money supply	M2/GDP	34.6	36.0	36.0	36.0	32.2	31.9	32.9	33.6	33.8	32.1
2. Monetary expansion/contraction											
Narrow money supply	% growth	12.1	12.8	9.1	3.2	14.0	16.0	14.2	18.3	11.2	2.6
Broad money supply	% growth	9.7	13.3	13.0	11.4	13.2	15.3	15.6	16.4	17.1	13.5
3. Causal factors											
3.1 External banking assets	Rs. mn.	93,724.0	83,892.0	59,448.0	82,966.0	101,717.0	129,487.0	129,152.0	167,147.0	185,005.0	225,989.0
	% growth	5.0	-10.5	-29.1	39.6	22.6	27.3	-0.3	22.7	9.6	18.1
3.2 Domestic credit	Rs. mn.	311,626.0	374,120.0	469,084.0	513,457.0	548,578.0	602,898.0	734,605.0	864,392.0	1,138,805.0	1,303,305.0
	% growth	14.3	20.1	25.4	9.5	6.8	9.9	21.8	11.6	24.1	12.6
3.2.1 Government	Rs. mn.	58,591.0	85,881.0	134,484.0	161,735.0	153,171.0	143,444.0	181,111.0	249,565.0	357,289.0	273,312.0
	% growth	26.4	46.6	56.6	20.3	-5.3	-6.3	26.3	11.6	30.1	-30.7
3.2.2 Private sector	Rs. mn.	253,035.0	288,239.0	334,599.0	351,722.0	395,407.0	430,575.0	526,236.0	680,693.0	856,842.0	1,029,993.0
	% growth	11.1	16.1	5.1	12.4	16.2	16.2	22.2	22.7	20.0	16.8
3.3 Other liabilities	Rs. mn.	-89,176.0	-99,936.0	-123,863.0	-145,696.0	-139,899.0	-151,638.0	-175,793.0	-208,608.0	-330,545.0	-381,552.0
	% growth	20.9	12.1	23.9	17.6	4.0	8.5	15.9	15.7	36.8	13.4

Notes: Data have been reclassified starting from 1990. For more information, see Central Bank of Sri Lanka, 1995, *Annual Report*.

From 2003, data are based on GDP estimates compiled by the Department of Census and Statistics.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A11: Interest Rates, 1994-2007														
(%, end of period)	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Bank rate	17.0	17.0	17.0	17.0	17.0	16.0	25.0	18.0	18.0	15.0	15.0	15.0	15.0	15.0
Treasury bills, yield rates														
3 month	18.7	19.3	17.5	10.0	12.0	12.1	17.8	12.9	9.9	7.3	7.2	10.1	12.8	21.3
12 month	19.4	19.0	17.4	10.2	12.6	12.8	18.2	13.7	9.9	7.2	7.6	10.4	13.0	20.0
Repurchase rate	20.0	16.5	12.8	11.0	11.3	9.3	17.0	12.0	9.9	7.0	7.5	8.8	10.0	10.5
Call money rate														
Maximum	28.0	102.0	31.0	20.0	16.5	14.3	32.0	13.0	10.9	8.2	10.6	11.1	15.1	40.0
Minimum	14.0	16.0	13.0	9.0	11.3	9.8	20.3	12.5	10.2	7.4	9.5	10.5	12.7	16.0
Weighted average prime lending rate	17.8	20.0	18.4	14.2	15.1	15.2	21.5	14.2	12.2	8.9	10.2	12.1	14.7	17.0
Commercial bank saving														
Maximum	13.0	13.0	13.0	11.0	10.0	10.0	10.0	12.0	11.0	7.2	7.7	10.3	10.5	16.5
Minimum	5.5	5.0	4.5	3.0	2.0	2.0	2.0	4.0	3.5	2.1	3.0	3.0	3.0	3.0
NSB saving	14.0	12.0	12.0	10.8	10.5	9.2	8.4	8.4	6.0	5.0	5.0	5.0	5.0	5.0
Commercial bank fixed deposit (one year)														
Maximum	17.0	17.0	17.8	15.3	13.0	12.5	15.0	14.5	11.0	7.7	9.8	11.5	14.0	20.0
Minimum	10.0	10.0	12.0	8.5	9.0	9.0	9.0	9.5	7.5	5.0	5.0	5.5	5.5	6.5
NSB fixed deposit (one year, paid on maturity)	14.0	16.0	15.0	11.0	11.5	11.5	15.0	13.0	10.0	7.0	8.0	9.0	11.0	15.0

Sources: Central Bank of Sri Lanka, *Annual Report*, various issues.Central Bank of Sri Lanka, *Bulletin*, Various Issues.

Table A12: Basic Indicators of the General Price Level, 1987-2007

	CCPI (1952 = 100) % change		GCCPI (1989 = 100) % change (Jan-June)		WPI (1974 = 100) % change		GDPD (1996 = 100) % change	
1987	652.8	7.7	-	-	414.9	13.4	38.4	7.0
1988	744.1	14.0	-	-	488.7	17.8	42.8	11.5
1989	830.2	11.6	103.8	-	532.9	9.0	46.9	9.6
1990	1,008.6	21.5	124.6	20.0	651.1	22.2	56.3	20.0
1991	1,131.5	12.2	138.9	11.5	710.8	9.2	62.5	11.0
1992	1,260.4	11.4	152.0	9.4	773.0	8.8	68.7	10.0
1993	1,408.4	11.7	164.8	8.4	831.8	7.6	75.2	9.5
1994	1,527.4	8.4	172.6	4.7	873.4	5.0	82.3	9.3
1995	1,644.6	7.7	179.3	3.9	950.7	8.9	89.2	8.4
1996	1,906.7	15.9	202.5	12.9	1,145.1	20.4	100.0	12.1
1997	2,089.1	9.6	220.1	8.7	1,224.3	6.9	108.6	8.6
1998	2,284.9	9.4	235.2	6.9	1,298.7	6.1	117.8	8.4
1999	2,392.1	4.7	244.1	3.8	1,295.3	-0.3	123.1	4.4
2000	2,539.8	6.2	252.0	3.2	1,317.2	1.7	131.3	6.7
2001	2,899.4	14.2	279.6	11.0	1,471.2	11.7	147.6	12.3
2002	3,176.4	9.6	309.3	10.6	1,629.0	10.7	159.9	8.4
2003	3,377.0	6.3	319.0	3.1	1,679.1	3.1	168.2	5.1
2004	3,632.8	7.6	-	-	1,889.0	12.5	183.0	8.8
2005	4,055.5	11.6	-	-	2,105.9	11.5	202.1	10.4
2006	4,610.8	13.7	-	-	2,351.6	11.7	224.9	11.3
2007	5,416.1(a)	17.5	-	-	2,924.4(a)	24.4	256.3	14.0

Notes: CCPI : Colombo Consumers' Price Index.
GCCPI : Greater Colombo Consumers' Price Index.
WPI : Wholesale Price Index.
GDPD : GDP deflator.
(a) : Provisional.

Sources: Department of Census and Statistics.
Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A13: Wage Rate Indices, 1987-2007
(December 1978 = 100)

	Workers in wages boards trades(a)		Government employees(b)	
	Nominal	Real	Nominal	Real
1987	277.7	101.8	297.4	109.1
1988	335.8	107.9	390.9	125.4
1989	338.1	112.0	421.8	121.9
1990	453.5	107.6	476.8	113.2
1991	518.8	109.7	534.6	113.2
1992	590.0	112.0	557.6	106.0
1993	685.8	116.6	675.5	114.8
1994	712.4	111.7	735.5	115.4
1995	740.3	107.8	792.5	115.4
1996	801.7	100.7	818.2	103.5
1997	849.1	97.3	906.5	104.0
1998	953.3	99.9	1,001.4	104.9
1999	977.6	97.8	1,001.4	100.2
2000	1,000.4	94.3	1,084.7	102.1
2001	1,049.3	86.6	1,310.8	108.1
2002	1,126.5	84.9	1,525.3	115.0
2003	1,205.2	85.4	1,525.0	108.1
2004	1,233.0	81.3	1,872.1	123.3
2005	1,329.7	81.3	2,417.5	142.7
2006	1,358.2	70.7	3,150.8	164.0
2007(c)	1,648.8	72.7	3,828.4	169.5

Notes: The wage rates used in the calculation of index numbers are minimum wages.
 (a): Combined index for workers in agriculture, industry and commerce, and services.
 (b): Combined index for non-executive officers and minor employees.
 (c): Provisional.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A14: Sri Lanka's Direction of Foreign Trade, 1990-2007

Unit		1990	1991	1992	1993	1994	1995	1996	1997	1998
1. Exports to selected countries and groupings										
U.S.A	US\$ mn.	492.5	559.0	837.6	1,006.8	1,115.3	1,353.5	1,395.8	1,666.4	1,890.2
U.K.	US\$ mn.	115.1	126.2	170.2	203.5	285.4	345.3	388.6	525.4	530.4
Germany	US\$ mn.	126.7	148.8	211.8	227.5	222.5	254.3	239.3	230.0	231.9
Japan	US\$ mn.	102.4	101.6	128.0	148.0	165.3	200.4	256.4	234.2	196.1
EU	% of total exports	25.0	27.0	32.8	31.2	31.3	31.0	29.4	35.0	33.6
Germany	% of exports to EU	25.5	27.0	26.3	25.5	22.2	21.6	19.8	17.1	17.9
UK	% of exports to EU	23.2	22.9	21.1	22.8	28.4	29.3	32.2	39.0	41
ASEAN	% of total exports	3.9	5.5	2.4	2.9	3.9	3.7	2.8	3.4	3
Singapore	% of exports to ASEAN	63.7	59.8	56.5	58.6	60.6	52.3	52.0	43.7	38.1
Malaysia	% of exports to ASEAN	3.3	23.6	7.7	4.0	4.6	15.7	23.5	16.6	10.1
SAARC	% of total exports	3.6	3.0	2.3	2.5	2.7	2.7	2.6	3.1	3
India	% of exports to SAARC	29.1	20.8	20.3	27.6	27.2	31.3	39.6	37.0	33.2
NAFTA	% of total exports	27.2	30	36.4	37.1	36.8	37.3	35.6	45.5	51.5
USA	% of exports to NAFTA	91.3	91.4	93.5	94.9	94.4	95.4	95.6	95.3	95.4
Canada	% of exports to NAFTA	5.4	5.2	4.3	3.4	4.3	3.5	3.1	3.2	3.1
APEC	% of total exports	39.5	43.7	47.6	48.7	49.6	50.1	48.7	59.8	58.9
USA	% of exports to APEC	62.8	62.7	71.5	72.3	70.1	71	69.8	72.4	83.4
Japan	% of exports to APEC	13.1	11.4	10.9	10.6	10.4	10.5	12.8	10.2	8.6
Singapore	% of exports to APEC	0.5	0.4	0.3	0.2	0.2	0.1	0.1	0.1	1.9
2. Imports from selected countries and groupings										
Japan	US\$ mn.	325.4	358.4	415.6	452.6	526.6	498.6	497.3	479.3	555.9
India	US\$ mn.	118.1	220.1	301.9	342.9	404.4	469.2	561.9	559.8	539.4
Hong Kong	US\$ mn.	120.4	212.5	241.0	312.4	316.6	357.4	354.1	411.3	411
U.S.A	US\$ mn.	207.7	174.5	159.4	131.3	284.7	172.7	198.3	186.6	229.5
U.K.	US\$ mn.	137.0	166.3	172.8	184.8	247.6	242.6	251.7	282.4	304.8
Taiwan	US\$ mn.	1555.8	207.4	214.0	225.7	250.2	286.4	287.8	372.1	378.7
EU	% of total imports	14.4	15.2	14.7	15.8	16.3	15.3	15.4	17.6	23.3
Germany	% of imports from EU	21.7	22.0	24.7	21.9	21.8	20.5	18.4	20.5	20.2
UK	% of imports from EU	35.5	36.0	33.5	29.2	31.8	29.8	30.1	31.6	30.3
ASEAN	% of total imports	12.8	13.8	15.1	14.5	13.2	12.8	12.6	14.7	19.6
Singapore	% of imports from ASEAN	29.7	32.3	44.8	35.8	37.2	36.6	37.7	38.3	36.8
Malaysia	% of imports from ASEAN	33.2	33.4	24.1	29.5	28.8	31.1	26.7	22.3	22.8
SAARC	% of total imports	6.9	10.3	11.8	10.7	10.3	10.2	11.9	13.1	15.1
India	% of imports from SAARC	64.1	70.3	72.7	80.1	82.7	86.1	86.9	83.9	83.3
NAFTA	% of total imports	8.5	6.3	5.2	3.7	6.3	3.6	4.3	5.7	7.1
USA	% of imports from NAFTA	91.4	91.3	87.0	89.4	95.0	91.3	84.6	64.7	75.0
Canada	% of imports from NAFTA	8.3	8.3	11.6	10.1	4.6	7.9	10.0	19.0	13.6
APEC	% of total imports	55.7	58.5	57.1	55.7	55.4	50.2	50.4	61.9	45.9
USA	% of imports from APEC	13.9	9.8	8.0	5.9	10.8	6.5	7.3	5.9	11.6
Japan	% of imports from APEC	12.1	11.8	11.9	11.3	11.0	9.4	9.2	9.4	28.1
Singapore	% of imports from APEC	6.9	7.6	11.9	9.3	8.8	9.3	9.5	9.1	15.7

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Unit		1999	2000	2001	2002	2003	2004	2005	2006	2007(a)
1. Exports to selected countries and groupings										
U.S.A	US\$ mn.	1,791.8	2,192.5	1,925.9	1,764.0	1,777.4	1,869.3	1,988.1	2005.5	1,970.0
U.K.	US\$ mn.	604.2	736.7	576.4	590.3	640.4	779.2	777.3	880.1	1,018.0
Germany	US\$ mn.	215.7	230.2	198.5	199.3	232.4	274.1	271.8	328.8	437.9
Japan	US\$ mn.	159.1	229.7	185.8	140.3	165.4	157.6	144.6	163.6	159.6
EU	% of total exports	35.3	33.4	32.3	35.2	35.9	38.3	37.2	40.7	45.3
Germany	% of exports to EU	16.2	15.2	15.8	14.4	15.3	14.9	13.9	14.5	15.6
UK	% of exports to EU	45.0	48.5	45.8	42.8	42.2	42.3	39.9	38.7	36.3
ASEAN	% of total exports	3.1	3.5	2.9	2.6	2.5	2.6	2.9	3.4	3.4
Singapore	% of exports to ASEAN	37.9	38.7	51.4	63.6	61.8	67.9	52.2	39.0	37.6
Malaysia	% of exports to ASEAN	6.0	5.0	5.9	8.4	11.7	7.1	9.5	12.9	16.4
SAARC	% of total exports	3.8	4.2	4.1	6.5	8.3	10.5	12.5	10.7	10.4
India	% of exports to SAARC	33.7	30.6	45.6	66.5	70.0	77.3	86.7	81.6	79.8
NAFTA	% of total exports	49.8	50.5	52.0	47.6	44.5	41.2	40.4	38.1	34.1
USA	% of exports to NAFTA	95.1	95.4	95.1	94.6	94.5	94.5	94.1	94.2	93.3
Canada	% of exports to NAFTA	3.1	3.1	3.4	3.3	3.4	3.6	3.7	3.6	3.7
APEC	% of total exports	57.8	59.5	54.6	52.2	52.2	47.8	46.2	44.0	39.5
USA	% of exports to APEC	84.1	83.5	83.1	82.5	80.6	81.4	82.3	81.5	80.5
Japan	% of exports to APEC	7.5	8.7	8.0	6.6	7.4	6.9	5.9	6.6	6.5
Singapore	% of exports to APEC	2.1	2.3	2.5	3.1	3.0	3.8	3.3	3.0	3.3
2. Imports from selected countries and groupings										
Japan	US\$ mn.	560.9	646.0	336.9	355.3	448.1	411.7	379.7	449.6	413.2
India	US\$ mn.	511.6	600.1	709.3	852.9	1,073.2	1,439.1	1,835.4	2,172.9	2,610.1
Hong Kong	US\$ mn.	459.1	515.9	500.3	491.0	559.5	619.4	648.2	659.1	724.8
U.S.A	US\$ mn.	216.2	254.9	265.6	218.7	188.3	240.1	204.5	200.6	412.1
U.K.	US\$ mn.	251.1	311.4	220.6	262.9	272.9	312.1	276.2	303.4	229.8
Taiwan	US\$ mn.	347.1	390.1	322.8	288.0	276.1	290.8	278.7	274.8	263.8
EU	% of total imports	19.4	18.8	18.0	18.0	18.8	18.2	16.7	15.9	14.5
Germany	% of imports from EU	15.8	16.5	16.3	13.5	13.4	15.7	14.3	16.2	16.9
UK	% of imports from EU	29.1	32.8	26.0	29.3	25.5	25.2	22.2	22.1	17.0
ASEAN	% of total imports	21.1	21.0	19.4	19.1	19.8	20.0	20.5	21.7	20.2
Singapore	% of imports from ASEAN	48.2	46.7	44.8	46.0	46.2	51.2	48.2	52.9	59.3
Malaysia	% of imports from ASEAN	18.0	20.5	22.7	21.7	25.6	24.1	25.7	23.7	15.0
SAARC	% of total Imports	14.2	14.0	15.1	19.1	19.9	23.1	26.6	27.2	30.2
India	% of Imports from SAARC	81.4	84.8	84.4	89.4	91.5	91.4	92.6	92.4	92.7
NAFTA	% of total imports	5.5	6.0	6.2	4.7	4.1	4.1	3.9	4.8	5.3
USA	% of imports from NAFTA	89.0	84.1	91.5	93.8	85.4	84.4	71.2	48.0	83.5
Canada	% of imports from NAFTA	9.3	15.6	8.2	5.8	14.2	15.3	28.0	51.4	16.1
APEC	% of total imports	53.4	54.9	55.6	52.1	49.2	46.4	44.0	43.8	46.1
USA	% of imports from APEC	9.1	9.2	10.1	8.5	7.1	7.6	6.2	5.3	9.6
Japan	% of imports from APEC	23.6	23.2	12.8	13.8	16.0	13.0	11.6	11.9	9.6
Singapore	% of imports from APEC	19.0	17.8	15.6	16.8	18.7	20.5	22.4	26.2	26.0

Note: (a): Provisional.

Sources: International Monetary Fund, *Direction of Trade Statistics*, various issues; Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A15: Structure of Commodity Imports, 1988-2007

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
1. Consumer goods										
Value (US\$ mn.)	548.2	581.5	709.4	782.1	734.6	774.5	930.6	982.0	1,030.0	1,084.0
Growth	16.9	6.1	22.0	10.3	-6.1	5.4	20.1	5.6	5.2	4.9
% of total imports	24.6	26.1	26.4	25.5	21.0	19.3	19.5	18.5	19.0	18.5
1.1 Food										
Value (US\$ mn.)	321.1	364.4	390.0	404.9	419.7	415.9	483.9	522.0	597.0	642.0
Growth	26.7	13.5	7.0	3.8	3.7	-0.9	16.4	7.8	14.3	7.5
% of total imports	14.4	16.4	14.5	13.2	12.0	10.4	10.2	9.8	11.0	11.0
1.2 Other										
Value (US\$ mn.)	227.1	217.1	319.4	377.2	314.9	358.7	446.6	461.0	433.0	442.0
Growth	5.3	-4.4	47.1	18.1	-16.5	13.9	24.5	3.1	-5.8	1.8
% of total imports	10.2	9.8	11.9	12.3	9.0	8.9	9.4	8.7	8.0	7.5
2. Intermediate goods										
Value (US\$ mn.)	1,267.8	1,255.4	1,391.7	1,553.3	1,884.4	2,154.4	2,425.0	2,900.0	2,971.0	3,235.7
Growth	7.8	-1.0	10.9	11.6	21.3	14.3	12.6	19.6	2.6	8.9
% of total imports	56.8	56.4	51.8	50.7	53.8	53.7	50.9	54.6	54.6	55.2
2.1 Petroleum										
Value (US\$ mn.)	246.5	232.4	358.7	311.5	318.0	309.2	296.3	386.9	479.9	539.5
Growth	-16.7	-5.7	54.4	-13.2	2.1	-2.8	-4.2	30.6	24.1	12.4
% of total imports	11.0	10.4	13.3	10.2	9.1	7.7	6.2	7.3	8.8	9.2
2.2 Textiles										
Value (US\$ mn.)	276.5	276.9	335.8	498.2	765.5	865.1	1,038.1	1,158.5	1,168.8	1,386.9
Growth	0.7	0.1	21.3	48.3	53.7	13.0	20.0	11.6	0.9	18.7
% of total imports	12.4	12.4	12.5	16.3	21.9	21.6	21.8	21.8	21.5	23.7
3. Investment goods										
Value (US\$ mn.)	379.8	333.4	584.4	720.1	850.9	1,046.8	1,366.5	1,189.0	1,203.0	1,324.0
Growth	-1.3	-12.2	75.3	23.2	18.2	23.0	30.5	-13.0	1.5	10.0
% of total imports	17.0	15.0	21.7	23.5	24.3	26.1	28.7	22.4	22.1	22.6
4. Total imports										
Value (US\$ mn.)	2,233.2	2,225.6	2,689.0	3,061.1	3,503.4	4,011.3	4,767.3	5,311.1	5,439.0	5,864.0
Growth	8.6	-0.3	20.8	13.8	14.5	14.5	18.8	11.4	2.6	7.7

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	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007(a)
1. Consumer goods										
Value(US\$ mn.)	1,128.0	1,131.0	1,261.0	1,126.0	1,189.0	1,344.0	1,440.0	1,503.0	1,782.0	1,768.0
Growth	4.0	0.3	11.5	-10.7	5.6	11.5	7.1	4.4	18.6	-0.8
% of total imports	19.2	18.9	17.3	18.9	19.5	20.1	18.0	16.9	17.4	15.6
1.1 Food										
Value (US\$ mn.)	596.0	551.0	566.0	545.0	566.0	564.0	596.0	611.0	757.0	831.0
Growth	-7.2	-7.6	2.7	-3.7	3.8	-0.4	5.7	2.5	23.9	8.9
% of total imports	10.1	9.2	7.8	9.1	9.3	8.5	7.5	6.9	7.4	7.3
1.2 Other										
Value (US\$ mn.)	532.0	581.0	696.0	581.0	623.0	780.0	844.0	891.0	1,024.0	937.0
Growth	20.6	9.2	19.8	7.2	25.2	25.2	8.2	5.7	14.9	-9.3
% of total imports	9.0	9.7	9.5	9.7	10.2	11.7	10.6	10.1	10.0	8.3
2. Intermediate goods										
Value(US\$ mn.)	3,108.0	3,168.0	3,916.0	3,430.0	3,622.0	3,948.0	4,828.0	5,458.0	6,161.0	6,747.0
Growth	-3.9	1.9	23.6	-12.4	-5.6	9.0	22.3	13.0	12.9	8.7
% of total imports	52.8	53.0	53.5	57.4	59.3	59.2	60.4	61.6	60.1	59.7
2.1 Petroleum										
Value (US\$ mn.)	345.0	500.0	901.0	731.0	789.0	838.0	1,209.0	1,655.0	2,070.0	2,497.0
Growth	-36.1	44.9	80.2	-18.9	7.9	6.2	44.3	36.9	25.1	17.1
% of total Imports	5.9	8.4	12.3	12.2	12.9	13.7	15.1	18.7	20.2	22.1
2.2 Textiles										
Value (US\$ mn.)	1,397.0	1,320.0	1,471.0	1,320.0	1,321.0	1,372.0	1,514.0	1,531.0	1,546.0	1,632.0
Growth	0.6	-5.5	11.4	-10.3	0.1	3.8	10.3	1.1	1.0	5.3
% of total imports	23.7	22.1	20.1	22.1	21.6	20.6	18.9	17.3	15.1	14.4
3. Investment goods										
Value(US\$ mn.)	1,477.0	1,565.0	1,737.0	1,081.0	1,169.0	1,320.0	1,670.0	1,869.0	2,246.0	2,685.0
Growth	11.3	5.9	11.0	-37.8	8.1	12.9	26.5	11.9	20.2	16.4
% of total imports	25.1	26.2	23.6	18.1	19.2	19.8	20.8	21.1	21.9	23.8
4. Total imports										
Value(US\$ mn.)	5,889.0	5,979.0	7,320.0	5,974.0	6,105.0	6,672.0	8,000.0	8,863.0	10,254.0	11,301.0
Growth	0.4	1.5	22.4	-18.4	2.2	9.3	19.9	10.8	13.6	9.3

Notes(a): Provisional.

Sources: Central Bank of Sri Lanka, Annual Report; various issues; IPS database.

Table A16: Structure of Commodity Exports, 1988-2007

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
1. Agricultural exports										
Value (US\$ mn.)	632.1	611.7	721.0	641.4	604.7	655.3	702.1	829.0	961.0	1060.0
Growth	6.7	-3.2	17.9	-11.0	-5.7	8.4	7.1	18.1	16.1	10.3
% of total exports	42.8	39.3	36.3	32.3	24.6	22.9	21.9	21.8	23.5	22.9
1.1 Plantation crops										
Value (US\$ mn.)	531.3	518.7	617.7	538.5	468.1	514.9	546.8	660.9	801.3	882.1
Growth	4.3	-2.4	19.1	-12.8	-13.1	10.0	6.2	20.9	21.2	10.1
% of total exports	36.0	33.3	31.1	27.1	19.0	18.0	17.0	17.4	19.5	19.0
1.1.1 Tea										
Value (US\$ mn.)	386.7	379.1	494.8	431.9	339.8	412.7	424.2	481.0	615.0	719.0
Growth	6.9	-2.0	30.5	-12.7	-21.3	21.4	2.8	13.3	28.2	17.0
% of total exports	26.2	24.3	24.9	21.7	13.8	14.4	13.2	12.6	15.0	15.5
1.1.2 Rubber										
Value (US\$ mn.)	116.5	86.3	76.9	63.8	67.5	64.0	72.5	111.0	104.0	79.0
Growth	17.1	-25.9	-10.9	-17.0	5.8	-5.3	13.3	53.8	-6.6	-24.4
% of total exports	7.9	5.5	3.9	3.2	2.7	2.2	2.3	2.9	2.5	1.7
1.1.3 Coconut kernel products										
Value (US\$ mn.)	28.2	53.3	46.0	42.8	60.8	38.3	50.1	69.0	81.0	82.0
Growth	-41.7	89.2	-13.7	-7.0	42.2	-37.0	30.9	37.1	17.7	2.0
% of total exports	1.9	3.4	2.3	2.2	2.5	1.3	1.6	1.8	2.0	1.8
1.2. Minor agricultural crops										
Value (US\$ mn.)	80.5	66.8	79.9	82.4	113.1	120.7	129.2	134.0	132.0	145.0
Growth	38.3	-17.0	19.5	3.2	37.3	6.7	7.0	3.5	-1.4	9.9
% of total exports	5.5	4.3	4.0	4.1	4.6	4.2	4.0	3.5	3.2	3.1
2. Mineral exports										
Value (US\$ mn.)	82.2	74.7	87.0	61.9	62.7	75.7	86.9	87.0	96.0	90.0
Growth	34.1	-9.1	16.4	-28.8	1.3	20.7	14.7	-0.1	10.3	-6.7
% of total exports	5.6	4.8	4.4	3.1	2.5	2.6	2.7	2.3	2.3	1.9
3. Industrial exports										
Value (US\$ mn.)	712.9	789.8	1,036.1	1,237.3	1,763.2	2,102.3	2,398.9	2,870.0	3,006.0	3,436.0
Growth	4.9	10.8	31.2	19.4	42.5	19.2	14.1	19.6	5.0	14.3
% of total exports	48.3	50.7	52.2	62.3	71.7	73.4	74.8	75.4	73.4	74.1
3.1 Textile & garments										
Value (US\$ mn.)	448.3	489.1	628.1	803.9	1,214.0	1,412.4	1,551.9	1,853.0	1,902.0	2,274.0
Growth	2.4	9.1	28.4	28.0	51.0	16.3	9.9	19.4	2.9	19.6
% of total exports	30.4	31.4	31.7	40.5	49.3	49.3	48.4	48.7	46.4	49.0
3.2 Petroleum products										
Value (US\$ mn.)	71.2	62.2	99.2	79.5	63.2	78.8	80.1	85.0	104.0	97.0
Growth	-19.1	-12.7	59.5	-19.9	-20.5	24.6	1.7	5.9	22.4	-6.3
% of total exports	4.8	4.0	5.0	4.0	2.6	2.8	2.5	2.2	2.5	2.1
4. Total commodity exports inc. petroleum										
Value (US\$ mn.)	1,475.4	1,558.4	1,983.9	1,987.5	2,460.8	2,863.7	3,208.6	3,806.6	4,199.0	4,736.0
Growth	5.6	5.6	27.3	0.2	23.8	16.4	12.0	18.6	10.3	12.8
5. Total commodity exports excl. petroleum										
Value (US\$ mn.)	1,404.2	1,496.2	1,884.7	1,908.0	2,397.5	2,784.9	3,128.5	3,721.7	3,991.0	4,542.0
Growth	7.3	6.6	26.0	1.2	25.7	16.2	12.3	19.0	7.2	13.8

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	1998	1999	2000	2001	2002	2003	2004	2005	2006(a)	2007(b)
1. Agricultural exports										
Value (US\$ mn.)	1088.0	947.0	1005.0	932.0	938.0	965.0	1065.2	1,153.8	1,292.7	1,507.2
Growth	2.6	-13.0	6.1	-7.3	0.6	2.9	10.4	8.3	12.0	14.2
% of total exports	22.9	20.6	18.2	19.3	20.0	18.8	18.5	18.2	18.8	19.5
1.1 Plantation crops										
Value (US\$ mn.)	878.1	738.0	806.0	755.0	728.0	770.0	849.0	905.9	1,027.1	1,194.9
Growth	-0.4	4.6	9.2	-6.3	-3.6	5.8	10.3	6.7	13.3	14.0
% of total exports	18.5	16.0	14.6	15.7	15.5	15.0	14.7	14.3	14.9	15.4
1.1.1 Tea										
Value (US\$ mn.)	780.0	621.0	700.0	690.0	660.0	683.0	739.0	810.2	881.2	1,025.2
Growth	8.5	-20.4	12.7	-1.4	-4.4	3.5	8.2	9.6	9.3	14.0
% of total exports	16.4	13.5	12.7	14.3	14.1	13.3	12.8	12.8	12.8	13.2
1.1.2 Rubber										
Value (US\$ mn.)	44.0	33.0	29.0	24.0	27.0	39.0	51.0	46.9	93.1	109.4
Growth	-44.3	-25.0	-12.1	-17.2	12.5	44.4	30.8	-8.0	98.5	14.9
% of total exports	0.9	0.7	0.5	0.5	0.6	0.8	0.9	0.7	1.4	1.4
1.1.3 Coconut kernel products										
Value (US\$ mn.)	56.0	84.0	77.0	41.0	41.0	48.0	59.0	48.8	52.8	60.3
Growth	-31.8	50.0	-8.3	-46.8	0.0	17.0	22.9	-17.3	8.2	12.4
% of total exports	1.2	1.8	1.4	0.9	0.9	0.9	1.0	0.8	0.8	0.8
1.2. Minor agricultural crops										
Value (US\$ mn.)	170.0	165.0	155.0	136.0	168.0	150.0	162.0	183.4	194.6	231.5
Growth	17.7	-2.9	-6.1	-12.3	23.5	-10.7	8.0	13.2	6.1	15.9
% of total exports	3.6	3.6	2.8	2.8	3.5	2.9	2.8	2.9	2.8	3.0
2. Mineral exports										
Value (US\$ mn.)	60.0	64.0	97.0	86.0	90.0	84.0	120.0	143.3	119.9	129.2
Growth	-33.1	6.7	51.6	-11.3	4.6	-6.6	42.9	19.4	-5.0	7.2
% of total exports	1.3	1.4	1.8	1.8	1.9	1.6	2.0	2.3	1.7	1.7
3. Industrial exports										
Value (US\$ mn.)	3,607.0	3,551.0	4,283.0	3,710.0	3,631.0	3,977.0	4,506.0	4,948.4	5,401.1	5,920.5
Growth	3.2	-1.8	20.6	-13.4	-2.1	9.5	13.3	9.8	8.8	8.8
% of total exports	74.9	77.0	77.6	77.0	77.3	77.5	78.3	78.0	78.5	76.5
3.1 Textile & garments										
Value (US\$ mn.)	2,460.0	2,425.0	2,982.0	2,543.0	2,424.0	2,575.0	2,809.0	2,894.6	3,080.4	3,341.7
Growth	8.2	-1.4	23.0	-14.7	-4.7	6.2	9.1	3.0	6.4	7.8
% of total exports	52.0	52.7	54.0	52.8	51.6	50.2	48.8	45.6	44.8	43.2
3.2 Petroleum products										
Value (US\$ mn.)	73.0	74.0	98.0	68.0	73.0	65.0	100.0	130.9	188.4	168.9
Growth	-25.9	1.4	32.4	-30.6	7.3	-10.9	53.8	30.9	43.0	-11.5
% of total exports	1.5	1.6	1.8	1.4	1.5	1.3	1.7	2.1	2.7	2.2
4. Total commodity exports inc. petroleum										
Value (US\$ mn.)	4,871.0	4,684.0	5,620.0	4,885.0	4,772.0	5,198.0	5,856.7	6,477.6	7,140.3	7,909.4
Growth	2.9	-3.8	20.0	-13.1	-2.3	8.9	12.7	10.6	10.2	10.2
5. Total commodity exports excl. petroleum										
Value (US\$ mn.)	4,725.0	4,536.0	5,424.0	4,749.0	4,626.0	5,068.0	5,657.6	6,215.8	6,882.7	7,740.5
Growth	4.0	-4.0	19.6	-12.4	-2.6	9.5	11.6	9.9	8.4	13.0

Notes: (a): Revised.
(b): Provisional.

Sources: Central Bank of Sri Lanka, *Annual Report*, various issues; IPS database.

Table A17: Tourism, 1988-2007

	Unit	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Tourist arrivals	No.	182,662	184,732	297,888	317,703	393,669	392,250	407,511	403,101	302,265	366,165
Excursionist arrivals	No.	6,108	4,064	3,954	2,665	5,651	6,093	8,413	10,556	12,863	18,265
Tourist nights	000	2,305	1,970	3,225	3,633	4,055	4,148	4,251	4,024	2,947	3,680
Earnings	Rs. mn.	2,438.3	2,739.7	5,303.3	6,485.8	8,825.6	10,036.8	11,401.6	11,551.6	9,559.1	12,980.0
Receipts per tourist per day	US\$ mn.	76.6	76.0	132.0	156.8	201.4	208.0	230.7	225.4	173.0	216.7
Average duration	US\$	33.3	38.6	41.1	42.8	49.7	50.1	54.2	56.1	57.9	58.6
Accommodation	Nights	12.6	10.7	10.8	11.4	10.3	10.6	10.4	10.0	9.8	10.1
Rooms	No.	9,977	9,459	9,556	9,679	10,214	10,365	10,742	11,255	11,600	12,370
Beds	No.	19,432	18,464	18,669	18,947	19,907	20,242	20,929	21,680	22,040	22,944
Occupancy rate, graded	%	32.1	31.0	47.2	48.4	55.3	57.0	56.6	52.6	40.3	49.1
Sri Lanka nationals	No.	245,065	258,950	306,367	237,424	339,109	375,740	422,367	459,441	488,055	482,850
Arrivals	No.	298,583	285,510	296,884	310,373	420,749	416,246	448,437	504,420	494,258	530,712
Departures	No.	19,960	21,958	24,964	26,878	28,790	30,710	33,956	35,068	31,963	34,006
Employment	No.	27,944	30,741	34,950	37,629	40,306	42,994	47,538	49,095	44,748	47,608
Direct	No.										
Indirect	No.										
Contd.../											
	Unit	1998	1999	2000	2001	2002	2003	2004	2005	2006(a)	2007(b)
Tourist arrivals	No.	381,063	436,440	400,414	336,794	393,174	500,642	566,202	549,308	559,603	494,008
Excursionist arrivals	No.	27,629	28,335	44,518	60,008	63,560	82,066	110,000	119,618	128,719	98,432
Tourist nights	000	3,944	4,479	4,056	3,435	3,989	5,093	5,742	4,754	5,793	4,940
Earnings	Rs. mn.	14,868.0	19,297.3	19,162.2	18,863.3	24,202.0	32,810.0	42,666.3	36,377	42,586	42,519
Receipts per tourist per day	US\$ mn.	231.5	274.9	252.8	211.1	253.0	340.0	416.8	362	410	384
Average duration	US\$	59.5	61.4	62.3	63.1	63.4	66.8	72.2	74.6	83.4	79.1
Accommodation	Nights	10.4	10.3	10.1	9.9	10.1	10.2	10.1	8.7	10.3	10.0
Rooms	No.	12,772	12,918	13,311	13,626	13,818	14,137	14,322	13,162	14,218	14,604
Beds	No.	23,373	24,216	24,953	25,595	25,956	26,511	26,854	24,740	27,117	27,500
Occupancy rate, graded	%	52.8	57.6	52.3	42.1	43.1	53.2	59.3	43.6	39.8	46.2
Sri Lanka nationals	No.	481,793	521,073	514,448	487,356	493,947	560,602	646,990	683,169	734,421	817,524
Arrivals	No.	518,050	496,963	524,212	505,341	533,565	561,126	680,248	727,301	756,735	862,011
Departures	No.										
Employment	No.	34,780	36,560	37,943	33,710	38,821	46,761	53,766	52,085	55,649	60,516
Direct	No.	48,692	51,184	53,120	47,194	54,349	65,465	75,272	72,919	77,909	84,723
Indirect	No.										

Notes: (a): Revised.
(b): Provisional.

Source: Ceylon Tourist Board, Annual Statistical Report, various issues.

Table A18: Monthly Tourist Arrivals, 1996-2007

	1996		1997		1998		1999		2000		2001	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	30,957	-32.7	32,652	5.5	37,224	14.0	44,379	19.2	43,311	-2.4	44,187	2.1
February	29,550	-30.6	35,010	18.5	35,283	0.8	41,526	17.7	43,287	4.2	46,575	7.6
March	26,442	-34.0	34,098	29.0	32,256	-5.4	41,022	27.2	40,110	-2.2	44,290	10.4
April	20,376	-39.6	26,907	32.1	25,578	-4.9	34,443	34.7	33,642	-2.3	36,906	9.7
May	17,655	-28.4	22,407	26.9	20,394	-9.0	25,212	23.6	23,404	-7.2	26,924	-15.0
June	19,668	-12.3	23,160	17.8	22,410	-3.2	26,184	16.8	21,825	-16.6	28,323	29.8
July	25,380	-29.5	30,867	21.6	29,529	-4.3	33,288	12.7	33,267	-0.1	28,566	-14.1
August	24,765	-30.9	32,034	29.4	31,446	-1.8	39,081	24.3	34,422	-11.9	15,717	-54.3
September	23,211	-24.7	29,793	28.4	31,653	6.2	33,915	7.1	31,035	-8.5	11,758	-62.1
October	23,511	-23.2	28,314	20.4	31,767	12.2	35,112	10.5	26,658	-24.1	12,904	-51.6
November	24,921	-12.1	31,995	28.4	38,421	20.1	41,952	9.2	32,469	-22.6	17,344	-46.6
December	35,829	12.0	38,928	8.6	45,102	15.9	40,326	-10.6	36,984	-8.3	23,300	-36.9
Total	302,265	-25.0	366,165	21.1	381,063	4.1	436,440	14.5	400,414	-8.3	336,794	-15.9

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	2002		2003		2004		2005		2006		2007(a)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
January	28,296	-36.0	40,647	43.6	49,950	22.9	38,187	-23.5	52,103	36.4	56,553	8.5
February	31,683	-32.0	39,081	23.4	43,584	11.5	36,645	-15.9	52,687	43.8	43,051	-18.3
March	33,084	-25.3	40,818	23.4	38,418	-5.9	50,418	31.2	54,746	8.6	35,031	-36.0
April	27,057	-26.7	33,714	24.6	30,672	-9.0	42,261	37.8	49,776	17.8	33,039	-33.6
May	26,661	-1.0	30,048	12.7	30,162	0.4	40,878	35.5	43,825	7.2	26,307	-40.0
June	26,355	-6.9	31,836	20.8	32,119	0.8	45,699	42.3	44,066	-3.6	30,810	-30.1
July	35,742	25.1	43,743	22.4	50,525	15.5	56,745	12.3	55,354	-2.5	44,142	-20.3
August	35,475	125.7	42,111	18.7	48,675	15.6	51,216	5.2	52,931	3.3	44,742	-15.5
September	32,982	180.5	36,054	9.3	51,525	42.9	43,536	-15.5	38,485	-11.6	37,104	-3.6
October	36,258	181.0	49,922	37.7	59,442	19.1	44,095	-25.8	38,815	-12.0	37,011	-4.6
November	37,395	115.6	54,946	46.9	64,971	18.2	48,457	-25.4	37,591	-22.4	45,102	20.0
December	42,183	81.0	57,722	36.8	66,159	14.6	51,171	-22.7	39,224	-23.3	61,116	55.8
Total	393,171	16.7	500,642	27.3	566,202	13.1	549,308	-2.9	559,603	1.9	494,008	-11.7

Note: Monthly growth figures reflect percentage changes compared to the same month in the previous year.

(a): Provisional.

Source: Ceylon Tourist Board, Annual Statistical Report, various issues.

Table A19: Tourist Arrivals by Country of Residence, 1996-2007

	1996		1997		1998		1999		2000		2001	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
North America	12,462	-14	15,951	28	17,529	10	18,477	5	17,319	-6	15,983	-8
Canada	4,689	-14	6,477	38	7,542	16	7,905	5	7,503	-5	7,609	1
U.S.A.	7,773	-15	9,474	22	9,987	5	10,572	6	9,816	-7	8,374	-15
Western Europe	167,343	-33	212,052	27	238,959	13	275,796	15	260,824	-5	203,984	-22
Germany	45,075	-43	59,814	33	74,058	24	77,259	4	70,584	-9	60,405	-14
United Kingdom	52,095	-18	62,997	21	66,432	5	80,919	22	84,693	5	67,830	-20
France	21,480	-31	25,392	18	26,874	6	34,458	28	25,992	-25	20,949	-19
Italy	11,988	-35	14,424	20	15,867	10	19,815	25	16,833	-15	12,074	-28
Netherlands	10,995	-23	15,957	45	22,977	44	29,670	29	22,618	-24	12,569	-44
Asia	102,558	-13	113,565	11	99,702	-12	114,375	15	91,521	-20	89,732	-2
Japan	11,724	-36	13,374	14	13,785	3	16,332	19	10,226	-37	9,237	-10
India	42,822	-10	47,010	10	37,356	-21	42,315	13	31,860	-25	33,924	7
Pakistan	11,748	4	11,439	-3	10,782	-6	11,421	6	10,005	-12	8,562	-14
Australasia	8,763	-15	11,712	34	12,159	4	15,159	25	18,228	20	13,105	-28
Australia	7,626	-16	10,392	36	10,329	-1	13,218	28	16,443	24	11,457	-30
Other(a)	11,139	14	12,912	16	13,092	1	12,633	-4	12,522	-1	13,990	12
Total	302,265	-25	366,165	21	381,063	4	436,440	15	400,414	-8	336,794	-16

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	2002		2003		2004		2005		2006(b)		2007(c)	
	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth	No.	Growth
North America	19,866	24	25,110	26	29,759	19	46,457	56	35,323	-24	28,355	-20
Canada	8,301	9	11,164	34	14,633	31	21,185	45	14,623	-31	11,869	-19
U.S.A.	11,565	38	13,946	21	15,126	8	25,272	67	20,700	-18	16,486	-20
Western Europe	200,295	-2	255,169	27	284,440	11	227,191	-20	228,447	1	194,448	-15
Germany	55,170	-9	58,908	7	58,258	-1	46,350	-20	47,402	2	35,042	-26
United Kingdom	67,533	0	93,278	38	106,645	14	92,629	-13	88,306	-5	94,060	7
France	19,984	-5	28,585	28	29,996	5	26,653	-11	22,693	-15	8,091	-64
Italy	12,177	1	15,654	29	18,862	20	10,192	-46	12,424	22	11,451	-8
Netherlands	11,748	-7	18,197	55	21,455	18	15,156	-29	19,360	28	17,526	-9
Asia	143,064	59	177,351	24	198,068	12	223,351	13	242,132	8	202,480	-16
Japan	13,602	47	17,115	26	19,641	15	17,148	-13	16,189	-6	14,274	-12
India	69,960	106	90,603	30	105,151	16	113,323	8	128,370	13	106,067	-17
Pakistan	6,756	-21	9,704	44	9,638	-1	11,029	14	11,145	1	10,204	-8
Australasia	13,209	1	22,965	74	26,540	16	29,738	12	25,127	-16	22,924	-9
Australia	11,217	-2	19,958	78	23,247	16	25,986	12	21,849	-16	20,241	-7
Other(a)	16,737	20	20,047	20	27,395	37	22,571	-18	28,576	27	45,801	60
Total	393,171	17	500,642	27	566,202	13	549,308	-3	559,603	2	494,008	-12

Notes: (a): Latin America & the Caribbean, East Europe, Africa, and Middle East.

(b): Revised.

(c): Provisional.

Source: Ceylon Tourist Board, *Annual Statistical Report*, various issues.

Table A20: Balance of Payments, 1996-2007

	Unit	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007(a)
1. Trade balance	US\$ mn.	-1,343.8	-1,225.0	-1,092.0	-1,369.0	-1,798.0	-1,157.0	-1,406.0	-1,539.0	-2,243.0	-2,516.0	3,370.0	-3,560.0
	% of GDP	-9.7	-8.1	-6.9	-8.7	-10.8	-7.4	-9.5	-8.1	-10.9	-10.3	-11.9	-11.0
2. Services balance	US\$ mn.	105.0	159.1	145.0	147.0	38.0	175.0	295.0	399.0	419.0	338.0	257.0	239.0
	% of GDP	0.8	1.1	0.9	0.9	0.2	1.3	2.0	2.1	2.0	1.4	0.9	0.7
3. Income, net	US\$ mn.	-197.0	-160.0	-180.0	-254.0	-305.0	-267.0	-253.0	-172.0	-204.0	-299.0	-389.0	-358.0
	% of GDP	-1.5	-1.1	-1.1	-1.6	-1.8	-1.9	-1.7	-0.9	-1.0	-1.2	-1.4	-1.1
4. Net private transfers	US\$ mn.	709.8	788.1	849.0	887.0	974.0	984.0	1,097.0	1,205.0	1,350.0	1,736.0	1,904.0	2,214.0
	% of GDP	5.1	5.2	5.4	5.6	5.9	7.0	7.5	6.3	6.5	7.1	6.7	6.8
5. Net official transfers	US\$ mn.	49.0	44.5	52.0	26.0	24.0	22.0	31.0	36.0	30.0	93.0	101.0	97.0
	% of GDP	0.4	0.3	0.3	0.2	0.1	0.2	0.2	0.2	0.1	0.4	0.4	0.3
6. Current account balance	US\$ mn.	-677.0	-393.0	-226.0	-563.0	-1,066.0	-244.0	-237.0	-71.0	-648.0	-650.0	-1,499.0	-1,369.0
	% of GDP	-4.9	-2.6	-1.4	-3.6	-6.4	-1.7	-1.6	-0.4	-3.1	-2.7	-5.3	-4.2
7. Capital and financial a/c	US\$ mn.	459.0	602.0	413.0	373.0	443.0	562.0	444.0	722.0	631.0	1,224.0	1,808.0	2,097.0
	% of GDP	4.2	4.2	2.6	2.4	2.7	4.0	3.0	3.8	3.1	5.0	6.4	6.5
Capital account	US\$ mn.	95.6	87.1	80.0	80.0	50.0	198.0	65.0	74.0	64.0	250.0	291.0	269.0
Financial account	US\$ mn.	363.0	515.0	334.0	293.0	393.0	364.0	379.0	648.0	567.0	974.0	1517.0	1828.0
8. Long-term	US\$ mn.	381.0	716.0	398.0	435.0	304.0	164.0	326.0	722.0	680.0	798.0	907.0	1251.0
Foreign direct investment	US\$ mn.	86.0	128.6	137.0	177.0	176.0	172.0	185.0	171.0	217.0	234.0	451.0	548.0
Private long-term (net)	US\$ mn.	2.0	47.0	2.0	196.0	82.0	-257.0	-21.0	-33.0	14.0	11.0	-35.0	31.0
Government long-term	US\$ mn.	259.0	239.0	203.0	62.0	47.0	249.0	162.0	554.0	439.0	553.0	491.0	672.0
9. Short-term	US\$ mn.	-18.0	-201.0	-64.0	-142.0	88.0	201.0	53.0	-75.0	-112.0	176.0	610.0	577.0
Foreign portfolio investment	US\$ mn.	6.4	13.0	-24.0	-13.0	-45.0	-11.0	25.0	2.0	11.0	60.0	51.0	101.0
10 Other (b)	US\$ mn.	98.1	27.3	-116.1	-101.0	174.0	71.0	-145.0	-2.0	202.0	323.0	293.0	364.0
11. Overall balance	US\$ mn.	-68.0	163.0	37.0	-263.0	-522.0	220.0	338.0	502.0	-205.0	501.0	204.0	531.0
	% of GDP	-0.5	1.8	1.4	-1.7	-3.1	1.6	2.3	2.6	-1.0	2.1	0.7	1.6

Notes: (a): Provisional.

(b): Valuation adjustments, errors, and omissions.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

Table A21: Exchange Rates Behaviour, 1996-2007

	Unit	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Nominal Exchange Rates													
U.S.A	S.L. Rs. per US\$	56.71	61.29	67.78	72.12	80.06	93.16	96.72	96.74	104.60	102.12	107.71	160.27
Japan	S.L. Rs. per Yen	0.49	0.47	0.59	0.71	0.70	0.71	0.82	0.90	1.02	0.87	0.90	0.97
U. K.	S.L. Rs. per Pound	95.86	101.60	112.62	116.72	119.37	135.06	155.12	172.19	201.37	175.94	211.29	217.15
European Union	S.L. Rs. per Euro	-	-	-	72.53	74.32	82.27	101.38	121.60	142.32	120.96	141.58	169.37
India	S.L. Rs. per Ind. Rs.	1.58	1.56	1.59	1.66	1.71	1.93	2.02	2.12	2.40	2.27	2.44	2.77
24 currencies													
Nominal Effective Exchange Rates (NEER) (2006 = 100)													
		-	-	-	-	-	-	-	110.31	97.57	104.77	94.35	87.79
Real Effective Exchange Rate (REER) (2006 = 100)													
		-	-	-	-	-	-	-	92.01	89.64	100.15	99.26	105.64

Sources: Central Bank of Sri Lanka, Annual Report, various issues.

Appendix B: Capital Market

Table B1: Sri Lanka's Capital Market Structure, 2003-2007

	2003	2004	2005	2006	2007(a)
1. Equity market:					
Market capitalization	262,800	382,100	584,000	834,800	820,700
of which central depository	136,059	195,032	259,780	370,076	418,088
2. Debt market:	1,035,394	1,165,491	1,266,802*	1,460,644*	1,507,693*
(i) Private	45,751	48,000	29,060*	42,260*	50,320*
(ii) Public	989,643	1,117,491	1,237,742	1,418,384	1,457,373
(a) Short-term(TBs)	219,295	243,886	234,174	257,732	307,012
(b) Medium & long-term	770,384	873,605	1,003,568	1,160,652	1,150,361
3. Total debt and equity (Rs. mn.)	1,298,194	1,547,591	1,850,802	2,295,444	2,328,393
as a percentage of GDP(%)	83.07	86.07	88.20	92.40	65.09
of which actually traded	147,159	209,532	270,680	393,576	449,288
through the central depository					
as a share of total (%)	11.7	13.5	14.6	17.1	19.3
4. Foreign participation in the central depository as a per cent of market capitalization (%)	14	14	14	14	19

Notes: (a): Provisional.

* Debentures listed is no longer available. (Source: CSE Fact Book 2005, 2006 and 2007).

Sources: Colombo Stock Exchange, *Annual Report*; Central Bank of Sri Lanka, *Annual Report*, various issues.

Table B2: Recent Developments in the Share Market, 1999-2007

	1999	2000	2001	2002	2003	2004	2005	2006	2007
1. Number of companies listed	237	239	238	238	244	242	239	237	235
New listings	4	5	2	9	8	5	6	2	-
De-listings	7	3	3	9	2	7	9	4	2
2. Number of companies traded	226	228	225	231	236	241	242	232	231
3. Market capitalization Rs. bn.	112.8	89	124	162	263	382	584	835	821
US\$ bn.	1.6	1.2	1.4	1.7	2.7	3.8	5.8	8.0	8.0
4. Price-earnings ratio times, year end	6.6	5.2	7.5	12.1	11.1	10.8	12.4	14.0	11.6
5. Number of shares traded (mn.)	486	449	747	1,220	2,255	2,752	5,128	3,912	2,952
Domestic (mn.)	357	350	607	1,035	1,932	2,479	4,313	3,178	2,049
Foreign (mn.)	129	99	140	185	323	273	815	734	902
6. Trades ('000)	205.7	160.0	159.7	283.2	481.3	645.1	1,100.4	9,523.8	8769.3
Domestic ('000)	193.6	150.0	152.8	273.2	460.9	611.6	1,038.5	9,082.2	8316.6
Foreign ('000)	12.1	10.0	6.8	10.0	22.8	33.4	61.9	44.2	45.3
7. Turnover Rs. bn.	14.8	11	14.1	30.5	73.8	59.0	114.6	105.1	105.0
US\$ bn.	0.2	0.1	0.2	0.3	0.7	0.6	1.1	1.0	1.0
Domestic Rs. bn.	9.3	7.9	11.4	24.3	59.9	47.9	89.9	70.7	63.8
Foreign Rs. bn.	5.5	3.1	2.6	6.2	13.8	11.1	24.6	34.5	41.2
8. Liquidity-turnover / market									
Capitalization ratio (%)	13.1	12.4	11.3	18.7	28.1	15.4	19.6	12.6	12.8
9. No. of new issues	4	4	-	5	4	-	-	-	-
10. Total no. of shares issued (mn.)	29.2	80	-	244	-	-	-	-	-
11. Value of shares issued (Rs. bn.)	0.4	0.1	-	3.6	-	-	-	-	-
12. Central depository:									
Domestic (Rs. bn.)	33.9	30.9	50.9	66.5	98.2	140.4	179.8	248.7	260.4
Foreign (Rs. bn.)	17.2	9.5	12.2	19.5	37.8	54.6	79.9	121.4	157.6
Total (Rs. bn.)	51.1	40.4	63.1	86.0	136.0	195.0	259.8	370.1	418.1
Percentage of market cap. (%)	45	45	51	53	52	51	44	44	51
13. Non-national activity									
Net purchases (Rs. mn.)	-950.8	-3,364.6	-1,024.8	2,441.5	209.3	1,105.0	6,144.5	5,377.0	11,254.3
Purchases (Rs. mn.)	5,050.1	1,445.0	2,111.9	7,477.7	13,943.9	11,278.0	27,712.4	37,167.0	46,796.8
Sales (Rs. mn.)	6,000.9	4,809.9	3,136.7	5,036.2	13,734.6	10,172.0	21,567.9	31,790.0	35,542.5
14. Price indices									
All Share 1985 = 100	572.5	447.6	621.0	815.1	1,062.0	1,506.9	1,922.2	2,722.4	2,541.0
Growth % change	-4.2	-21.8	38.7	31.2	30.2	41.9	27.6	41.6	6.7
Sensitive 1985 = 100	937.5	698.5	1,031.0	1,374.6	1,898.0	2,073.7	2,451.1	3,711.8	3,291.9
Growth % change	-6.2	-25.4	47.6	33.3	38.1	9.3	18.2	51.4	11.3

Note: 1000 Million = 1 Billion.

Source: Colombo Stock Exchange, *Annual Report*, various issues.

Table B3: Market Concentration
(% of total market capitalization)

	2007(%)
Dialog	19.85
JKH	9.86
SLT	6.93
Commercial Bank	4.17
Distilleries	3.67
Hatton National Bank	2.83
Carsons	2.38
DFCC	2.01
Nestle	1.72
National Development Bank	1.68
Total	55.10

Note: As at year 2007, the top ten of the 232 listed companies accounted for 55.1% of total market capitalization.

Source: Colombo Stock Exchange, *Annual Report*, various issues.

Table B4: New Equity Listings - 2006 & 2007

Company	No. of shares offered	Issue price Rs.	No. of shares subscribed by public	No. of shares devolved to underwriters	Date listed
1. New listings-2006					
Blue Diamonds Jewellery Worldwide Ltd.	65,589,385	2.50	30,057,291	–	6-Jan-06
Cargo Boat Development Co. Ltd.	3,400,012	15.00	3,400,012	–	4-Jan-06
Commercial Leasing Co. Ltd.	2,016,667	60.00	2,016,667	–	30-Jan-06
Regnis (Lanka) Ltd.	1,207,271	50.00	1,207,271	–	20-Jan-06
Chemical Industries (Colombo) Ltd.	8,100,000	62.00	8,100,000	–	29-Mar-06
Chemical Industries (Colombo) Ltd.	2,430,000	35.00	2,430,000	–	29-Mar-06
Dankotuwa Porcelain Ltd.	18,094,296	10.00	12,791,509	5,302,787	25-Apr-06
Seylan Merchant Leasing Ltd.	5,047,475	18.00	5,047,475	–	20-Apr-06
The Fortress Resorts Ltd.	38,882,344	10.00	38,882,344	–	23-May-06
Seylan Bank Ltd.	83,560,000	12.50	83,560,000	–	2-May-06
Vidullanka Ltd.	2,981,250	20.00	2,981,250	–	3-May-06
Overseas Realty (Ceylon) Ltd.	69,057,200	15.00	10,133,921	58,923,279	23-Aug-06
Pan Asia Banking Corporation Ltd.	55,571,883	10.00	55,068,524	–	26-Oct-06
Seylan Merchant Leasing Ltd.	3,028,485	20.00	3,028,485	–	30-Oct-06
Diesel & Motor Engineering Co. Ltd.	1,100,000	50.00	1,100,000	–	20-Nov-06
People's Merchant Bank Ltd.	12,500,000	20.00	12,500,000	–	14-Nov-06
Value (Rs.)	4,705,479,692				
Issues (No.)	15				
2. Right issues - 2006 by sector					
	No. of issues	No. of shares	Value(Rs.)		
Banks, Finance & Insurance	6	161,724,510	2,122,643,100		
Chemicals & Pharmaceuticals	1	10,530,000	587,250,000		
Hotels & Travels	1	38,882,344	388,823,440		
Land & Property	2	72,457,212	1,086,858,180		
Motors	1	1,100,000	55,000,000		
Manufacturing	3	84,890,952	405,279,972		
Power & Energy	1	2,981,250	59,625,000		
Total	15	372,566,268	4,705,479,692		
3. New listing-2007					
	No. of shares offered	Issue price Rs.	No. of shares subscribed by public	No. of shares devolved to underwriters	Date listed
Kshatriya Holdings PLC	19,679,528	10.00	19,679,528	–	12-Feb-07
Kelsey Development Ltd.	5,809,758	20.00	5,809,758	–	12-Feb-07
The Fortress Resorts Ltd.	20,161,215	10.00	17,242,725	2,918,490	27-Feb-07
Lanka Tiles Ltd.	5,052,420	35.00	5,052,420	–	1-Mar-07
John Keells Holdings PLC	92,103,534	140.00	92,103,534	–	6-Feb-07
Amana Takaful PLC	12,500,099	30.00	12,500,099	–	22-Mar-07
Commercial Bank of Ceylon Ltd.	40,288,996	138.00	40,288,996	(Voting)	4-Apr-07
Commercial Bank of Ceylon Ltd.	2,790,138	65.00	2,790,138	(Non-voting)	4-Apr-07
ACME Printing & Packing Ltd.	4,472,160	14.00	3,510,191	961,969	24-Apr-07
DFCC Bank	21,639,134	140.00	21,639,134	–	27-Apr-07
Kshatriya Holdings PLC	73,798,230	10.00	73,798,230	–	21-Jun-07
Dialog Telecom PLC	740,343,492	21.00	740,343,492	–	21-May-07
John Keells Hotels PLC	496,413,675	5.75	496,413,675	–	28-Jun-07
Marawila Resorts Ltd.	14,000,000	4.00	14,000,000	–	7-Aug-07
Muller and Phipps (Ceylon) Ltd.	216,000,000	1.00	87,571,714	–	31-Dec-07
First Capital Holdings PLC	18,750,000	10.00	18,750,000	–	17-Aug-07
Parquet (Ceylon) Ltd.	1,324,800	10.00	1,324,800	–	23-Oct-07
LB Finance Ltd.	10,100,000	17.00	10,100,000	–	27-Nov-07
Coco Lanka Ltd.	6,300,000	18.00	6,300,000	–	7-Nov-07
Ceylon Glass Company PLC	395,869,200	1.90	395,869,200	–	5-Nov-07
The Lanka Hospitals Corporation Ltd.	67,119,651	15.00	67,119,651	–	20-Dec-07
Ceylon Hotels Corporation PLC	150,000,000	2.00	150,000,000	–	31-Dec-07
Value (Rs.)	44,622,201,960				
Issues (No.)	21				

Contd...../-

4. Right issues - 2007 by Sector	No.of issues	No. of shares	Value(Rs.)
Banks, Finance & Insurance	6	161,724,510	2,122,643,100
Chemicals & Pharmaceuticals	1	10,530,000	587,250,000
Hotels & Travels	1	38,882,344	388,823,440
Land & Property	2	72,457,212	1,086,858,180
Motors	1	1,100,000	55,000,000
Manufacturing	3	84,890,952	405,279,972
Power & Energy	1	2,981,250	59,625,000
Total	15	372,566,268	4,705,479,692

Source: Colombo Stock Exchange, *Annual Report*, various issues.

Table B5: Structure of Debt Market, 2003-2007

(Rs. .bn.)	2003	2004	2005	2006	2007(a)
1. Private Debt:					
(a) Commercial paper(year end)	11.10	14.50	10.90	23.50	31.20
(b) Certificates of deposit	24.98	21.03	18.16	18.76	19.10
(i) Commercial banks	23.64	19.79	17.06	17.70	17.76
(ii) Finance companies	1.34	1.23	1.10	1.06	1.34
(c) Debentures (listed)	9.67	12.47	**	**	**
Total private debt	45.75	48.00	29.06*	42.26	50.30
2. Public Debt:					
(a) Short-term					
(i) Treasury bills	219.29	243.88	234.17	257.73	307.01
(ii) Central Bank securities	—	—	—	—	—
(b) Medium & long-term					
(i) Treasury bonds	483.11	643.35	751.57	885.97	1018.85
(ii) Rupee securities	248.41	164.76	140.56	116.71	131.51
(iii) Certificates of deposit	—	—	—	—	—
Total public debt	955.20	1052.00	1126.30	1,260.41	1,457.37
3. Total Debt	1000.95	1100.00	1155.36*	1,302.67*	1,507.67*

Notes: (a): Provisional.

** All corporate debentures listed on the Colombo Stock Exchange were transferred to the DEX with effect from August 2005.

* Debentures listed is no longer available. (Source: CSE Fact Book 2005, 2006 and 2007).

Sources: Central Bank of Sri Lanka, *Annual Report*, various issues; Colombo Stock Exchange, *Annual Report*, various issues.

Table B6: Listed Debentures, 2005-2007

Issuer	Issued (No.)	Par value (Issue price Rs.)	Interest (p.a.)	No.of debt subscribed	Date listed		
1. Listings 2005							
Seylan Merchant Leasing Ltd.	1,000,000	100	10.25%	63,000	18.07.05		
		100	11.00%	399,050	18.07.05		
		100	11.50%	111,850	18.07.05		
		100	12.00%	90,000	18.07.05		
		100	11.75%	23,000	18.07.05		
Senkadagala Finance Company Ltd.	2,500,000	100	12.50%	313,100	18.07.05		
		100	14.00%	2,242,200	10.10.05		
		100	Floating	257,800	10.10.05		
2. Listings 2006							
Seylan Merchant Leasing Ltd.	10,000,000 with an option to issue up to a further 5,000,000 if oversubscribed	100	13.00%	7,646,400	25.07.06		
		100	13.50%	4,620,800	25.07.06		
		100	Floating	305,950	25.07.06		
DFCC Bank	Unsecured subordinated redeemable debenture	1,000	13.75%	200,000	17.11.06		
			Floating	170,000	17.11.06		
			Floating	40,000	17.11.06		
			14.00%	590,000	17.11.06		
3. Listings 2007							
Commercial Bank of Ceylon Ltd.	Issue of 10,000,000 with an option to issue up to a further 500,000	1,000	13.50%	527,800	23.01.07		
		1,000	Floating	131,020	23.01.07		
		1,000	13.75%	250	23.01.07		
		1,000	Floating	300	23.01.07		
		1,000	14.00%	467,260	23.01.07		
		1,000	Floating	400	23.01.07		
Seylan Merchant Bank PLC	950,000	100	16.00%	321,390	08.01.07		
		100	17.00%	628,260	08.01.07		
	Issue of 1,000,000 with an option to issue up to a further 950,000	100	Floating	350	08.01.07		
		100	16.00%	588,080	01.01.07		
		100	16.50%	352,300	01.01.07		
		100	16.25%	9,000	01.01.07		
		100	16.75%	6,300	01.01.07		
		100	16.50%	11,120	01.01.07		
		100	17.00%	8,500	01.01.07		
		100	17.00%	8,600	01.01.07		
		100	17.50%	16,100	01.01.07		
		Seylan Bank PLC	Issue of 5,000,000 with an option to issue up to a further 5,000,000	100	15.75%	2,916,200	18.01.07
				100	16.75%	4,275,450	18.01.07
				100	Floating	302,350	18.01.07
Sampath Bank Ltd.	Issue of 10,000,000 with an option to issue up to a further 5,000,000	100	15.50%	222,650	04.10.07		
		100	17.50%	5,206,725	04.10.07		
		100	Floating	9,570,625	04.10.07		
Nation Trust Bank PLC			14.10%	1,650,000	25.05.07		
			Floating	1,650,000	25.05.07		
			Floating	1,700,000	25.05.07		
Hatton National Bank PLC			Floating	2,625,000	13.01.07		
			Floating	2,500,000	13.01.07		
			Floating	3,000,000	13.01.07		
			Zero coupon	5,143,445	13.01.07		
			Zero coupon	13,628,000	13.01.07		
			16.00%	5,000,000	28.11.07		
			16.75%	7,000,000	28.11.07		
Nationla Development Bank PLC			17.50%	250,000	24.12.07		

Source: Colombo Stock Exchange.