SRI LANKA STATE OF THE ECONOMY 2024

Economic Scars of Multiple Crises: From Data to Policy



INSTITUTE OF POLICY STUDIES OF SRI LANKA

SRI LANKA
STATE OF THE
ECONOMY
2024

INSTITUTE OF POLICY STUDIES OF SRI LANKA
100/20, Independence Avenue, Colombo 7, Sri Lanka

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Institute of Policy Studies of Sri Lanka

ISBN 978-955-7397-33-7

National Library of Sri Lanka-Cataloguing-In-Publication Data

Sri Lanka state of the economy 2024. - Colombo:
Institute of Policy Studies of Sri Lanka, 2024.
332 p.; 25 cm.

ISBN 978-955-7397-33-7

i. 330.95493 DDC 23
1. Sri Lanka-Economic conditions
2. Sri Lanka-Economic conditions-21st century
3. Sri Lanka-Economic development

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The contributions of Gayendri Karunaratne (editorial support), Nayomi Jayakody (administrative support), Githma Chandrasekera (data visualisation) under the overall guidance of Dinali Perera are acknowledged.

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ACRONYMS

A-Level	Advanced Level
CBSL	Central Bank of Sri Lanka
CCPI	Colombo Consumers Price Index
CEB	Ceylon Electricity Board
CGE	Computable General Equilibrium
CIT	Corporate Income Tax
COLA	Cost of Living Allowance
COVID-19	Coronavirus
CPC	Ceylon Petroleum Corporation
CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
DCS	Department of Census and Statistics
EDB	Export Development Board
EDR	External Debt Restructuring
EFF	Extended Fund Facility
EUIPO	European Union Intellectual Property Office
FDI	Foreign Direct Investment
FFS	Fossil Fuel Subsidy
FI	Financial Institution
FIT	Flexible Inflation Targeting
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GI	Geographical Indication
GOSL	Government of Sri Lanka
HIES	Household Income and Expenditure Survey
ICT	Information and Communication Technology
IMF	International Monetary Fund
IPS	Institute of Policy Studies of Sri Lanka
ISIC	International Standard Industrial Classification
ITC	International Trade Centre
LCB	Licensed Commercial Bank
LFC	Licensed Finance Company
LFS	Labour Force Survey
LKR	Sri Lankan Rupee
LPG	Liquefied Petroleum Gas
LTV	Loan-to-Value
MIC	Middle-income Country
MLB	Macro-linked Bond
MOE	Ministry of Education
MOH	Ministry of Health

NBFI	Non-bank Financial Institution
NCD	Non-communicable Disease
NCPI	National Consumer Price Index
NCS	National Citizen Survey
NEREC	National Education Research and Evaluation Centre
NGO	Non-governmental Organisation
NIPO	National Intellectual Property Office
OECD	Organisation for Economic Co-operation and Development
OFC	Other Field Crop
O-Level	Ordinary Level
OOPE	Out-of-pocket Expense
OSL	Overseas Sri Lankans
PAYE	Pay-as-you-earn
PBOC	People's Bank of China
PC	Provincial Council
PIT	Personal Income Tax
PSP	Public Service Pension
PUBAD	Ministry of Public Administration and Management
RCA	Revealed Comparative Advantage
RCEP	Regional Comprehensive Economic Partnership
REER	Real Effective Exchange Rate
RMG	Ready-made Garments
ROO	Rules of Origin
RVC	Regional Value Chain
SDG	Sustainable Development Goal
SEA	Sustainable Energy Authority
SHI	Social Health Insurance
SLBFE	Sri Lanka Bureau of Foreign Employment
SOE	State-owned Enterprise
STEM	Science, Technology, Engineering and Mathematics
THE	Total Health Expenditure
TVET	Technical and Vocational Education and Training
UHC	Universal Health Coverage
UK	United Kingdom
US	United States
USD	United States Dollar
VAT	Value Added Tax
WFH	Work from Home
WHO	World Health Organization
WLB	Work-life Balance
YoY	Year-on-year

ECONOMIC STABILITY AND RESILIENT GROWTH

1. Policy Perspectives

There has been positive news on Sri Lanka's economic front in 2024. Signs of a slow but steady improvements to economic growth are occurring on the back of improved macroeconomic fundamentals with low inflation and a stable exchange rate. Too often in the past, recovery efforts from a downturn have relied on a flood of foreign borrowing. This time around, the complex pairing for a self-sustaining recovery in tandem with debt sustainability is demanding more credible macroeconomic policymaking.

There has been positive news on Sri Lanka's economic front in 2024. Signs of a slow but steady improvements to economic growth are occurring on the back of improved macroeconomic fundamentals with low inflation and a stable exchange rate.

The recovery, however, has come about with sizeable social and political costs. Harsh austerity in the midst of a deep economic crisis hurts. For large swathes of the population, incomes dropped and many more lost livelihoods. Higher taxes and price increases have eaten further into wages. In ordinary circumstances, the societal backlash would have diluted the political will to carry through the necessary reforms. Recent years, though, have been out-of-the-ordinary for Sri Lanka – hit by two 'once in a generation events' (a pandemic and a sovereign debt default) that struck deep. The economic crisis and resultant queues and shortages meant that Sri Lankans largely accepted the sacrifices they had to make. However, despite the visible absence of widespread social unrest, the crucial presidential election outcomes in September 2024 will arguably be seen as a test of how the economic, social and political disruption has been handled. The winner will also see it as an opportunity to reshape the context over the next five years on how the country's economic strategy should adjust.

Despite Sri Lanka's return to positive economic growth from the third quarter of 2023, the rebound is still in its early fragile state. In the run-up to the presidential elections, the uncertainty cast a pall in the second half of 2024. Uncertainty means firms and households delay investment and consumption, reducing demand and negatively impacting a much-needed boost to the growth momentum. Such political and policy uncertainty is not behind Sri Lanka. The country is expected once again to face parliamentary elections that determine the strength of political representation to carry through and implement policy agendas.

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At the heart of the disputed policy options is the appropriateness of macroeconomic measures, and more centrally, the fiscal austerity demanded in the midst of a deep economic downturn. The prevailing approach to fiscal policy of 'there is no alternative' to debt and deficit targets is an article of faith that continued adherence to Sri Lanka's International Monetary Fund (IMF) Extended Fund Facility (EFF) engagement is crucial. Without it, once a country has declared a debt standstill and with no recourse to further foreign financing, the only way to keep essential services running is to print new money and make the Sri Lankan Rupee (LKR) nearly worthless as inflation spirals.

To ease the adjustment costs of IMF-style fiscal rigour, other proposals have been floated. One such is that countries like Sri Lanka should seek debt forgiveness (or debt write-offs) from creditors. But demanding debt write-offs can involve costly trade-offs, especially for a 'richer' middle-income country (MIC) like Sri Lanka, unlike its low-income country counterparts. Not only is it seen as rewarding bad behaviour – where countries and their governments sidestep responsibility for policy errors – but it can also come with a price tag when a country seeks to re-access international capital in the future. As an aspirational MIC, Sri Lanka's need to raise such financing in the future cannot be discounted. Domestic resources and foreign direct investment (FDI) flows alone will not suffice given the scale of investments in physical and social infrastructure required in the long term to bridge the yawning output gap that has opened up since the crisis. Alternatively, a more combative stance – and implicitly more protracted negotiations (although swifter alignment is possible) – to obtain higher haircuts at debt restructuring negotiations to ease the burden of repayments, too, has trade-offs. The empirical evidence points to lower output costs for the debtor country, the quicker it is able to reach an agreement with creditors.[1]

The harsh reality is that for countries in debt-default, fixing over-extended fiscal positions via adjustments to how a government taxes and spends and tackling the accumulated debt stock can only be done under IMF oversight. This 'outsourcing' of the policy model for recovery leaves little or no room for 'heterodox' policies. So far, Sri Lanka has followed the IMF blueprint and generated returns on the macroeconomic front. In line with intentions to support those who lose out and need help, a social spending floor ring-fenced certain welfare expenditures whilst keeping a lid on overall government outlays. The social impact of these measures has been painful. They include the removal of subsidies on fuel; a wage freeze on the public sector; tax increases, removal of tax exemptions and imposition of new taxes, amongst others. Implementing these has required persistent efforts by policymakers. To ensure as far as possible that Sri Lanka will not revert to reckless policy experimentation – especially of unfunded fiscal expansionism – rules and disciplines are also being entertained via legal enactments.

The returns from the fiscal tightening are to be found in macroeconomic data. The fiscal deficit narrowed to 8.3% of gross domestic product (GDP) in 2023 (albeit marginally higher than the budget target of 7.9% of GDP) with a primary surplus of 0.6% of GDP. The consolidation continued into the first half of 2024, with tax revenues up by 43% and expenditures down by 5% compared to the same period in 2023.

1 Fang, C., Schumacher, J., & Trebesch, C. (2020). *Restructuring Sovereign Bonds: Holdouts, Haircuts and the Effectiveness of CACs.* Working Paper Series No. 2366. Frankfurt: European Central Bank.

These more credible fiscal policy numbers have had the desired impact to boost confidence amongst Sri Lanka's many foreign creditors owed a total of approximately United States Dollars (USD) 37 billion (Bn). On the heels of the successful second review of the IMF-EFF programme, a bilateral creditor agreement was reached in June 2024. It deals with USD 10 Bn by extending relief via a five-year grace period (from 2022), maturity extensions (to 15 years) and reduction in interest rates (to 2.1% or lower). Negotiations with the bondholder group (representing 50% of outstanding bonds) to restructure USD 12.5 Bn are still ongoing. The initial bondholder group request to restructure all as macro-linked bonds (MLBs) with repayment contingent on Sri Lanka's GDP performance – captured by a one-time single test of average nominal GDP in USD – has evolved to something more appealing for Sri Lanka. The provisional deal involves a bundle of three types of bonds, including MLBs where payouts would be contingent on real economic growth. The framework envisages a 28% haircut and interest rate reductions (11% reduction on past payments). The terms have to be presented to all bondholders for their concurrence in addition to other tests, including that of comparable treatment viz. bilateral creditors.

Sri Lanka is buying time for itself up to 2028 when it must begin repayments. The country's 48-month IMF-EFF programme too is scheduled to end mid-2027. Any change to the outlook for government finances – based on the IMF's debt sustainability analysis (DSA) – will see an unravelling of the consensus arrived at so far and set back the recovery since the economic and political upheaval of 2022.

The political will to maintain the fiscal targets – even allowing for changes at the margin – will be testing. On the expenditure front, the current freeze on public sector wages and pensions which has seen purchasing power diminish for a large part of the workforce and elderly pensioners, is untenable beyond a certain point. The brewing industrial and social unrest will not abate. And, as has happened all too often in the past, it has encouraged Sri Lanka's proclivity towards 'competitive populism' with tax relief and spending proposals floated as election promises. On the other hand, efforts to make spending more efficient and effective via restructuring and/or sale of state-owned enterprises (SOEs) for instance, fail to make headway, mired in ideological campaigns.

Thus, the biggest challenge is to ensure fiscal credibility is maintained while responsibly countering the growth-retarding effects of fiscal contractions. Strict fiscal austerity measures on an already depressed economy are a drag on growth in the near term. Depressed wages hold back consumption and below par public investment damages medium-term growth.

So far, monetary policy is helping to soften the blow. As inflationary pressures cooled, interest rates have been allowed to drift down in the hope of encouraging consumption and private investment. According to data from the Department of Census and Statistics (DCS), as the Sri Lankan economy made a slow return to positive growth from the third quarter (3Q) of 2023, the initial recovery was driven by consumption, with investment being the key driver by the first quarter (1Q) of 2024.

A consumer response to kick-starting the economic recovery is to be expected after a severe tightening of household spending. However, consumption spending is likely to remain modest as the cost-of-living squeeze and fall in real wages and disposable incomes continue to bite and savings are run

down. Research suggests that even controlling for income and other variables, a period of economic hardship tends to depress consumption for some time.[2]

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Whilst the high-inflation episode is over, it has left lasting damage. Lower-income households suffered disproportionately owing to spending a greater share of their incomes on food, which saw the biggest price jump in the consumption basket. Aside from the inequitable fallout, as shown by the DCS household survey to assess the impact of the economic crisis,[3] there has been a concerning decline in living standards. Nearly 60% of households reported a decrease in incomes and 22% have fallen into debt as a result. As noted earlier, when consumers are weighed down by falling incomes and debt, consumption-driven recoveries tend to be anaemic.

In these circumstances, durable growth matters. Strong and lasting growth generates jobs, and stronger employment fuels income and spending. A cursory glance at unemployment numbers might suggest a positive trend in Sri Lanka's labour market. In 2023, unemployment dropped to 4.7% from a high of 5.5% in 2020. This was not because more jobs were created, but owing to a marked increase in economic inactivity in the labour market. The newly inactive workers might be those who are discouraged from seeking employment, those who choose to remain in education, or those looking for a job abroad, etc. They may choose to return to the labour force if job growth picks up or their savings run down, but for now, their disconnection from the labour market poses downside risks to productivity growth and output expansion.

Private investment can boost productivity growth and generate quality jobs. It is encouraging that private credit is growing – albeit not as briskly as might be desired at 6.2% as of mid-2024. This is partly owing to the likelihood of election-related uncertainty. More concerningly, Sri Lanka is also unlikely to see higher FDI flows in 2024 for the same reason. Nonetheless, there are other promising indicators – imports of machinery and equipment and building materials were up by more than 25% by mid-2024 against total non-fuel import growth of 15% compared to the same period in 2023, signalling a return of positive investor intentions. The path of monetary policy too will dictate how sustained the private investment momentum will be. While interest rates continue to drift lower, Sri Lanka's rapid disinflation adds a layer of complexity. Low inflation, estimated at an annual average of 2.5% as of mid-2024 means real interest rates are rising, with the possibility of hampering, rather than boosting the recovery in private investment.

Excess capacity and weak inflation typically prompt central banks to keep monetary policy loose for as long as possible to ease credit conditions in a bid to stimulate consumption and investment. In

2 Malmendier, Ulrike., & Leslie Sheng Shen. (2024). "Scarred Consumption," *American Economic Journal: Macroeconomics,* vol 16(1), pp. 322-355.

3 Department of Census and Statistics. (2023). *Household Survey on Impact of Economic Crisis*. Battaramulla: Department of Census and Statistics.

the past, eclectic practices between prioritising price stability and economic growth have generated undesirable booms and busts. However, as in the case of fiscal rules and disciplines, Sri Lanka's legal enactments to confer more instrumental autonomy to the Central Bank of Sri Lanka (CBSL) has moved it firmly in the direction of low and stable inflation as the priority. The accompanying flexible inflation targeting (FIT) does leave some room to consider potential output as a factor, but even under such conditions, monetary policy has limits in ensuring durable growth when firms and households are burdened by debt. The stimulus also loses steam when faced with the intractable problem of investor sentiments and election-related uncertainty.

Anaemic and low economic growth for any extended time period can become a slow burning predicament in the making. Most international financial institutions (IFIs) put Sri Lanka's near term growth forecast at 2.0-2.5% in 2024 and expect it to settle to an average of 3% in the medium-term. At these rates, or even assuming a slightly more robust output expansion of 4% in the medium- to longer-term, Sri Lanka will likely see a permanent output loss as experienced in other emerging market crises episodes.[4] The loss, however, would be amplified if the current self-sustaining growth trajectory is usurped by an over zealous attempt to accelerate growth at the expense of macroeconomic stability. If that were to happen, the country would see a decade of lost growth and be at risk of a prolonged era of relative decline.

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The priority is to avoid sluggish growth, stagnant living standards and high poverty and inequality. These are high level objectives that have broad consensus. The question that remains is how to go about achieving them.

The economic policy direction to achieve stabilisation and move on to robust growth and prosperity draws polarised debates. With little or no room to manoeuvre around the standard IMF-EFF policy prescriptions, a measure of macroeconomic stability has been achieved. Any undoing of commitments made up to 2027 under the programme will have immediate repercussions on financing available to the government, investor sentiment and consumer confidence. The end result will be to make the transition to sustained growth that much harder.

Thus, on the assumption that Sri Lanka's macroeconomic policy direction will not be altered materially in the near term, what policy tools to use to boost growth and reduce inequalities are priorities. Indeed, these are policy questions posed globally as the popularity of industrial policy sees a remarkable resurgence in the developed world. Multilateral rules and disciplines are being set aside to roll out domestic subsidies and tax incentives to revive the manufacturing sector and create jobs. Notably, tit-for-tat tariff protectionism and retaliation are on the rise. These developments also influence the framing of economic strategies elsewhere, including in Sri Lanka. Self-sufficiency and

4 Cerra, V., & S.C. Saxena. (2018). *The Economic Scars of Crises and Recessions*. IMF Blog, https://www.imf.org/en/Blogs/Articles/2018/03/21/the-economic-scars-of-crises-and-recessions

import substitution within a more inward-looking policy thinking have habitually come up against more globally-integrated and outward-looking policy prescriptions. This time is no different as these ideas compete for space in a politically charged election year in Sri Lanka.

Given the legacy of the traumatic events since 2022, such ideological battles to reflect this context are understandable. Many argue that trade and regulatory policies of recent decades have held back Sri Lanka's industrial transformation, and instead, import and debt-dependency precipitated the 2022 crisis. But, rather than tying up industrial policy in ideological and political agendas, it is now increasingly recognised that industrial and trade policies do not operate in isolation in the current cross-border global supply networks. Instead, these are complementary and work together to gear firms to successfully compete globally. The deeper structural problems that exist in the Sri Lankan economy – pertaining to the labour market, education sector, the state's share in economic activities, etc. – stand the best chance of being resolved if the necessary degree of consensus is secured.

In order to do this, a robust analysis of the direct socio-economic fall-out of the crisis, how it was managed, who lost out and how they were supported through the crisis, amongst others, need to be understood. The data to do so remains sketchy, with 2019 being the last Household Income and Expenditure Survey (HIES) conducted by the DCS. Other available data, including the DCS' Labour Force Surveys (LFSs) and the National Citizen Survey 2022-23 by the United Nations Development Programme (UNDP) are used in this report to provide answers to some key questions.

Whilst many would agree that some semblance of normality has been restored on the economic front, the scars of Sri Lanka's economic meltdown run deep – poverty has doubled, inequality has widened and living standards have dropped precipitously. The depth and severity vary across social groups. The poorer households are more vulnerable to being forced to adopt coping mechanisms and even curtail the consumption of basic necessities with adverse longer-term consequences on their well-being.

As to which households across the income distribution have been hit the hardest owing to specific crisis impacts and response measures need to be better understood. One such central issue is whether Sri Lanka's current fiscal strategy embraces distributional concerns. Employing a framework developed by the Commitment to Equity (CEQ),[5] the progressivity of Sri Lanka's fiscal instruments and their equalising ability are examined in some detail. The Institute of Policy Studies of Sri Lanka (IPS) research finds, amongst others, that the Pay-as-you-earn (PAYE) tax exhibits high progressivity – a striking 96% of PAYE tax revenue is contributed by the wealthiest 10% of the population. On the other hand, government higher educational spending is found to be regressive with the bottom 40% of households receiving only 22% of such spending. Robust distributional analysis of government tax and spending thus provides clear policy guidance to develop a long-term fiscal strategy that can meet basic societal needs and, at the same time, indicate room for adjustments that provide fiscal flexibility to respond to shocks.

5 Arunatilake, Nisha., & Jayawardena, Priyanka. (2019). *CEQ Master Workbook: Sri Lanka (2009-2010).* CEQ Data Center on Fiscal Redistribution. New Orleans, Louisina and Washington, D.C.:CEQ Institute, Tulane University and the World Bank.

On top of the economic crisis, a key downside development was accompanying high food inflation that took a heavy toll on the nutrition status of poorer households. An IPS analysis that matches data from the UNDP 2022-23 survey to the HIES 2019 indicates that the percentage of households who skipped meals surged from 6.3% to 20.1%, whilst the percentage of persons who chose cheaper or less favoured food options swelled from 17.1% to 59.6% over the same years. Additionally, simulation analysis to examine the predicted food expenditure shares in 2023, for instance, suggests that the estate sector and the poorest quintile will see a 36% and 21% decrease in calorie consumption, respectively. This is despite a simulation of a 50% increase in expenditures, suggesting that they were the hardest hit in both the quality and quantity of food intake.

Poor health outcomes are a well-known outcome of insufficient nutrition and exacerbate the pressure on Sri Lanka's already overburdened public health system. As a share of GDP, the country's domestic general government health expenditure of 1.9% compares poorly to 2.9% for the Southeast Asian region and 4.1% globally.[6] A comparison of household expenditure on health over the crisis period using HIES 2019 and UNDP 2022-23 data suggests a significant increase in the financial burden of healthcare, especially for the less well-off. For instance, households in the lowest expenditure quintile experienced a 250% surge in their health expenditure – albeit from a much lower base – compared to only a 15% increase for the richest quintile. Given that poorer households already spend a substantial portion of their income on necessities, having to reallocate an even larger share of limited resources to healthcare means difficult trade-offs, such as cutting back on other essential expenses like food and education.

For many such poorer households, aside from cutting down on essential expenses, stretching limited resources has meant employing other coping strategies such as secondary jobs, drawing down savings, resorting to borrowing, etc. As of 2023, some 55% of households had some form of financial obligations or outstanding loans that they were managing or repaying, while 22% of households had been indebted due to the economic crisis.[7] Pawning jewellery is one of the most popular strategies used by households (38%) as per the UNDP 2022-23 survey, but a higher share of households in the middle quintiles use pawning services compared to the poorest and the richest segments. The poorest may have less jewellery or may have already pawned their valuables given the series of adverse shocks faced by Sri Lankan households over the past four years.

For such households that lack economic weight, the economic crisis has worsened distribution and social mobility for the most part. They must reasonably believe that the worst is over and economic growth will return, and that when demand recovers, they will find jobs and livelihoods to regain lost living standards. Using the DCS's LFS in the absence of more recent HIES data, the IPS research reveals that Sri Lanka's education participation rates have improved significantly between 2018 and 2022 – for instance, the number of 17-19 year old students in schools rose by 25% and those in vocational training institutions increased by 55%. In part, this may be explained by the 13-year guaranteed education programme which established a new vocational

6 World Health Organization. (2023). *Global Health Observatory Data Repository*. Geneva: World Health Organization.

7 Department of Census and Statistics. (2023). *Household Survey on the Impact of the Economic Crisis*. Battaramulla: Department of Census and Statistics.

subject stream in Advanced Level (A-Level) classes and made it easier for those who drop out of school to pursue vocational education.

Despite the encouraging signs of students actively 'skilling' themselves, it is to be hoped that they will not struggle to find jobs, even when demand recovers, and importantly, that their motivations to seek jobs are not eroded. A troubling drop in Sri Lanka's labour force participation rate to 45.1% in the fourth quarter (4Q) of 2023 (from an annual 51.8% in 2018) is found to be driven by a rise in inactivity as per IPS' research, overshadowing the decline in unemployment. Delving deeper into LFS data points to deeper structural problems – for instance, only the services sector is generating jobs without harming its productivity, and the share of high-skilled workers in the Sri Lankan labour market is not only low but also on the decline from 23% in 2018 to 20% in 2023. Most concerningly, access to decent work – framed as formal full-time employment – is found to have decreased over the crisis period. For instance, those with the highest access (prime-aged men) have seen a five percentage points drop during 2018-2022.

Even those with access to decent work – Sri Lanka's public sector employees – have suffered a sharp drop in real incomes as nominal wage growth failed to keep up with price inflation. Making up 35% of formal employment and 15% of the labour force as per DCS data, Sri Lanka's public sector share is only slightly above the global average (11%). The problem is that it is bottom-heavy, while higher wages are not backed by productivity increases, and the numbers have not shrunk despite government revenues declining sharply over time. Public sector jobs are still coveted for lower risks of redundancy, shorter work hours, getting pay rises for years of service and seniority, and generous pension benefits. But, a blanket wage freeze has seen their real incomes melt away. The IPS analysis offers possible wage increment paths – for instance, if a 30% pay rise is on the cards, to keep the wage bill more or less at the same share of GDP, a 20% downsize may have to be considered to address questions of productivity and higher quality provision of public services along the way.

Sri Lanka's depressed labour market conditions are reflected in high numbers leaving the country in search of better job opportunities abroad. There is a dearth of data to fully understand the scale of outmigration, especially of skilled professionals, and its long-term consequences. Indeed, even the evidence from LFS data of a drop in the share of high skilled workers, including evidence from the public service on a five-year no-pay leave scheme points to it. But, information gathered by the IPS from one of the hardest hit sectors, information and communication technology (ICT), suggests that the worst is over and some impacted sectors have managed the crisis. Some of the more popular 'pull' countries – Australia, the United Kingdom (UK) and Canada – are also imposing their own caps on migration more recently. For Sri Lanka, the surest way to halt or reverse the 'drain' is to fix its economic collapse and offer better reasons for its citizens to stay.

Under par skills development and labour market constraints will hamper efforts to boost productivity and pose a downside risk to regaining Sri Lanka's long-term potential output. Aside from labour and skills issues, weak productivity and competitiveness have held back economic progress, not least in generating sufficient earnings from exports to service Sri Lanka's foreign debt obligations. As industrial policy makes a come-back globally, Sri Lanka must avoid past policy errors in defining it narrowly to protect import-competing industries and instead, devise complementary strategies to increase competitiveness and productivity more broadly.

One key means being used extensively at present to break into new markets is free trade agreements (FTAs). However, FTAs have not been without its fair share of critics, and Sri Lanka's latest move to sign on to the Regional Comprehensive Economic Partnership (RCEP) will renew those debates. RCEP membership does hold opportunities – such as the potential to link to regional manufacturing value chains – but also some concerning threats. More than 95% of Sri Lanka's trade deficit is with RCEP countries, with over half originating from trade with China. However, an IPS partial equilibrium analysis suggests that if China completely eliminates tariffs for Sri Lanka, under this hypothetical scenario, export earnings can increase by 42.3% in the base year. But, a complete tariff elimination is unlikely and negotiations will have to carefully factor in the trade-offs related to revenue losses, higher trade deficits, and domestic industry and labour market impacts on the less competitive Sri Lankan economy.

For the most part, the agriculture sector remains protected from such trade liberalisation efforts owing to its 'sensitive' nature of being a large source of employment and livelihoods in rural Sri Lanka. But long-standing structural problems within the country's food crop production sector face fresh appraisal as farmers and consumers continue to be buffeted by high food price volatility. Despite some recovery in farm profits by the Maha 2023 season after a sharp dip in 2021, high input costs and price volatility continue to plague the sector. Converting traditional subsistence agriculture to one that maximises productivity can involve diversifying into exports of minor agricultural crops such as spice products. Here, IPS analysis suggests significant market potential for key spice exports where Sri Lanka enjoys a high revealed comparative advantage (RCA). With high RCAs, the International Trade Centre (ITC) data show significant export potential in new markets for Sri Lankan spice exports.

Tapping into new markets more broadly will also benefit from a strategic shift from 'brown to green' by embracing global efforts to tackle climate change. Indeed, advanced economies are pushing through regulations where buyer requirements on climate change mitigation and carbon footprint reductions will impact Sri Lankan exports. Apparel, tea, and rubber products – the main electricity-consuming industries in the country's export basket – are experiencing higher energy input costs and its ability to adapt will determine the extent to which Sri Lanka's manufacturing exports remain competitive in international markets.

Under the thematic focus 'Economic Scars of Multiple Crises: From Data to Policy', this year's 'Sri Lanka: State of the Economy 2024' report looks at these issues in detail to better understand the scale of challenges ahead for the country, address socio-economic divisions and avoid an extended period of low growth and stagnant living standards. As the nation collectively elects its president and prepares for parliamentary elections next, the consensus on the need for a more prosperous and equal society is universal and undisputed. It sets the stage for a reassessment of how best to drive rising living standards in the decade ahead and meet basic societal demands on institutional and governance arrangements.

After the recent economic turmoil, the degree of economic stability which has been restored lays a path that may provide sufficient flexibility in the medium-term to respond to these demands. The most crucial is to permit public finances to become adequately stable so that Sri Lanka can move beyond crisis management to tackle deeper structural problems in the economy. What is to be avoided are any

attempts to do this haphazardly and leave Sri Lanka highly exposed to another economic shock. The lessons learnt from the economic crisis – both successes and shortcomings – have shed sufficient light for policymakers to grasp the costs to be borne and opportunities to be seized in plotting a course for the country's future economic success.

2. Economic Performance and Outlook

2.1 Introduction

The Sri Lankan economy returned to positive growth from the third quarter (3Q) of 2023 after six consecutive quarters of negative growth – the country's longest and deepest stretch of economic contraction ever experienced. The growth recovery was supported by the unwinding of tight monetary policy conditions as inflationary pressures decelerated sharply – from a peak of 70% in September 2022 to a low 1.5% by October 2023 – towards a stable price trajectory whilst the Sri Lankan Rupee (LKR) too regained a degree of lost value and steadied thereafter.

Underpinning the monetary and exchange rate stability has been concerted efforts to meet fiscal targets set out under Sri Lanka's External Fund Facility (EFF) agreement with the International Monetary Fund (IMF). Following the first performance review, measures to bridge revenue shortfalls were addressed and the IMF Executive Board approval was granted to release the second tranche in December 2023. Further revenue enhancing tax measures were flagged in the second review in June 2024. The unrelenting pressure to meet fiscal targets is tied into Sri Lanka's ongoing and crucial negotiations on external debt restructuring (EDR). This is viewed as the final hurdle before entering a stretch where more certainty prevails to allow longer term planning for deliverables on self-sustaining growth and development outcomes.

There is no doubt that the average Sri Lankan citizen has suffered deeply as a result of the economic meltdown. In addition to high inflation wiping out savings, a series of tax increases, the adoption of market pricing on fuel, a shake-up of the welfare system and a clampdown on government spending have eaten into living standards. In this harsh environment, the poor have suffered disproportionately from loss of livelihoods and incomes. Whilst policy packages have partially helped to cushion the impact of inflation for the poorest households, those on low- to middle-incomes have borne the brunt of declining real disposable incomes. While the modest recovery so far marks a significant milestone for a country that suffered a severe economic setback, very few tools are available to boost growth and recoup lost output and living standards in the short- to medium-term. Against this background, this chapter examines developments in key macroeconomic policy arenas, the limits and risks in deploying these policy levers to sustain the recovery and prospects for the Sri Lankan economy in 2025.

2.2 Fiscal Policy

The inability of successive governments to bridge high and persistent deficits between fiscal expenditures and revenues has been a hallmark of Sri Lanka's repeat boom-bust cycles and regular bailout programmes with the IMF. More recently, such weaknesses were heightened as governments accumulated debt in foreign currencies. Post-crisis, Sri Lanka's shock therapy to bridge deficits as well as reduce foreign borrowing relies on orthodox fiscal policy measures. Upward tax revisions and spending cuts are the more immediate bitter pills of fiscal austerity, while fiscal rules are being slowly built in to avoid the risk of future slippage.

The fiscal-centric adjustment is not without its fair share of critics. Substituting borrowing with taxation depresses private investment and output. Curtailing expenditure – on social capital such as infrastructure and services, or social expenses such as welfare – impacts future output and runs the risk of creating social disharmony, respectively. Indeed, the political and social dimensions of harsh austerity measures can often be overlooked as the technical discussions dominate and dictate the numerous 'targets' and 'performance criteria'.

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Sri Lanka, as a country that neglected to embark on a fiscal adjustment path unilaterally in response to eminent signs of a crisis, has been compelled to do so within a relatively short period to meet IMF programme targets. Under such conditions, the adjustment process can be arduous both for the government and its citizens. In Sri Lanka's case, revenue consolidation as a priority benchmark has seen the tax revenue to gross domestic product (GDP) share improve, climbing steadily to 9.8% in 2023, albeit being still below the pre-pandemic share of 10.9% in 2018 during the preceding IMF programme (Figure 2.1a). What is pertinent is that, this time around, the tax revenue increase has been achieved under much more demanding conditions – i.e., that of an economy undergoing a significant contraction in output over a longer spell.



The mix of tax levers used to achieve a given revenue target can be less than optimal when done under such crisis conditions. In Sri Lanka's case too, consumption tax increases via adjustments to the Value Added Tax (VAT) rate, removal of VAT exemptions, as well as reduced thresholds for Personal Income Taxes (PITs), for instance, have come under criticism on the grounds of affordability and equity. At the broadest level, though, a notable improvement is seen in the breakdown of direct and indirect taxation, where heavy dependence on the latter is considered to limit the progressivity

of a country's tax burden. This need not necessarily be the case if it is offset on the expenditure side to address equity issues. Nonetheless, at a time when social harmony is under threat owing to the downside impacts of an economic crisis, requiring those who can afford to pay more to do so can be an important socio-political message for better compliance. In Sri Lanka's case, there has been a welcome shift towards more direct taxation – with the indirect tax share falling from a high of nearly 82% in 2018 to 66.5% by 2023 (Figure 2.1a).

Figure 2.1a
Tax Revenue Trends

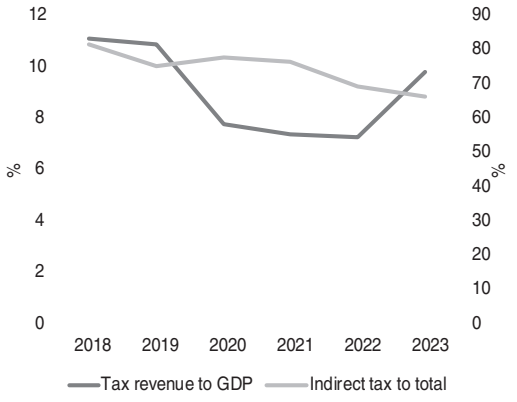
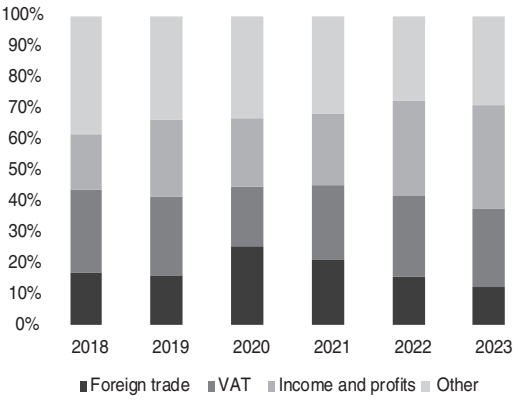


Figure 2.1a
Tax Revenue Composition



Source: Based on data from the Ministry of Finance and the Central Bank of Sri Lanka (CBSL).

Seemingly, attempts have been made to build the revenue enhancement drive around the principle of progressivity in taxation. Moreover, the share of PITs and Corporate Income Tax (CIT) revenues in total tax revenues increased from 18% in 2018 to 33.5% by 2023 (Figure 2.1b). The share of VAT collections has been more or less stagnant at around 25-27% during the same period. To strengthen transparency in tax estimation, the Ministry of Finance compiles an aggregate of revenues foregone, according to which, the total value under VAT exemptions amounted to LKR 550 Mn. in 2022-23 (relative to a VAT collection of LKR 695 Mn in 2023).

Fiscal policy adjustments, however, should not be confined only to revenue consolidation, especially in crises. A reallocation of public expenditure from high cost, low social impact investments is warranted – for instance, from defence-related spending to those on health and education. The broad trajectory of public expenditures in Sri Lanka suggests that there has been very limited success in curtailing spending as a share of GDP, with total expenditure at 19.4% in 2023 against 17.5% in 2018 (Figure 2.2a). In fact, a further downside is that despite the higher spending ratio, the share of capital spending has shrunk. This can hinder future output growth in the economy over time.

Figure 2.2a
Government Expenditure

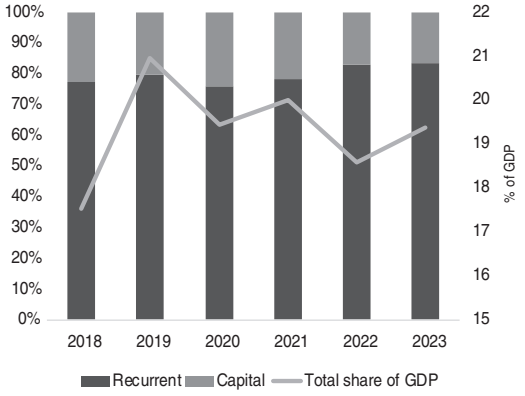
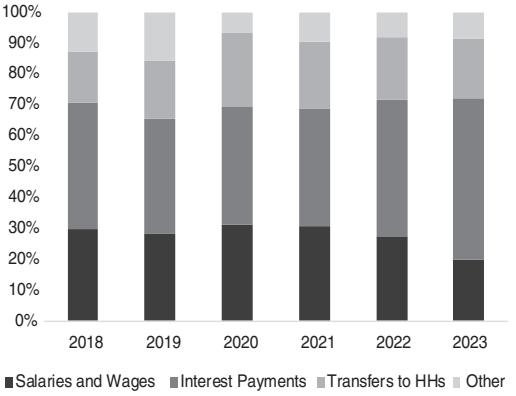


Figure 2.2b
Composition of Recurrent Spending



Source: Based on data from Ministry of Finance and the CBSL.

The higher share of recurrent spending also does not cover areas that generate larger social impacts. Rather, the share of interest payments in recurrent spending has increased from 40.8% in 2018 to 52.3% in 2023 (with interest payments amounting to 85% of total revenues in 2023 compared to 44% in 2018). The domestic debt share of interest payments has crept up from 75% in 2018 to 95% in 2023 as an outcome of the debt repayment standstill on foreign borrowing and high domestic interest rates that prevailed in 2022-23. Efforts underway to restructure Sri Lanka's public debt are projected to lift the burden of high outlays on debt servicing, with the government seeking a five-year moratorium on foreign debt repayments as part of its negotiating stance.

Fiscal adjustments also need to ensure that the government can meet the basic societal demand of maintaining an adequate standard of living for all.

Fiscal adjustments also need to ensure that the government can meet the basic societal demand of maintaining an adequate standard of living for all. Transfers to households have increased from 16.4% of total recurrent spending in 2018 to 19.4% in 2023. This is largely owing to increased welfare spending since the pandemic and the introduction of the Aswesuma programme. The combined spending on Samurdhi and Aswesuma recipients accounted for 0.9% of GDP in 2023 (5.6% of total recurrent spending) compared to 0.3% of GDP in 2018 (and 1.9% of recurrent spending) as shown in Figure 2.3a.

Figure 2.3a
Spending on Samurdhi/Aswesuma

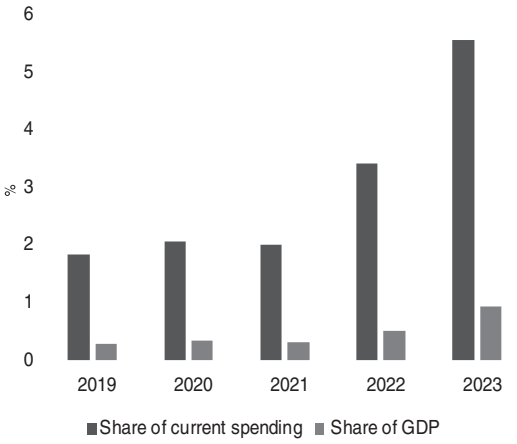
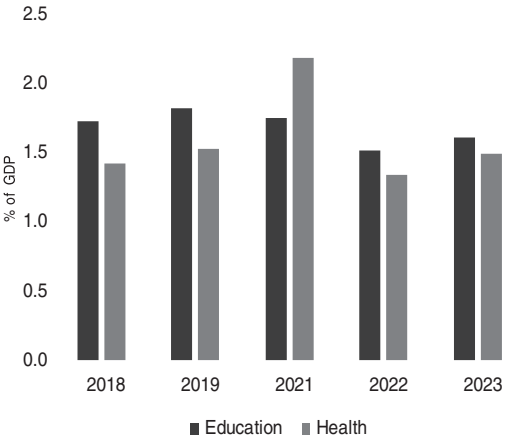


Figure 2.3b
Spending on Education and Health



Source: Based on data from the Ministry of Finance and the CBSL.

Reallocating public expenditures to high impact social sectors such as health and education shows a mixed score card. As a share of GDP, budget allocations to health and education have varied (Figure 2.3b). As expected, the health budget increased amid the pandemic, but is only marginally up to 1.5% of GDP in 2023 relative to 1.4% in 2018. By contrast, the education sector has fared poorly, with spending declining to 1.6% of GDP in 2023 from a low 1.7% in 2018. Clearly, these are sub-optimal outcomes that will hinder socio-economic progress and Sri Lanka's future output growth. Such outcomes form the basis of criticisms levelled against the adherence to tight austerity in the midst of a severe economic downturn. Whilst both the health and education sectors include sizeable household private expenditures, the crisis-related drop in household incomes adds to the adverse spending impacts in these crucial areas.

More encouragingly, a noteworthy decline is to be seen in the share of recurrent expenditures on salaries and wages of public servants, down from 30% in 2018 to 20% in 2023 owing to a freeze on pay revisions, offset by a limited extent through ad hoc cost-of-living allowances being paid out. The size and productivity of the country's large public sector is often contested. Whilst Sri Lanka's bureaucracy is a large absorber of public funds, as a share of total employment, the current estimate of approximately 15% is not overly high by global shares generally. By regional standards though, the share is much higher than in neighbouring countries of South and Southeast Asia. Indeed, the share of public employment in total employment tends to be higher in more advanced economies with higher tax revenues, and lower in developing countries struggling to raise sufficient revenues.

Table 2.1
Public Spending in Selected Reform Areas

	2019	2020	2021	2022	2023
Public sector employment in total employment (%)	14.9	14.8	15.2	15.1	14.6
Defence-related salaries and wages of total salaries (%)	27.6	25.1	24.3	23.3	23.2
Ministry of Defence spending in total expenditure (%)	11.2	9.1	8.5	7.9	7.3
Ministry of Defence spending as a share of GDP (%)	2.3	1.8	1.7	1.5	1.4
Financial outturn of 52 key SOEs (LKR Bn.)	3.8	33.7	-97.8	-744.6	455.8

Note: Bn=billions, SOEs=state-owned enterprises.
Source: Based on data from the Ministry of Finance and the CBSL.

Sri Lanka's problem is one of weak revenues to remunerate public sector workers, alongside critical issues related to their productivity. By skills, it is bottom heavy, with a mere 4.5% of total employees in government institutions being at the highest skill levels. For all practical purposes though, the current freeze on salaries and wages of public servants can only be a short-term temporary fix and runs the risk of attrition of those with higher skills if adequate compensation for the recent bout of high inflation and income taxes are ignored for too long. In the medium to longer term, a more strategic resourcing of personnel is clearly warranted if public service delivery is to become more efficient and productive. If not addressed, higher wages in the public sector which are not adequately backed by productivity increases give rise not only to lower quality services but continued taxation on citizens at large to meet the wage bill. A related contested area on the public sector salaries and wages bill is that of defence spending in Sri Lanka's post-conflict setting. The data suggests a progressive lowering in defence-related spending (Table 2.1).

Another contentious area is fiscal support to prop up loss-making state-owned enterprises (SOEs) – with 52 key SOE recording staggering losses of LKR 755 billion (Bn) in 2022. The introduction of a market reflective fuel price formula and cost recovery revisions to electricity tariff rates in 2023, alongside other measures such as the Treasury absorbing some of the debt, have taken the edge off the worst of the losses incurred by the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB), respectively. The turnaround has seen the financial outturn give way to a positive LKR 455 Bn in 2023 as the government gears itself to divest other key loss-making entities such as the national carrier, SriLankan Airlines.



Fiscal policy measures over the last two years, underpinning Sri Lanka's pivot from an unfunded fiscal slackening to a tight fiscal policy to turn the country's macroeconomic fundamentals in the right direction, have come with considerable political costs. It is, therefore, not surprising that in the run up to the presidential elections in September 2024, most aspirants put forward proposals to ease the burden by way of public sector salary revisions, higher welfare handouts, a reset of PIT rates and thresholds, etc. These promises are being made while the IMF considers new central government taxes – such as property taxes and wealth transfer taxes – as being the way forward for Sri Lanka under its current EFF commitments. On a practical note, a gradual easing will be possible only after there are assured signs that the fiscal turnaround is more firmly entrenched. This is because, unlike in similar circumstances in the past, fiscal prudence is tightly entwined with the yet-to-be completed debt restructuring negotiations.

A successful debt restructuring outcome is crucial for Sri Lanka to exit the vicious cycle of allocating a growing share of fiscal revenues to servicing debt repayments or requiring higher taxes or more borrowing. Thus, while the many critics of fiscal austerity measures point to valid concerns – the immediate downside impacts of inadequate support to the poor, the medium to longer term impacts on future output from constrained health and education spending and physical infrastructure developments, etc. – the menu of alternative options put forward tend to be scarce.

One policy being advocated to overcome the fiscal choke is to seek debt forgiveness (or debt write-offs) from Sri Lanka's multiple creditors. Whilst it can yield benefits in the short-term as cash-flows improve, such benefits may be offset by the reputational damage to the country. This is particularly so for middle income countries like Sri Lanka that are often compelled to rely on market access to tap lenders and investors alike. In most instances, the creditors who are asked to bear loan-write offs are accountable to their taxpayers. The moral hazard of countries choosing to fund themselves by borrowing internationally via democratically elected representatives and not bearing the cost of such actions by demanding debt forgiveness remains a highly contested issue.[1]

1 Del Ponte, A., & P. DeScioli. (2022). Pay Your Debts: Moral Dilemmas of International Debt. *Political Behaviour*, 44(4):1657-1680.

On the assumption that fiscal parameters will be met under the EFF programme, Sri Lanka anticipates an improvement in its primary deficit and gross financing needs over the medium term. In 2023, the Treasury achieved a primary surplus of 0.6% of GDP and brought the overall deficit down to 8.3% of GDP (Table 2.2). In 2024, the primary surplus target is set for 1% of GDP with a fiscal deficit of 7.3% of GDP. Any relaxing of these targets or attempts to push back their timelines will unsettle creditors and investors alike. Such risks are particularly high for a country like Sri Lanka that is prone to habit forming divergences in reporting planned and actual fiscal targets regularly.

Table 2.2
Fiscal Outcomes and Targets (LKR Bn)

	2019	2020	2021	2022	2023	2024[a]
Revenue and grants	11.9	8.8	8.3	8.4	11.1	13.6
Expenditures	21.0	19.4	20.0	18.6	19.4	20.9
Primary balance	-3.4	-4.4	-5.7	-3.7	0.6	1.0
Fiscal balance	-9.0	-10.7	-11.7	-10.2	-8.3	-7.3
Public debt	81.9	96.6	100.0	114.2	103.9	114.2

Note: a.Target under IMF-EFF programme.
Source: Based on data from the Ministry of Finance and the CBSL.

Thus, any transgressions from the agreed fiscal path runs a heavy risk of unwinding progress on Sri Lanka's debt restructuring negotiations. In turn, the economy can plunge back into chaos as access to external resources – for both the government and private sector – remains firmly shut and the painful recovery phase drags on for many more years. These are prone to raise the risks of a repeat default given that sovereign defaults tend to be counter-cyclical – i.e. defaults occur in times of weak or volatile growth.[2] To mitigate such threats, to date, Sri Lanka's policy approach has been to keep to the IMF-EFF fiscal commitments as much as possible until clear signs of exiting from the economic crisis emerge, and to try and introduce rules to the country's fiscal framework as a backstop to sustain more disciplined policy in the future.

From mid-2023, unwinding the tight monetary policy cycle has been the main instrument to mitigate the demand contraction after a large part of the population saw their purchasing power erode from the combined impacts of consumer price inflation and substantial tax increases.

2 Aguiar, M. and M. Amador. 2014. Sovereign Debt. *Handbook of International Economics*, vol 4. chp. 11., pp 647–687.

2.3 Monetary Policy and Exchange Rate

Not surprisingly, default episodes compromise other key economic fundamentals such as price stability. In 2022, Sri Lanka recorded historically high inflation rates – touching 70% at its peak – generating a conflict of its own between monetary and fiscal policies. Aggressive policy rate adjustments in terms of both pace and magnitude saw sharply higher interest rates on government securities – a high of 33% at one point – that raised the cost of debt servicing and further adding to fiscal pressures.

From mid-2023, unwinding the tight monetary policy cycle has been the main instrument to mitigate the demand contraction after a large part of the population saw their purchasing power erode from the combined impacts of consumer price inflation and substantial tax increases. Policy interest rates were lowered by 725 basis points from June 2023 to July 2024 (Figure 2.4a). Market interest rates followed, albeit with a lag and additional regulatory requirements imposed early on by the CBSL on commercial bank lending rates. The notable upward and downward rate adjustments through the crisis also engineered illiquidity in the financial market, requiring an injection of liquidity by the CBSL to nudge interest rates down.

Figure 2.4a
Policy Rates and Liquidity

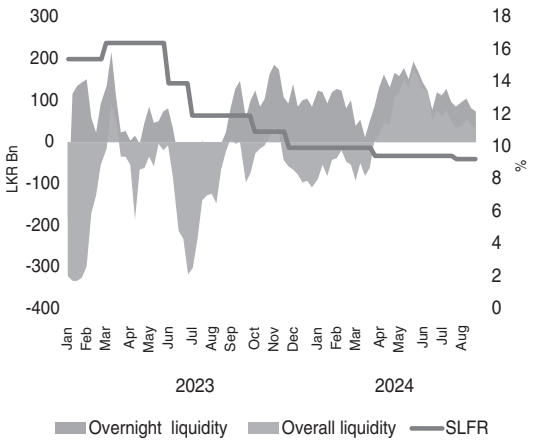
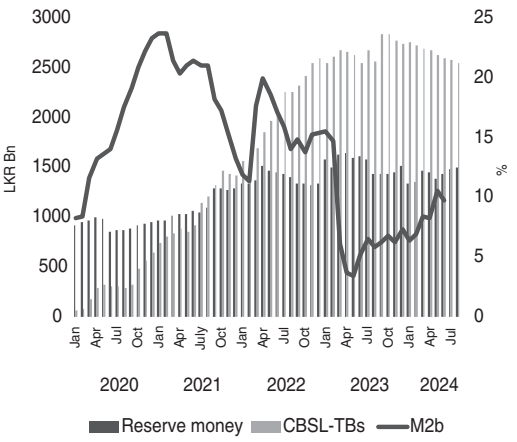


Figure 2.4b
Monetary Base



Note: CBSL-Tbs, M2b, and SLFR denote Treasury bills holdings by the CBSL, broad money and Standard Lending Facility Rate, respectively.

Source: Based on data from the CBSL.

The monetary financing of government expenditures by the CBSL is unwinding slowly (Figure 2.4b). Despite the credit extended over time via CBSL purchase of government securities, Sri Lanka's monetary base has not expanded concurrently as net foreign assets were in negative territory up to April 2024. As foreign assets are built up, it can inject new money into the economy via reserve money growth. Unlike in the past, Sri Lanka's subdued demand conditions in the economy may mean the likelihood of any immediate inflationary consequences is low. Whilst broad money growth picked up as demand for credit recovered following the monetary policy relaxation, it remains within manageable levels as of mid-2024 at 9.8%.

Figure 2.5a
Credit Growth

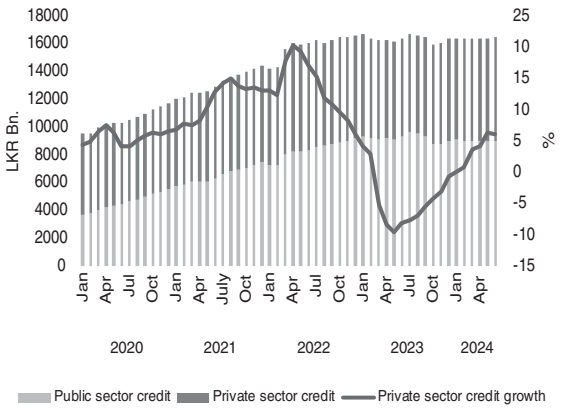
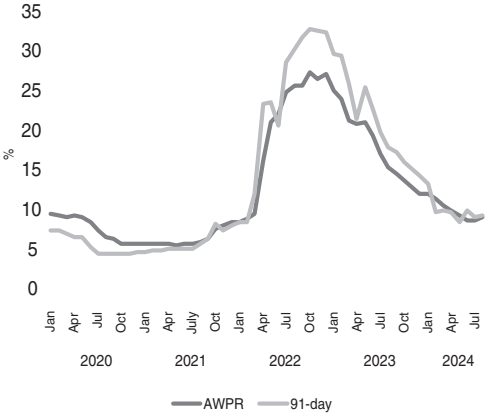


Figure 2.5b
Market Interest Rates



Note: AWPR and 91-day denote Average Weighted Prime Lending Rate and 91-days Treasury bill rate, respectively.
Source: Based on data from the CBSL.

Credit growth to the private sector has been slow to recover (Figure 2.4a). The contraction in credit growth to the private sector hit a low of 9.5% in May 2023 before a slow reversal to positive growth in the first quarter (1Q) of 2024. The fiscal weaknesses also imposed its own cost in terms of high demand for credit from the government and the consequent high yields on government securities (Figure 2.5b). In effect, it meant that investments in government securities offered extraordinary returns to investors, further dampening productive private investments to support output growth. By mid-2024, private sector credit growth slowed as expected, as investors adopt a cautious approach as elections loomed closer.

Additionally, the lagged impacts of monetary policy and slow recovery in investor sentiments are projected when corporates are weighed down by debt, overall, in the midst of a sharp devaluation of the currency and weak economic conditions. The asset quality across the banking sector has deteriorated with the ratio of stage three loans to total loans weakening from 5.2% in 2020 to 12.8% by 2023.[3] Monetary policy thus has limits in stimulating a robust recovery, and while the GDP outlook remains relatively favourable, growth tends to be rather fragile and anaemic.

Nonetheless, the policy measures have been successfully in achieving the primary objective of cooling inflation in the Sri Lankan economy. Having hit a peak of 70% year-on-year (YoY) in September 2022, inflation bottomed out sharply at 1.5% in October 2023. At the height of the inflationary spiral, food inflation (31% share) and transport (14%) together accounted for 45% of the 70% inflation rate,[4] underlining the mostly supply-side causes. In this context, the significant hike in interest rates applied by the CBSL was primarily to rein in inflationary expectations rather than employing monetary policy

3 Central Bank of Sri Lanka. (2023). *Annual Economic Review 2023*. Colombo: Central Bank of Sri Lanka.

4 This was driven by both domestic and global developments. On the domestic front, food supply shortages were owing to a temporary ban on chemical fertiliser usage, import restrictions and currency pressures combined with international commodity price increases.

to correct demand-driven overheating of the economy. The sharp disinflation too was driven by more stable or declining food and fuel prices in subsequent months, reinforced by dampened demand conditions in the economy. By August 2024, YoY inflation was still at a low of 0.5% with food and transport continuing to be key drivers in the first half of the year (Figure 2.6).

Figure 2.6a
Consumer Price Inflation

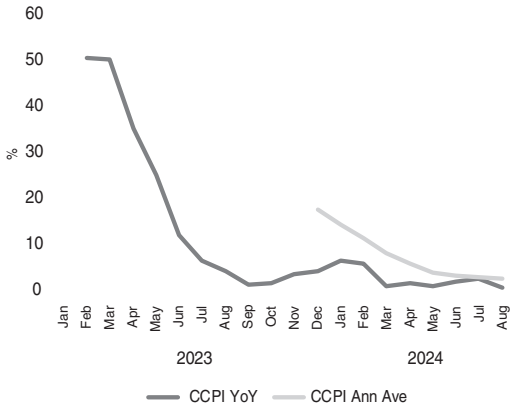
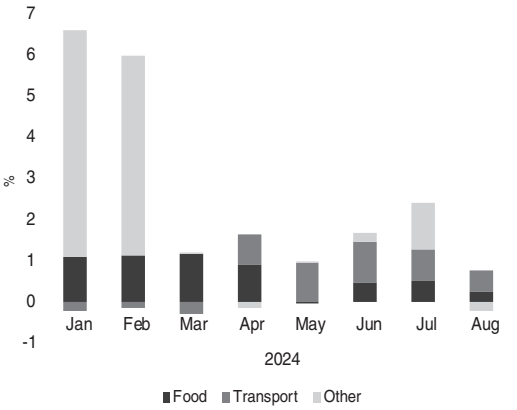


Figure 2.6b
Key Drivers of Inflation



Source: Based on data from the Department of Census and Statistics (DCS).

Approaches to monetary policy have evolved over decades of attempts by central banks globally to search for the most appropriate nominal anchor. These have included directed credit when interest rates were considered too blunt to allocate financial resources effectively, exchange rate targeting, the adoption of monetary aggregate targets, etc. Monetary targeting proved problematic due to the instability of the demand for money and central banks increasingly switched to inflation targeting – or a variation of 'flexible' inflation targeting to accommodate output/employment considerations. For Sri Lanka too, the passage of a new Central Bank Act in July 2023, which offers instrumental independence in pursuing a flexible inflation targeting (FIT) regime, is likely to assist anchor medium term inflation expectations more firmly. A medium-term inflation target of 5%, allowing for a 2% deviation either way, is considered feasible on the assumption that macroeconomic fundamentals related to the primary deficit and public debt are maintained at the current trajectory. A FIT regime also provides greater clarity on the interface between monetary policy and exchange rate management, unlike in the past where unsustainable efforts to target both interest rates and exchange rates have seen Sri Lanka suffer from periodic bouts of high price instability.

The perils of such reckless policy experimentation were never more evident than in the events that led up to Sri Lanka's debt default. Following the arbitrary decision to maintain a pegged exchange rate for nearly a year while official reserves haemorrhaged and then implementing a free float overnight when reserves were at its lowest, saw the subsequent currency volatility bottom out by end 2022. Since then, the LKR has regained some of its lost value, reflecting a correction to the overshooting associated with the sudden and sharp devaluation at the height of the economic crisis (Figure 2.7a).

Figure 2.7a
Exchange Rate and Reserves

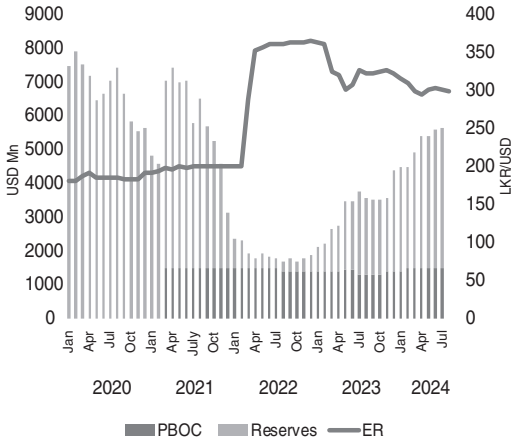
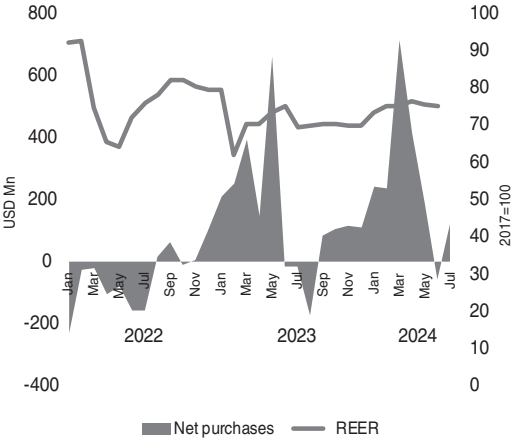


Figure 2.7b
Net USD Purchases and REER



Note: ER=Exchange Rate, REER=Real Effective Exchange Rate, PBOC= People's Bank of China, USD=United States Dollars.
Source: Based on data from the CBSL.

Additionally, the stronger LKR is also the result of a gradual build-up of reserves, notwithstanding a swap facility of approximately United States Dollars (USD) 1.5 Bn arranged with the People's Bank of China (PBOC) in the first quarter (1Q) of 2021. This was initially excluded from reported official reserves given certain conditions for its usability, but as reserves continued to plummet, the swap facility was included in the count by year end. From the fourth quarter (4Q) of 2022, the CBSL began to aggressively record net purchases of USDs (Figure 2.7b). Numerous factors have helped, including the standstill on foreign debt repayments, restrictions on imports and capital flows, mandatory conversion of foreign currency export earnings, and a rebound in tourism, remittances and export earnings in the economy. In 2023, net purchases amounted to USD 1.9 Bn with the same amount purchased in the first seven months of 2024. Correspondingly, Sri Lanka's official reserves as of July 2024 stood at USD 5.6 Bn with PBOC conditional funds making up USD 1.5 Bn of the total.

As the pace of reserve accumulation accelerated, the LKR appreciated by just over 11% in 2023. In 2024, the appreciation has been a more modest 7% up to August. In turn, the nominal appreciation has also translated into a real appreciation of the currency, supported by Sri Lanka's sharp disinflation episode (Figure 2.7b). Real exchange rates – adjusted for differences in the rates of inflation of trading and/or competitor countries – measure international competitiveness and are therefore more important than nominal rates in terms of their economic impact. The CBSL compiles a real effective (trade-weighted) exchange rate (REER) for the LKR against a basket of external currencies. The soundness or otherwise of REER indices is subject to debate. Decisions on which price or cost deflator to use (consumer prices, GDP deflator, export prices, unit wage costs in manufacturing, unit labour costs across all sectors, etc.) has a bearing. The choice of a base that captures changes in overall prices relative to that base year also matters. In practice, a REER based on consumer prices tends to be the most common given the availability of regular and up-to-date data. But here too, the inclusion of non-traded goods and services and indirect taxes distort the REER as a measure of international competitiveness.

The CBSL's trade weighted 24-currency basket of trading and competitor partners indicates an appreciation of the REER from its low point in May 2022 when the LKR devalued sharply and domestic inflation began to surge. Given that labour costs would account for a large share of Sri Lanka's manufactured exports, the competitive advantage would have been quite substantial as real wage growth lagged. Even accounting for a real appreciation since, the REER index suggests the LKR is still relatively more competitive than it was pre-crisis.

2.4 Macroeconomic Stabilisation and Growth Drivers

The improvements to macroeconomic fundamentals are expected to translate into output growth. The proximate drivers – from labour inputs, private capital formation, and allocative efficiency – will determine the direction of the near term recovery and prospects for medium-term resilience and sustainability.

As expected, with the onset of a more stable macroeconomic environment, the Sri Lankan economy returned to positive output growth in the third quarter (3Q) of 2023 – a welcome reversal from six consecutive quarters of negative growth (Figure 2.8a). From a production and sector-wise perspective, the contraction was sharpest in the industry sector owing to greater supply disruptions, for instance from fuel shortages, restricted travel, etc. Given the low base effect, the recovery is also more notable in industry sector activities.

Figure 2.8a
Quarterly GDP

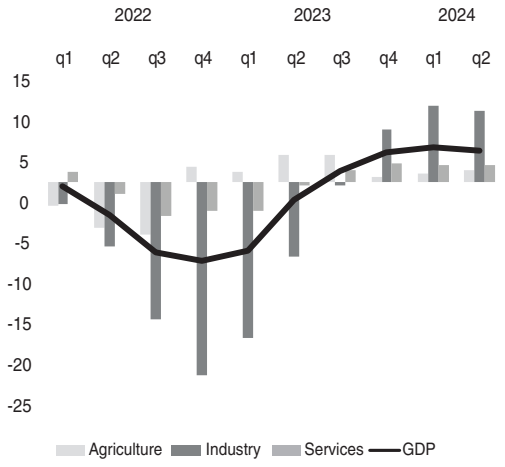
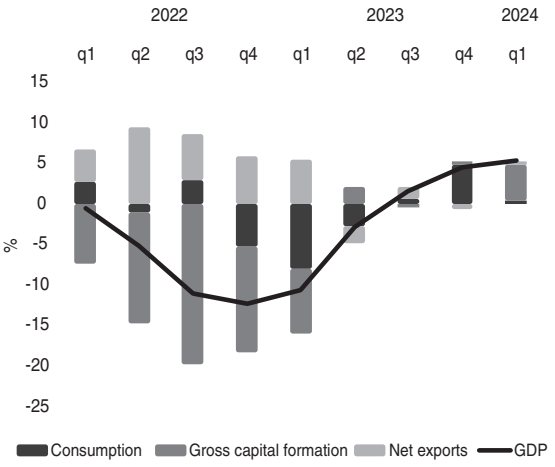


Figure 2.8b
Growth Drivers



Source: Based on data from the DCS.

From the expenditure side, in the recovery cycle, the bigger driver of output growth initially was an immediate resumption of consumption spending as expected (Figure 2.8b). At the aggregate level, private consumption which fell to a low of 61.2% of GDP in 2021 recovered to a near 70% of GDP by end 2023 (see Table 2.3). The recovery in consumption follows notable downside pressures from rising food prices in 2021, with household spending share on food going up (Figure 2.9a). Subsequently though, increasing transport costs as market-based pricing kicked in, has seen continued spending pressures on households. General inflationary pressures are also to be found in a higher share of household spending on basics such as clothing and footwear.

By contrast, the share of household spending on education has shrunk although the share of spending on health has remained more constant given its critical and often non-adjustable nature. Given that the last available Household Income and Expenditure Survey (HIES) is from 2019, it is unclear how the recovery is distributed across income deciles, post-crisis. More than likely, spending by lower-income households would have been disproportionately impacted owing to a bigger share of their income being spent on food and energy. These saw the highest price rises.

Figure 2.9a
Household Consumption

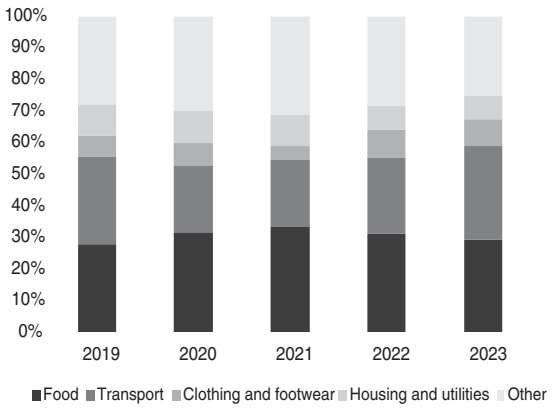
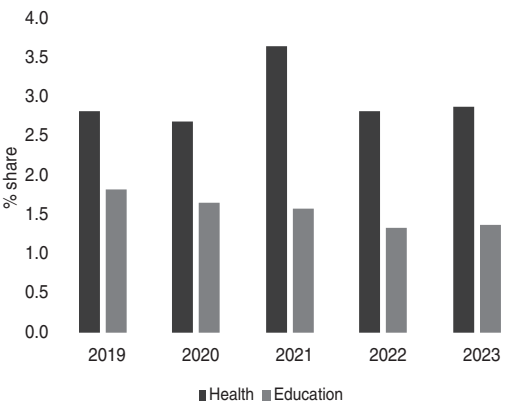


Figure 2.9b
Household Education and Health Spending



Note: HH denotes households.
Source: Based on data from the DCS.

A corollary to higher consumption as disposable incomes shrink is an overall reduction in domestic savings as households draw down accumulated savings (Table 2.3). Indeed, it is not surprising to find higher firm and household indebtedness resulting from these conditions – a survey by the DCS finds that 22% of households fell into debt due to the economic crisis.[5] In turn, a drop in savings is mirrored by an overall reduction in private investment.

5 Department of Census and Statistics. (2023). *Household Survey on Impact of Economic Crisis – 2023*. Battaramulla: Department of Census and Statistics.

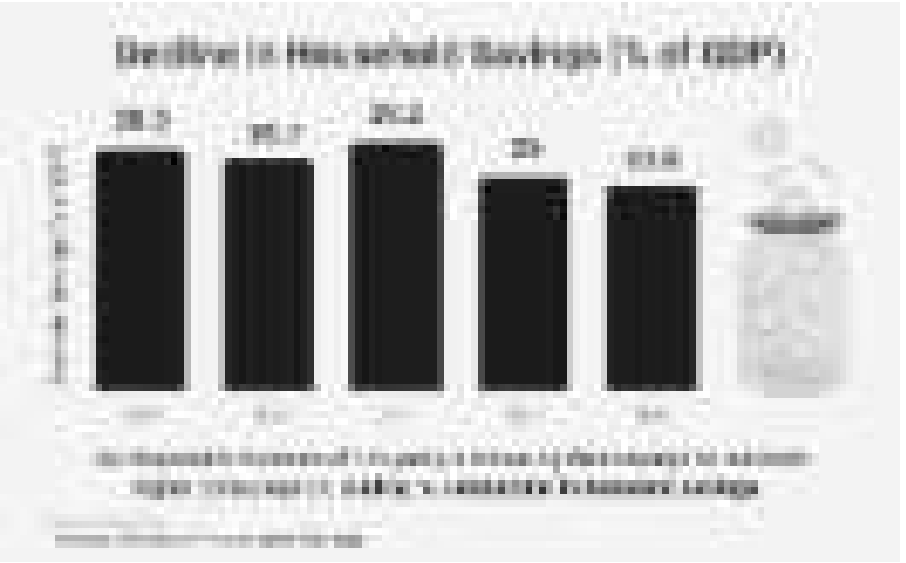


Table 2.3
Consumption, Investment and Savings (% of GDP)

	2019	2020	2021	2022	2023
Total consumption	71.7	73.3	70.7	75.0	76.2
Private consumption	62.7	62.9	61.2	67.8	69.3
Total investment	34.1	32.9	36.7	28.6	25.3
Private investment[a]	30.1	27.7	32.3	24.4	21.9
National savings	32.0	31.3	33.0	27.2	27.2
Domestic savings	28.3	26.7	29.3	25.0	23.8

Note: a. Estimated as a deduction of public investment from gross domestic capital formation.
Source: Based on data from the Ministry of Finance and the CBSL.

Under par private investment hampers efforts to boost productivity and poses a downside risk to long-term potential output. Here, prospects for employment and wage growth matter. On the face of it, employment seems robust with the unemployment rate declining post-pandemic and settling at pre-pandemic levels (Table 2.4). However, Sri Lanka's post-economic crisis has been characterised by a prominent labour market feature – a downward drift in the labour force participation rate, suggesting that many may be deterred from seeking employment and/or have continued to stay in education. Whether these newly inactive workers will soon return to the labour force as their savings are run down remains to be seen.

Table 2.4
Selected Labour Market Indicators

	2019	2020	2021	2022	2023
Unemployment rate (%)	4.8	5.5	5.1	4.7	4.7
Labour force participation rate (%)	52.3	50.6	49.9	49.8	48.6
SLBFE foreign job placement (Nos.)	203,087	53,711	122,264	311,056	297,656
Passport issuances (Nos.)	571,373	209,411	382,560	911,689	908,722
Nominal informal private sector wage index (2018=100)	106.0	112.7	123.1	153.3	170.8
Real informal private sector wage index (2022=100)[a]	171.7	174.7	180.2	153.3	145.6
Nominal senior level public sector wage index (2016=100)	117.4	131.4	131.4	141.5	141.5
Real senior level public sector wage index (2016=100)	103.1	108.7	101.7	74.9	61.8

Note: a: Deflated by the CCPI.
Source: Based on data from DCS and the CBSL.

In addition to the rise in labour market inactivity, Sri Lankan workers have also sought job opportunities abroad with the numbers leaving on registering with the Sri Lanka Bureau of Foreign Employment (SLBFE) spiking in 2022. Registered departures are clearly underestimates given that many professionals seeking employment overseas will find job placements independently of the SLBFE. In addition to the impetus provided by the economic crisis, the pandemic era restrictions on free movement across borders no doubt are partly to explain the surge in migration and issuance of passports during 2022-23.

As jobs and household incomes take time to normalise, the stimulus of domestic consumption-driven growth will remain modest.

Outmigration has been incentivised by the cost-of-living crisis and run down of savings. Most Sri Lankans have also seen their real wages shrink in recent years. Whilst a robust measure of private sector wages is not readily available, the Informal Private Sector Wage Rate Index suggests that real wages have contracted by 20% during 2021-2023. By comparison, the public sector real wage decline is even sharper at nearly 40% for those at the most senior level. Thus, wage adjustments have lagged well behind Sri Lanka's high inflationary episode where the public sector has clearly fared worse with a freeze on salary revisions. Employee and trade union demands for higher wages have firmed up, and the extent to which expectations of inflation become embedded in wage growth will need to be carefully watched.

As jobs and household incomes take time to normalise, the stimulus of domestic consumption-driven growth will remain modest. Improvements on the macroeconomic fundamentals will not fully translate into gains in private investment, although a pick-up is seen in the first quarter (1Q) of 2024.

This is largely owing to the uncertainties prevailing over Sri Lanka's 2024 presidential elections, and thereafter, the follow up parliamentary elections. Fiscal constraints also mean that public investment too remains relatively low – falling from a recent high of 5.2% of GDP in 2020 to 3.4% of GDP in 2023.

Lacklustre domestic economic conditions can often compel more aggressive pursuit by private firms to expand demand for Sri Lanka's goods and services abroad. Such a shift is being encouraged by government efforts to improve overall allocative efficiency in the economy. Regulatory reforms pertaining to the performance of SOEs, reforms to Sri Lanka's labour and land laws to improve the functioning of such markets, policies to improve the investment environment through streamlined investment approval processes, preferential access to regional markets, etc., are amongst a raft of reforms slowly making its way through legislative processes. These are contested areas of reform where implementation, even if laws are enacted, will largely depend on political leanings towards the establishment of a more deregulated economy. Even otherwise, the impacts of such reforms on productivity take time to materialise. In the interim, over the next 18 months or so, established firms will have to depend on a more favourable external economic environment to complement domestic efforts to drive growth by catering to foreign consumers. As seen in Figure 2.8b, the contribution of net exports to Sri Lanka's growth recovery has sputtered after a promising post-pandemic recovery in 2022.

Thus, much will depend on emerging global economic conditions. Here too, many risks and challenges prevail; geopolitical tensions, trade wars, and complex intractable problems such as climate change spell greater uncertainty and volatility in global economic conditions. These hold both opportunities and potential downside risks for Sri Lanka.

2.5 Global Economic Conditions and Impacts

On the growth front, the outlook for the global economy remains reasonably positive as disinflation in much of the world steadied output expansion (Table 2.5). In 2024, overall output growth of 3.3% is predicted to continue into 2025. Whilst emerging economies still remain the stronger growth centres, advanced economies are projected to see a slight improvement in 2024-25, while the former are expected to experience a marginal deceleration in output expansion.

Table 2.5
Global Growth Forecasts (%)

	2023	2024	2025
Global economy	3.3	3.2	3.3
Advanced economies	1.7	1.7	1.8
US	2.5	2.6	1.9
Euro zone	0.5	0.9	1.5
Emerging markets	4.4	4.3	4.3
China	5.2	5.0	4.5
India	8.2	7.0	6.5

Source: IMF, World Economic Outlook, July 2024.

The easing of tight monetary policy in many advanced economies including in the Euro zone, preempted similar action by the United States (US) Federal Reserve. Despite having higher interest rates than other large advanced economies – and a strengthening USD – US economic growth remains strong, expanding at three times the pace of the Euro zone. Elsewhere, after years of strong growth, China's economy is being hampered by the threat of a property crunch that is largely responsible for a slowdown in growth forecast. In contrast, strong consumer demand is expected to keep output expansion fairly robust in India, albeit at a slightly slower pace.

World trade contracted in both volume (1.2%) and value (5%) in 2023 but is expected to turnaround in 2024 on the back of lower energy prices and consumer inflation. In volume terms, growth of 2.6% in 2024 and 3.3% in 2025 is forecast.[6] Notwithstanding the forecasts, for much of the world, the threat of political dysfunction and uncertainty looms large in 2024 as a large cohort of countries face crucial elections. Moreover, geopolitical conflicts and escalating trade wars are generating disruptive volatility and adding another layer of uncertainty to the global economic outlook.

Figure 2.10a
Commodity Prices

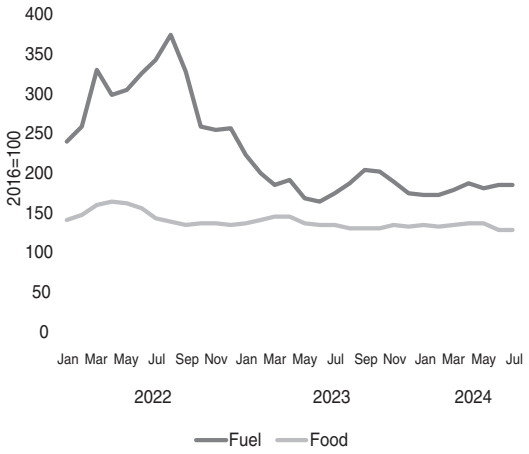
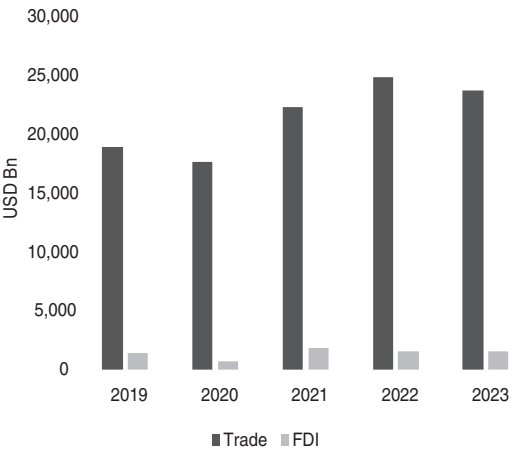


Figure 2.10b
Trade and FDI



Source: Based on data from the IMF, WTO and the Organisation for Economic Cooperation and Development (OECD).

The outbreak of the Russia-Ukraine conflict saw global commodity prices climb and then subsequently begin a steep decline and then level off (Figure 2.10a).[7] Commodity prices are expected to decline rather than climb, despite the turmoil in the Middle East and assuming no major outbreaks of further conflicts. Nonetheless, commodity prices will remain around 38% above price levels that prevailed in the five years before the pandemic.[8] Of equal concern is disruption to trade and investment flows on the back of US efforts to limit China's access to advanced technologies and efforts by the

6 World Trade Organization. (2024). *Global Trade Outlook and Statistics 2024*. Geneva: World Trade Organization.

7 International Monetary Fund. (n.d.). *IMF Primary Commodity Price Indices*, https://www.imf.org/en/Research/commodity-prices

8 World Bank. (2024). *Global Commodity Prices Report 2024*. Washington, D.C.: World Bank.

Western countries in general to reduce their dependence on Chinese supply networks and tit-for-tat retaliatory measures. These include, for instance, the imposition of duties by the European Union (EU) on Chinese electric vehicles and retaliation by China on EU exports of meat products into the country. The US is increasingly using sanctions for what it deems to be transgressions in providing military support to Russia whilst continually blocking efforts to fill vacancies on the dispute resolution mechanism adopted by the World Trade Organization (WTO). In the absence of a functioning dispute settlement process, transgressions and other tit-for-tat tariff disputes escalate and remain unresolved.

Efforts by the Western countries to reduce their dependence on Chinese supply networks or limit China's access to advanced technologies – often couched as measures that are narrowly targeted to protect national security – have seen a raft of domestic subsidies rolled out in support of 'industrial policy'. Indeed, the clean energy transition and competition for green resources, including critical minerals such as lithium, copper and nickel, is not only reshaping trade but also investment flows. A study published by the IMF in 2023 finds evidence of FDI being directed along geopolitical lines. Not only is FDI found to have fallen as a share of global GDP – from an average of 3.3% in the 2000s to just 1.3% during 2018-2022 – but the study also finds that the US and its closest allies emerge as the relative winners, with geopolitical proximity found to be more important than geographic proximity.[9] Indeed, in 2023, global FDI flows remained below pre-pandemic levels for the second year in a row.[10] China received a record-low level of FDI inflows while the US continued to be the highest recipient.

The geopolitics reshaping global trade and investment can sometimes provide opportunities for countries outside close alignments. In the case of Sri Lanka, for instance, a study by the Institute of Policy Studies of Sri Lanka (IPS) finds potential export opportunities for the graphite sector in electric vehicle (EV) batteries as trade wars heat up between the US and China.[11] But, overall, low and middle-income countries can be vulnerable to these broader developments too. Sri Lanka is a particular case of a country that is heavily reliant on the goodwill of its bilateral creditors as it navigates through a debt standstill and restructuring negotiations. It is also reliant on FDI from the very same countries whose support is sought for recovery efforts. In such conditions, countries are more vulnerable to being compelled to choose sides and need strong strategic and diplomatic skills to navigate the inevitable dilemmas.

2.5.1 Sri Lanka's External Sector Performance

In 2023, Sri Lanka posted a surplus on its external current account, equivalent to 1.8% of GDP despite a trade deficit of 5.8% of GDP (Table 2.6). The shrinking trade deficit is not because of strong export earnings but due to a series of import restrictions intended to save USD outflows.[12]

9 Ahn, JaeBin., Carton, Benjamin., Habib, Ashique., Malacrino, Davide., Muir, Dirk ., & Presbitero, Andrea. (2023, April). Geoeconomic Fragmentation and Foreign Direct Investment. In *IMF World Economic Outlook*.

10 Organisation for Economic Cooperation and Development. (2024, April). *FDI in Figures.* Paris: Organisation for Economic Cooperation and Development.

11 Wijesinghe, Asanka., Weerasinghe, Malisha., & Dissanayake, Chaya. (2024). *Trade Wars in Electric Vehicle Supply Chains: A Win for Sri Lanka's Graphite Industry*?, International Research Series No. 17. Colombo: Institute of Policy Studies of Sri Lanka.

12 Wijesinghe, Asanka., Rathnayake, Nilupulee., & Yogarajah, Chathurrdhika. (2023). *Import Controls in Sri Lanka: Political Preference and Incentive Distortions*. International Economics Series, No. 15, Colombo: Institute of Policy Studies of Sri Lanka.

Whilst these have been gradually eased over time, restrictions on vehicle imports – that account for a sizeable component of import spending – is yet to be fully relaxed. Mirroring these underlying factors, it is evident that neither Sri Lanka's export share of GDP nor its share of global merchandise exports have improved. Rather, the latter has declined from 0.06% in 2019 to 0.05% in 2023.

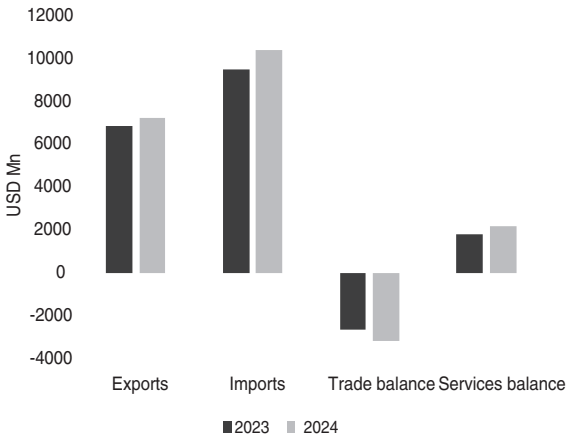
Table 2.6
External Sector Developments

	2019	2020	2021	2022	2023
Current account balance (% of GDP)	-2.1	-1.4	-3.7	-1.9	1.8
Trade balance (% of GDP)	-9.0	-7.1	-9.2	-7.0	-5.8
Exports (USD Mn)	11,940	10,047	12,498	13,106	11,911
Imports (USD Mn)	19,937	16,055	20,637	18,291	16,811
Export share of GDP (%)	13.4	11.9	14.1	17.7	14.1
Export share in world (%)	0.06	0.06	0.06	0.05	0.05
FDI (USD Mn)	744	434	592	884	712
FDI (% of GDP)	0.8	0.5	0.7	1.2	0.8
Remittances (USD Mn)	6,717	7,104	5,491	3,789	5,970
Remittances (% of GDP)	7.5	8.4	6.2	5.1	7.1

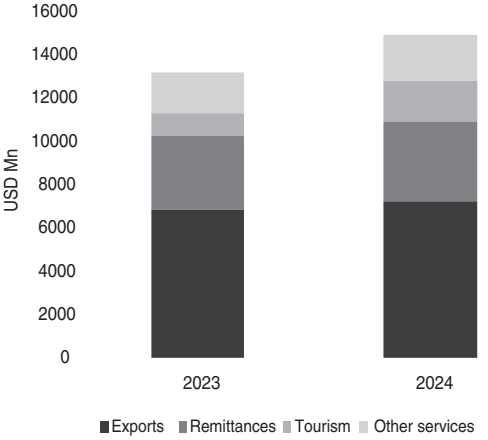
Source: Based on data from the CBSL and IMF, International Trade Statistics.

Sri Lanka has also not been particularly successful in increasing FDI inflows, although to retain FDI inflows amounting to 0.8% of GDP as of 2023 might still be considered creditable in view of the country's reputational risks following the debt standstill of 2022. More positively, remittance inflows, which dipped sharply in response to the LKR crisis have recovered – inflows in the first seven months of 2024 amounting to USD 3.7 Bn match pre-pandemic (2019) levels. The other sizeable source of foreign exchange earnings often referenced is tourism. Indeed, tourism receipts are estimated to have increased to USD 2 Bn in 2023 from USD 1.1 Bn as tourist arrivals doubled to 1.5 Bn from a year ago. Up to July 2024, arrivals have already exceeded this (1.2 Bn) but earnings are at a lower estimate of USD 1.9 Bn. Estimates of foreign currency earnings from tourism are subject to some dispute. These are survey-based, corresponding to tourist arrivals, and at best, are an approximate rule-of-thumb estimate. But, given the broader economy-wide impacts of tourist visitors on employment and livelihoods, tourism remains a key sector to watch as Sri Lanka's economic recovery takes effect.

Figure 2.11a
External Balances



Figures 2.11b
External Earnings



Source: Based on data from the CBSL.

In the first seven months of 2024, foreign exchange earnings from exports, tourism and remittances are doing better compared to the same period in 2023 (Figures 2.11a and 2.11b). The trade balance, however, is widening as the remaining import restrictions are eased, but a surplus in the external current account is anticipated still for a second year in a row, albeit a much reduced one. The foreign currency inflows, in a context where foreign debt repayments are temporarily suspended, will allow the CBSL to build up its reserves in preparation for a gradual loosening of remaining crisis-induced regulatory measures on foreign currency conversions, capital flows and imports.

By order of their importance, earnings from goods exports are crucial, and exports of garments which made up 48% of industrial exports and 37% of total exports in 2023, hold the key to higher earnings. Garment exports of USD 2.6 Bn up to July 2024 show a rebound to catch up with 2023 levels, but it still remains well below the 2022 high (USD 3.2 Bn) achieved in the same period. Consumer sentiment in major markets – the three most critical for Sri Lanka being the US, EU and the United Kingdom (UK) – and domestic competitiveness matter. Whilst the former is beyond Sri Lanka's control, higher utility and wage costs and an appreciating currency have eroded some of the early competitive advantage afforded by the sharp LKR devaluation in 2022. Accessing new markets – not only for garments, but exports more generally – has been a key policy thrust of the government through engagement with various trade agreements. Despite such initiatives, however, questions remain around identification of partner countries with whom trade agreements are being pursued, the depth and breadth of intended liberalisation and net welfare gains and losses that might accrue to the Sri Lankan economy over the medium to long term. Indeed, market access is only one element of the problem. Domestic competitiveness – through efficiency and productivity gains – matters more in translating market access to durable export performance.

Some of those efficiency gains can come with FDI, bringing technology and innovation through joint venture partnerships. But, FDI has been one of the key casualties of Sri Lanka's economic meltdown

as noted previously. Much of the FDI that did come in has gone into less productive sectors like hotels and mixed-development projects in the past. In 2023 too, the hotels sector received the single largest inflow, followed more welcomingly by the telecommunications sector.[13] Realistically, attracting the desired efficiency-seeking FDI will take more time and effort. In the interim, Sri Lanka will likely see more strategic-seeking FDI into sectors such as energy and ports. Not surprisingly then, the top FDI investing countries in 2023 were Japan (USD 230 Mn) followed by India (USD 193 Mn.). By stock of FDI, India and China remain the largest sources, each with a total holding of USD 2.2 Bn. Often times, strategic-seeking FDI comes in the form of government-to-government negotiations and partly explains why the same major country sources of FDI can also end up as the largest official bilateral creditors.

External sector conditions for Sri Lanka in the immediate, medium and long term will be heavily influenced by the terms of the external debt restructuring (EDR). In June 2024, a debt treatment agreement was reached with the country's bilateral creditors. These include the Official Creditor Committee (OCC) led by Japan, France and India (together accounting for about USD 6 Bn of Sri Lanka's outstanding debt of USD 37 Bn) and the Export Import Bank of China (EXIM) covering another USD 4 Bn. A five-year moratorium (up to 2028), extended maturities for full repayment (up to 2043) and reduced interest rates (at or below 2.1%) are intended to help Sri Lanka keep its debt repayments to below 4.5% of GDP when the EFF programme ends and debt servicing resumes in 2028.

With a restructuring of USD 12.5 Bn of international sovereign bonds (ISBs) still in progress, a provisional deal announced in July 2024 with the ad hoc bondholder group (representing 50% of outstanding ISBs) suggests issuing macro-linked bonds (MLBs) – i.e., linking repayments to GDP performance during Sri Lanka's IMF programme – is likely to be a part of the deal. A headline haircut (set at about 28%) and coupon rate reduction (11% reduction on past interest rate) apply if IMF estimated GDP growth benchmarks are reached. A higher than targeted growth achievement on the part of Sri Lanka is met by reduced haircuts and higher coupons and vice versa. Whilst it is to enable a fair sharing of upside and downside risks, a one time single test is attractive to bondholders as this is also more likely to see the bonds become index-eligible. For Sri Lanka, the primary risks lie in the event of an economic recession post-EFF, whereby total external debt repayments could rise once more (even assuming no fresh borrowings occur). MLBs thus remain complex instruments.

2.6 Economic Outlook

Sri Lanka's economic outlook on the growth front is clearly an indicator that will be watched for multiple reasons, including its debt sustainability should MLBs come into force. Aside from such considerations, the severity of the economic deprivations suffered by most of the country's citizens demands answers to how the economy will evolve. For the average Sri Lankan, while the absence of queues, blackouts and galloping prices is a relief, improved macroeconomic fundamentals mean very little in terms of perceptions of 'living standards' or 'cost-of-living' crisis. Households will likely feel

13 Central Bank of Sri Lanka. (2024). *Annual Economic Review 2023*. Colombo: Central Bank of Sri Lanka.

they are continuing to experience an economic recession as attested to by some pre-election related public polling.

There are no guarantees that Sri Lanka will return to its pre-crisis growth trend. Indeed, some studies warn of permanent losses to output and economic welfare arising from economic recessions of the sort that Sri Lanka witnessed. A notable real output gap has opened in Sri Lanka, and even if an output growth of 4% in 2024 is assumed, real GDP will still be well below 2018-2019 levels (Figure 2.12a). It will take Sri Lanka a considerable number of years to match the pre-crisis real output levels and the potential higher growth that would have materialised if not for the 2022 downturn.

Figure 2.12a
Real GDP Output

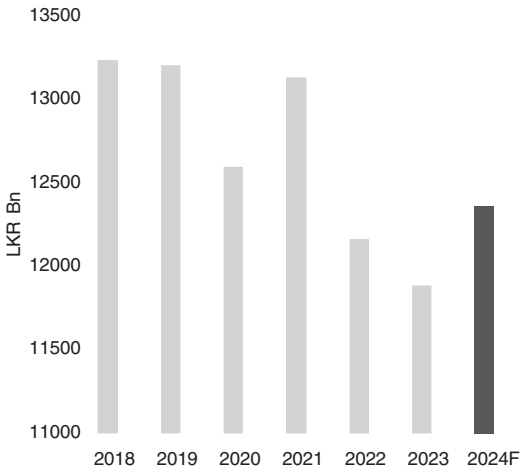
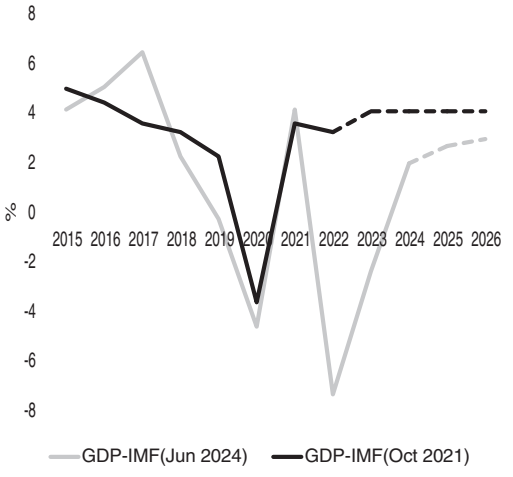


Figure 2.12b
GDP Forecasts and Output Gap



Source: Based on data from the DCS and IMF, World Economic Outlook (October 2021) and Country Report No. 24/161 (June 2024).

Whilst continuing with macroeconomic stability measures, the next phase of Sri Lanka's economic revival must focus on achieving strong and durable growth. Recoveries after a deep-rooted crisis can be weak and fragile and, therefore, remain highly susceptible to a reversal of fortunes.

In the case of Sri Lanka, long used to regular boom-busts stemming from a flood of foreign borrowing and subsequent credit growth, currency overvaluation and economic overheating, the malaise of low growth-low inflation is new. The recovery so far is partial and uneven. Monetary policy has been the main tool used to boost demand, but it has limits. A substantive erosion in the purchasing power of households – with the 'squeezed middle' (i.e., those on low to middle incomes) being the most exposed – is a drag on growth. Relatively high real interest rates as YoY inflation drifts to a low 0.5% by August 2024 (and annual inflation at just 2.5%), can disincentivise private investment. To add to all this, leading up to elections, the uncertainty has also suppressed investment volumes, with credit growth to the private sector levelling off. In such conditions, the fragile recovery can be reversed sharply if the macroeconomic policy setting becomes out of sync once again.

Unravelling the gains made on regaining macroeconomic stability must be avoided. In the first half of 2024, the fiscal policy reforms have continued to deliver. Tax revenues are up by 43% while recurrent spending is down by 5%. The primary balance is stronger and the overall fiscal imbalance has shrunk. Low interest rates will help keep a lid on the government's financing costs. During the debt repayment moratorium, steady improvements on the fiscal front will allow Sri Lanka greater flexibility to conduct necessary reforms to address shortcomings. In the near term, these are likely to include at least a partial accommodation of growing demands for higher wages and a reset of tax thresholds. If done sensibly without an excessive impact on IMF fiscal targets and timelines, Sri Lanka's current trajectory of slow but steady improvements to output growth can continue uninterrupted.

There are also no immediate threats to the low inflationary pressures in the economy. Some volatility can be expected given the pass through of international oil prices under the current quarterly price adjustments and the intractable problem of domestic food price instability. Better anchoring of inflation expectations can help keep a lid on a wage-price spiral. Indeed, with dampened household disposable incomes, lower savings and indebtedness in some instances, the threats of a wage-price spiral and demand-driven overheating lessens. Higher labour market inactivity also means that there is scope to attract workers into jobs in the near term without necessarily driving up wages across-the-board.

The low inflationary outlook will also help absorb any domestic price pressures emanating from currency movements. A gradual build-up of reserves through purchases from the forex market is underway to allow an orderly easing of remaining restrictions on imports and forex flows and help Sri Lanka deal with any unanticipated shocks. Whilst the reserves position still remains rather fragile – sufficient for only 2.8 months of imports (excluding the PBOC swap) and below the 3 month rule-of-thumb – an early resolution to the EDR negotiations will likely help. Indeed, the empirical evidence points to lower output costs for a debtor country, the quicker it is able to reach an agreement with creditors. Thus, the trade-off between demanding higher haircuts versus lowering those ambitions is clear. For Sri Lanka, a settlement ahead of elections was also preferred to lower downside risks. At the same time though, a deal that ties the country to certain economic targets and an election that sets the economic policy direction for the next five years was always going to be a complex pairing. On the assumption that the EDR negotiations proceed smoothly post-election, a resolution can strengthen business investments, some of which are currently held back by Sri Lanka's 'default' status.

There is thus a case for modest optimism that the turbulence of electoral cycles, including parliamentary elections, can be navigated to ensure a slow and steady acceleration in output growth in the medium-term. Efforts to strengthen governance and the functioning of key economic institutions which have broad cross-party and public support will hopefully help avert a recurrence of the ill-fated economic instability of the past few years. However, while arguably grounds exist for a more thorough overhaul of regulatory policies to strengthen productivity, efficiency and competitiveness, the very real distributional and social impacts of the economic crisis may mean that securing the necessary degree of consensus required to deal with these deeper problems gets harder.

What Sri Lanka must avoid is a poorly-handled economic disruption post-election to provide relief through unfunded spending measures that will unsettle creditors and investors alike. A return to short-termism in policy setting will cripple the recovery efforts, intensify political polarisation and leave the country highly exposed to a prolonged period of relative economic decline.

SOCIO-ECONOMIC DISPARITIES AND EQUITY

3. Progressivity and Pro-poorness of Taxes and Welfare Spending

3.1 Introduction

Sri Lanka shows signs of gradual economic recovery following the unprecedented economic crisis in early 2022. Since then, the Government of Sri Lanka (GOSL) implemented a range of measures to restore economic stability. Tax reforms were initiated from May 2022 onwards, encompassing amendments to the Personal Income Tax (PIT) structure, increasing the Corporate Income Tax (CIT) rates, and raising indirect taxes. Further, a cost recovery pricing mechanism was introduced for fuel and electricity. Through revenue-focused fiscal consolidation measures, the objective is to reinstate fiscal sustainability and enhance the country's fiscal discipline. This, in turn, is expected to reinstate macroeconomic stability and ensure debt sustainability.

These fiscal measures, encompassing tax revisions, impact individuals directly and indirectly in varying magnitudes. Thus, in parallel to these changes, a marked increase is evident in welfare payments granted in light of the economic hardships the most vulnerable face. Therefore, the government initiated the 'Aswesuma' welfare benefit programme as part of a social safety net to alleviate ongoing hardships. This covers and replaces the previously implemented flagship cash transfer programme, Samurdhi, with a more targeted benefit scheme. It also provides umbrella coverage for other existing government assistance programmes, such as assistance for the differently-abled, elderly, and kidney patients.[1] Apart from the above-mentioned welfare measures, the student welfare programmes continued to ensure accessible education and to reduce regional inequalities.

With limited fiscal resources available, the efficiency of spending is critical. In this context, evaluating the effectiveness and efficiency of fiscal policy is crucial in tackling development challenges and speeding up poverty alleviation. Against this backdrop, this chapter discusses the progressivity of taxes and government welfare spending. Accordingly, the chapter analyses the major tax and welfare benefits, the effects of which can be attributed to households through the use of microdata. Hence, by employing a framework developed by the Commitment to Equity (CEQ) Institute at Tulane University, this chapter examines the progressivity of Sri Lanka's fiscal instruments and their equalising ability.[2] The analysis aims to provide empirical evidence on the effectiveness of these fiscal interventions in achieving a more equitable distribution of wealth.

3.2 Tax Policy Reforms in Sri Lanka

In late 2019, the GOSL implemented a shallow tax system that purportedly resembled a trickle-down approach. These reforms encompassed reductions in tax rates for PIT, CIT and Value Added Tax (VAT), and streamlining tax bases for VAT and PIT. Thus, these reforms eroded a sizeable share of government revenue, further risking the country's fiscal fragility, a key trigger of the unprecedented

1 This refers to those affected by Chronic Kidney Disease of Unknown Etiology (CKDu), commonly known as kidney patients.

2 Arunatilake, Nisha., & Jayawardena, Priyanka. (2019). *CEQ Master Workbook: Sri Lanka (2009-2010).* CEQ Data Center on Fiscal Redistribution: CEQ Institute, Tulane University and the World Bank.

economic crisis in 2022. Such weaknesses in the fiscal landscape have significantly influenced Sri Lanka's persistent macroeconomic instability, prompting a call for fiscal reforms as a key priority in the GOSL's economic recovery agenda.

Consequently, the GOSL undertook several reform measures to restore economic stability. As a pivotal policy measure, a four-year International Monetary Fund (IMF) Extended Fund Facility (IMF-EFF) programme was approved for Sri Lanka in March 2023. The goals of the IMF-backed initiative encompass restoring macroeconomic stability and debt sustainability, ensuring stability in the financial sector, improving governance, protecting social safety net programmes, and fostering economic growth.[3] The government responded to fiscal imbalances by implementing bold and ambitious revenue policy measures from May 2022 onwards. These reforms primarily concentrated on tax policy measures, including amendments to the PIT structure by lowering the tax-free threshold and raising tax rates, increasing the CIT rate while eliminating sector-specific concessions and exemptions, reintroducing mandatory Withholding Taxes (WHT), and raising indirect taxes – VAT rates and excise tax on alcohol and tobacco products. Apart from the measures explained above, as a part of the state-owned enterprise (SOE) reforms, cost recovery fuel and electricity pricing mechanisms have been implemented under the IMF-EFF programme. This entails regular price adjustments for fuel on a monthly basis and electricity on a quarterly basis.

These reforms led to a surge in GOSL revenue in 2023. For instance, tax revenue has surged by 55.4% and the tax revenue to GDP ratio has increased from 7.3% in 2022 to 9.8% in 2023 (see Table 3.1). The primary reasons for the growth in tax revenue are the noteworthy increases in income tax collection brought about by the effective operation of WHT and Pay-as-you-earn (PAYE) Taxes, as well as the exceptional performance of goods and service taxes, such as VAT. The composition of tax revenue indicates that 33% of tax revenue comes from direct taxation based on income and profits, while the remaining portion is sourced from indirect taxes. Among direct taxes, 21% originates from non-CITs. The primary indirect tax, VAT, contributes approximately 26% to overall tax revenue. Furthermore, in 2023, excise taxes on cigarettes, liquor, and petroleum contributed around 4.4%, 6.3%, and 5.3%, respectively, to the tax revenue.

Tax reforms have played a pivotal role in the notable surge in tax revenue in 2023. Given the direct impact of certain taxes, such as PIT and goods and services taxes, on individuals, evaluating how the tax burden is distributed among various income brackets is imperative. Understanding the impact is crucial to creating fair and effective tax policies. Thus, this section delves into the progressivity of taxes, focusing on those areas where individual contributions are apparent: PIT and sales-related excise taxes. Through this analysis, the aim is to assess how the tax burden is shared across income groups, ultimately evaluating the fairness and equity of the tax system.

3 Ministry of Finance. (2024). *Fiscal Management Report 2024*. Colombo: Ministry of Finance.

Table 3.1
Tax Revenue from Income Taxes and Goods and Service Taxes

	2022	2023	Growth (2022-2023) (%)	As a % of Tax Revenue
Gross domestic product (GDP)	24,063,762	27,629,665	-	-
Tax revenue as a % of GDP	7.3	9.8	-	-
Tax revenue	1,751,132	2,720,563	55.4	
Taxes on income and profits	534,021	911,356	70.7	33.5
Corporate tax	464,443	559,710	20.5	20.6
Non-corporate tax	49,537	193,488	290.6	7.1
PAYE	25,546	144,955	467.4	5.3
PIT	23,991	48,533	102.3	1.8
WHT	19,839	157,911	696.0	5.8
Taxes on domestic goods and services	857,459	1,399,126	63.2	51.4
VAT	463,072	694,460	50.0	25.5
Excise tax	342,523	469,622	37.1	17.3
Liquor	165,188	170,260	3.1	6.3
Cigarettes/tobacco	104,160	118,481	13.7	4.4
Petroleum	53,074	143,642	170.6	5.3
Motor vehicles and other	20,101	37,239	85.3	1.4

Sources: Central Bank of Sri Lanka. (2023). *Annual Economic Review 2023.* Colombo: Central Bank of Sri Lanka; Ministry of Finance. (2023). *Annual Report 2023.* Colombo: Ministry of Finance.

3.2.1 Progressivity of Personal Income Taxes

Despite broadening the tax base, PAYE taxes exhibit high progressivity.

The government has undertaken significant revisions to PIT with the primary objective of boosting tax revenue. Consequently, the tax structure has been revised to broaden the tax base – the PIT-free limit was lowered from Sri Lankan Rupee (LKR) 3.0 million (Mn) to LKR 1.2 Mn per annum and the tax rates revised progressively ranging from 6% to 36% for every LKR 500,000 tax slab exceeding the tax relief.[4] The revisions to PIT policies have yielded significant results, particularly in the revenue generated from PAYE. The PAYE revenue surged by an impressive 467.4%, skyrocketing to LKR 145 billion (Bn) in 2023 compared to LKR 25.5 Bn in 2022 (Table 3.1). The massive hike in PAYE revenue underscores the effectiveness of the revised tax policies in achieving the GOSL's objective of enhancing tax revenue.

A simulation analysis by the Institute of Policy Studies of Sri Lanka (IPS) reveals a notable trend in Sri Lanka's direct taxation system. Despite broadening the tax base, PAYE taxes exhibit high progressivity.

4 Previous PIT tax rates were 6%-18% for every LKR 3 Mn tax slab exceeding the tax relief.

This analysis reveals that, following the implementation of the new tax regime, a striking 96% of PAYE tax revenue is contributed by the wealthiest 10% of the population (Figure 3.1). Furthermore, the wealthiest 20% of income earners shoulder an overwhelming 99% of PAYE taxes. This distribution underscores the significant contribution of higher-income individuals to the PIT pool, indicating a progressive taxation structure. Consequently, the distribution of taxes among the wealthiest groups among the affluent segments serves as a mechanism for income equalisation, as it ensures that those with higher incomes contribute proportionally more to the national revenue through PITs.

Further, the simulation analysis shows that approximately 20% of employees in the public and semi-government sectors and roughly 8% in the private sector are liable to pay PAYE taxes (Table 3.2).[5] Greater compliance is ensured due to the formal PAYE collection procedure enforced through employers in a streamlined revenue collection process. Conversely, tax avoidance loopholes exist for other individual-level PIT administrations. For instance, simulation findings reveal that around 300,000 individuals are liable to pay PITs,[6] with an estimated PIT revenue of LKR 131 Bn. However, the PIT revenue collected from this category amounts to around LKR 48 Bn, significantly lower than the study estimate, indicating high tax evasion (Table 3.1).



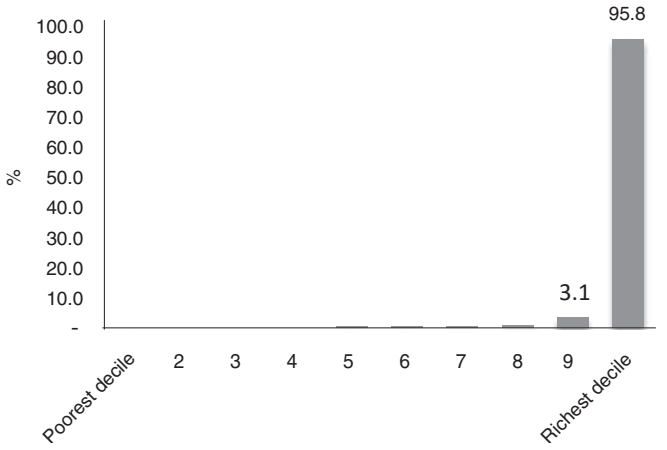
A reform initiative by the GOSL has commenced to address these challenges and bolster the PIT administration, effective January 2024. Accordingly, all individuals above 18 must register with the Inland Revenue Department (IRD) and obtain a taxpayer identification number (TIN). Further, revenue administration reforms have been initiated to improve compliance with the revenue targets agreed upon under the IMF-supported reform programme. For example, implementing a Revenue Administration Management Information System (RAMIS) will enhance revenue administration at

5 Public sector and private sector monthly wage earners, whose wages exceed the tax free threshold were considered as PAYE tax liable persons.

6 Employers and self-employed people whose annual income exceeds the tax free threshold were considered as PIT liable persons.

the IRD.[7] Furthermore, the online portal for individual registration and PIT filing will be simplified. These measures aim to ensure comprehensive income tax registration for all adults, enhancing tax compliance and revenue collection.

Figure 3.1
Distribution of PAYE Taxes Across Deciles



Source: Author's calculations, based on Labour Force Survey (LFS) 2022 data from the Department of Census and Statistics (DCS).

Table 3.2
Estimated Tax Liability by Sector of Employment[a]

Sector of Employment	Tax Liable Individuals	As a % of Total Individuals in Each Sector
Public/semi-government	228,709	18.6
Private	223,403	8.2
Employer	121,175	51.2
Self-employed	174,707	6.5

Note: a. Tax liability is considered as monthly wage/income that exceeds the tax-free threshold.

Source: Author's calculations, based on Labour Force Survey (LFS) 2022 data from the Department of Census and Statistics (DCS).

3.2.2 Distribution of Indirect Taxes

In line with IMF-EFF recommendations, the GOSL implemented major revisions to excise taxes on alcohol and tobacco products. For instance, in January 2023, a 20% increase in excise taxes for alcohol and tobacco was followed by a subsequent 20% upward revision in July 2023. The third consecutive increase within a year occurred in January 2024, with a 14% hike in excise taxes on

7 Ministry of Finance. (2024). *Fiscal Management Report 2024.* Colombo: Ministry of Finance.

A considerable share of alcohol and cigarette consumption originates from more affluent households.

these products. In general, these revisions aimed to bolster revenue while simultaneously addressing public health concerns associated with excessive consumption of these products.

Revenue data reveal that despite declining cigarette sales, the revenue generated from cigarette excise duty witnessed a marked increase. Specifically, this amounted to a 13.7% rise to LKR 118.5 Bn in 2023, compared to LKR 104.2 Bn in 2022 (Table 3.1). This surge in revenue is primarily attributed to excise tax adjustments implemented throughout 2023. Similarly, revenue earned from excise duty on liquor grew marginally by 3.1% during the same period. This marginal growth may reflect various factors, including changes in consumption patterns and market dynamics. One notable challenge in implementing excise taxes is the proliferation of fake stickers on liquor products in several areas of the country.[8] These illicit activities undermine the anticipated revenue gains and challenge the integrity of the taxation system. As such, robust enforcement measures are imperative to safeguard the collection of due revenue, particularly in the liquor sector.

The IPS fiscal analysis reveals alcohol and tobacco excise taxes emerge as a favourable policy option, considering the distribution of alcohol and tobacco taxes across different household income levels. A considerable share of alcohol and cigarette consumption originates from more affluent households (Figure 3.2). Due to their higher spending on alcohol and tobacco, the top 20% of the wealthier segment of the population shoulder much of the tax – with around 43% of alcohol taxes and 44% of tobacco taxes. Conversely, the bottom 40% segment contributes to around 19% of alcohol and 14% of tobacco taxes. Thus, excise taxes on tobacco and alcohol are progressive in the above-explained context.

Further, a recent IPS study on tobacco consumption reveals that economically disadvantaged groups are more responsive to price changes in tobacco and tend to reduce their consumption.[9] This suggests that raising the price of tobacco products would have a progressive effect, disproportionately benefiting lower-income groups by luring them to cut back on smoking. The study also underlines how price increases may discourage new smokers and how sensitive beedi and cigarette consumers are to price increases. Higher prevalence elasticity values for both products suggest that price adjustments can effectively prevent smoking initiation. Furthermore, cross-price elasticity analysis provides valuable insights into the nuanced relationship between cigarette and beedi consumption in Sri Lanka. Contrary to industry arguments, changes in cigarette prices do not yield a significant substitution effect on the use of beedis. The data suggest that consumers are not easily swayed by price changes to switch from one tobacco product to another. Specifically, a rise in cigarette prices does not lead to an evident shift towards beedi consumption. Therefore, well-implemented taxation policies targeting both cigarettes and beedis can serve as robust measures to reduce smoking prevalence and promote public health.

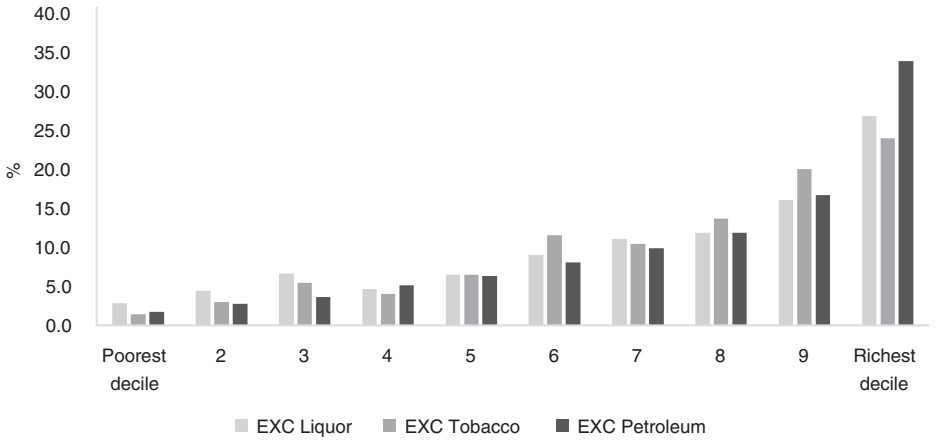
8 Ministry of Finance. (2024). *Fiscal Management Report 2024.* Colombo: Ministry of Finance.

9 Jayawardena, P., Pathiraja, E., & Dissanayaka, N. (2024). *Strategies to Curb Beedi and Smokeless Tobacco Consumption in Sri Lanka*. Colombo: Institute of Policy Studies of Sri Lanka.

Another IPS study investigating similar research areas examines the price sensitivity of arrack and beer to reveal the significant impact of pricing on consumer behaviour.[10] The price elasticities of these beverages underscore the effectiveness of pricing as a tool to influence consumption patterns. In particular, raising the price of arrack can act as a strong disincentive, preventing the initiation of new users and contributing to overall control over its prevalence. The robust elasticity of beer consumption further highlights the role of economic interventions in regulating and moderating beer consumption patterns.

These insights underscore the potential effectiveness of alcohol and tobacco taxation in lowering consumption and generating revenue. The above-explained studies emphasise pricing strategies to serve as powerful levers in controlling and reducing tobacco and alcohol use, promoting better public health outcomes. This type of intervention results in a drop in consumption, contributing to a decline in the adverse health consequences of alcohol and tobacco use. This, in turn, eases the strain on the healthcare system by lessening the burden of treating alcohol-related health issues. On the one hand, lowering the incidence of non-communicable diseases (NCDs) translates to lower healthcare costs in the long run. On the other hand, as discussed before, targeting a more financially healthy population segment and using excise taxes on these products can leverage the higher disposable income of wealthier households, potentially leading to a more substantial revenue stream while addressing public health concerns. Alcohol and tobacco taxes are a strategically sound policy choice because of this dual benefit.

Figure 3.2
Distribution of Excise Taxes Across Deciles



Source: Author's calculations based on Household Income and Expenditure Survey (HIES) 2019 data by the DCS.

10 Jayawardena, Priyanka. *Price Elasticity of Arrack and Beer Use in Sri Lanka* (Unpublished). Colombo: Institute of Policy Studies of Sri Lanka.

3.3 Government Spending: Distribution of Transfers Across Income Groups

Given the severe and prolonged impact of Sri Lanka's economic crisis on vulnerable households, measures were taken to reinforce social safety nets following the macroeconomic adjustment programme under the IMF-EFF. For instance, the expenditure on welfare programmes, encompassing public service pensions, social safety net payments, free medical supplies, fertiliser subsidies, student welfare and nutritional programmes, amounted to LKR 912.4 Bn in 2023.[11] This allocation represents 3.8% of GDP, highlighting a significant investment in social welfare initiatives. The expenditure on public service pensions stood at 8% of recurrent expenditure, indicating a significant portion allocated to this. Further, the allocation towards Aswesuma stood at LKR 172 Bn, constituting 3.7% of total recurrent expenditure (Table 3.3). These substantial welfare allocations underscore the importance placed on addressing socio-economic challenges and supporting vulnerable segments of the population.

Table 3.3
Expenditure on Welfare Programmes (LKR Mn)

	2022	2023
GDP	24,063,762	27,629,665
Total expenditure	4,472,556	5,356,591
Recurrent expenditure	3,519,634	4,699,679
Public service pension	309,067	372,364
Pharmaceuticals (free medicine)	75,718	143,740
Empowering the vulnerable and needy:		
Aswesuma	-	172,032
Samurdhi	36,823	-
Assistance to elderly	4,830	-
Allowance for disabled people	2,153	-
Financial support for kidney patients	1,154	-
Fertiliser subsidy	56,810	52,334
School children:		
School uniforms	2,355	2,539
Textbooks	1,650	22,967
Nutrition programme	3,308	12,500
Season tickets	6,400	8,270

Sources: Central Bank of Sri Lanka. (2023). *Annual Economic Review 2023.* Colombo: Central Bank of Sri Lanka.; Ministry of Finance. (2023). *Annual Report 2023.* Colombo: Ministry of Finance.

11 Ministry of Finance. (2023). *Annual Report 2023.* Colombo: Ministry of Finance.

These figures reflect concerted efforts by the government to prioritise social welfare and ensure the well-being of people. The specific allocations to welfare programmes like Aswesuma demonstrate targeted efforts to address the economic hardships faced by the most vulnerable and a commitment to inclusive growth and addressing societal disparities. Continued monitoring and evaluation of these expenditure patterns are essential to ensure resource optimisation – i.e. for the efficient utilisation of resources and the effective delivery of welfare benefits to those in need. Against this backdrop, this section will analyse the progressivity,[12] of the key public welfare spending.

3.3.1 Public Service Pensions

The Public Service Pension (PSP) is the primary pension programme available to permanent public sector workers who have completed a minimum service requirement of ten years. In 2023, there were 704,795 pensioners, with total pension payments amounting to LKR 372.3 Bn.[13] Further, pension payments experienced a 20.5% growth in 2023, mainly due to a net rise in pensioners. For instance, the number of pensioners has increased by 4.2% from 676,430 in 2022 to 704,795 in 2023.[14] This increase is mainly due to a policy decision to reduce the compulsory retirement age for public servants from 65 to 60. Accordingly, individuals aged above 60 in 2022 were mandated to retire as of 31 December 2022, leading to a substantial rise in total pension expenditure.

Figure 3.3a
Distribution of Total Pension Benefit

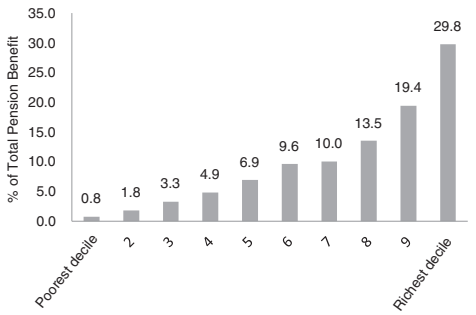
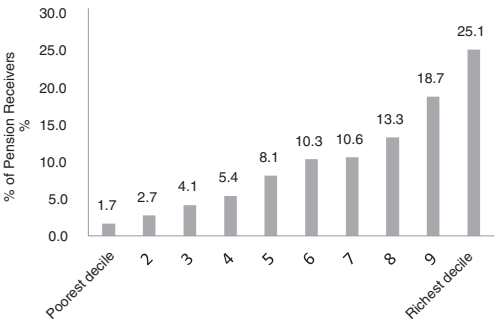


Figure 3.3b
Distribution of Pension Receivers



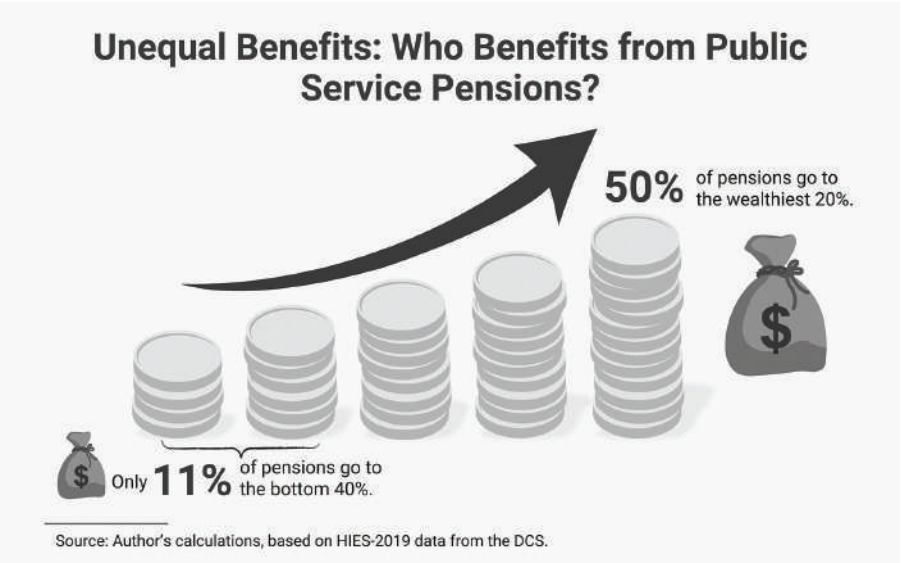
Source: Author's calculations, based on HIES-2019 data from the DCS.

The IPS' distributional analysis reveals that PSP favours the richest 20%. Around 50% of public service pension benefits are enjoyed by individuals belonging to the wealthiest 20% of the population (Figure 3.3a). This highlights a significant concentration of pension benefits within this socio-economic group. Here, only 11% of pension benefits are directed towards the bottom 40%. This is mainly because pension beneficiaries are from the better-off segment – around 44% of pension receivers belong to the wealthiest 20% of the population (Figure 3.3b).

12 A proportionately higher share of benefits accruing to lower-income groups of the population indicates a progressive nature.

13 Ministry of Finance. (2023). *Annual Report 2023.* Colombo: Ministry of Finance.

14 *Ibid.*



3.3.2 Aswesuma Welfare Benefit Programme

In July 2023, the GOSL launched the new Aswesuma welfare benefit programme to replace the Samurdhi programme. As a crucial social safety net component, the Aswesuma programme aims to mitigate the persistent economic challenges the population faces.

Under this new scheme, payments will be disbursed across four distinct social categories: transitional, vulnerable, poor, and extremely poor (Box 3.1). Furthermore, the programme will extend the assistance allowances to cater to the needs of the differently-abled, elderly, and kidney patients. However, the new programme prevents the same person from receiving two kinds of benefits. Underscoring its comprehensive approach to addressing societal needs, this initiative aims to rectify past errors in social welfare benefits programmes. Accordingly, several measures were implemented to strengthen the selection criteria, including data recertification, verification procedures and regular reviews, to enhance the programme's targeting effectiveness.

However, the Aswesuma beneficiary identification process encountered certain challenges, prompting the implementation of remedial measures to ensure fairness and transparency. In response to concerns raised, provisions were established for submitting objections and appeals, allowing individuals to contest decisions regarding their eligibility for welfare benefits. Acknowledging the importance of addressing these issues promptly, the government decided that individuals who are currently benefiting from the Samurdhi programme but were not selected despite having applied for Aswesuma benefits would continue to receive assistance under the Samurdhi programme.[15] This decision was made to provide temporary relief until the appeals and objections review process is completed and comprehensive under the Aswesuma programme.

15 Central Bank of Sri Lanka. (2023). *Annual Economic Review 2023.* Colombo: Central Bank of Sri Lanka.

Around 73% of the total Aswesuma welfare benefits are allocated to the bottom 40% of the population.

Using data from the Household Income and Expenditure Survey 2019 (HIES-2019), the IPS analysis sheds light on the effectiveness and impact of Sri Lanka's flagship anti-poverty programme. Based on the Samurdhi recipient households reported in HIES-2019 data, the analysis reveals that the Aswesuma programme is progressive and pro-poor.[16] The data analysis indicates that the programme disproportionately benefits the poorest deciles of the population. For instance, simulation analysis shows around 33% of the total Aswesuma welfare allocation is directed towards the poorest decile, indicating a strong emphasis on targeting those in greatest need (Figure 3.4a). Moreover, around 73% of the total Aswesuma welfare benefits are allocated to the bottom 40% of the population, illustrating the programme's pro-poor orientation.

Delving deeper into the analysis reveals that the total allocation of Aswesuma accounts for a significant slice of the income of the poorest decile, amounting to 34% (Figure 3.4b). This highlights the substantial impact of the programme in supplementing the income of the most economically vulnerable households and alleviating poverty at the grassroots level. However, continuing the Samurdhi beneficiaries might result in continuing the existing mistargeting. For example, the IPS analysis finds that if all Samurdhi beneficiaries receive the Aswesuma benefit, it will result in 27% of Aswesuma spending benefiting non-poor middle and upper-income households (excluding the bottom 40%).

In addition to the Aswesuma welfare benefits for the vulnerable, the distribution of benefits under other assistance programmes to the elderly, differently-abled persons, and kidney patients also show progressive characteristics. The analysis reveals that around 52% of the total spending on these direct transfers and assistance programmes benefits the bottom 40% of the vulnerable group (Figure 3.4a). While these programmes are less progressive due to their eligibility criteria, their impact on the income of the poorest decile is relatively modest, adding only 2% to the incomes of the poorest decile (Figure 3.4b). Despite this limitation, the progressive nature of these direct transfers and assistance programmes underscores their importance in promoting social welfare and reducing inequality.

These findings point to the importance and effectiveness of the Aswesuma programme in addressing poverty and inequality in Sri Lanka. By targeting resources towards the poorest segments of society, the programme is vital in promoting social inclusion, reducing disparities, and enhancing the welfare of vulnerable populations.

16 The new allowance under the Aswesuma programme was allocated to reported beneficiaries of the Samurdhi programme, based on the income group of the beneficiary.

Figure 3.4a
Distribution of Total Aswesuma Benefit

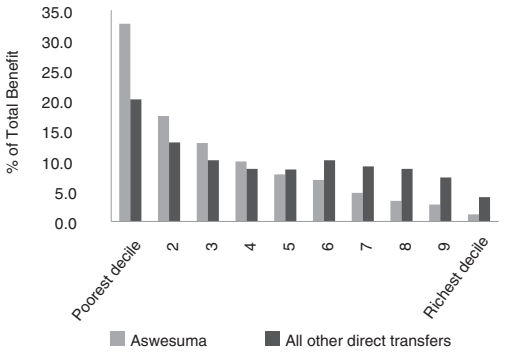
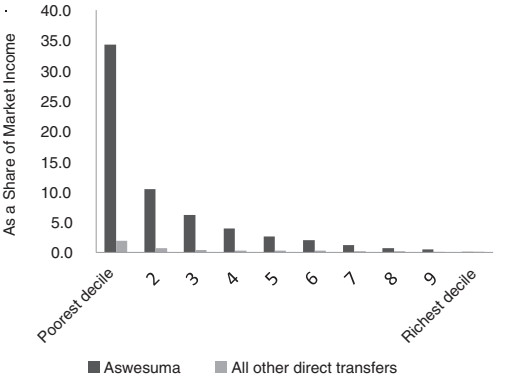


Figure 3.4b
Aswesuma Benefit as a Share of Income



Source: Author's calculations, based on HIES-2019 data from the DCS.

Box 3.1
Aswesuma Welfare Benefit Programme

The Aswesuma welfare benefit scheme was under the Welfare Benefits Board's (WBB) purview. This new programme was developed using a welfare benefit information system that considers multidimensional parameters and employs an improved verification approach to target needy sectors effectively. Around 3.3 Mn families were surveyed across the island, and 1.8 Mn low-income families qualified for the initial round of assistance. An electronic database was established under the WBB, and through the 'Aswesuma Welfare Benefit Payment Scheme,' cash transfers were directly deposited into the bank accounts of eligible recipients.

Aswesuma programme can be classified into four major categories: transitional, vulnerable, poor, and severely poor. It also provides opportunities for appeals in cases of non-inclusion in the benefit scheme. The enhanced selection mechanism has allowed for a larger allocation of funds to each vulnerable household. As a result, the total cash transfers to these households have increased over threefold compared to pre-crisis levels in 2019.

Aswesuma Payment Scheme

Social Group Receiving Welfare Benefits Payments	Number of Welfare Beneficiaries/ Families	Proposed Monthly Welfare Allowance per Family Unit (LKR)
Transitional Up to 31 December 2023	400,000	2,500
Vulnerable Up to 31 March 2024	400,000	5,000
Poor For 03 years, from 01 July 2023	800,000	8,500
Severely Poor For 03 years, from 01 July 2023	400,000	15,000

Payments for Differently-abled Persons, Chronic Kidney Disease of Unknown Etiology (CKDu), and Elderly Beneficiaries

Social Category Receiving Welfare Benefits	Number of Current Beneficiaries	Monthly Welfare Benefit Allowance (LKR)
Persons with disabilities receiving support	72,000	5,000
People receiving renal support	39,150	5,000
People receiving elderly assistance	416,667	2,000

Sources: Central Bank of Sri Lanka. (2023). *Annual Economic Review 2023*. Colombo: Central Bank of Sri Lanka.; Government Gazette. (April 2023). *Welfare Benefits Act,* No. 24 of 2002. Colombo: Department of Government Printing. Ministry of Finance. (2023). *Annual Report 2023.* Colombo: Ministry of Finance.

3.3.3 Distribution of Student Welfare Programmes

Despite prevailing challenges, the government has remained committed to ensuring free education and minimising regional disparities through continued support for student welfare programmes. Existing student welfare programmes, such as student uniforms, textbooks, and school meals, were sustained to support their educational needs. Providing school uniforms and textbooks has been upheld as a universal initiative, benefiting approximately 4.5 Mn students nationwide.[17] Free textbooks and student uniforms are universally provided to all government school students, regardless of their socio-economic background. This universal approach ensures equal access to essential educational resources and promotes inclusivity within the education system.

On the other hand, the school meal program, which was previously only offered in about 80% of government schools, has been extended to all students enrolled in primary grades as of 2024. Additionally, 9,134 government schools benefit from the school meal program, which serves nearly 1.6 Mn children.[18] Under the theme of fostering a healthy and active generation of children, the school meal programme aims to address declining nutritional issues among school students, improve daily school attendance rates, instil positive practices on eating and health, enhance educational achievement levels, and support local food initiatives. Recognising the impact of rising food prices on the nutritional status of school children, the government took proactive measures to address this concern. In response to the upsurge in prices, the per student per day price of nutritious meals was increased from LKR 30 to LKR 100 in 2022.[19] This pricing adjustment aimed at ensuring that students received adequate nutrition despite economic challenges. These student welfare measures underscore a commitment to safeguarding school children's well-being and mitigating the adverse effects of the economic crisis on their education.

17 Ministry of Finance. (2023). *Annual Report 2023.* Colombo: Ministry of Finance.

18 The Morning (2024, April 7). *School Mid-day Meal Programme: Starving for Funds and Quality Food.*

19 Ministry of Finance. (2022). *Annual Report 2022.* Colombo: Ministry of Finance.

Figure 3.5a
Progressivity of Student Welfare Programmes

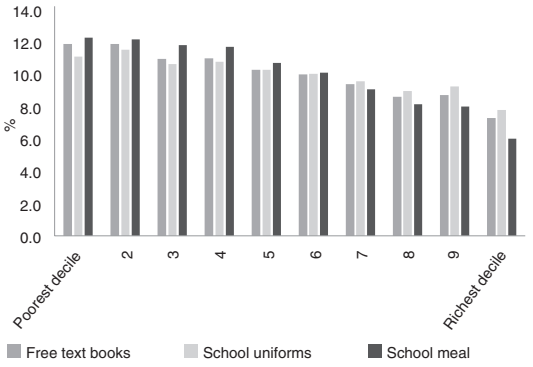
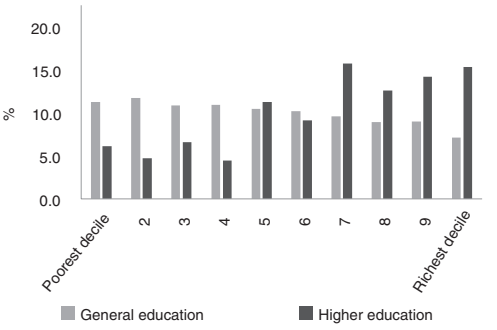


Figure 3.5b
Distribution of Education and Higher Education Spending Across Deciles



Source: Author's calculations, based on HIES-2019 data from the DCS.

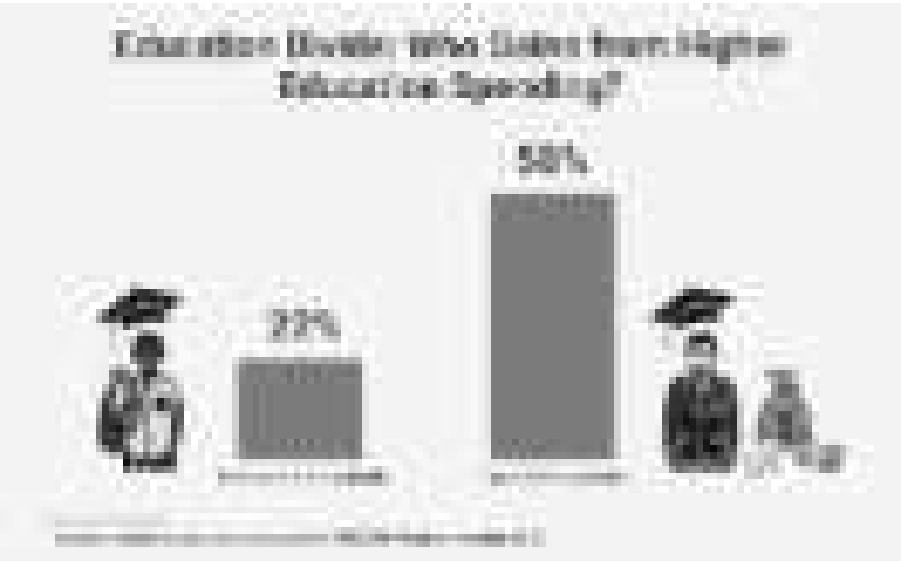
The distributional analysis reveals the universality of student welfare programmes, free textbooks and uniforms, resulting in less progressive distribution of student welfare benefits. For instance, around 16% of spending on textbooks and 17% on school uniforms benefit the top 20% of the wealthiest group (Figure 3.5a). Similarly, general education spending in Sri Lanka is less progressive – around 16% of these benefits are enjoyed by the richest 20% (Figure 3.5b). However, the school meal programme is slightly more progressive than the universal programmes explained above as it targets primary school students.

Since all students, regardless of their economic status, receive most of the education welfare benefits discussed above, these may not effectively target and support economically disadvantaged students who may require additional support to access education. Additionally, the distributional analysis reveals that higher education spending is regressive. For instance, only 22% of higher education benefits go to the bottom 40% of households, while approximately 30% of these benefits are received by the top 20%. This is mainly because students from poorer households are less likely to attend, and these students do not receive higher education benefits. These could perpetuate educational inequalities and hinder efforts to promote equity in education.

Furthermore, the distributional analysis of general education spending shows that the poorest 40% segment receives a slightly higher share – 44% of the education benefit. This is mainly due to two reasons: the child population is higher in poorer groups, and the other is that high-income households may choose private education. However, private provision for general education in Sri Lanka is quite limited. For instance, only 10% of the Ministry of Education (MOE) approved private schools function in the country.[20] With the nationalisation of private schools in 1961, the GOSL did not allow the establishment of private schools that provide general education. The IPS' Sri Lanka: State of the Economy 2023 report points to the fact that enhancing private sector participation in general education could allow students from families who can afford the costs to choose private schools

20 Central Bank of Sri Lanka. (2022). *Annual Report 2022.* Colombo: Central Bank of Sri Lanka.

while those who cannot do so, can still benefit from better-funded state schools.[21] By implementing these measures, the government can enhance investments in state schools, thereby maintaining educational standards and equity.



3.3.4 Progressivity of Water and Fertiliser Subsidy

The GOSL provides substantial subsidies on essential commodities to reduce consumers' cost of living. These subsidies are aimed at essentials, including agriculture, electricity, and water. Subsidising the price of fertiliser ensures that the government bears a significant portion of the fertiliser expenses, making it more affordable for farmers and promoting agricultural productivity. Electricity and water are provided at concessional rates to consumers, with varying subsidy levels based on different consumption levels. This tiered approach ensures that basic electricity and water needs are affordable, particularly for low-income households.

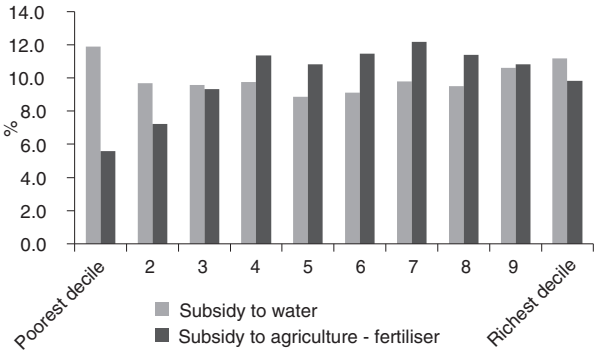
As discussed before, several reform measures were implemented during 2022/2023 due to fiscal constraints. Introducing a cost-reflective electricity tariff system was a key component of these reforms. This involved discontinuing the previous subsidised electricity tariffs and implementing a new cost-reflective electricity tariff system reflecting the actual electricity production and distribution cost. The new tariff schedule designed to recover costs more effectively, is adjusted quarterly based on a formula to ensure alignment with current costs. In parallel, water tariffs also underwent an upward price revision, aiming to ensure water supply services' sustainability by aligning prices more closely with the costs incurred in providing these services. Despite the economic challenges, the fertiliser subsidy programme continued with the objective of ensuring food security.

The rash ban on importing inorganic fertilisers and other agrochemicals (and later lifted in late 2021), along with the foreign exchange paucity to import necessary fertilisers, resulted in severe shortages.

21 Jayawardena, Priyanka. (2023). Improving Equity and Quality in Education, In *Sri Lanka: State of the Economy 2023*. Colombo: Institute of Policy Studies of Sri Lanka.

These shortages heavily impacted paddy production, reducing yields and exerting an economic strain on farmers. The GOSL introduced a fertiliser subsidy voucher for farmers cultivating paddy to address these issues. This measure aimed to alleviate the impact of the shortages by providing financial support to farmers, enabling them to purchase the fertilisers needed for their crops and thereby stabilising paddy production. Therefore, as discussed above, the government has introduced a fertiliser subsidy voucher for farmers cultivating paddy in the Yala season of 2023, to lower production costs by allowing them to purchase either chemical or organic fertilisers. This subsidy provides LKR 20,000 per hectare (ha) and LKR 40,000 for two ha of paddy cultivation.[22] A total allocation of LKR 10 Bn has been made under this subsidy, benefiting around 650,000 farmers. The financial assistance has been disbursed through vouchers, which can be used exclusively to purchase chemical or organic fertilisers.

Figure 3.6
Distribution of Subsidies Across Deciles



Source: Author's calculations, based on HIES-2019 data from the DCS.

Table 3.4
Distribution of Subsidy Receiving Households

	Fertiliser	Water
Poorest Decile	5.9	9.0
2	7.6	9.0
3	9.7	9.2
4	11.2	10.0
5	10.9	9.4
6	11.5	9.4
7	12.2	10.7
8	11.4	10.2
9	10.7	11.3
Richest Decile	9.0	11.7

Source: Author's calculations, based on HIES-2019 data from the DCS.

22 This sections was drawn from Ministry of Agriculture and Plantation Industries, https://www.agrimin.gov.lk/web/index.php/en/news-scroll/2124-22-05-2023-1e

In 2023, LKR 52.3 Bn was allocated to fertiliser subsidies (Table 3.3). Regrettably, the IPS distributional analysis reveals that despite the substantial allocation, the benefits of the fertiliser subsidy disproportionately favour non-poor households. Only about 33% of the total fertiliser subsidy spending benefited the bottom 40% of the vulnerable population, while over 20% of the benefits went to the wealthiest 20% (Figure 3.6). Apart from this, water subsidies are less progressive and are not effectively pro-poor. Approximately, the top 20% income bracket receives 22% of the water subsidy benefits. This resembles partial disparity because the poor often lack access to land or piped water, limiting their ability to benefit from such subsidies (Table 3.4).

Only about 33% of the total fertiliser subsidy spending benefited the bottom 40% of the vulnerable population.

3.4 Policy Recommendations

3.4.1 Tax Policies

Direct tax – strengthening progressive taxation and enhancing tax compliance: The recent revisions to the PIT structure regarding the tax-free threshold, tax rates, and tax brackets have raised PAYE tax contributions significantly in Sri Lanka. Despite broadening the tax base, PAYE taxes exhibit substantial progressivity, with simulations indicating that the wealthiest 10% of the population contribute a striking 96% of PAYE tax revenue. The concentration of the tax burden among higher-income individuals underscores how well the progressive tax system works to promote income equality. However, challenges persist in the form of tax avoidance loopholes within the administration of other individual-level PITs. Simulation findings reveal the potential loss of PIT tax revenue from this category, indicating significant tax evasion. To address these challenges and enhance the administration of PITs, the following policy recommendations are proposed:

- Effectively employ the new tax registration procedure to capture all liable individuals within the tax net. This will involve updating taxpayer databases and ensuring comprehensive coverage for all income earners.
- Effectively use the new tax registration procedure and adopt modern technology solutions for tax administration, including electronic filing systems, online payment platforms, and real-time data integration with financial institutions.
- Implement strict surveillance procedures to ensure compliance with PIT regulations. This includes leveraging advanced data analytics and automated systems to track income and tax payments accurately.
- Develop targeted strategies to combat tax evasion, such as increasing penalties for non-compliance, conducting regular audits, and promoting voluntary compliance through taxpayer education programmes.

Indirect taxes – excise tax on tobacco and alcohol: A significant portion of alcohol and cigarette consumption in Sri Lanka originates from more affluent households. The top 20% of wealthier households contribute approximately 43% of alcohol and 44% of tobacco taxes. Taxes on alcohol and tobacco are therefore advantageous policy measures since these impose a proportionately higher tax burden on wealthier households with more discretionary income. Furthermore, when prices rise, people in lower socio-economic categories usually cut back on their alcohol and tobacco use. This reduction benefits lower-income groups by decreasing their consumption of harmful products, ultimately lessening the burden on the healthcare system by lowering the incidence of NCDs related to alcohol and tobacco use. Therefore, excise taxes on these products present a dual benefit of generating substantial revenue and addressing public health concerns. Thus, implementing higher excise tax rates on both tobacco and alcohol products is imperative.

Authorities should use the new tax registration procedure and adopt modern technology solutions for tax administration, including electronic filing systems, online payment platforms, and real-time data integration with financial institutions.

Further, empirical studies by the IPS reveal that upward revisions in the prices of alcohol and tobacco could also potentially discourage future consumers from purchasing these goods, thus reducing the entry of new users. The World Health Organization (WHO) recommends effective taxes on these harmful products, which lead to higher real consumer prices.[23] This approach also adjusts for inflation and is considered beneficial as it effectively decreases consumption and prevalence. Thus, periodic adjustments to excise tax rates are crucial to keep pace with inflation and changes in income levels, ensuring the taxes remain effective over time. Furthermore, the WHO Framework Convention for Tobacco Control (WHO-FCTC) recommends broad-based taxes to minimise incentives for consumers to switch to lower-cost options in the same product category or less expensive tobacco product categories against tax, retail price increases or other related market effects. Thus, effective taxation for both tobacco and alcohol can be leveraged as a useful tool in discouraging the initiation of these products.

Enforcing strict regulations and penalties for alcohol manufacturers involved in producing counterfeit products or engaging in tax evasion is crucial. The GOSL should introduce QR code technology to track and verify the authenticity of alcohol products. This system can help reduce tax evasion, provide fast and effective scanning, and ensure that only legitimate products are sold. Further, authorities should conduct swift and targeted raids on individuals and entities suspected of participating in the illegal alcohol market. Enhanced monitoring could improve tax collection. For example, advanced data analytics and technology can be used to monitor the production, distribution, and sale of tobacco and alcohol products.

23 World Health Organization. (2017, January 1). *Price and Tax Measures to Reduce the Demand for Tobacco*, https://fctc.who.int/publications/m/item/price-and-tax-measures-to-reduce-the-demand-for-tobacco

3.4.2 Government Welfare Spending

Aswesuma programme: On the spending side, the analysis reveals that the Aswesuma programme is progressive and pro-poor, with data indicating that it disproportionately benefits the poorest segments of the population. Simulation analysis shows approximately 73% of the benefits are allocated to the bottom 40% of the population, illustrating the programme's strong pro-poor orientation. These findings underscore the importance and effectiveness of the Aswesuma programme in addressing poverty and inequality in Sri Lanka. By targeting resources towards the poorest segments of society, Aswesuma plays a vital role in promoting social inclusion, reducing disparities, and enhancing the welfare of vulnerable populations.

Enhancing private sector participation in general education could allow students from wealthier families to choose private schools while less affluent students benefit from better-funded state schools.

However, the continuation of Samurdhi beneficiaries within the Aswesuma programme may perpetuate existing mistargeting issues. If all current Samurdhi beneficiaries receive Aswesuma benefits, 27% of Aswesuma spending will go to households in the top 60% of the income distribution, undermining the programme's effectiveness. To ensure that resources are allocated to those who need them the most, authorities should thus make use of the welfare benefits information system that has been built. This should take into account multidimensional parameters and utilising an enhanced verification approach. Further, it is essential to conduct regular audits and reviews to identify and address any mistargeting issues, ensuring that benefits reach the intended recipients.

Public spending on education: Free textbooks and student uniforms are universally provided to all students attending government schools in Sri Lanka, aiming to ensure equal access to essential educational resources and promote inclusivity. The government aims to promote educational access and equity by continuing these programmes, particularly among economically disadvantaged communities. However, the distributional analysis of general education spending reveals that around 16% of benefits are enjoyed by the richest 20%. Because of this, these schemes might not adequately target and assist economically disadvantaged children who require extra help to obtain education which could lead to the perpetuation of educational disparities.

Thus, enhancing private sector participation in general education could allow students from wealthier families to choose private schools while less affluent students benefit from better-funded state schools. Encouraging private investment by easing restrictions on establishing private schools could further reinforce this aim. Through these, the government could redirect a portion of public funds saved from the reduced universal distribution of educational welfare towards improving state schools' infrastructure, resources, and quality. These are expected to enhance the equitable distribution of resources to state schools, focusing on underfunded and underserved regions.

Fertliser subsidy: The allocation of fertiliser subsidies has been notably imbalanced, with only about 33% of the total subsidy spending reaching the bottom 40% of the vulnerable population. In comparison, over 20% of the benefits have been captured by the wealthiest 20%. Despite this disparity,

the government maintains the fertiliser subsidy to ensure food security, recognising that affordable fertiliser indirectly helps the poor by reducing the cost of final agricultural products. To enhance the effectiveness of this subsidy, the government should implement a robust system to manage rice production, ensuring that farmers benefiting from the fertiliser subsidy contribute efficiently to the food supply chain. This approach would help to ensure that the intended support reaches those who need it the most and that the broader goals of food security and economic stability are achieved.

3.5 Conclusion

By implementing progressive tax rates and reducing the tax-free threshold, the government has succeeded in significantly expanding the PAYE tax contributions. The GOSL can enhance the effectiveness of the PIT system, ensure equitable tax contributions (fair tax pay), and enhance tax compliance. This comprehensive approach will address current challenges in tax administration, reduce evasion, and maintain the progressive nature of the tax regime, thereby promoting a fair and efficient tax system in Sri Lanka. Maintaining the PIT system's progressive nature is vital to ensure that higher-income individuals contribute proportionally more to national revenue.

Sri Lanka can enhance the effectiveness of its excise tax policies on tobacco and alcohol. This approach will not only generate significant revenue but also promote public health by reducing the prevalence of smoking and alcohol consumption. Addressing the illicit market and leveraging technology will also strengthen tax compliance and enforcement, ensuring a comprehensive and strategic approach to tobacco and alcohol taxation.

On the spending side, the direct transfer Aswesuma programme is progressive; thus, their contribution supports reducing poverty and promoting equality. The authorities can enhance the effectiveness and impact of the Aswesuma programme, ensuring that it continues to play a crucial role in advancing social justice and poverty alleviation in Sri Lanka. Through ongoing evaluation and adjustment, these programmes can maximise their benefits for the most marginalised communities while maintaining fiscal sustainability and optimal resource allocation.

The GOSL can more effectively target educational welfare benefits to support economically disadvantaged students, reduce educational inequalities, and promote equity in education. A balanced and inclusive education system that serves all societal segments will be made possible by promoting private-sector involvement and increasing state support for schools.

4. Access to Food and Nutrition

4.1 Introduction

The coronavirus (COVID-19) pandemic and the subsequent economic crisis in 2022 in Sri Lanka led to severe economic disruptions, affecting food availability, affordability, and accessibility. During the economic downturn, supply chain disruptions resulted in significant shortages of essential food items. Import restrictions, fuel shortages, and logistical challenges exacerbated these disruptions, making it arduous for food to reach markets and consumers.[1] Agricultural decline due to economic constraints led farmers to face hardships in accessing seeds, fertilisers, and other inputs, reducing crop yields and further diminishing food availability. Poor policies such as fertiliser bans further hindered agricultural productivity and output.

Food affordability, too, was a critical issue for households during these tumultuous years and persists today. The crisis of food inflation triggered inflation and price hikes. The Household Survey on the Impact of the Economic Crisis , conducted in 2023 by the Department of Census and Statistics (DCS), reports that a substantial 91% of households experienced a marked increase in their total monthly expenditures. Rising food costs were a main contributor to increased expenditure for households, as cited by 99% of those in the survey. Households, particularly those with low incomes, struggled to afford basic food and other essential items during the period. This was further aggravated by significant income losses due to job cuts and business closures, as 60.5% of households saw a decline in their average monthly income.[2]

The topic of food and nutrition accessibility remains crucial, as the current progress towards calmer waters after four turbulent years stretches beyond identifying geographic or demographic disparities. Access in this chapter focuses on the difficulties and limitations households face in food consumption. Disparities due to poor infrastructure or higher transportation costs and vulnerable groups, including children, the elderly, and those with pre-existing health conditions, were heavily and disproportionately affected by the crisis, as they face greater barriers to food access and higher risks of malnutrition.[3] However, the dual pressure of rising costs and falling incomes forced households to adopt various coping strategies to manage their financial burdens and severely constrained their ability to buy adequate and nutritious food. Approximately 97.2% of households reported employing at least one coping strategy to manage their food consumption under economic stress. As food prices have surged dramatically, households have prioritised essential food items over others. This prioritisation often means cutting back on more nutritious but expensive food and thus focusing primarily on the quantity of energy intake despite the predicted decline in calorie intake. The decrease in nutritional intake is not limited to calories alone. The protein and fat content of diets has also declined. Proteins from food items like meat, fish, and eggs have become less accessible, with significant drops in the grammes (g) of protein that Sri Lankan Rupees (LKR) 100 can purchase.

1 This section draws from, Supply Chain Disruptions and Food Security, World Food Programme 2022.

2 Household Survey on Impact of Economic Crisis, DCS, 2023.

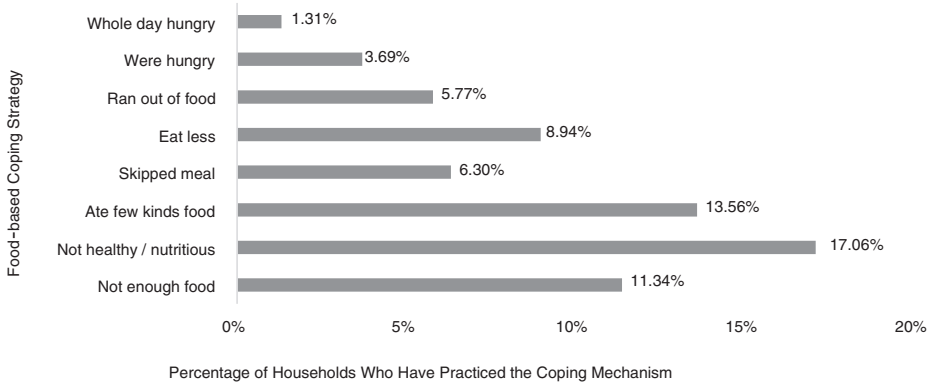
3 This section draws from, Sri Lanka Economic Crisis 2023 Situation Report, United Nations Children's Fund (UNICEF).

Despite the myriad coping mechanisms and reduced food consumption in general, as indicated by the Food Consumption Score,[4] 93% of households still maintain an acceptable level of food consumption, while 7% fall into the borderline or poor categories in 2023 on the road to economic recovery. This statistic highlights that households adapt while facing severe changes in access to calories and nutrients per LKR. Addressing these critical issues remains a top priority as the country recovers and moves forward. Ensuring access to food and nutrition is not only essential for the immediate well-being of the population but also for the long-term stability and development of the nation. This chapter explores why access to food and nutrition is of paramount importance in the post-crisis context of Sri Lanka.

4.2 Expenditures and Food Coping Strategies

Between 2019 and 2022, Sri Lanka saw noteworthy adjustments in food coping techniques, reflecting the tremendous impact of the COVID-19 pandemic and a severe economic crisis.

Figure 4.1
Food-based Coping Strategies in 2019

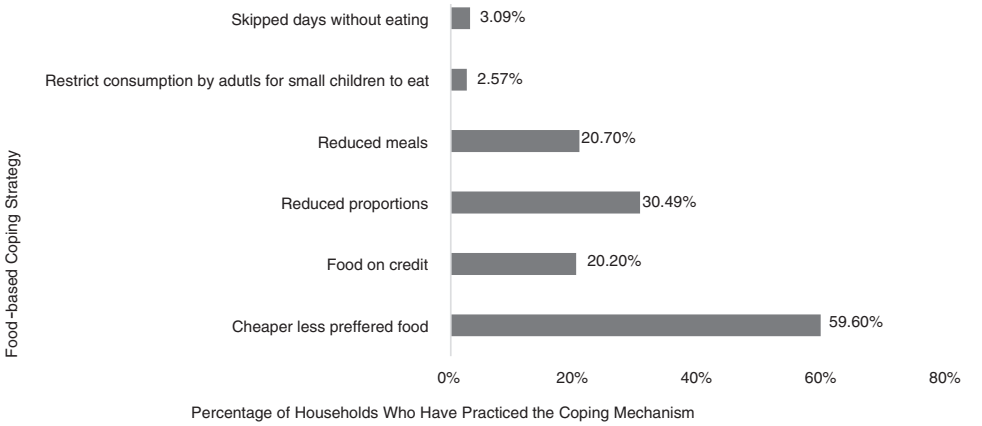


Source: Based on the DCS Household Income and Expenditure Survey (HIES) 2019.

Figure 4.1 shows the percentage of households that practiced the relevant coping mechanisms during the year 2019. Figure 4.2 reflects the coping strategies practiced during the year 2022, in which the percentage of households using similar coping strategies has increased.

4 Food Consumption Score measures dietary diversity and food frequency.

Figure 4.2
Food-based Coping Strategies in 2022



Source: United Nations Development Programme (UNDP). National Citizen Survey 2022-2023.

Based on two globally set thresholds, the Food Insecurity Experience Scale (FIES) identifies three classes of food insecurity, namely marginally insecure, moderately insecure, and severely insecure. When moving from food security to mild food insecurity, households experience uncertainty regarding obtaining food. At a mild food insecurity level, households compromise on food quality and variety. At moderate food insecurity, households tend to reduce food quantity and start to skip meals. At the severe stage of food insecurity, households run out of food and experience hunger for more than a day.

To see how the percentages have changed, similar coping strategies and the percentages used by households were compared during the years 2019 and 2022. Following infographic shows how the percentage of households has changed. Here, numbers 1, 2, and 3 represent moderate food insecurity coping strategies, and 4 represents coping strategies used at a severe stage of food insecurity. It can be observed that the percentage of households using food in security coping strategies grew in 2022 compared to 2019. Importantly, the above comparison uses two different data sources by matching the UNDP 2022-2023 coping strategies with those of HIES 2019 strategies.



The percentage of households who skipped days without eating has jumped from 1.3% to 3.1% showing the "severe food insecurity" due to food inflation and economic crisis". The percentage of persons who chose cheaper or less favoured food options increased the highest, from 17.1% to 59.6%.[5] This huge increase reflects the severe economic crisis, inflation, and disruptions in food supply networks. According to the literature, widespread job losses and lower earnings may have led many people to rely on cheaper, non-perishable food items, which were more economical and frequently accessible.[6]

Table 4.1
Comparison of Similar Coping Strategies Practiced by Households in 2019 and 2022

Number of Coping Strategies	Coping Strategy	2019	Coping Strategy of 2022 Matched with Coping Strategy of 2019	2022
1	Unable to eat healthy and nutritious food	17.1%	Rely on less preferred, cheaper food	59.6%
2	Ate only a few kinds of food	13.6%	Reduced proportions of meals	30.5%
3	Had to skip a meal	6.3%	Reduced number of meals per day	20.7%
4	Were hungry but did not eat	1.3%	Skipped days without eating	3.1%

Source: Based on UNDP National Citizen Survey 2022-2023, and DCS HIES 2019.

The mix of proteins, carbohydrates, fats, and micronutrients in meals is essential for sustaining both general health and nutrition. Prior to 2019, the meal composition in Sri Lanka generally included

5 This section draws from- UNDP National Citizen Survey 2022-2023, and DCS HIES 2019.

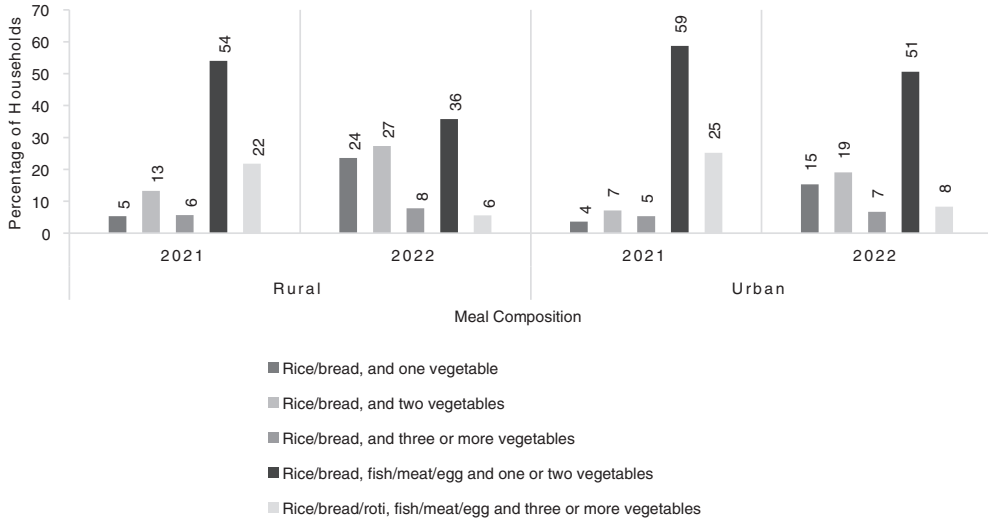
6 Barman A., Das R., & De P.K. (2021). Impact of COVID-19 in Food Supply Chain: Disruptions and Recovery Strategy. *Current Research in Behavioural Sciences*. 2,100017.

vegetables, fish, and occasionally meat in a well-balanced combination.[7] The data from 2021 to 2022, as per the National Citizen Survey 2022-2023 by the UNDP show notable shifts in the meal composition of Sri Lanka's rural and urban sectors (Figure 4.3). The proportion of rural households that consumed a meal consisting of bread or rice and one vegetable increased substantially from 5% in 2021 to 24% by 2022. In a similar vein, the percentage of individuals eating bread or rice with two vegetables increased from 13% to 27%.

The percentage of households who skipped days without eating has jumped from 1.3% to 3.1% showing the 'severe food insecurity' due to food inflation and the economic crisis. The percentage of persons who chose cheaper or less favoured food options increased the highest, from 17.1% to 59.6%.

On the other hand, meals that included three vegetables, rice or bread, and fish, meat, or egg fell steeply from 22% to 6%. The tendency was similar, though less severe, in urban areas. Lunch meals, including bread or rice and one vegetable, grew from 4% in 2021 to 15% in 2022, while meals containing two vegetables grew from 7% to 19%. Meals including three vegetables and either meat, fish, or egg fell from 25% to 8%. These modifications point toward simpler, less varied meals with fewer vegetables and protein sources. This trend reflects financial limitations and restricted access to a wide range of foods.

Figure 4.3
Change in Meal Composition Comparison in Rural and Urban Sectors, 2019-2022



Source: UNDP National Citizen Survey 2022-2023.

7 Bandara, S. K. T. (2021). Changes in Food Consumption Patterns in Sri Lanka: Food Security and Sustainability: A Review of Literature. *Open Journal of Social Sciences*, 9, 213-237.

Sri Lanka experienced a serious economic crisis in 2022, worsening the situation. Due to the polarity in food costs (high) and incomes (low), many households were turning to less healthy, less expensive food. Despite these obstacles, some households used community support networks and home gardens to improve meal variety and nutritional quality.[8]

4.3 Food Consumption Post-Economic Crisis

4.3.1 Food Prices and Calorie and Macronutrient Costs

High food inflation was the leading cause of household expenditures following the economic crisis. Table 4.2 presents a comparative analysis of the prices of key food items in Sri Lanka over three different years: 2019, 2021, and 2023. Here, 2019 is considered the starting period of several crises, 2021 is the middle of the COVID-19 pandemic, and 2023 is a transitionary period for the country following major upheavals. The data highlight remarkable changes in the cost of staple and essential food items, reflecting the impact of economic conditions, particularly the country's severe economic crisis in 2022. Across all food items listed, a noticeable rise is seen in prices from 2019 to 2023. This trend indicates significant inflation and increased living costs in Sri Lanka over the past few years.

During the same period, the upward trend in prices of various food items paints a grim picture. For instance, staple foods such as one kilogramme (Kg) of rice increased from LKR 93 to LKR 207, 1 Kg of dhal from LKR 148 to LKR 373, and 1 Kg of wheat flour from LKR 95 to LKR 223 from 2019 to 2023. This more than doubling in price reflects the inflationary pressures and supply chain issues affecting the staple food of many Sri Lankans. Animal protein sources such as meat, fish, eggs, and dried fish reported a similar rise in prices. The prices of meat, fish, and eggs more than doubled, and the price of dried fish jumped by 77%. Vegetables, yams, and fruits, which add dietary diversity and are a key source of essential vitamins and minerals, also saw similar price hikes of over 100%. The price of 400g milk powder increased dramatically from LKR 357 in 2019 to LKR 1,160 in 2023. This steep increase indicates severe affordability issues for dairy products.

8 Sooriyaarachchi, P. (2022). Fruit and Vegetable Consumption During the COVID-19 Lockdown in Sri Lanka: An Online Survey. Nutrire, 47(12), 12.

Table 4.2
Price of Essential Food Items – Calories and Carbohydrates

Food Item	Unit of Measurement	2019	2021	2023
Rice	1 Kg	93	118	207
Dhal	1 Kg	148	225	373
Wheat flour	1 Kg	95	102	223
Coconut	1 nut	51	84	107
Milk, powdered	400g	357	405	1,160
Sugar	1 Kg	106	129	257
Meat	1 Kg	925	1,049	1944
Fish	1 Kg	767	927	1,603
Dried fish	1 Kg	936	1,047	1,658
Egg	1 egg	20	19	50
Vegetables	1 Kg	152	186	311
Yams	1 Kg	165	187	286
Fruits	1 Kg	162	167	378

Source: DCS, Open Market Retail Prices Dashboard, http://www.statistics.gov.lk/DashBoard/Prices/

The significant price increases across all food items highlight the growing challenge of food affordability. Household expenses on food are the most common driver of increased household expenditures during the economic crisis as reported by 99% of households, whereas other costs on transport, health, and education, while high, are relatively infrequent than food expenses.[9] The increased cost of staple foods like rice, dhal, and wheat flour conveys that even basic dietary needs are becoming more challenging to meet, particularly for low-income families. The rising prices of protein sources such as meat, fish, and eggs indicate potential reductions in protein intake, which is crucial for maintaining health, especially among children and pregnant women. Higher costs for vegetables and fruits can lead to decreased consumption of these essential food groups, resulting in likely micronutrient deficiencies.

Given the changes in prices, the cost of calories and nutrient intake is high. Table 4.3 presents a detailed comparison of the caloric yield from LKR 100 worth of various food items over three different years: 2019, 2021, and 2023. This comparison is crucial for understanding how economic conditions, particularly the economic crisis of 2022, have impacted energy affordability.

Key trends highlight a general decline in caloric yield; across most food items, there is a noticeable decline in the number of calories purchasable for LKR 100 from 2019 to 2023.

9 This section draws from- Household Survey on Impact of Economic Crisis (2023), DCS.

The key trends highlight a general decline in caloric yield; across most food items, there is a noticeable decline in the number of calories purchasable for LKR 100 from 2019 to 2023.[10]

Table 4.3
Calories and Nutrients Per LKR 100 Food – Calories and Carbohydrates

	Calories/LKR 100 Food (K Cal)			Carbohydrates/LKR 100 Food (g)		
Food Item	**2019**	**2021**	**2023**	**2019**	**2021**	**2023**
Rice	3,869	3,053	1,740	829	654	373
Dhal	2,156	1,418	855	324	213	128
Wheat flour	3,566	3,310	1,509	738	685	312
Coconut	2,803	1,685	1,324	25	15	12
Milk, powdered	480	422	147	49	43	15
Sugar	545	447	225	123	101	51
Meat	173	153	82	0	0	0
Fish	124	103	59	0	0	0
Dried fish	303	271	171	0	0	0
Egg	489	505	193	0	0	0
Vegetables	266	217	130	29	24	14
Yams	474	419	275	83	74	48
Fruits	398	387	171	67	66	29

Source: Based on DCS Open Market Retail Prices Dashboard, and Medical Research Institute of Sri Lanka, Sri Lanka Food Composition Table.

The caloric yield from rice worth LKR 100 has more than halved from 3,869 K Cal in 2019 to 1,740 K Cal in 2023. Price levels of rice, a staple food in Sri Lanka, reflect the severe impact of inflation and economic instability on basic dietary staples. Another staple, dhal, shows a similar decline from 2,156 K Cal in 2019 to 855 K Cal in 2023, and wheat flour caloric yield has dropped from 3,566 K Cal in 2019 to 1,509 K Cal in 2023. The calories gained from meat and fish have also seen a sharp decline. For example, meat worth LKR 100 decreased from 173 K Cal in 2019 to 82 K Cal in 2023, and fish from 124 K Cal to 59 K Cal. This suggests that protein-rich animal products have become less affordable, potentially leading to nutritional deficiencies. Interestingly, dried fish shows a slight increase in caloric yield from 2019 to 2021 but then a decline in 2023. This indicates initial resilience followed by the impact of prolonged economic stress. Milk powder and eggs show steep declines following 2021, reflecting volatility in the affordability of nutrient-dense foods. The caloric yield from vegetables has reduced from 266 K Cal to 130 K Cal, and fruits have seen a drastic reduction from 398 K Cal in 2019 to 171 K Cal in 2023, which could affect dietary diversity and overall health.

The data on calories gained from LKR 100 worth of food from 2019 to 2023 illustrates the impact of economic instability on food security in Sri Lanka. The quality of calories is another major concern

10 This section is Based on DCS Open Market Retail Prices Dashboard and Medical Research Institute of Sri Lanka, Sri Lanka Food Composition Table

as considerations for macro and micronutrients are likely to change as households move away from nutritious foods to cheaper alternatives to meet energy needs. To highlight the rising nutrient costs, Table 4.3 shows how the price of nutrients per LKR 100 of each food item has changed between 2019 and 2023. A clear decline is seen across most food items in the amount of carbohydrates purchasable for LKR 100 from 2019 to 2023. This trend indicates that the economic crisis has reduced the affordability of carbohydrate-rich foods, impacting overall dietary intake. The carbohydrate yield from rice has decreased significantly from 829g in 2019 to 373g in 2023. Dhal, another important source of carbohydrates, declined from 324g in 2019 to 128g in 2023. The carbohydrate content obtained from wheat flour has dropped from 738g in 2019 to 312g in 2023, indicating that even basic grain products have become less accessible.

Table 4.4
Calories and Nutrients Per LKR 100 Food – Proteins and Fats

	Proteins/LKR 100 Food (g)			Fats/LKR 100 Food (g)		
Food Item	**2019**	**2021**	**2023**	**2019**	**2021**	**2023**
Rice	91	72	41	19	15	8
Dhal	136	89	54	36	24	14
Wheat flour	109	102	46	11	10	5
Coconut	26	16	12	287	173	136
Milk, powdered	36	32	11	16	14	5
Sugar	2	1	1	4	3	2
Meat	22	19	10	9	8	4
Fish	25	21	12	2	2	1
Dried fish	60	53	34	45	41	26
Egg	40	41	16	37	38	14
Vegetables	15	12	7	9	8	5
Yams	17	15	10	2	2	1
Fruits	7	7	3	10	10	4

Source: Based on DCS Open Market Retail Prices Dashboard, and Medical Research Institute of Sri Lanka, Sri Lanka Food Composition Table.

In addition to carbohydrates, the quantity of protein available per LKR 100 in most food products has decreased significantly between 2019 and 2023 (Table 4.4). The other major nutrient in fats saw a similar yet sizeable decline of over 50% in the amount of fat obtained in LKR 100 purchases of food items.

4.4 Calories and Nutrient Intake

4.4.1 Predicted Changes to Food Expenditure Shares in 2023

As food shares and quantities are likely to change as prices increase, calorie intake and nutrient composition will likely transform. The results from a quadratic ideal demand system are used to make predictions after accounting for price hikes in significant food items highlighted in Table 4.2. Figure 4.4 shows the percentage change in predicted shares of food item expenditures from two simulations. These simulations are based on a demand system estimation incorporating future prices and other relevant factors influencing consumer behaviour. The bars represent the changes in expenditure shares for various food items, with Simulation 1 keeping expenditure constant between 2019 and 2023 and Simulation 2 increasing expenditure by 50% between 2019 and 2023.

Box 4.1
Food Demand Estimation

Quadratic Almost Ideal Demand System (QUAIDS): This model is an extension of the Almost Ideal Demand System (AIDS) model developed by Deaton and Muellbauer in 1980. The QUAIDS model, introduced by Banks, Blundell, and Lewbel in 1997, incorporates quadratic terms into the AIDS model to allow for greater flexibility in modelling consumer demand. This extension enables the QUAIDS model to capture non-linear relationships and varying elasticities of demand across different income levels and prices more accurately.

The QUAIDS model uses budget shares as dependent variables, allowing it to reflect how consumers allocate their total expenditure among different goods. Simulating price changes using the QUAIDS model involves several steps. Using the HIES 2019, data on household expenditures, prices of goods, and socio-economic characteristics are used to estimate household behaviours. The QUAIDS model is fitted using data to obtain estimates of how budget shares respond to changes in prices and total expenditure. Then, two separate scenarios are defined for simulations to observe how households change their expenditure and consumption patterns in 2023. First, the changes on prices (Table 4.2) from 2019 to 2023 are considered at the same level of expenditure as 2019. Second, same price changes are observed at an expenditure level that is 50% higher than the 2019 levels. Simulation 1 serves to capture the changes in food consumption as a direct result of price changes. Simulation 2 examines how food expenditures change as households increase expenditure in response to price hikes.

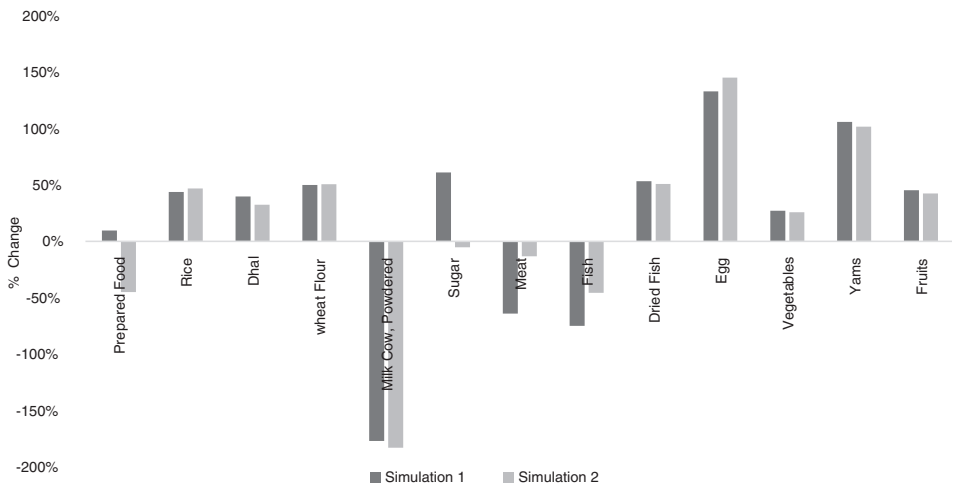
Source: Authors' compilation based on multiple sources.

Staple foods such as rice saw a significant increase in the expenditure share for rice in both simulations, with Simulation 1 showing a slightly higher increase. This indicates that consumers might shift towards more affordable staple foods like rice as prices for other food items rise. Like rice, the dhal expenditure share increases in both simulations, emphasising its importance as an affordable protein source in the diet. The share of expenditures on wheat flour increases, further highlighting a

trend towards staple grains to meet caloric or energy needs as foods high in carbohydrates provide the highest energy or calories per LKR 1. Such trends will continue as wheat flour and other staple products are exempted from Value Added Tax (VAT) reforms in January 2024. Thus, these items will continue to be cheaper alternatives than other food groups.

Both simulations have decreased expenditure shares on animal protein sources such as meat and fish. This trend suggests consumers are cutting back on more expensive protein sources in response to rising prices, opting for cheaper alternatives. The share of expenditure on dried fish decreases in both simulations, likely due to its relatively high cost compared to other protein sources. The most noteworthy change is observed in the expenditure share for powdered milk, which decreases significantly in both simulations, and is especially worse in Simulation 1. This suggests a sharp decline in the consumption of dairy products due to their excessive cost, probably to be exacerbated due to the removal of VAT exemption on dairy products from January 2024 onwards. The expenditure share for eggs increases in both simulations, indicating a preference for this relatively affordable protein source as other protein options become less accessible. The vegetable expenditure share decreases in both simulations, indicating higher prices and reduced affordability. Fruits also face a decline in shares, suggesting that fruits are becoming less affordable for many households, impacting dietary diversity and nutrition. Prepared foods have seen a decrease in both simulations, indicating a move away due to rising costs, as highlighted in a study by the Institute of Policy Studies of Sri Lanka (IPS).[11]

Figure 4.4
Per Cent Change in Predicted Shares of Food Item Expenditures, 2019-2023



Source: Authors' estimates using data from DCS HIES 2019.

11 Arunathilake, N., Abayasekara, A., Athuada, L., & Kasturiratne, A. (Forthcoming.) *The Effects of Shocks on Food Environments and Household Diets: A Case Study of Sri Lanka During COVID-19 and the Economic Crisis*. International Development Research Centre.

The increased expenditure shares for staple foods like rice, dhal, and wheat flour indicate a shift towards more basic, affordable food items. This shift may result in a less varied diet, with potential long-term impacts on nutritional quality and health outcomes.[12] The decrease in household expenditure shares for meat, fish, and dried fish suggests a reduction in the consumption of high-cost protein sources. This trend could lead to protein deficiency, particularly among low-income households that are already vulnerable to nutritional insecurity. The significant reduction in the household expenditure share for powdered milk highlights the challenges of maintaining adequate dairy consumption. Eggs, on the other hand, have become a more prominent source of protein due to their relative affordability, which might partially offset the shrink in sources of other protein. The decreased expenditure shares for vegetables and fruits are concerning from a public health perspective. Reduced consumption of these essential food groups can lead to deficiencies in vitamins and minerals, further exacerbating nutritional problems.

Increased expenditure shares for staple foods like rice, dhal, and wheat flour indicate a shift towards more basic, affordable food items. This shift may result in a less varied diet, with potential long-term impacts on nutritional quality and health outcomes.

Box 4.2
Prepared Food Consumption

The opportunity cost associated with purchasing food away from home can significantly influence consumer behaviour and food prices. In the context of food consumption, when individuals choose to buy food away from home, they consider several factors beyond the immediate price of the meal. Preparing meals at home requires time for shopping, cooking, and cleaning. For many consumers, especially those with busy schedules, the time saved by purchasing ready-made meals or dining out can be a significant factor. The opportunity cost of the time saved can make the higher monetary cost of eating out more acceptable. The opportunity cost of potentially healthier, home-cooked meals can influence food choices. While home-prepared meals can be tailored to individual nutritional needs, eating out often involves consuming higher-calorie, less nutritious options. However, the perceived immediate convenience and satisfaction may outweigh long-term health considerations for many consumers.

In Sri Lanka, the HIES 2019 reports that the poorest 10% of households spend around 16% of their food expenses on prepared foods relative to 12% of the richest 10%. The urban poor exhibit significantly higher expenditures at around 31% of the budget spent of prepared foods. Both simulations show a decline in the expenditure share for prepared food, with Simulation 1 indicating a larger decrease. This suggests that as prices hikes have been relatively high, the consumers have reduced their spending on prepared foods despite their convenience. An IPS study reports qualitative evidence of a decrease in prepared food consumption due to rising costs that supports the results of the simulations.

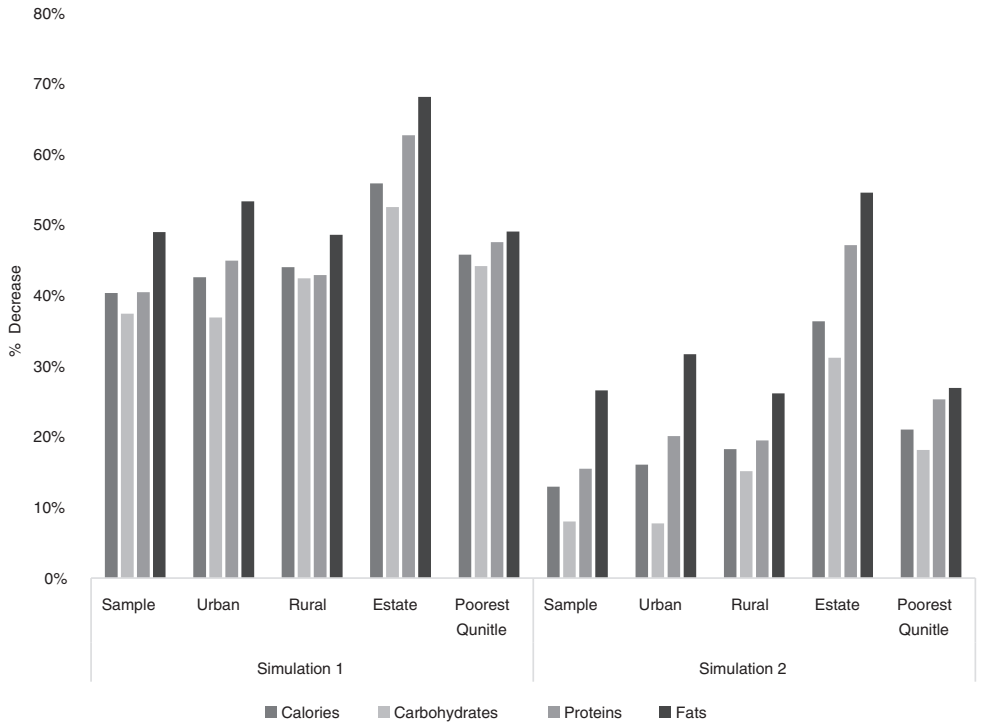
Source: Authors' compilation based on various sources.

12 Riptanti, E. W., Masyhuri, M., Irham, I., & Suryantini, A. (2020). The Ability of Dryland Farmer Households in Achieving Food Security in Food-insecure Area of East Nusa Tenggara, Indonesia. AIMS Agriculture & Food, 5(1).

4.4.2 Percentage Decrease in Calories and Nutrients Between 2019 and 2023

Changes to food are likely to affect calorie and nutrient intake. Figure 4.5 shows the percentage decline in the intake of calories, carbohydrates, proteins, and fats across different demographic groups (urban, rural, estate, and the poorest income quintiles) between 2019 and 2023. The data is presented for two simulation scenarios: Simulation 1 using 2019 expenditures and Simulation 2 using a 50% increase in 2019 expenditure levels.

Figure 4.5
Per Cent Decrease in Predicted Calories and Macronutrients, 2019-2023



Source: Authors' estimations using data from DCS HIES 2019.

Both simulations indicate a general decrease in calories, carbohydrates, proteins, and fats during the said period. The percentage decrease is relatively consistent across all demographic groups, reflecting a widespread reduction in nutrient intake. In Simulation 1, where household expenditures remain constant, a sizeable decrease in nutrient intake with fats shows the highest reduction. Other alarming nutrition statistics warn of major adverse shifts in calories, carbohydrates, and proteins, all decreasing by approximately 37-40% in the general population. Urban areas exhibit a similar pattern, with fats decreasing by over 50%. The decrease in calories and carbohydrates is slightly less than those in rural and estate areas, indicating a marginally better nutrient retention in urban settings. Rural areas show a considerable decrease across all indicators by over a 40% reduction. Carbohydrates

and proteins also decrease significantly. The estate sector displays much higher decreases across all the indicators, with calorie and carbohydrate consumption falling by over 50% and protein and fat consumption falling by over 60%. The fall in calories and nutrient intake is also high for the poorest quantile of the population, with all indicators seeing a decrease of over 40%.

In Simulation 2, with changes to prices and expenditures, the overall decreases are less severe than in Simulation 1, but fats still show the highest reduction. Carbohydrates see the smallest decrease in the general population. Urban areas show a considerable decrease in fats, at 32%, with proteins and carbohydrates decreasing by roughly 16-20%. Rural areas exhibit similar trends to urban areas in Simulation 2 but with slightly lower decreases in fats and proteins. The estate sector and the poorest quintile of the population display larger falls across all indicators. The estate sector and poorest quintile record a 36% and 21% decrease in calorie consumption, respectively, despite a simulation of a 50% increase in expenditures, suggesting that they were the hardest hit in both the quality and quantity of food intake (see infographic).



The data indicate a worrying trend of decreased nutrient intake across all demographic groups in Sri Lanka between 2019 and 2023. Both simulations significantly reduce calories, carbohydrates, proteins, and fats. Decreased nutrient intake indicates worsening food security and access to nutrition, likely due to economic constraints, rising food prices due to supply chain disruptions and LKR depreciation. The sizeable reduction in proteins and fats relative to carbohydrates suggests a shift away from energy-dense foods, which could lead to energy deficiencies, particularly affecting children's growth and adults' work capacity.

4.4.3 Changes to Calories and Nutrients Return to LKR in 2023

The demand system analysis reveals a shift in household food consumption trends. While a notable increase in carbohydrate expenditures relative to other food groups, the absolute amounts have decreased since 2019. Financially constrained households are adopting more cost-effective approaches to food acquisition, often relying on cheaper, high-energy foods to meet caloric needs. Table 4.5 provides a detailed breakdown of changes in the value of calories and nutrients in a LKR 100 bundle of food consumed by households.

Simulations show a general decrease in the cost-effective capabilities of households from 2019 to 2023 across all demographic groups. The 2019 energy and nutrient levels suggest that the estate sector and poorest quintiles of the population are highly adaptable and cost-effective in acquiring calories, largely through expenditures on protein-heavy items relative to other demographic groups. In Simulation 1, calories per LKR 100 saw a decrease in the estate sector, rural sector, and the poorest quintile, pushing down the population average. The urban sector and richest quintile saw an increase in their caloric efficiency, largely through increases in the carbohydrate composition of an LKR 100 food basket. In all demographic groups, carbohydrate consumption in LKR 100 has increased, suggesting that purchasing carb-rich foods is a cost-effective mechanism to fulfil caloric requirements. However, despite resorting to cost-effective mechanisms, the population's capabilities to be cost-effective are constrained due to the high prices and income losses. While cost-effective capacities of the poorest quintiles are relatively high compared to the richest quintile, the economic crisis has worsened such capabilities of the poor while forcing even the richest quintiles to become more cost-efficient than before (see infographic).[13]

While cost-effective capacities of the poorest quintiles are relatively high compared to the richest quintile, the economic crisis has worsened such capabilities of the poor while forcing even the richest quintiles to become more cost-efficient than before.

13 Kaufman, P. R., MacDonald, J. M., Lutz, S. M., & Smallwood, D. M. (1997). *Do the Poor Pay More for Food? Item Selection and Price Differences Affect Low-Income Household Food Costs* (No. 34065). United States Department of Agriculture, Economic Research Service.

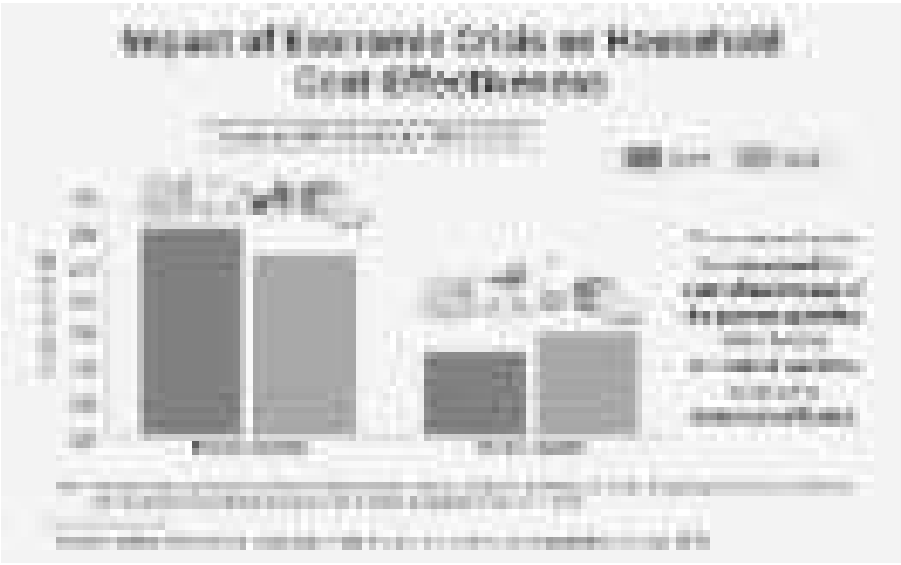


Table 4.5
Value of Calories and Nutrients Per LKR 100 Food Basket, 2019-2023

Indicator	Population	Estate	Rural	Urban	Poorest Quintile	Richest Quintile
			2019			
Calories (K Cal)	267.14	287.20	268.52	252.85	280.81	244.35
Carbohydrates (g)	42.97	48.88	43.40	38.72	46.81	36.41
Proteins (g)	8.49	8.37	8.42	8.94	8.33	8.87
Fats (g)	5.78	5.32	5.73	6.18	5.49	6.34
			2023 Simulation 1			
Calories (K Cal)	264.81	280.86	262.69	257.53	273.18	251.91
Carbohydrates (g)	44.73	51.45	43.71	43.32	46.89	40.54
Proteins (g)	8.38	6.94	8.37	8.74	7.83	9.45
Fats (g)	4.90	3.75	5.14	5.12	5.02	5.06
			2023 Simulation 2			
Calories (K Cal)	262.87	278.24	260.71	256.46	272.84	249.82
Carbohydrates (g)	44.71	51.18	43.78	43.13	47.16	40.58
Proteins (g)	8.10	6.75	8.03	8.64	7.66	9.11
Fats (g)	4.80	3.68	5.02	5.10	4.94	4.93

Note: g – grammes.
Source: Authors' estimations using data from HIES 2019.

Simulation 2 highlights a similar story despite the increase in expenditure. The poorest quintile resorts to increasing its share of carbohydrates in a food basket while sacrificing the need for other essential macronutrients. The richest income quintiles also show an increased capacity for cost-effectiveness through increased calories, carbohydrates, and proteins in an LKR 100 food basket.

The shrinking cost of fats is noteworthy as it indicates better access to energy-dense foods, which are essential for meeting daily caloric needs. Improved affordability of proteins and carbohydrates is crucial for maintaining balanced diets and preventing malnutrition. On top of the existing struggle for the affordability of food items, the deterioration in the cost-effective capacities of the most vulnerable groups calls for an improvement in the accessibility of more food options. Lower food costs can help alleviate food insecurity and improve access to nutrition, especially for vulnerable populations. As the estate sector and the poorest income group are highly affected in calorie efficiency relative to others, affordability and accessibility could determine their longstanding troubles in procuring sufficient foods.

4.5 Health Implications and Policy Recommendations

4.5.1 Health Implications

Nutrition is key in shaping individual well-being, influencing various aspects of life including labour market outcomes, education, and health. The significance of adequate nutrition cannot be overstated, as it serves as a fundamental determinant of human capital development and economic productivity.

Nutrition plays a crucial role in shaping educational outcomes and academic achievement, with malnutrition exerting detrimental effects on cognitive development, learning abilities, and school performance. Numerous studies have found adverse impacts of nutritional deficiencies on educational attainment and cognitive functioning, particularly during early childhood and adolescence.[14] Malnourished children often exhibit slower cognitive development, reduced attention spans, and concentration difficulties; and iron deficiency anaemia and iodine deficiency, have been linked to impaired brain development and suboptimal cognitive performance.[15] In Sri Lanka, school-age children reported several nutritional challenges. Anaemia, a condition in which the body does not have sufficient red blood cells that provide oxygen to body tissues, is highly prevalent in children aged 10-17 at 18.3%, with male students being affected disproportionality more at 22%. Iron deficiency was found in 13% of the children with anaemia.[16] Educational and nutritional outcomes are interlinked as low education outcomes trap households in cycles of poverty and food insecurity.[17] Therefore, addressing malnutrition is essential for academic success and for breaking the intergenerational

14 Grantham-McGregor, S., Cheung, Y. B., Cueto, S., Glewwe, P., Richter, L., Strupp, B., & International Child Development Steering Group (2007). Developmental Potential in the First Five Years for Children in Developing Countries. Lancet, 369(9555), 60–70.

15 Victora, C. G., Adair, L., Fall, C., Hallal, P. C., Martorell, R., Richter, L., Sachdev, H. S., & Maternal and Child Undernutrition Study Group (2008). Maternal and Child Undernutrition: Consequences for Adult Health and Human Capital. *Lancet*, 371(9609), 340–357.

16 Eilander, A., Muthayya, S., van der Knaap, H., Srinivasan, K., Thomas, T., Kok, F. J., Kurpad, A. V., & Osendarp, S. J. (2010). Undernutrition, Fatty Acid and Micronutrient Status in Relation to Cognitive Performance in Indian School Children: A Cross-sectional Study. *The British Journal of Nutrition*, 103(7), 1056–1064.

17 Alderman, H., Behrman, J. R., & Hoddinott, J. (2006). Nutrition, Malnutrition, and Economic Growth. *Economics & Human Biology*, 4(2), 152–153.

transmission of poverty through education. If children in low-income households face nutritional barriers to accumulating human capital, generational inequalities could continue and widen in the long run.

Poor health outcomes are a well-known outcome of insufficient nutrition. Inadequate dietary intake contributes to a series of severe health problems and chronic diseases. Poor nutrition, characterised by deficiencies in essential nutrients and micronutrients, undermines immune function, increases susceptibility to infectious diseases, and impairs physiological processes.[18] Moreover, malnutrition in all its forms – undernutrition, overnutrition, and micronutrient deficiencies – contributes to the global burden of disease, exacerbating morbidity and mortality rates.[19] Additionally, poor nutrition during pregnancy raises the risk of adverse birth outcomes, including low birth weight and preterm birth, with long-term implications for child health and development.[20] Targeted and effective policy measures are key in ensuring the vast funds spent on malnutrition significantly improve the nutrition status of Sri Lanka.[21]

Since the COVID-19 and economic crisis, health outcomes related to pregnancies and children under the age of five highlight the extent of nutritional impacts on children under the age of five. The Family Health Bureau reports a rise in the presence of low birth weight from 12.3% in 2019 to 14.8% in 2023. Figure 4.6 illustrates the changes to other poor nutritional outcomes in children under five in the same period. Children who are underweight have increased by 3.1%, and stunting has increased following the periods of increased wasting in children in 2022 and 2023. Stunting, and by extension, wasting are attributed to longstanding movements away from a balanced diet as the quality of diet has taken a back seat to quantity as food prices rose by a substantial 128% between 2019 and 2023.[22] Therefore, long-term health complications due to the inability to purchase nutritious food will leave individuals at risk and increase the cost of healthcare to the country in the long run.[23] In Sri Lanka, the rise in non-communicable diseases (NCDs) has become a serious public health concern. NCDs,

Stunting, and by extension, wasting are attributed to longstanding movements away from a balanced diet as the quality of diet has taken a back seat to quantity as food prices rose by a substantial 128% between 2019 and 2023

18 Müller O., & Krawinkel, M. (2005, August). Malnutrition and Health in Developing Countries. *Canadian Medical Association Journal*, 2;173(3), 279-86.

19 Black, R. E., Victora, C. G., Walker, S. P., Bhutta, Z. A., Christian, P., de Onis, Ezzati M., Grantham-McGregor, S., Katz, J., Martorell, R., Uauy, R. & The Maternal and Child Nutrition Study Group (2013). Maternal and Child Undernutrition and Overweight in Low-income and Middle-income Countries. *The Lancet, 382*(9890), 427–451.

20 Bhutta Z. A., Das J. K., Rizvi A., Gaffey M. F., Walker N., Horton S., Webb P., Lartey A., Black, R. E., The Lancet Nutrition Interventions Review Group, & The Maternal and Child Nutrition Study Group. (2013, June) Evidence-based Interventions for Improvement of Maternal and Child Nutrition: What Can be Done and at What Cost?. *Lancet, 382*(9890), 52-477.

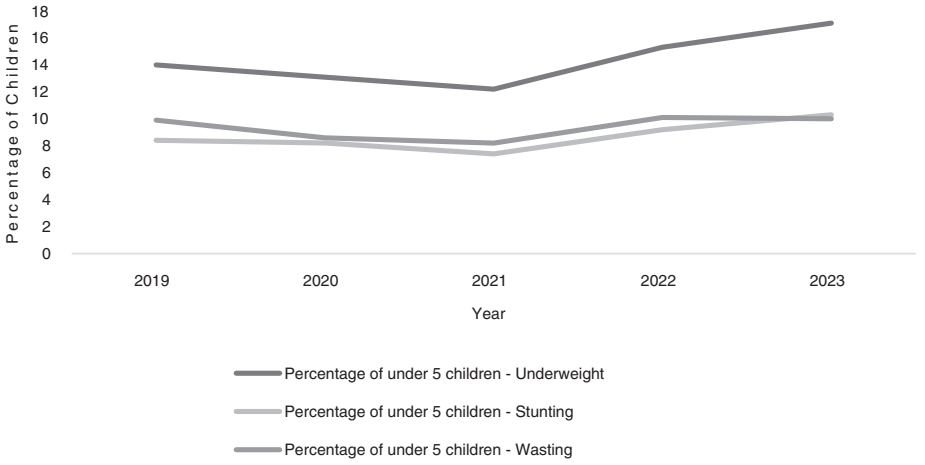
21 Jayawardena, P. (2020). *A Proactive Path to Combat Malnutrition in Sri Lanka, Health and Education Research Series – No 16*, Colombo: Institute of Policy Studies of Sri Lanka.

22 Based on statistics obtained from the Food and Agriculture Organization (FAO), Consumer Price Indices data for Sri Lanka.

23 Brinkman, H. J., De Pee, S., Sanogo, I., Subran, L., & Bloem, M. W. (2010). High Food Prices and the Global Financial Crisis have Reduced Access to Nutritious Food and Worsened Nutritional Status and Health. *The Journal of Nutrition, 140*(1), 153S-161S.

such as diabetes, cardiovascular diseases, and obesity, are influenced by various dietary factors, including excessive carbohydrate consumption. This section explores how high carbohydrate intake contributes to the prevalence of NCDs in Sri Lanka and the associated health implications.

Figure 4.6
Nutrition Indicators of Under Five Children in Sri Lanka



Source: Based on statistics obtained from Family Health Bureau, Ministry of Health, Sri Lanka.

Not only insufficient nutrition, but excessive carbohydrate consumption is strongly correlated with high NCD prevalence. In Sri Lanka, the traditional diet includes a high consumption of rice, bread, and sugary foods, contributing to high carbohydrate intake among the population. Table 4.5 shows that meals have increasingly high carbohydrate concentrations, as people tend to switch to such substitutes due to price hikes in quality foods. High carbohydrate intake, especially from refined sugars and starches, can lead to elevated blood glucose levels. According to the World Health Organization (WHO), diabetes prevalence in Sri Lanka has been rising, with dietary habits being a key contributing factor. Obesity, a major risk factor for several NCDs, including Type 2 diabetes, cardiovascular diseases, and certain cancers, is also a potential ill effect of excessive carbohydrate intake. The consumption of high-carbohydrate diets has been linked to increased levels of low-density lipoprotein (LDL) cholesterol and decreased levels of high-density lipoprotein (HDL) cholesterol, both of which are risk factors for heart disease.[24]

Nutritional effects extend to labour markets as adult workers are often seen as nutrition providers to other household members. The relationship between nutrition and labour market outcomes is complex, with nutrition having both direct and indirect effects on productivity, earnings, and employment opportunities. Individuals experiencing malnutrition or inadequate dietary intake often exhibit diminished cognitive abilities, impaired physical stamina, and reduced productivity levels,

24 Ludwig D.S., Pereira, M.A., Kroenke, C.H., Hilner, J.E., Horn, L.V., Slattery, M.L., & Jacobs, D.R. (1999, October). Dietary Fiber, Weight Gain, and Cardiovascular Disease Risk Factors in Young Adults. *Journal of American Medical Association*. 1999;282(16):1539–1546.

leading to hardships in securing employment and tend to earn lower wages compared to their adequately nourished counterparts.[25] Furthermore, chronic malnutrition and micronutrient deficiencies have been linked to increased absenteeism and higher rates of workplace injuries.[26,27] Such findings further shed light on the plight of working adults about nutrition in the context of Sri Lanka. Adults are engaged in various food coping mechanisms that are not only detrimental to more vulnerable household members but also to themselves. Reducing food consumption or eating low-quality food, especially as a mechanism to allow better nutritional outcomes for children and the elderly, is noted as a common coping strategy (Table 4.1). Thus, poor nutrition harms individual economic productivity and, as a result, also contributes to societal and community losses in human capital accumulation and labour market efficiency in Sri Lanka.

Long-term health complications due to the inability to purchase nutritious food will leave individuals at risk and increase the cost of healthcare to Sri Lanka in the long run.

In conclusion, poor nutrition impacts labour market outcomes, education, and health, perpetuating cycles of poverty and impeding human capital development. The evidence presented in this chapter underscores the urgency of addressing malnutrition as a critical determinant of individual and societal well-being.

4.5.2 Nutrition-related Policies and Programmes in Sri Lanka

In response to issues in food security and nutrition in Sri Lanka, the Government of Sri Lanka (GOSL), in collaboration with international organisations, has implemented several nutrition-related policies and programmes to improve the nutritional status of the population.

The revised National Nutrition Policy (NNP) 2021-2030 is a cornerstone of Sri Lanka's strategy to combat malnutrition. This policy aims to end all forms of malnutrition by 2030 by promoting diversified and balanced diets, improving maternal and child nutrition, and enhancing food security. Key actions include promoting the consumption of a variety of foods to ensure a balanced diet, enhancing nutrition education and awareness among the public, strengthening food fortification programmes to address micronutrient deficiencies, implementing targeted interventions for vulnerable groups such as pregnant women, infants, and young children. The Emergency Nutrition Action Plan 2022-2024 addresses the immediate nutritional needs arising from the economic crisis. The plan focuses on providing emergency food assistance to the most vulnerable populations, distributing fortified foods and micronutrient supplements to prevent

25 Behrman, J. R. (1996). The Impact of Health and Nutrition on Education. *The World Bank Research Observer*, 11(1), 23–37; Hoddinott, J., Maluccio, J. A., Behrman, J. R., Flores, R., & Martorell, R. (2008). Effect of a Nutrition Intervention During Early Childhood on Economic Productivity in Guatemalan Adults. Lancet, 371(9610), 411–416.

26 Fitzgerald S., Kirby A, Murphy A., & Geaney F., (2016, Dec). Obesity, Diet Quality and Absenteeism in a Working Population. *Public Health Nutrition*, 19(18):3287-3295.

27 de Medeiros, M. A., Zangirolani, L. T., Cordeiro, R. C., da Costa, P. R., & Diez-Garcia, R. W. (2014). Nutritional Variables and Work-related Accidents: A Case-control Study. *Work* (Reading, Mass.), 49(4), 619–626.

malnutrition, and supporting community kitchens and food distribution centres to ensure access to nutritious meals. Enhancing monitoring and evaluation systems to track nutritional status and programme effectiveness.

Box 4.3
Free School Meal Programme

In 2024, Sri Lanka launched a comprehensive school lunch programme aimed at addressing nutritional deficiencies and enhancing educational outcomes for primary school children. This initiative, led by the MOE, seeks to provide nutritious meals to all students in grades 1-5 across the nation. The primary goal is to improve the nutritional intake of children, thereby addressing malnutrition and associated health issues. By providing balanced meals, the programme aims to reduce rates of undernutrition, including stunting and wasting among school-aged children. In addition to nutrition, the programme is designed to increase student attendance and engagement by ensuring that children are not attending school on empty stomachs. It also helps alleviate food insecurity for vulnerable families, ensuring that children receive at least one meal and essential nutrients regardless of their home situation.

The initiative in 2024 targets over 1.6 Mn children in 9,134 government schools, including those with fewer than 100 students. It operates under the banner 'Healthy Active Generation' and provides breakfast between 7:30 am and 8:30 am to align with expert nutritional recommendations. The GOSL has allocated LKR 16.6 billion (Bn) for this initiative, with additional support from international organisations such as the World Food Programme and the United States Department of Agriculture. The budget per student has been increased from LKR 85 to LKR 110 to account for rising food costs. The programme emphasises sourcing food locally, which not only ensures freshness and cultural relevance but also supports the local economy by creating jobs in the agricultural and food production sectors.

Challenges still exist in funding and resource allocation. Securing adequate and consistent funding is a significant challenge. The programme relies on both GOSL allocations and international aid to maintain its operations. Transparent financial oversight mechanisms have been established to ensure accountability and effective use of funds. Effective implementation also requires infrastructure. This includes ensuring schools have the necessary kitchen facilities and that a reliable supply chain exists for food delivery.

Maintaining high nutritional standards is essential. The meals provided are designed to meet specific dietary requirements, incorporating a variety of food groups to ensure a balanced diet. This approach helps address micronutrient deficiencies and overall dietary quality among children.

Source: Compiled by the authors based on multiple sources.

The GOSL has also prioritised school meal programmes as a critical intervention to address child malnutrition. The 2024 initiative provides free nutritious meals to all primary school children, ensuring that they receive at least one balanced meal per day. This programme aims to improve attendance

and academic performance by ensuring children are well-nourished.[28] Community and household nutrition programmes also play a crucial role. Several community-based programmes have been launched to enhance household food security and nutrition, such as home gardening initiatives that encourage families to grow their own vegetables and fruits, providing a sustainable source of nutrition. Nutrition education campaigns also aim to teach families about the importance of balanced diets and proper food preparation methods.

4.6 Conclusions and Recommendations

Addressing the deficiencies discussed above in access to food and nutrition is crucial to preventing long-term health and economic consequences and costs to both individuals and the country. Much focus must be placed on integrating various nutrition-related policies and programmes to create an interconnected effort between multiple stakeholders. This includes coordinating efforts between different government ministries, such as health, agriculture, and education, to implement nutrition initiatives and prioritise nutritional needs as needed. In Sri Lanka, the Ministries of Health, Agriculture, and Education play pivotal roles. The Ministry of Health leads efforts in promoting public health nutrition, managing emergency nutrition plans, and overseeing the NNP implementation. It focuses on maternal and child health, food fortification, and nutrition education. The Ministry of Agriculture supports food security by promoting sustainable agricultural practices and boosting the production of nutrient-rich crops. This Ministry also collaborates on initiatives like home gardening and community farming to ensure food diversity. The Ministry of Education (MOE) implements school meal programmes and nutrition education in schools to improve children's dietary habits and academic performance. The free meal programme for primary school students launched in 2024 is a classic example of this Ministry's contribution. Improved coordination among these groups enhances nutritional access by identifying and communicating immediate food and dietary needs to relevant agricultural authorities, enabling focused production that meets local demand. Collaborating with international organisations and non-governmental organisations (NGOs) to leverage additional resources and expertise could benefit local policymakers.

Implementing monitoring and evaluation frameworks to assess the impact of nutrition programmes and make necessary adjustments could improve responses and reduce long-run difficulties with food and nutritional access. Implementing monitoring and evaluation frameworks is critical for assessing the effectiveness of nutrition programmes and identifying dietary deficiencies. Regular data collection on nutritional status, programme reach, and impact helps identify gaps and areas for improvement. For instance, the Emergency Nutrition Action Plan 2022-2024 includes detailed monitoring to track the nutritional status of children and pregnant women. Moreover, engaging with communities and stakeholders to gather feedback ensures that programmes are responsive to the beneficiaries' needs. Finally, conducting periodic reviews and audits of programmes to ensure compliance with standards and objectives is crucial. These reviews help in fine-tuning strategies and reallocating resources where necessary.

28 Sri Lanka Mirror. (2024, March 25). "2024 School Meal Program" inaugurated (Pics) – Sri Lanka Mirror; The Morning. (2024, March 25). Sri Lanka Launches Free Meals Programme for Primary School Students.

In addition to effective stakeholder coordination, a good blend of other interventions is necessary to address the ongoing food security and nutrition challenges. Strengthening social protection programmes by expanding and enhancing the current social protection systems, such as cash transfers and food assistance, can provide immediate relief to vulnerable households. Programmes such as Aswesuma can be strengthened to address immediate and short-term nutritional needs and other structural and long-term issues using the eligibility criteria. Promoting agriculture by investing in sustainable agricultural practices, improving access to agricultural inputs, and supporting smallholder farmers can boost food production and ensure long-term food security. Improving nutrition education by raising awareness about the importance of balanced diets and proper nutrition through community-based programmes and educational campaigns can help improve dietary practices. Government taxation on food can also be enhanced to consider nutrition deficiencies and to reduce the harmful effects of excessive carbohydrate intake without compromising the demand for energy requirements.

The difficulties Sri Lankans have faced in meeting food and nutritional needs highlight the importance of building resilient food systems that can withstand economic and climatic shocks. This includes enhancing infrastructure, diversifying food sources, and strengthening supply chains. Resilience in food systems ensures food security, supports livelihoods and promotes sustainable agricultural practices. Enhancing infrastructure such as irrigation and water management ensures reliable water supply to agriculture, especially during droughts. Transportation and storage facilities investments can improve rural road networks that enhance market access for farmers, allowing them to sell their produce more efficiently. Diversifying food sources by promoting crop diversity focuses on cultivating various crops that can reduce dependency on a few staple crops and enhance food security. Crop diversification includes promoting the growth of legumes, vegetables, and fruits alongside traditional staples like rice to meet the country's nutritional needs. In addition to the local development of food systems, expanding policies that facilitate both domestic and international trade can help stabilise food prices and supply. Trade agreements and partnerships can ensure a steady flow of food imports and exports, buffering against local production shortfalls. Maintaining strategic food reserves is another crucial measure. These reserves can be utilised during emergencies to ensure food availability and stabilise prices, thereby protecting the most vulnerable populations from food insecurity.[29]

In the wake of the 2022 economic crisis and several other external shocks that preceded it, ensuring access to food and nutrition remains a pressing issue for Sri Lanka in the near term. Addressing this challenge is vital for the population's immediate health and well-being and the country's long-term economic recovery, social stability, and human capital development. Through interventions, Sri Lanka can overcome these challenges and build a more resilient and equitable food system for all its citizens. Effective approaches to improve nutritional outcomes must adopt a multisectoral approach, with interventions across health, education, agriculture, and social protection sectors. By prioritising investments in nutrition-sensitive policies and programmes, policymakers can mitigate the adverse effects of poor nutrition and promote human capital accumulation in an inclusive economic environment.

29 This section draws from -Strategic Grain Reserves - Guidelines for their Establishment, Management and Operation, FAO (1997).

5. Progress Towards Universal Health Coverage

5.1 Introduction

The World Health Organization (WHO) defines 'Universal Health Coverage' (UHC) as "*all people have access to the full range of quality health services they need, when and where they need them, without suffering financial hardship. It covers the full continuum of essential health services, from health promotion to prevention, treatment, rehabilitation, and palliative care*."[1] According to this definition, the concept of UHC encompasses coverage with quality health services, financial risk protection, and universality. Achieving UHC stands is a pivotal target (Target 3.8) under the 2030 Sustainable Development Goals (SDGs) gauged through two indicators: the coverage of essential health services (SDG 3.8.1) and catastrophic health spending (SDG 3.8.2).

Despite ambitious targets, the global response is currently off track, primarily due to the disruptions caused by the coronavirus (COVID-19) pandemic.[2] The external shocks that followed the pandemic saw the world trapped in a permacrisis, with a growing disparity in UHC, among others. In Sri Lanka too, while UHC is one of the guiding principles of its National Health Policy 2016-2025 (NHP), multiple crises that the country has undergone, including the COVID-19 pandemic and particularly the economic crisis have placed immense pressure on the health system. Previously acknowledged as a model for achieving exceptional health outcomes with relatively low healthcare costs, Sri Lanka's healthcare system faces numerous obstacles at present, even in delivering basic healthcare services to the populace. Under these circumstances, it is crucial to explore alternative policy measures that can ensure the sustainability of the UHC concept during challenging times. This discussion is particularly important given the upcoming national elections – both presidential and general – as these will create policy windows that provide opportunities to advocate for alternatives.[3]

In this setting, this chapter explores the impacts of Sri Lanka's economic crises on its progress toward achieving UHC. In doing so, it pays special attention to health financing and financial protection, one of the core dimensions of UHC. First, the chapter presents the background context of UHC in Sri Lanka. This includes a discussion of the main dimensions of UHC, an overview of the country's health system, and the status of health financing and financial protection. The next section discusses the impact of the economic crisis on UHC, focusing on government spending on health and the impact on health financing and access to healthcare at the household level. Finally, the chapter outlines policy recommendations and strategies to achieve UHC, followed by a conclusion based on the discussion.

1 World Health Organization. (2024). *Universal Health Coverage*, https://www.who.int/health-topics/universal-health-coverage#tab=tab_1

2 World Health Organization. (2024). *Triple Billion Progress*, https://www.who.int/data/triple-billion-dashboard

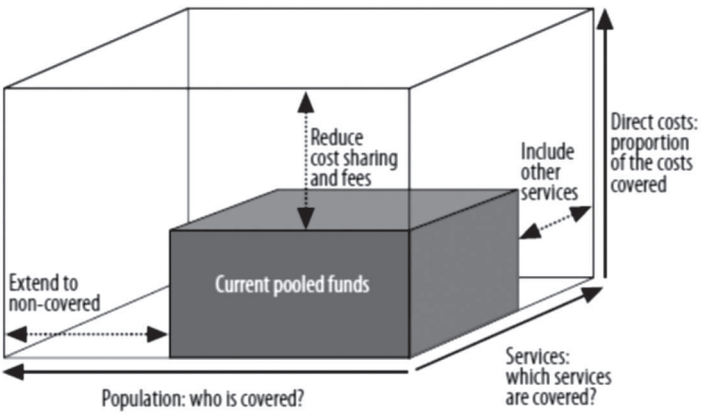
3 Reich, M., & Balarajan, Y. (2014). Political Economy Analysis for Nutrition Policy. *The Lancet Global Health*. 2(12), E681-E682.

5.2 UHC in the Sri Lankan Context

The WHO defines UHC as having three main components: quality of care, financial security for healthcare, and access to health services. Access to health services entails ensuring that everyone, regardless of socio-economic status or location, gets a comprehensive range of essential health services, including prevention, promotion, treatment, rehabilitation, and palliative care. Moreover, UHC seeks to shield individuals and households from financial hardship resulting from healthcare costs, thereby ensuring financial protection. This involves preventing catastrophic out-of-pocket expenses (OOPE) and preventing individuals from falling into poverty due to excessive medical bills. Adequate and sustainable health financing mechanisms are critical for UHC, requiring the mobilisation of funds from various sources such as government budgets, social health insurance (SHI) contributions, taxation, and donor funding to cover healthcare costs for the entire population. Additionally, UHC underscores the importance of providing high-quality health services that are safe, productive (efficient and effective), timely, equitable, and people-centric, necessitating the functioning of competent healthcare providers who adhere to evidence-based clinical guidelines and care standards.

The three dimensions of UHC, namely, population coverage, the range of services offered, and the degree of financial protection, are depicted using the UHC cube (see Figure 5.1).

Figure 5.1
Three Dimensions to Consider when Moving towards UHC



Source: World Health Organization. (2010). *World Health Report 2010 Health System Financing: The Path to Universal Coverage*. Geneva: World Health Organization.

While the UHC agenda emphasises the shared goal of providing high-quality services to all individuals, it acknowledges that each country is at a different stage in this journey, offering varying levels of services to diverse segments of the population with varying degrees of financial protection. The UHC cube provides a structured approach to achieving this. Firstly, defining the benefit package is crucial, as no country can afford to cover all services. Decisions must be made based on technical considerations, such as cost-effectiveness and political agreements, as removing services from an

existing package can be contentious. Determining the beneficiaries is another key aspect. Although the goal is universal coverage, reaching 100% of the population is challenging. Many countries begin with 'low-hanging fruit' such as formal sector employees and gradually expand coverage to other groups. However, the inclusivity of the coverage may vary from country to country. Vulnerable populations are often the hardest to reach and are included last unless equity goals drive health financing reforms. Given that financial protection is a central objective of UHC, typically measured by OOPE, a key goal is reducing OOPE, particularly user fees. This poses a sizeable challenge in achieving UHC – i.e. finding alternative funding mechanisms to replace user fees.

5.2.1 Overview of Sri Lanka's Healthcare System

Sri Lanka's healthcare system is comprised of public and private health services, with the government acting as the primary healthcare provider for both curative and preventive care. The public sector bears the main responsibility, offering facilities that handle 95% of inpatient care and 50% of outpatient care, while the private sector focuses more on curative services, whereas its role in preventive care is somewhat limited. The government's healthcare system operates under a partially devolved structure, with the Ministry of Health (MOH) overseeing national health services, facilities, medical education, policymaking, and procurement of medical supplies.[4]

The inception of Sri Lanka's 'free health' policy traces back to 1951, inspired by Britain's National Health Service legislation of 1946. Following the commissioning of the Cumpston Report in 1950 aimed at reforming healthcare in post-independence Ceylon, user fees were eliminated in the public healthcare system, and state services were centralised under a unified health department. However, the nation's notable advancements in health and well-being after gaining independence cannot be solely attributable to healthcare sector efforts.[5] Alongside investments in public health infrastructure and expanded healthcare coverage, improvements in health were closely linked to advancements in literacy and education levels, enhanced living conditions, and food security measures, among others. These interconnections between health and various other measures contributed to overall health improvements. For instance, policies such as food subsidies initiated following World War II food-rationing scheme and the implementing 'free education' in 1945, providing universal access to primary and secondary education, heavily influenced the country's health status. Despite the gradual erosion of these policies over subsequent decades, their lasting impact continues to shape societal expectations and government responsibilities.[6]

Though a developing country, Sri Lanka's healthcare system has been acclaimed for its remarkable feats, achieving sound social and health outcomes through cost-effective yet impactful evidence-

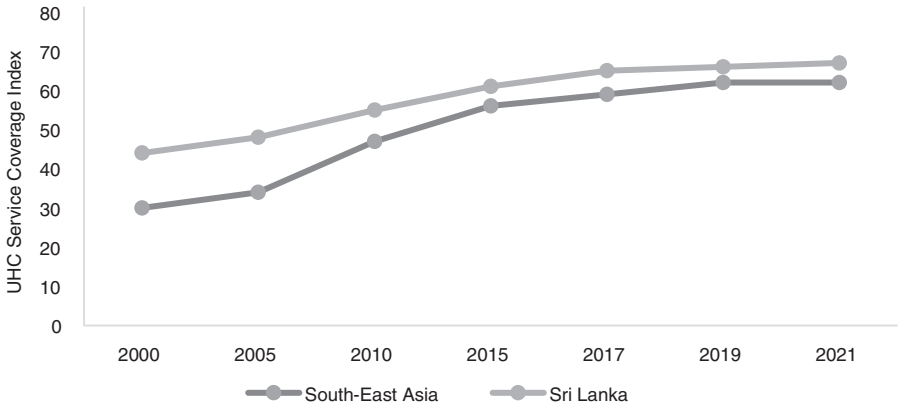
4 The framework of Sri Lanka's healthcare system is shaped by the Health Services Act of 1953 and the Provincial Council Act of 1988. Prior to the 1980s, the central health department or ministry managed government health services. However, the 13th Amendment in 1987 decentralised the responsibility for health services to Provincial Councils, each with its own provincial health ministry.

5 Gunatilleke, G., Wanigasekera, E., Namasivayam, P., & Asirwatham, S.R. (1984). *Intersectoral Action for Health: Sri Lanka Study* (Ed.). V. Gunawardena. Colombo: Marga Institute.

6 Kumar, R. (2019). Public–Private Partnerships for Universal Health Coverage? The Future of "Free Health" in Sri Lanka. Global Health 15 (Suppl 1), 75 (2019).

based interventions.[7] This success is attributed to a well-organised healthcare delivery system that offers free services at all government healthcare facilities. The last case of Polio in Sri Lanka was detected in 1993. The WHO declared the country as having eliminated leprosy in 1995, malaria in 2016, lymphatic filariasis in 2016, measles in 2019, rubella and congenital rubella syndrome in 2020, and mother-to-child transmission of human immunodeficiency virus (HIV) and syphilis in 2020. The country has effectively controlled vaccine-preventable diseases and saw a massive reduction of food and water-borne illnesses, with zero mortality attributed to diarrheal disease. Moreover, the curative healthcare sector has achieved notable milestones, successfully managing epidemic outbreaks and conducting advanced surgical procedures, including organ transplantation. These achievements are also reflected in the continuous increase in the country's UHC index (Figure 5.2).

Figure 5.2
UHC Service Coverage Index, /100, 2000-2021



Note: The coverage of essential health services (defined as the average coverage of essential services based on tracer interventions that include reproductive, maternal, newborn and child health, infectious diseases, non-communicable diseases (NCDs) and service capacity and access, among the general and the most disadvantaged population). The indicator is an index reported on a unitless scale of 0 to 100, which is computed as the geometric mean of 14 tracer indicators of health service coverage. The tracer indicators are as follows, organised by four components of service coverage: 1. Reproductive, maternal, newborn and child health 2. Infectious diseases 3. NCDs 4. Service capacity and access.

Source: World Health Organization. (2024). *Data.WHO.int, UHC Service Coverage Index* [Indicator], https://data.who.int/indicators/i/9A706FD

Even if Sri Lanka is progressing towards achieving UHC, a closer look at the UHC index reveals certain spheres where the country is still lagging and needs more attention (Table 5.1). The prevalence of hypertension treatment in the country, recording a low coverage, is a major area of concern. Service coverage indices calculated for the health workforce density

Even if Sri Lanka is progressing towards achieving UHC, a closer look at the UHC index reveals certain spheres where the country is still lagging and needs more attention.

7 Directorate of Policy Analysis and Development, Ministry of Health. (2022). *Review of the National Health Policy 2016-2025.* Colombo: Directorate of Policy Analysis and Development, Ministry of Health.

comprising physicians, psychiatrists, and surgeons, tuberculosis treatment coverage, and care-seeking behaviour for suspected acute respiratory infection indicate only medium coverage.

Table 5.1
Sri Lanka UHC Service Coverage Index - SDG 3.8.1, Sub-Indices, and Tracer Indicators

Reproductive, maternal, newborn and child health (RMNCH)	Family planning methods satisfied by modern methods	74
	Antenatal care, 4+ visits	>80
	Child Immunisation (DTP3)	>80
	Care-seeking behaviour for acute respiratory infection (ARI)	52
Infectious diseases	Tuberculosis treatment	48
	HIV antiretroviral therapy	66
	Insecticide-treated nets use	NA
	Access to at least basic sanitation	>80
NCDs	Prevalence of hypertension treatment	36
	Diabetes prevalence	>80
	Tobacco non-use	69
Service capacity and access	Hospital beds density	>80
	Health workforce	44
	International Health Regulations Core Capacity Index	64
Service coverage sub-indices	RMNCH	76
	Infectious diseases	66
	NCDs	60
	Service capacity and access	66
UHC SCI (SDG 3.8.1)		67

Notes: Legend as below.

Very high coverage (>= 80)	
High coverage (60-79)	
Medium coverage (40-59)	
Low coverage (20-39)	
Very low coverage (20)	
Not Applicable	NA

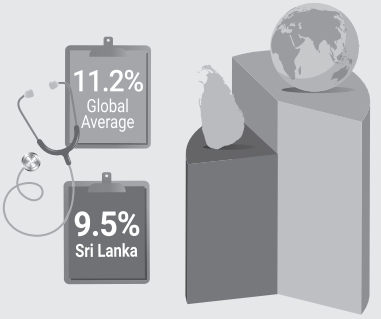
Source: WHO and the World Bank Group. (2023). *Tracking Universal Health Coverage: 2023 Global Monitoring Report*. Geneva: World Health Organization.

5.2.2 Health Financing and Financial Protection

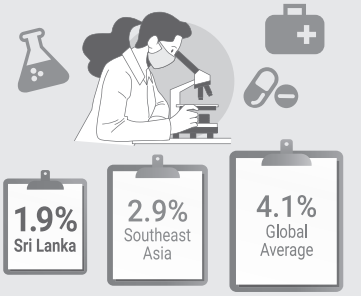
Healthcare financing in Sri Lanka is primarily through two sources, each contributing roughly half of the total expenditure: (1) government transfers funded through general taxation and (2) direct payments by households, referred to as OOPE. For example, in 2021, government transfers covered 45% of total health expenditure (THE), while OOPE accounted for 44%.[8] Other funding sources, such as SHI contributions, voluntary health insurance, and external aid, make minor contributions, each accounts for less than 5% of THE. Typically, external donor financing represents a small fraction, around 1-2% of total current health expenditure. However, a surge in external donor funding in 2021, reaching 4.3%, was likely due to the global support received during the pandemic in the form of donations and aid.

Arguably, Sri Lanka's healthcare system faces formidable challenges due to insufficient government spending, which results in inadequate meeting of the growing demand for services from epidemiological and demographic transitions.[9] Currently, government health expenditure accounts for only about 8-9% of its total spending, reflecting a shortfall compared to global averages. For instance, in 2021 and before the onset of the economic crisis, domestic general government health expenditure (GGHE-D) as a percentage of general government expenditure (GGE) stood at 9.5%, while the global figure stood at 11.2%. Similarly, when considering GGHE-D as a percentage of gross domestic product (GDP), Sri Lanka reported 1.9%, compared to 2.9% for the Southeast Asian region and 4.1% globally.[10]

Government Health Expenditure: How Does Sri Lanka Compare Globally?



Government Health Expenditure as a % of Total Government Spending (2021)



Government Health Expenditure as a % of GDP (2021)

Source: WHO's Global Health Observatory Data Repository (2023).

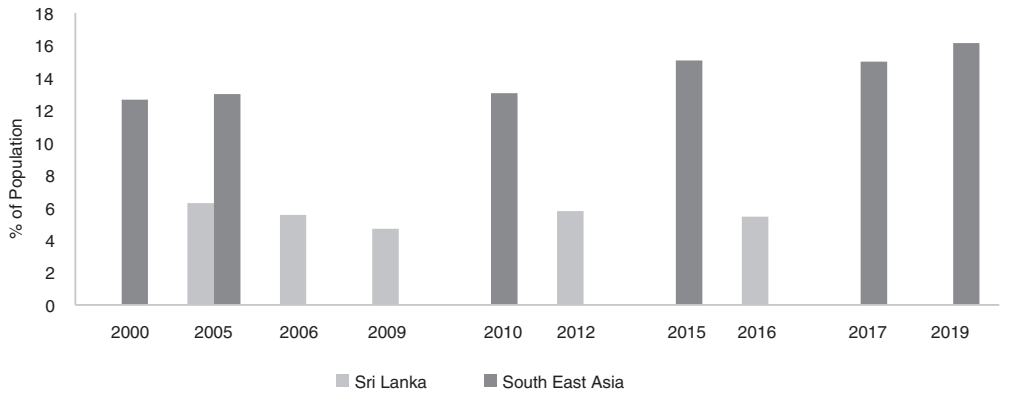
8 World Health Organization. (2024). *Global Health Expenditure Database Health Expenditure Profile Sri Lanka*, https://apps.who.int/nha/database/country_profile/Index/en

9 Rajapaksa, De Silva., Abeykoon, Somatunga., Sathasivam, Perera,... Weerasinghe. (2021). *Sri Lanka Health System Review.* World Health Organization Regional Office for South-East Asia. New Delhi.

10 World Health Organization. (2023). *Global Health Observatory Data Repository*, https://apps.who.int/gho/data/node.main.HEALTHFINANCING

Health financing policies directly influence the degree of financial protection provided. Inadequate financial protection mechanisms can result in serious financial hardships stemming from OOPE and increasing barriers to accessing healthcare services. With OOPE remaining a major source of healthcare financing in Sri Lanka, many citizens, particularly susceptible populations, probably face financial burdens in meeting their healthcare needs. This situation can potentially lead to catastrophic health expenditure, wherein a household's healthcare spending exceeds a certain threshold of their income or expenditure. SDG 3.8.2 specifies that catastrophic health spending occurs when a household allocates over 10% of its total household expenditure or income towards healthcare. Figure 5.3 illustrates the percentage of the population in Sri Lanka and the South East Asia region that has incurred catastrophic health expenditure. The percentage of households spending more than 10% of their total household expenditure on health is lower in Sri Lanka compared to the South East Asia region. For instance, in 2016, only 5.4% of households in Sri Lanka exceeded this threshold, whereas in the South East Asia region, the figure was almost threefold higher at 15%.

Figure 5.3
Population with Household Expenditures on Health Greater than 10% of Total Household Expenditure or Income



Note: The figure depicts the available data points from the source; some data points are missing.

Source: World Health Organization. (2024). *The Global Health Observatory Population with Household Expenditures on Health Greater than 10% of total Household Expenditure or Income (SDG 3.8.2),* https://www.who.int/data/gho/data/indicators/indicator-details/GHO/population-with-household-expenditures-on-health-greater-than-10-of-total-household-expenditure-or-income-(sdg-3-8-2)-(-)

Impoverishment serves as another crucial metric for assessing health financial protection. This indicator measures the proportion of households that become impoverished or further impoverished due to OOPE, calculated using a relative poverty line reflecting essential needs such as food, housing, and utilities. When individuals or families encounter substantial OOPE for medical care, especially if these expenses are not adequately covered by insurance or other financial aid, they may struggle to afford the other essential necessities. Consequently, their overall quality of life may decline, increasing the risk of falling below the poverty line. In Sri Lanka, it has been estimated that approximately 0.7% of households, or roughly 149,200 people, have been pushed into poverty

(at the United States Dollars (USD) 1.90 level) due to OOPE health spending as per the 2020 update.[11] Compared to the South East Asia regional figure of 1.95% in 2019, Sri Lanka was doing relatively well in terms of health and financial protection at the household level. However, the economic crisis that intensified after 2020 may have changed this scenario.

Insufficient government investment in health services, the increasing burden of NCDs, which are now the leading causes of premature death and disability, an ageing population, and the expanding privatisation of health services threaten Sri Lanka's progress towards UHC. Indeed, it is understandable that a relatively low-income country like Sri Lanka, whose health system was originally designed to address infectious diseases and provide child and maternal health services, will face serious difficulties in achieving and sustaining UHC through an epidemiological transition from infectious to NCDs. Some argue that owing to these challenges, Sri Lanka can no longer provide quality healthcare at a low cost, and the country's limited investment in health is hindering rather than supporting efforts to achieve good health outcomes.[12]

Several measures are proposed to advance health financing reforms towards UHC. These include making the budget process more responsive to the health sector needs, taking measures to reduce the proportion of OOPE's contribution to total health expenditure (e.g., expanding prepaid pooled financing such as social health insurance schemes and increasing synergies between the current OOPE and the tax-based health financing), developing an organisational set-up for health financing which can enhance efficiency, equity and accountability and leveraging the non-state actors towards public policy goals are some such measures proposed.[13] The pandemic and the economic crisis have only added to the challenges. Thus, understanding the impacts of these shocks in some detail is crucial in formulating measures to achieve UHC.

5.3 Impact of the Economic Crisis on UHC: Evidence from Data

During an economic crisis, several challenges arise in achieving UHC. These can include constraints on healthcare budgets due to reduced government revenue and austerity measures, disruptions in healthcare delivery due to shortages of medical supplies, equipment, and personnel, potential loss of health insurance coverage as individuals lose their jobs,[14] exacerbation of mental health issues due to heightened stress and anxiety,[15] and widening health inequalities.[16] Thus, the impacts strain the healthcare system, on the one hand, and the economic hardships faced by the population also

11 World Health Organization. (2020). *Monitoring Progress on Universal Health Coverage and the Health-Related Sustainable Development Goals in the WHO South-East Asia Region: 2020 Update*. World Health Organization, Regional Office for South-East Asia. New Delhi, https://iris.who.int/bitstream/handle/10665/334213/9789290227885-eng.pdf?sequence=1&isAllowed=y

12 Chapman, A. R., Dharmaratne, S. D. (2019). Sri Lanka and the Possibilities of Achieving Universal Health Coverage in a Poor Country. *Global Public Health*, 14(2), 271–283.

13 Gopalan, S. (2023). Health Financing Options for Sri Lanka: What, and Why? *The Ceylon Medical Journal*, 68(S1), 58–61.

14 Maruthappu, Watkins, Noor, Williams, Ali, Sullivan, Atun. (2016). Economic Downturns, Universal Health Coverage, and Cancer Mortality in High-Income and Middle-Income Countries, 1990-2010: A Longitudinal Analysis. *Lancet*. 13;388(10045):684-95.

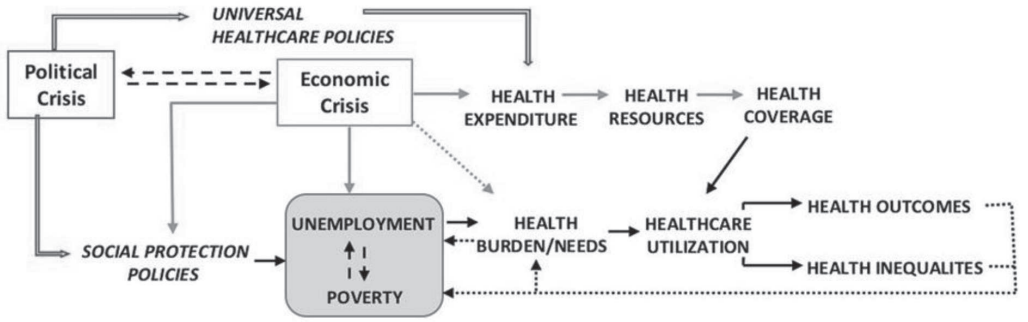
15 Frasquilho, Matos, Salonna, Guerreiro, Storti, Gaspar…Caldas-de-Almeida (2015). Mental Health Outcomes in Times of Economic Recession: A Systematic Literature Review. *BMC Public Health* 16, 115.

16 Bacigalupe, A., Escolar-Pujolar, A. (2014). The Impact of Economic Crises on Social Inequalities in Health: What Do We Know So Far? *International Journal of Equity in Health* 13, 52 (2014).

impact affordability. On the other hand, individuals may be forced to forgo or delay seeking healthcare services due to cost concerns, leading to unmet healthcare needs and exacerbating health disparities. Supply chain disruptions in the health system and shortages or delays in obtaining resources can compromise the quality of care and access to essential treatments.

Such challenges are exacerbated by the fact that economic crises are often interlinked with political crises (Figure 5.4). This was so in Sri Lanka, where it faced severe political turmoil at the height of its economic crisis, massive social unrest and weakening of public confidence in the country's political system. Such instability disrupts UHC policy continuity and focus due to limited financial resources, deterioration in the healthcare delivery system, reduced public trust, and the diversion of attention and resources away from UHC priorities. Additionally, changes in political institutions, including changes in political leaders, interests, ideologies, and networks during a political crisis, can lead to policy changes that further hinder progress.[17]

Figure 5.4
The Political and Economic Crisis Cascade Effects



Source: Massuda, A., Hone, T., Leles, F., De Castro, M., & Atun, R. (2018). The Brazilian Health System at Crossroads: Progress, Crisis, and Resilience. *BMJ Global Health* 2018;3: e000829.

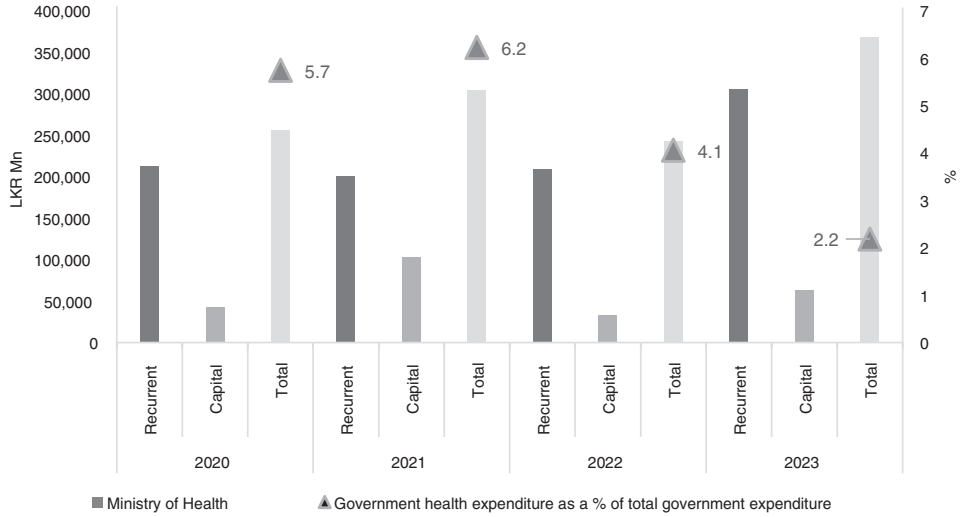
5.3.1 Priority to Health by the Government

'Priority to health by the government' refers to the intentional allocation of resources, funding, policies, and attention to enhance and uphold the health and well-being of the population. When the government puts health first, especially in trying times, it exemplifies its dedication to protecting the health of its people and recognises the importance of a healthy population for social and economic progress. This commitment is typically reflected by GGHE-D as a percentage of GGE. Figure 5.5 illustrates Sri Lanka's government budgetary allocations to the MOH over the past four years, representing a percentage of total government expenditure. As depicted in the figure, the share of government expenditure on the MOH has notably decreased by 2023. From 2021 to 2022, the GGHE-D as a percentage of GGE decreased by 2.17 percentage points, indicating that a smaller portion of the government's overall budget was allocated to health expenditure during this period. This trend

17 Shearer, J., Abelson, J., Kouyaté, B., Lavis, J., & Walt, G. (2016). Why do Policies Change? Institutions, Interests, Ideas and Networks in Three Cases of Policy Reform. *Health Policy and Planning, 31*(9), 1200–1211.

continued into the following year, with an additional decrease of 1.87 percentage points from 2022 to 2023. This further decline highlights a significant reduction in the priority given to health funding within the government's budget over these two years. Despite this, the 2023 budget allocations show that the MOH remains within the top five Ministries with the highest share of government budget allocations. The top Ministries are the Ministry of Finance (MOF), Ministry of Public Administration, Ministry of Transport, Ministry of Defence, and MOH, with budget allocations of 15.3%, 3.1%, 2.5%, 2.4% and 2.2%, respectively. However, the Ministry of Defence receiving a higher allocation than the MOH remains a concern, given the current context.

Figure 5.5
Government Expenditure on Health, 2020-2023



Notes: The government's domestic sources for health encompass internal transfers and grants, transfers and subsidies to voluntary schemes, as well as social health insurance contributions. However, in this context, only the government's allocation for the MOH is considered.
The 2020 figure includes the allocations for MOH, State Ministry of Indigenous Medicine Promotion, Rural and Ayurvedic Hospitals Development and Community Health, State Ministry of Production, Supply and Regulation of Pharmaceuticals, and State Ministry of Primary Healthcare, Epidemics and COVID Disease Control.

Source: Authors' compilation based on Ministry of Finance, Economic Stabilisation and National Policies. *Budget Estimates* (Various issues).

5.3.2 Health Financing and Access to Health at the Household Level

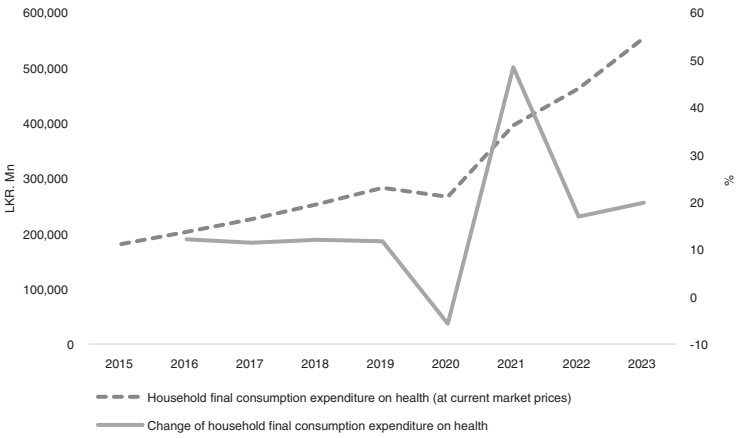
As mentioned previously, an economic crisis can profoundly affect household expenditure on health. At the onset of a crisis, household health spending may rise, which can be particularly pronounced for the poorest households. For example, during the economic crisis in Greece, escalations in health spending were observed among low-income households.[18] However, as the crisis persists, households' ability to allocate funds to healthcare services and essential medical supplies may

18 Crookes, C., Palladino, R., Seferidi, P., Hirve, R., Siskou, O., & Filippidis, F. (*2020*). Impact of the Economic Crisis on Household Health Expenditure in Greece: An Interrupted Time Series Analysis. BMJ Open. 2020;10: e038158.

diminish due to declining income levels. Consequently, due to weakening purchasing power, families may be compelled to prioritise spending on basic needs like food, shelter, and education, often at the expense of healthcare. This shift can lead to reduced utilisation of healthcare services, delays in seeking medical attention, and an increased reliance on seeking cheaper or alternative healthcare options. Additionally, households may resort to coping mechanisms such as borrowing money or selling assets to cover healthcare costs, further deepening their financial vulnerability.

In Sri Lanka, as indicated by the Classification of Individual Consumption by Purpose (COICOP), at the macro level, household final consumption expenditure on health has generally been on the rise, with growth rates ranging from 11.4% to 12.1% (Figure 5.6). However, a much sharper rise in health expenditure is evident after 2020. From 2020 to 2021, health expenditure surged by an overwhelming 48.4%. Following the steep rise in 2021, the trend in expenditure growth was seen in 2022 and 2023, with growth rates of 16.9% and 19.8%, respectively. This spike can be attributed to several factors, including the heightened demand for healthcare services and medical supplies due to the COVID-19 pandemic and the increased cost of healthcare due to the economic crisis.

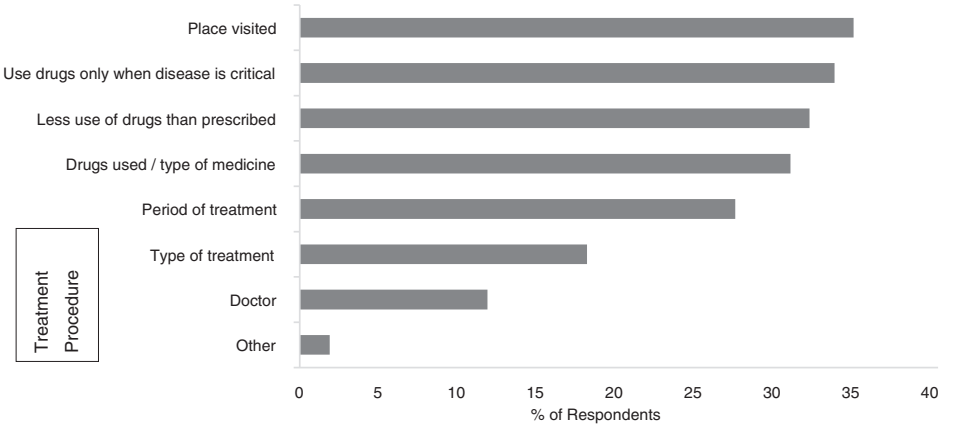
Figure 5.6
Household Final Consumption Expenditure on Health



Source: Department of Census and Statistics. (2023). *National Accounts of Sri Lanka*, http://www.statistics.gov.lk/NationalAccounts/StaticalInformation/Reports/DetailedTables/e-Household-Final-Consumption2023

According to a survey conducted by the Department of Census and Statistics (DCS) to gauge the impact of the economic crisis on households, approximately 29% of individuals reported experiencing some form of illness. Among these individuals, 7% altered their treatment approaches, which is directly due to the economic turmoil. These changes included seeking treatment at different locations, using medications only when conditions became critical, and reducing the medication taken as prescribed (Figure 5.7).

Figure 5.7
Change in Treatment Procedure



Note: Since it has multiple answers, the summation of percentages is not equal to 100.

Source: Department of Census and Statistics. (2023). *Household Survey on Impact of Economic Crisis – 2023*. Battaramulla: Department of Census and Statistics.

To gain deeper insights into the impact of the economic crisis on households, data from two primary sources were analysed: the Household Income and Expenditure Survey (HIES) 2019 and the National Citizen Survey (NCS) 2022-23. The HIES, conducted by the DCS, is a comprehensive national sample survey that collected data from households across all districts in twelve monthly rounds from January to December 2019. With a sample size of 25,000 household units, this survey aimed to assess changes in living conditions by examining household income and expenditure patterns. The HIES data include pertinent health-related information such as health expenditure at the household level, individual utilisation of curative health services, the prevalence of chronic illnesses and disorders, and access to healthcare facilities.

Similarly, the NCS 2022-23, conducted by the United Nations Development Programme (UNDP) surveyed 25,000 households between November 2022 and March 2023. This survey aimed to capture the changing vulnerabilities experienced by Sri Lankans amidst the economic downturn. The NCS 2022-23 provides valuable insights into household health expenditure, their access to healthcare services, the prevalence of chronic illnesses and disabilities at the individual level, and participation in social protection programmes for healthcare at the household level.

While inherent limitations exist in directly comparing results from two distinct data sources to assess the pre- and during-economic-crisis scenarios, these datasets were utilised due to the absence of HIES data beyond 2019. This approach aimed at gaining a nuanced understanding of how the economic crisis has impacted households in terms of healthcare expenditure, utilisation, and access.

During the period concerned, the average household expenditure increased significantly at the national level, nearly doubling (see Table 5.2 and infographic). This increase was particularly pronounced in the rural sector. By 2022/2023, monthly household health expenditure as a percentage of total monthly expenditure surpassed the 10% mark both nationally and across sectors.

Table 5.2
Average Household Health Expenditure

	2019	2022/2023	2019		2022/2023	
	National		Urban	Rural	Urban	Rural
Monthly household health expenditure (LKR)	2,056	4,143	3,599	1,760	4,587	4,051
Monthly household health expenditure as a % of total monthly expenditure	3.14	11.08	2.96	2.26	10.78	9.28

Source: Authors' calculations based on HIES 2019 and NCS 2022-23.

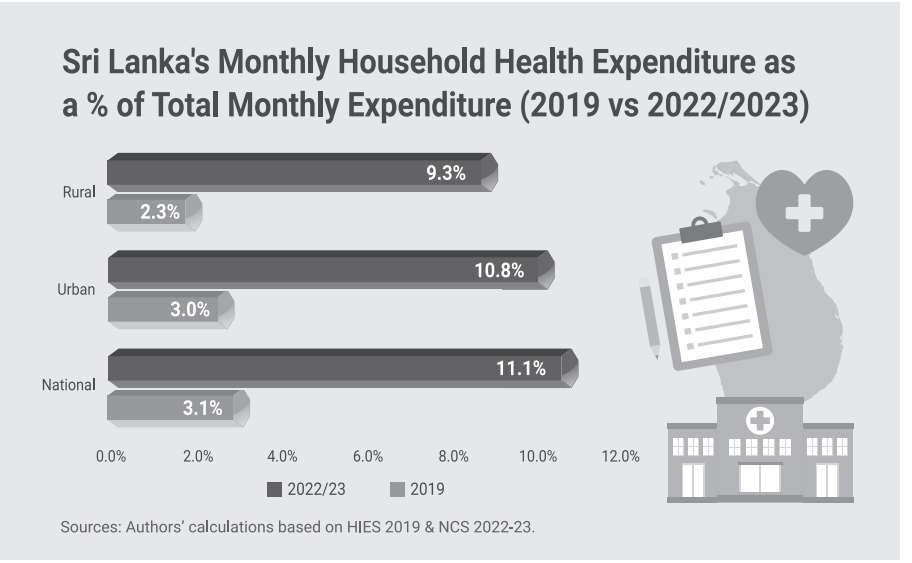
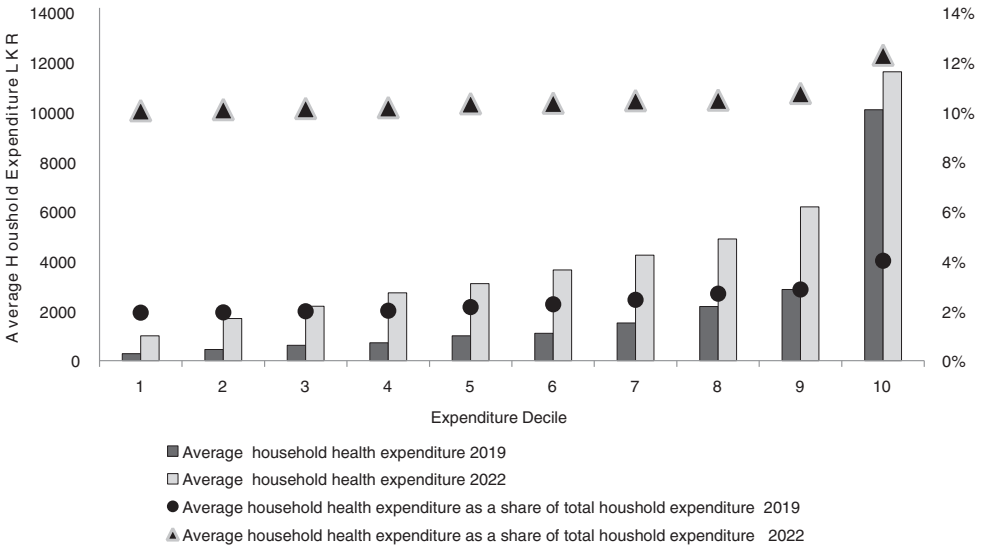


Figure 5.8 provides a comparison of household health expenditure and average household health expenditure as a share of total household expenditure across different expenditure deciles between 2019 and 2022/2023. The analysis reveals that households in all expenditure deciles have experienced a significant increase in the financial burden of healthcare. This increase is evident in both absolute terms (total health expenditure) and relative terms (health expenditure as a percentage of total household expenditure). For lower deciles, which represent the poorest households, the burden can become particularly pronounced. For instance, households in the lowest expenditure quintile experienced a 252% increase in their health expenditure from 2019 to 2022, rising from Sri Lankan Rupees (LKR) 285 to LKR 1,004. Similarly, households in the second lowest quintile saw a 276% increase. However, the richest households only experienced a 15% increase, with health expenditure rising from LKR 10,099 to LKR 11,627. The poorer households, which already spend a substantial portion of their income on necessities, now have to allocate an even larger share of their limited resources to healthcare. This situation can lead to difficult trade-offs, such as cutting back on other essential expenses like food, education, and housing. Although the households in middle and upper expenditure deciles generally have higher incomes, the spike in healthcare costs still represents a serious financial strain. The rising cost of healthcare can erode disposable income, reducing the ability of these households to save or invest in other areas.

Figure 5.8
Household Health Expenditure by Expenditure Deciles, 2019 and 2022/2023



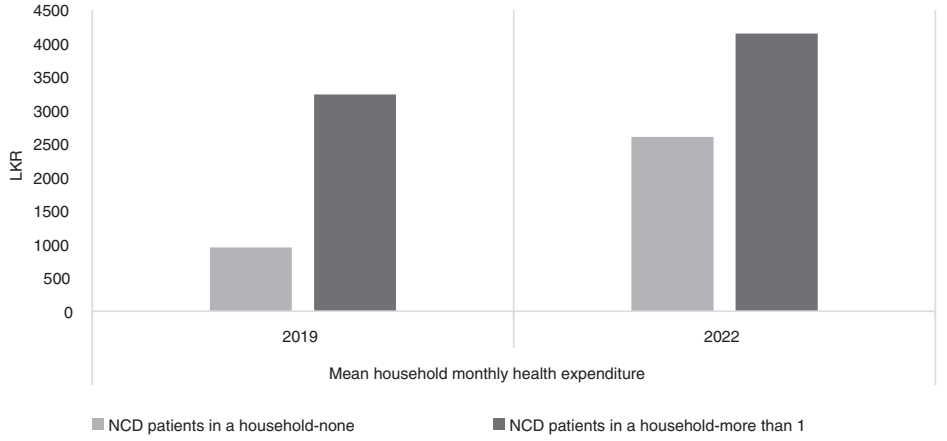
Source: Authors' calculations based on HIES 2019 and NCS 2022-23.

Households in all expenditure deciles have experienced a significant increase in the financial burden of healthcare. This increase is evident in both absolute and relative terms. For lower deciles, which represent the poorest households, the burden can become particularly pronounced.

Households with members suffering from chronic illnesses (i.e., NCDs), usually bear a higher financial burden. Managing chronic diseases often requires continuous medical care, regular doctor visits, ongoing medication, and sometimes specialised treatments or therapies. This can lead to substantial OOPE, particularly in settings where public health coverage is limited or insufficient. Consequently, as mentioned before, the financial impact will likely worsen for these households during an economic downturn. To quantify this impact, average household health expenditure was compared between households with no NCD patients and households with one or more NCD patients (Figure 5.9). Health expenditure is higher for households with NCD patients compared to those without NCD patients in both periods. Health expenditure increased for both groups from 2019 to 2022/2023. However, the increase was more pronounced for households without NCD patients, which saw an increase of LKR 1,648, compared to an increase of LKR 906 for households with NCD patients. This situation may arise because NCD patients, given the long-term nature of their conditions, tend to skip or reduce their routine medications and other tests due to rising costs, assuming that doing so does not significantly affect their illnesses.[19]

19 Madurawala, S., Ipchita Bharali, I., Ranasinghe, S., & Arunatilake, N. (2023). *Improving Data and Knowledge for Strategic Planning, Budgeting, and Financing of NCDs in Sri Lanka: A Qualitative Analysis*. Institute of Policy Studies of Sri Lanka and the Centre for Policy Impact in Global Health, University of Duke. Unpublished Research Report.

Figure 5.9
Financial Burden on Households with Patients with Chronic Illnesses, 2019 and 2022/2023



Source: Authors' calculations based on HIES 2019 and NCS 2022-23.

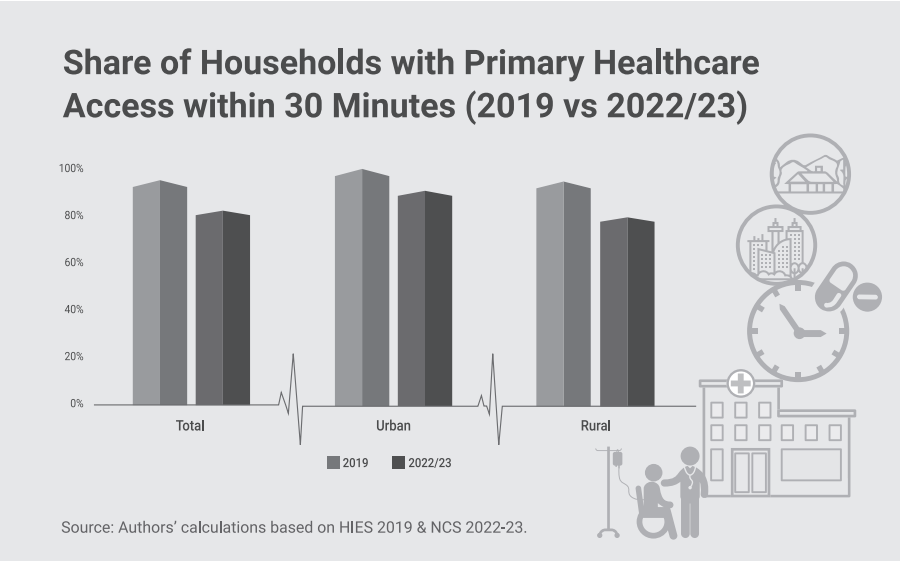
5.3.3 Accessibility

Healthcare accessibility refers to the extent to which individuals or communities can obtain needed healthcare services in a timely manner. It encompasses various factors that influence the ability of individuals to access healthcare, including physical proximity to healthcare facilities, availability of healthcare services, affordability of care, transportation options, and cultural or social barriers. For this discussion, physical accessibility is considered.

A general decline in access to healthcare from 2019 to 2022/2023 is seen across all areas. In 2019, 95% of households had access to primary healthcare within 30 minutes, whilst this percentage decreased to 82% by 2022/2023.

The data indicates a general decline in access to healthcare from 2019 to 2022/2023 across all areas (see infographic). In 2019, 95% of households had access to primary healthcare within 30 minutes, whilst this percentage decreased to 82% by 2022/2023. A sectoral comparison reveals that the reduction is more pronounced in rural areas (0.14 points) compared to urban areas (0.08 points), indicating that rural areas have been more adversely affected during this period. Even before the economic crisis, access to healthcare facilities was lower for households in rural areas. During the economic crisis, this situation has further deteriorated. This decline stemmed from several factors associated with access to primary healthcare. Transport issues, exacerbated by the fuel crisis, were major contributors to both household access and service delivery limitations.[20] Additionally, financial limitations have led to a reduction in services offered, particularly in rural areas, and staff shortages have further restricted access to healthcare during the crisis.

20 Madurawala, S., Ipchita Bharali, I., Ranasinghe, S., & Arunatilake, N. (2023). *Improving Data and Knowledge for Strategic Planning, Budgeting, and Financing of NCDs in Sri Lanka: A Qualitative Analysis*. Institute of Policy Studies of Sri Lanka and the Centre for Policy Impact in Global Health, University of Duke. Unpublished Research Report.



5.4 Policy Recommendations and Strategies to Achieve UHC in Sri Lanka

Lessons from other countries that have encountered similar health system challenges due to financial crises, such as Thailand, Vietnam, Indonesia and Greece, urge a long-term approach to health reform to foster system resilience. Resilience involves anticipating, coping with, and learning from economic shocks. Effectively addressing the impact on the health system requires absorptive, adaptive, and transformative responses.[21]

Adaptation policy measures are particularly pertinent given Sri Lanka's current economic and political context. These measures can provide immediate relief while laying the groundwork for more sustainable and resilient health system improvements in the future.

Absorption policy measures focus on investing in activities to build health system resilience right from the onset of the shock. During the first year of a crisis, it is crucial to absorb the immediate impacts on the health system to ensure essential health services remain accessible and affordable for the poor. These measures include maintaining basic health functions, immunisation services, and reproductive, maternal, and child health services. Adaptation policy measures involve mid-term interventions that start immediately but yield benefits beyond five years. Countries experiencing comparable financial crises have prioritised the provision of critical health services. They have also enacted intermediate changes to improve financial protection, refocus service delivery from hospitals

21 Peiris, D., Ingale, S., Downey, L., Schierhout, G., Bhaumik, S., Jan, S., & Nambiar, D. (2023). *Health Service Delivery Reforms during and after Economic Crises – A Rapid Evidence Review and Country Case Study Analysis*. Sydney: The George Institute for Global Health.

to primary care facilities, and broaden the scope of current social health insurance programmes. Transformative policy measures are long-term strategies with activities beginning currently, whereas benefits are realised beyond five years. A key transformative measure is investing in the primary healthcare sector to shift services away from specialist and hospital care.

Based on the earlier discussion, this section presents some adaptation policy measures that Sri Lanka could implement to strengthen health financing, enhance financial protection, and improve physical accessibility to healthcare services. Adaptation policy measures are particularly pertinent given the country's current economic and political context. These measures can provide immediate relief while laying the groundwork for more sustainable and resilient health system improvements in the future. These measures address two critical dimensions of UHC and aim to ensure UHC for citizens despite the negative impacts of the economic crisis.

5.4.1 Strengthening Health Financing and Enhancing Financial Protection

Understandably, the earlier discussion indicates that the economic crisis negatively impacts both major healthcare financing sources of Sri Lanka, namely government funding and OOPE, meaning that reaching UHC is far more challenging than envisaged. With the fiscal constraints faced by the government, its priority and focus on the country's health system could easily be diverted to other competing priorities of non-health sectors. Given the strong interdependence between the country's health outcomes and the quest for economic recovery apart from regular economic development, such a diversion could have negative repercussions on both areas. Strategies proposed for strengthening health financing and enhancing financial protection are discussed below.

With fiscal constraints , the priority and focus on Sri Lanka's health system could easily be diverted to other competing priorities in non-health sectors. Given the strong interdependence between health outcomes and the quest for economic recovery , such a diversion could have negative repercussions on both areas.

Enhance domestic resource mobilisation: Explore avenues for increasing domestic resource mobilisation for healthcare through innovative financing mechanisms such as earmarked taxes, sin taxes on harmful substances like tobacco and alcohol, and health insurance contributions. The Philippines introduced sin taxes on alcohol and tobacco products in 2012 (Sin Tax Reform Act of 2012), leading to a surge in government revenue and funding for healthcare services. Despite concerns on earmarked taxes that the MOF might offset its allocated funds by the amount generated through these taxes, the potential for such mechanisms remains significant. Sri Lanka could consider implementing earmarked taxes for specific products like Sugar-Sweetened Beverages (SSBs).[22] Many initiatives have successfully utilised earmarked tax revenues from SSBs. For instance, French Polynesia directs

22 Madurawala, S., Kiringoda, K., Thow, A. M., & Arunatilake, N. (2023). Fiscal Policies and Regulations for Healthy Diets in Sri Lanka: An Analysis of the Political Economy of Taxation and Traffic Light Labelling for Sugar-Sweetened Beverages. *Global Health Action*, 16(1), 2280339.

these funds towards a general prevention fund, Mexico uses these for drinking water initiatives, and in the US, Philadelphia allocates these to preschool children's education.[23]

Reduction of OOPE: Overall, the data indicate a worsening situation in terms of financial protection against health costs at the household level. As healthcare expenses consume a larger portion of household budgets, the risk of financial hardship and poverty due to health expenditures increases, and makes UHC a more challenging and daunting task. This underscores the need for targeted policy interventions to alleviate the financial burden of healthcare on households, especially those in lower expenditure deciles, amidst the ongoing economic crisis. Thailand's Universal Healthcare Coverage Scheme provides comprehensive healthcare coverage to all citizens and significantly reduces OOPE, and similarly, Australia's Pharmaceutical Benefits Scheme (PBS) subsidises the cost of prescription medications, and are examples of interventions aimed at reducing OOPE.

Box 5.1
Australia's Pharmaceutical Benefits Scheme

Australia's Pharmaceutical Benefits Scheme (PBS) is a government programme that provides affordable access to prescription medicines for Australian residents. The PBS was introduced in 1948 with the objective of ensuring that all Australian residents have reliable and affordable access to a wide range of necessary prescription medicines.

Key features:

- **Subsidised medications:** The PBS subsidises the cost of many prescription medicines, making them more affordable for patients. This helps to reduce the financial burden on individuals who require medication for chronic or acute health conditions.
- **Co-payments:** Patients are required to make a co-payment for PBS-listed medicines. The co-payment amount depends on whether the patient holds a concession card. For concession card holders, the co-payment is significantly lower.
- **Safety net:** The PBS includes a safety net to protect individuals and families from high medication costs. Once a patient reaches a certain threshold of OOPE within a calendar year, their co-payments are reduced for the rest of the year.

Prescription and coverage:

- **Wide range of medicines:** The PBS covers a broad spectrum of prescription medications, including those for common conditions like hypertension, diabetes, and asthma, as well as more specialised and high-cost drugs for cancer, HIV, and other serious illnesses.
- **Regular reviews:** The list of subsidised medicines is regularly reviewed and updated by the Pharmaceutical Benefits Advisory Committee (PBAC) to ensure it includes the most effective and necessary medications. The PBAC is an independent expert body appointed by the Australian Government. Members include doctors, health professionals, health economists

23 Thow, A., Downs, M., Mayes, C., Trevena, H., Waqanivalu, T., & Cawley, J. (2018). *Fiscal Policy to Improve Diets and Prevent Non-communicable Diseases: from Recommendations to Action*. Bulletin of the World Health Organization *96*(3), 201–210.

and consumer representatives. No new medicine can be listed unless the committee makes a positive recommendation.

- **Eligibility:** The PBS is available to Australian residents who hold a Medicare card. Certain visitors from countries with reciprocal healthcare agreements may also be eligible.

Financial impact:

- **Government expenditure:** The PBS represents a significant portion of the Australian government's healthcare expenditure, reflecting its commitment to ensuring medication affordability.
- **Cost-effectiveness:** The programme negotiates prices with pharmaceutical companies, ensuring that the government obtains medications at a cost-effective rate.

Access and availability:

- **Community pharmacies:** PBS medicines are available through community pharmacies across Australia. Patients can present their prescription at any PBS-approved pharmacy to receive their medication at the subsidised rate.
- **Online services:** The PBS also provides information online, including details about covered medications, co-payment amounts, and safety net thresholds.

Australia's PBS system has been found to be extremely effective at reducing prescription drug spending. The benefits of the PBS include lower prescription drug prices, lesser per capita expenditure on prescription drugs and direct patient benefits through co-payments.

Sources: Pharmaceutical Benefits Scheme. (2024). *About the PBS*, https://www.pbs.gov.au/info/about-the-pbs;
Waldrop, T. (2023). *Value-based Pricing of Prescription Drugs Benefits Patients and Promotes Innovation,* https://www.americanprogress.org/article/value-based-pricing-prescription-drugs-benefits-patients-promotes-innovation/

Introducing alternative health financing options: The SHI system is known to be the most suitable and sustainable health financing option available for Sri Lanka.[24] By pooling risks and resources through SHI, individuals and households can be protected from catastrophic health expenditure, ensure financial risk protection, and enhance access to quality healthcare services, especially during times of economic uncertainty. However, considering the various cost elements related to its introduction and implementation, as well as the current scarcity of resources, SHI is better suited as a long-term strategy. Thailand provides a classic example of a country achieving UHC through a comprehensive SHI system (Box 5.1). Considering the government's financial limitations, options like user fees and public-private partnerships (PPPs) can be viewed as medium-term fixes. However, addressing the equity issues posed by these financing options is imperative.

24 This section drawn from- Building a Resilient Health System, In *Sri Lanka State of the Economy 2023, Economic Policy Choices: From Stabilisation to Growth*. Colombo: Institute of Policy Studies of Sri Lanka.

Box 5.2
Implementing UHC: Best Practices from Thailand

Despite considerable investment in health since the 1970s, in 2000, Thailand continued to face massive challenges in healthcare delivery. Approximately, 30% of the population (18 Mn people) did not have health insurance and no guaranteed access to free medical care. In addition, OOP payments accounted for a third of THE and these impacted poor households disproportionately. Thailand adopted a UHC scheme in April 2001, with public primary health facilities as the main healthcare providers.

The main objectives of the UHC scheme were to focus on promoting health, prevention, and care, while emphasising the role of primary healthcare. In addition, equity was a key consideration for the government - in an attempt to ensure that health subsidies were progressive, largely benefitting the poor and ensuring all citizens were protected against financial risks to obtaining healthcare.

The UHC had three main features:

1. A tax-financed scheme free at the point of service - chosen based on the progressivity of the tax system in Thailand, where the rich pay a much larger proportion of taxes than the poor.
2. A comprehensive benefits package with a primary care focus - this package covered outpatient, inpatient and accident emergency services and dental care.
3. A fixed annual budget with a cap on provider payments.

Despite increased general government expenditure on health between 2001 and 2008, from USD 1.9 billion (Bn) to USD 7.4Bn (76% real increase), health expenditure as a percentage of GDP remained between 3-4%.

The scheme encountered significant challenges initially, in part caused by the move from supply-side financing (where the MOH allocated budgets to its administrative units and service tiers) to demand-side financing and organisational reforms required within the MOH but is nevertheless seen as being very successful, not least in reducing OOP payments by households from 33% of total expenditure to 15% in 2008.

Key Characteristics of the Three Main Public Health Insurance Schemes in Thailand as of 2020

Insurance Scheme	Population Coverage	Source of Revenue	Mode of Provider Payment	Access to Service
Civil Servant Medical Benefit Scheme (CSMBS)	9%, government employees plus dependents (parents, spouse, and up to 2 children).	General tax, non-contributory scheme.	Fee for service, direct disbursement to mostly public providers and Diagnostic Related Groups (DRG) for inpatient treatment.	Free choice of public providers.

Social Health Insurance	16%, private sector employees, excluding dependents.	Tripartite contribution is equally shared by the employer, employee, and the government.	Inclusive capitation for both outpatient and inpatient plus additional adjusted payments for accident, emergency and high-cost care.	Registered public and private contractors.
Universal Coverage Scheme (UCS)	75%, and the rest of the 'Thai' population not covered by the SHI and the CSMBS.	General tax.	Capitation for outpatients and global budget plus DRG for inpatients.	Registered contractors, notably the network of public hospitals (Contracting Unit for Primary Care).

Sources: Collaborative Africa Budget Reform Initiative. (2015). *Universal Health Coverage (UHC): Magic Cube or Pandora's Box?*. Background Report for International Conference on Financing Healthcare in Africa: Challenges and Opportunities 2015. Pretoria: Collaborative Africa Budget Reform Initiative; Tangcharoensathien, V., Tisayaticom, K., Suphanchaimat, R., Vuthiphan Vongmongkol, V., Viriyathorn, S., & Limwattananon, S. (2020). Financial Risk Protection of Thailand's Universal Health Coverage: Results from Series of National Household Surveys between 1996 and 2015. *International Journal for Equity in Health 19,* 163 (2020).

5.4.2 Improve Physical Accessibility to Healthcare Services

Improving physical accessibility to healthcare services in Sri Lanka amid an economic crisis requires strategic planning and innovative approaches. It is essential to ensure that individuals can access essential health services despite financial constraints and logistical challenges. The strategies below outline suggestions for enhancing the physical accessibility of healthcare services.

Mobile health clinics: Mobile health clinics offer a solution at a relatively low cost by delivering essential healthcare services directly to communities, especially those in remote and underserved areas. These clinics operate on a scheduled basis, travelling to different locations to provide preventive care, health screenings, immunisations, and basic treatments. for example, Brazil employs mobile health clinics known as '*Unidades Básicas de Saúde Móveis'* (Mobile Basic Health Units). These units are deployed to offer healthcare services to underserved populations residing in remote areas, urban slums, and indigenous communities. Here, they provide a range of services, including vaccinations, prenatal care, dental services, and health education. In a similar vein, India also utilises a mobile health clinic system to extend healthcare services to communities in need.

Telemedicine and telehealth: Leveraging telemedicine and telehealth technologies can overcome geographical barriers and enable individuals to access healthcare services remotely. Investing in telemedicine platforms and digital health solutions can facilitate virtual consultations, medical advice, and remote patient monitoring. As a result, there is a lesser need to physically visit healthcare facilities, thus expanding outreach at a reduced cost. For instance, *eSanjeevani*, the National Telemedicine Service of India launched by its Ministry of Health, and Family Welfare of India in 2019, has successfully brought health services to rural areas and remote communities.[25] This cloud-based *eSanjeevani* platform proved its effectiveness during the COVID-19 pandemic.

25 Ministry of Health and Family Welfare, Govt. of India. (2024). *eSanjeevani - National Telemedicine Service*, https://esanjeevani.mohfw.gov.in/#/about

Community health workers (CHWs): Empowering community health workers and volunteers to deliver healthcare services within local communities can significantly improve access to care, especially in rural and remote areas. By training and deploying CHWs to provide basic healthcare services, health education, and preventive care interventions at the grassroots level can assist in effectively bridging the gap between communities and formal healthcare facilities. Notable examples of successful CHW programmes include Ethiopia's Health Extension Programme, which trains and deploys Health Extension Workers to provide essential healthcare services, health education and promote healthy behaviour in rural areas, and Bangladesh's 'Community Health Care Providers' programme, which trains and mobilises CHWs to deliver essential healthcare services, maternal and child health services, and health education in remote and underserved areas.[26]

Transportation subsidies: It can be less expensive for people from low-income households to commute to healthcare facilities if they receive transport subsidies or vouchers. Given the government's financial constraints, putting this plan into practice could be difficult, but it still remains a viable long-term solution. The government can explore partnerships with transportation providers or offer subsidies to reduce transportation costs for individuals seeking medical care, ensuring that financial constraints do not prevent access to healthcare services. Developed countries like Canada, Sweden, and Norway, as well as low- and middle-income countries such as India (under *Janani Shishu Suraksha Karyakram scheme*), Mexico (under *Seguro Popular* programme), and Indonesia (under *Jaminan Kesehatan Nasional* scheme), provide transportation subsidies for their citizens to enhance access to healthcare services.

5.5 Conclusion

The recent and ongoing crises in Sri Lanka, especially the economic crisis, pose significant challenges to the country's commitment to achieving UHC. Once praised for its remarkable health outcomes with relatively low investments, the Sri Lankan health system is now under scrutiny for its ability to sustain quality healthcare at a low cost. The sustainability of the system has been called into question due to emerging difficulties like an ageing population and rising NCDs, as well as the system's resilience in the face of shocks like the economic crisis and the COVID-19 pandemic.

The previous sections of this chapter clearly demonstrate that the economic crisis has had a significantly negative impact on the country's health system, especially in terms of health financing and access to healthcare. The discussion revealed that the country's two major health financing sources, government spending and OOPE, face critical challenges, raising questions about the ability to ensure the financial protection of citizens. This situation underscores the urgent need to explore alternative health financing mechanisms. The economic crisis has significantly affected people's health-seeking behaviour and their physical access to healthcare services.

In this context, this chapter proposes three policy priority areas to ensure progress towards UHC: strengthening health financing, enhancing financial protection, and improving physical accessibility

26 Schleiff, M., Aitken, I., Alam, M., Damtew, Zufan., & Perry, Henry. (2021). *Community Health Workers at the Dawn of a New Era: 6. Recruitment, Training, and Continuing Education*. Health Research Policy and Systems. 19. 10.1186/s12961-021-00757-3.

to healthcare services. Adaptive policy measures are considered more suitable for tackling the present challenges in Sri Lanka's health system to achieve UHC. Key policy measures to strengthen health financing and enhance financial protection include enhanced domestic resource mobilisation, reduction of OOPE, and the introduction of alternative health financing options. To improve physical accessibility to healthcare services, the recommended policy measures include implementing mobile health clinics, leveraging telemedicine and telehealth, utilising CHWs, and providing transportation subsidies.

6. Coping Mechanisms: Pawning Amidst Crises

6.1 Introduction

Sri Lanka has been experiencing a series of adverse shocks in recent years. The country was hit by the coronavirus (COVID-19) pandemic in 2020, followed in 2022 by its worst economic crisis since independence. Additionally, Sri Lanka has had to face the consequences of unfavourable policy decisions by the government such as the ban on chemical fertiliser imports in 2021, as well as a prolonged drought in 2022. Having minimal time for recovery between crises and encountering multiple shocks within a short timeframe has severely restricted Sri Lankan households, particularly low- and middle-income groups, in many ways.

Household vulnerability has heightened due to rising expenditure with reduced incomes, and shortage of essential goods, adversely impacting people's living standards. The consecutive crises have also contributed to increases in food insecurity, poverty and inequality in the country.[1] As a result, households were pushed to rely on numerous coping strategies, such as taking on additional work (secondary jobs) or working longer hours, cutting down essential expenses, withdrawing savings, and borrowing from various sources.[2] Among the various coping strategies employed, pawning gold jewellery (also referred to as gold-backed loans) has gained increasing attention in recent times. Attractive features of pawning, such as flexible repayments and a relatively simple loan process, are likely to have contributed to its popularity among households.

With the rising demand and supply of pawning services in Sri Lanka, there seems to be a revival in the pawning market amidst crises.

While the demand for pawning seems to have surged, the supply of pawning services has also experienced a considerable increase in recent times. Pawning has gained much prominence as a key financial product, contributing to the lending portfolios of formal financial institutions (FIs), such as banks and licensed finance companies (LFCs).[3] In particular, the LFCs sector has shown remarkable growth in pawning, following the government restrictions on vehicle imports and subsequent diversification of portfolios by the companies. With the rising demand and supply of pawning services in Sri Lanka, there seems to be a revival in the pawning market amidst crises.

Against this background, this chapter examines the impacts of multiple crises of recent times on households and the different coping mechanisms employed by them to face adversities, with a focus on the demand and supply of pawning (gold-backed loans) in Sri Lanka.[4] The analysis is based on

1 World Bank. (2023). *Sri Lanka Development Update, October 2023: Mobilising Tax Revenue for a Brighter Future*. Washington, D.C.: World Bank.

2 Department of Census and Statistics Sri Lanka. (2023). *Household Survey on Impact of Economic Crisis - 2023*. Battaramulla: Department of Census and Statistics Sri Lanka.

3 Central Bank of Sri Lanka. (2023). *Financial Stability Review*. Colombo: Central Bank of Sri Lanka.

4 In this chapter, pawning refers primarily to pawning gold items such as gold jewellery.

both primary and secondary data and information. Primary data/information were gathered through (i) a rapid household survey of pawning carried out by the Institute of Policy Studies of Sri Lanka (IPS) during April – June 2024 and (ii) key informant interviews (KIIs) with providers of pawning services including selected banks, LFCs, and semi-formal sources. Additionally, the United Nations Development Programme (UNDP) Citizens Survey 2022/2023 dataset and other secondary sources were used.

6.2 Effects of Multiple Crises on Households

As mentioned earlier, multiple crises in recent years have impacted the Sri Lankan economy and people's lives in many ways. Inflation reached nearly 70% in September 2022 (measured by the Colombo Consumer Price Index), with rising food prices placing Sri Lanka among the world's top 10 countries with the highest food price inflation. The economic crisis also led to acute shortages of essentials, including medicine, fuel, and certain food items. Amid these adversities, the poverty rate doubled (measured at United States Dollars (USD) 3.65 a day, 2017 purchasing power parity) from 13.1% in 2021 to 25% in 2022 and increased further to 25.9% in 2023.[5] The crises also affected employment via reduced work hours, increased job losses, and income/pay reductions. The Department of Census and Statistics (DCS) (2023) reveals that 48% of employed persons have experienced a reduction in work hours while 45.8% have undergone a pay cut or income loss since March 2022. Moreover, 60.5% of households experienced a drop in income due to the crisis.[6]

Adding to these burdens were the adverse effects on food security and health conditions. With 24% of households considered to be food insecure during the second half of 2023, the share of underweight children below the age of five grew from 14% to 16.2% between June 2022-2023. Furthermore, the share of pregnant women with anaemia rose from 13.3% to 16.2% during the same 12-month duration.[7]

Evidence also suggests that the crises led to 'indebtedness' among households. As per the Household Survey on the Impact of the Economic Crises conducted by the DCS in 2023, 54.9% of households had some form of financial obligations or outstanding loans that they were managing or repaying, while 22% of households had been indebted due to the economic crisis.[8] Examining the different sources of borrowing indicates 'mortgage matters' as one of the key sources used by 31% of households who were in debt. While 'mortgage matters' in the survey have taken into consideration a broad range of sources such as pawning gold jewellery, mortgaging land, vehicles and housing, etc., it is likely that pawning gold jewellery accounts for the largest share in this category. Another recent survey reveals that 38.5% of households were in debt (i.e. had some form of outstanding borrowing) at the end of 2022/early 2023. While the sources of loans/debt varied from public and private banks (38%),

5 World Bank. (2023); World Bank. (2024). *Sri Lanka Development Update, April 2024*: Bridge to Recovery. Washington, D.C.: World Bank.

6 Department of Census and Statistics Sri Lanka. (2023). *Household Survey on Impact of Economic Crisis – 2023*. Battaramulla: Department of Census and Statistics Sri Lanka.

7 World Bank. (2023); World Bank. (2024). *Sri Lanka Development Update, April 2024*: Bridge to Recovery. Washington, D.C.: World Bank.

8 Department of Census and Statistics Sri Lanka. (2023). *Household Survey on Impact of Economic Crisis – 2023*. Battaramulla: Department of Census and Statistics Sri Lanka.

Samurdhi banks (19%), and money lenders, about 13.5% of households have taken loans through pawning gold jewellery.[9] However, the share of households that borrowed through pawning is likely an underestimation as gold-backed loans obtained from formal FIs, including banks and leasing/finance companies, may be reported under those sources rather than under pawning. Regardless of the differences in numbers between the two surveys mentioned above, it is evident that the use of pawning facilities has been popular among households to meet additional income needs or to cope with crises in recent times. Against this backdrop, the next section explores in more detail the preferences and use of pawning across different geographical settings and among different population groups.

6.3 Demand-side Analysis of Pawning

6.3.1 Pawning as a Coping Strategy Among Households

Pawning (or gold-backed loans) refers to borrowing by offering a gold item, such as gold jewellery as collateral to a pawnbroker/lender. It has been commonly used among households in Sri Lanka, particularly given the wide acceptance of gold as a form of savings or asset accumulation. Moreover, the salient features of pawning, such as quick access to credit, minimal documentation including the absence of personal guarantor requirements, and the ability to borrow for any purpose, have made it a popular coping strategy during emergencies. These features of pawning are discussed in greater detail in Section 6.5.

According to the UNDP National Citizen Survey 2022-2023, households employ several strategies to meet additional financial requirements during emergencies. These include taking on additional work, borrowing from various sources, including FIs, informal lenders, friends and family, and credit purchases from local shops, etc. Interestingly, of the diverse strategies employed to meet additional financial needs, pawning jewellery emerged as the most popular strategy adopted by 37.9% of households. The second most used strategy is interest-free borrowings from friends and relatives (29.6%). This is followed by taking on additional work (15.3%) and credit purchases from local shops (11.5%). Borrowing from FIs such as banks, i.e., obtaining regular loans from formal sources, seems to be a less popular coping mechanism to meet additional income needs during times of crises (9.2%).

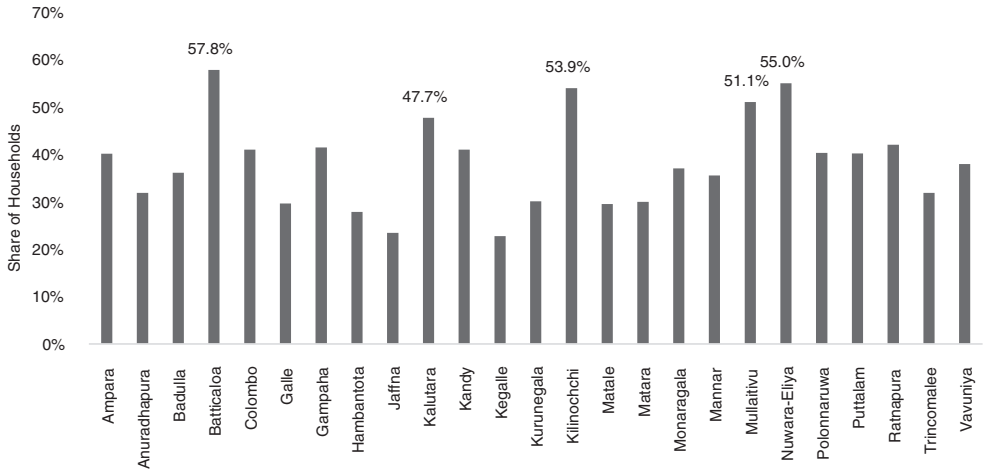
At the provincial level, pawning gold jewellery was the most widely preferred coping mechanism across seven of the nine provinces in the country and the second-most preferred in the remaining provinces. In the North Central and Southern provinces, where pawning is ranked second, interest-free borrowing from friends or relatives takes precedence. District-level data also reveal that pawning is among the top two strategies used by households except for Anuradhapura where it was the third-most-popular strategy with interest-free borrowings from friends/relatives and credit purchases from local shops appearing as the first and second, respectively.

Although a high preference is seen for pawning facilities irrespective of geographic location, variations exist in the share of households using pawning across districts. For example, pawning seems to be

9 United Nations Development Programme. (2023). *Understanding Multidimensional Vulnerabilities: Impact on People of Sri Lanka*, https://www.undp.org/srilanka/mvi.

largely popular in the Batticaloa, Nuwara-Eliya, Kilinochchi, and Mullaitivu districts, where over 50% of households in these districts utilise pawning services as a mechanism to meet their additional income requirements (Figure 6.1). This is followed by several other districts where pawing services are obtained by around 35% - 40% of households. These include Mannar, Badulla, Monaragala, Vavuniya and Ampara. Although pawning jewellery is used by less than 25% of households in the Jaffna and Kegalle districts, it is still among the three most popular coping strategies used by households. Coinciding with the higher popularity of pawning use in the majority of districts in the North and East, a higher share of Tamil households (46%) seems to engage in pawning compared to the Sinhalese (37%). A possible explanation for this could be the socio-cultural factors that the Tamil community associates with gold ownership, such as to be given as a dowry at marriage.[10]

Figure 6.1
Use of Pawning by Households - District-Level Analysis



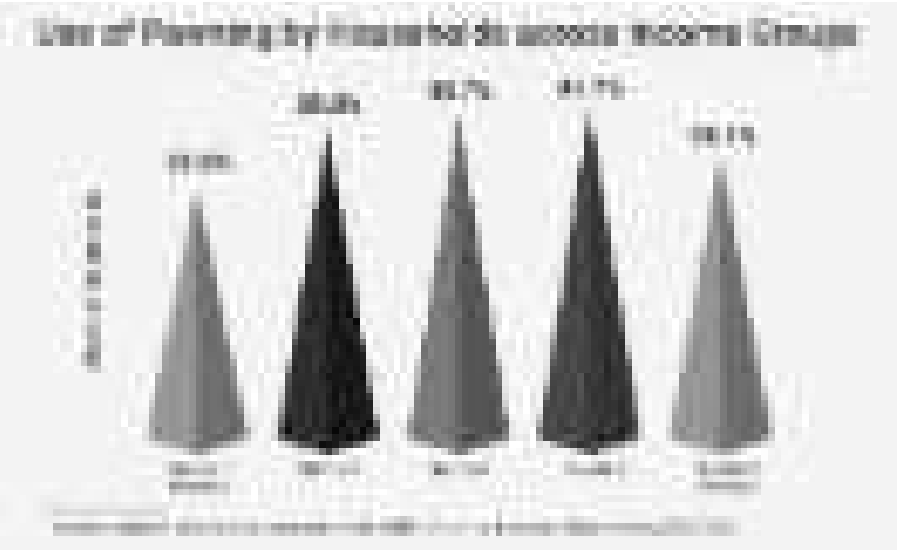
Source: Authors' calculations using data from UNDP Sri Lanka, National Citizen Survey 2022-2023.

A considerable share of households across all income groups also seems to rely on pawning services.

While a considerable share of households across all income groups also seems to rely on pawning services, the extent of pawning use varies across different groups. As shown in Figure 6.2, a higher share of households in the middle groups (quintiles 2-4) use pawning services compared to the poorest and the richest segments (quintiles 1 and 5). Households in the poorest quintile rely more on interest-free borrowing from friends/relatives and buying on credit from local shops. A possible explanation for the relatively low use of pawning services among the poorest households could be that they have less/no gold jewellery. Furthermore, given the series of adverse shocks faced by Sri Lankan households over the past four years, poorer households may have already pawned their valuables, hence, pawning may no longer be a feasible option for them.

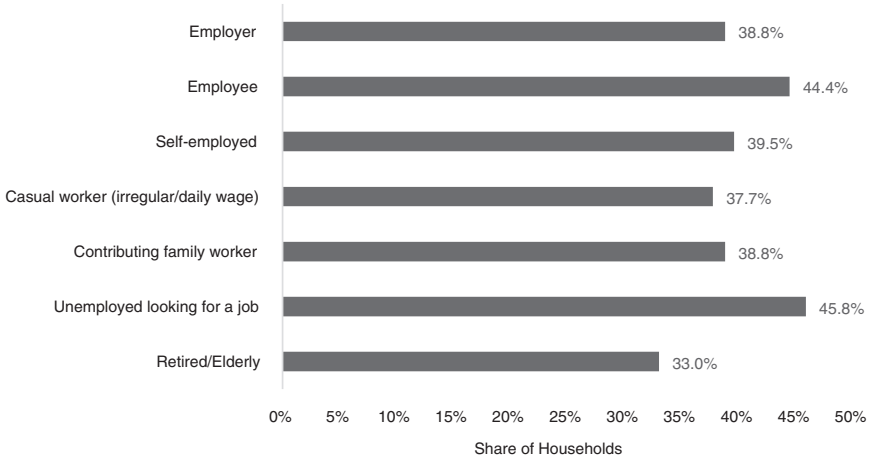
10 Sudusingha, S. (2024). *Dowry: The Serpent Sustained by Tradition*. Mawrata News. (R. M. Saleem, Trans.), https://mawratanews.lk/news/dowry-the-serpent-sustained-by-tradition/

Figure 6.2



In addition to households of all income levels, pawning is also used by those with different employment statuses. As shown in Figure 6.3, this includes 44.4% of employees, 39.5% of own-account workers (self-employed), 38.8% of employers and unpaid family workers, and 37.7% of casual workers in the sample. The highest share of pawning users based on employment status are those 'unemployed but seeking employment' (46%) as of January 2022. Further analysis reveals that most of them remained in the same employment status as of October 2022, implying they were still seeking employment. Considering this, it is reasonable to assume that the high rate of using pawning facilities among this cohort is due to the challenges these households faced in the absence of employment. Interestingly, a considerable share of the retired or elderly (60+ year population) also use pawning facilities.

Figure 6.3
Pawning by Employment Status



Note: Calculations are based on the employment status of the head of the household.
Source: Authors' calculations using data from UNDP Sri Lanka, National Citizen Survey 2022-2023.

In addition, pawning appears to be popular among households engaged in diverse economic activities across all three sectors – agriculture, industries, and services. Despite slight variations, around 34%-45% of households in economic activities such as wholesale and retail trade, tourism, construction, fishing, education as well as health-related employment use pawning services. The plantation sector workers record the highest share (45.5%), which aligns with the previous finding of high pawing use among the Tamil community.

Based on these survey findings, it is evident that pawning is a widely preferred financial instrument across all geographies and by all demographic groups, particularly to meet additional income needs/ emergency expenses. Considering this, the next section explores the varied reasons that households obtain pawning services and the different service providers they utilise.

6.3.2 Reasons for Pawning and Preferred Service Providers

To get more insights into household preferences and the use of pawning, a rapid survey of households was conducted by the IPS. The survey aimed to gather information on several aspects related to pawning including reasons for households' preference towards it, the reasons that make households obtain pawning services, the frequency of usage, and the diverse pawning service providers accessed by households.[11]

The findings of the rapid survey further confirmed the popularity of pawning, particularly as a coping mechanism among Sri Lankan households in times of distress, as around 65% of the respondents had relied on pawning services during the past four years. While about 20% of the respondent households have started using pawning facilities only recently (since 2020), many others have used it whenever needed for over a decade. Interestingly, about one-third of households who started using pawning facilities after 2020, have accessed this service multiple times since then, with a smaller share of them having used pawning facilities more than five times over the last four years.

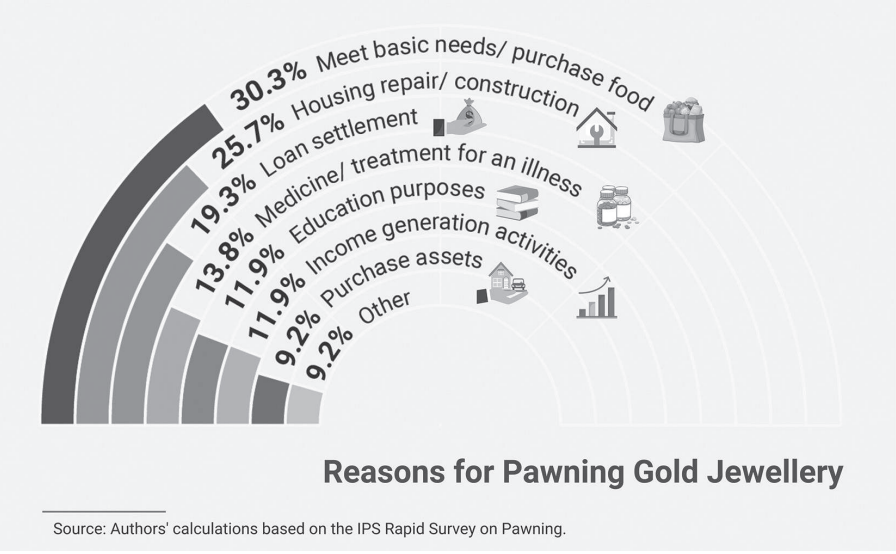
Delving into the reasons that compel households to rely on pawning reveals that nearly a quarter of the respondents obtained pawning services for multiple reasons while the remainder used it for a single purpose, particularly within the last four-year period. Meeting basic needs, including purchasing food and other essentials emerged as the main reason for households' reliance on pawning services, accounting for 30% of respondent households (Figure 6.4). This was followed by 26% relying on pawning for housing-related purposes such as construction and repair and 19% relying on pawning to settle existing loans. This also aligns with the DCS Economic Crisis survey results, which find that the highest share of households (22%) who were in debt have taken loans to meet daily food requirements, followed by 17% to construct/repair houses.

Interestingly, the reasons for households to use pawning facilities vary to some extent based on their income levels. In this regard, a larger share of lower-income groups (earning an average monthly household income of less than Sri Lankan Rupees (LKR) 100,000) used pawning to meet their basic needs such as purchasing food and other essentials and housing-related requirements, while

11 A rapid household survey on pawning was conducted by the IPS between April and June 2024, using a combination of online and in-person interviews. The survey included a total of 160 respondents across 18 districts of the country.

relatively higher-income groups mainly pawned for reasons such as income generation activities. These findings suggest that although all households irrespective of income level use pawing services, they do so for different reasons.

Figure 6.4



Source: Authors' calculations based on the IPS Rapid Survey on Pawning.

The survey findings also revealed the diversity of service providers accessed by households for their pawning needs and reasons for their preferences. Most households that obtained pawning services have accessed formal service providers such as banks and finance and leasing companies. However, some households were found to have accessed semi-formal/informal service providers such as pawning centres/pawn brokers. Interestingly, a smaller number of households have relied on both formal and semi/informal service providers simultaneously. Box 6.1 provides more insights into the reasons behind households' preference towards different pawning service providers.

Box 6.1
Voices of Pawning Clients on their Choice of Service Providers

"I use 'X' [Private Bank] and 'Y' [Finance Company] for my pawning requirements. The bank is good, but it is reluctant to accept certain types of gold jewellery like those with stones or low-karat (K) gold items. The finance company accepts these, so I go to both places depending on the jewellery I want to pawn."

- Government sector employee (female, 47 years from Colombo district)

"The best place to pawn is bank 'X' [State Bank]. Some banks give customers a relief period to recover jewellery even after sending a red notice, before auctioning jewellery. We have used pawnshops too earlier, but we now prefer this bank. Pawnshops usually give a higher amount for gold than banks, but they do not offer flexible terms like banks."

- Semi-government employee (male, 39 years from Kottawa)

"I prefer 'X' [Pawn Centre] to banks, as it is quick and gives a higher value for gold. However, the interest rates are much higher compared to banks. I am okay with that because I usually take money only in an emergency and settle it within 2-3 months."

- Private sector employee (male, 45 years from Gampaha)

"I go to the pawnshop in the town to pawn my bangle. As it is not 22K gold, the bank does not accept it. I have pawned my gold chain at 'X' bank [a licensed specialised bank]"

- Elderly casual worker (female, 72 years from Galle)

Source: Authors' compilation based on an IPS rapid survey on pawning.

Considering the diverse pawning service providers in the country, the next section looks at it in more detail, concerning the evolution of Sri Lanka's pawning industry and its emerging trends since the pandemic.

6.4 Supply-side Analysis of Pawning

6.4.1 Evolution and Current Status of the Pawning Industry

Pawning can be defined as an arrangement between a borrower and lender under which money is borrowed by keeping a gold item as collateral. The loan amount is generally lower than the collaterals' market value, to incentivise repayment by the borrower while protecting the lender in case of default.[12] While pawning transactions have been executed in more informal settings for over a century in Sri Lanka, the history of pawning services by formal sector institutions dates back to 1964, when the People's Bank began pawnbroking services. In 1970, pawning reached around 64% of the Bank's loan portfolio, which further increased to over 80% by 1983, indicating the popularity of pawning services in Sri Lanka from the early days.[13] The pawning industry in Sri Lanka has since expanded, with diverse service providers entering the market.

The providers of pawning in Sri Lanka can be broadly categorised as formal, semi-formal, and informal sources (Figure 6.5).

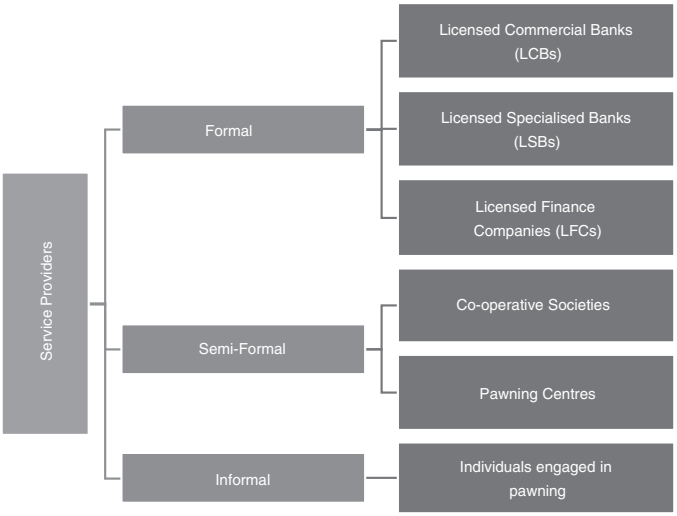
- The formal sector service providers include both (i) regulated banks, i.e., licensed commercial banks (LCBs) and licensed specialised banks (LSBs), and (ii) Non-Bank Financial Institutions (NBFIs) that primarily include Licensed Finance Companies (LFCs). Currently, the majority of domestic banks in the country including LCBs and LSBs, and over 25 LFCs offer pawning services.
- The semi-formal sector consists of cooperative societies and pawning centres that operate under the Pawnbrokers Ordinance No. 13 of 1942. Cooperative societies are primarily of two types: Co-operative Rural Banks (CRBs) and Thrift and Credit Cooperative Societies (TCCSs). Currently, most of the 2,420 CRBs in the country as well as nearly 2,000 TCCSs are engaged in providing pawning services.[14] However, the exact number of licensed pawn centres in operation is undefined.
- The informal sector service providers include various informal pawnbrokers/individuals involved in offering pawning services outside the existing regulatory frameworks.

12 Karunagoda, K. (2007). *Informal Markets for Financial Services in Sri Lanka*. Colombo: Association of Professional Bankers.

13 Bouman, F. J., & Bastiaanssen, R. (2018). Pawnbroking and Small Loans: Cases from India and Sri Lanka. In D. W. Adams, & D. A. Fitchett (Eds.), *Informal Finance in Low-Income Countries. (Chapter 13).* New York: Routledge.

14 Based on KIIs with the Department of Cooperative Development and the Federation of TCCSs.

Figure 6.5
Providers of Pawning Services in Sri Lanka



Source: Authors' illustration based on various information sources.

With the entrance of new players into the market, particularly the formal sector players, the terms and conditions of the services offered by different providers have also been updated slightly to enhance flexibility and cater to varying customer requirements. Historically, the term 'pawning' has been commonly used by all service providers to refer to gold-backed loans. However, in more recent decades, an offering named 'gold loans' has emerged in the market, particularly following the entry of formal FIs such as LFCs into the business.

The key difference between pawning and gold loans lies in the regulatory frameworks governing the two products and their loan durations. The pawning transactions are done under the Pawnbrokers Ordinance No. 13 of 1942 (Pawnbrokers Ordinance),[15] while gold loans are executed under the provisions of the Mortgage Act. Therefore, a gold loan transaction can be broadly considered a mortgage agreement entered between a borrower and lender. Moreover, pawning services are generally offered for a duration of 12 months, while gold loans can vary between 1-12 months. In terms of interest rates, there is no notable difference between pawning and gold loans, however, interest rates of gold loans can vary by the loan duration such that loans for shorter periods often entail higher interest rates.

While some formal FIs offer two products – pawning and gold loans – many offer only one of them. However, it is interesting to note that most FIs use these two terms interchangeably or commonly use the term 'pawning' to refer to both.[16] As such, this chapter mostly uses the term pawning to refer to both pawning and gold loans.

15 As per the Banking Act No. 30 of 1988, the provisions of the PawnBrokers Ordinance (Chapter 99) do not apply to LCBs and LSBs that are permitted to carry on the pawning business, and these banks can carry on the pawning business subject to conditions determined by the Monetary Board (CBSL, Banking Act No 30 of 1988).

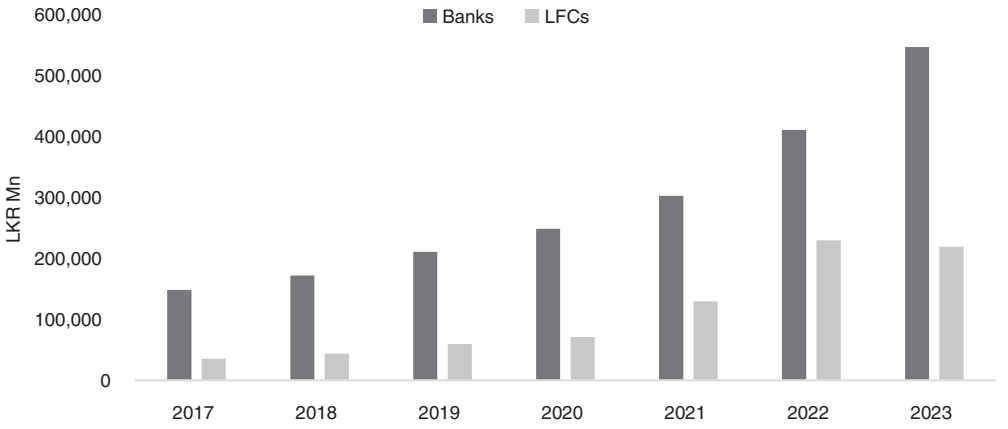
16 According to KIIs with selected Banks and LFCs.

6.4.2 Recent Trends of Pawning Amidst Crises

In recent years, pawning seems to have gained increasing attention in Sri Lanka's financial sector than ever before. There has been significant growth in pawning advances by formal FIs, especially since the pandemic. The banking sector remains dominant in the country's pawning industry, recording a total pawning volume of around LKR 546.7 billion (Bn) in 2023 (Figure 6.6). This accounts for over twice the pawning advances by NBFIs. The banking sector has experienced high growth in its pawning advances since the pandemic (nearly 120% growth), recording an annual growth rate of over 30% since 2022. This has more than doubled the share of pawning in the total loan portfolio from around 3% in the pre-pandemic period to 7.3% in 2023. Pawning also accounted for around 30% of personal loans and advances disbursed by commercial banks to the private sector in 2023.

In addition to the banking sector, the LFC sector has also shown unprecedented growth in its pawning advances, recording an annual growth rate of 81.5% in 2021, followed by 77.7% in 2022. Despite a slowdown in 2023, pawning advances by the LFCs have soared by over 200% since 2020.[17]

Figure 6.6
Pawning Advances and Gold Loans by Banks and LFCs



Source: Based on data from Central Bank of Sri Lanka (CBSL), Annual Economic Review 2023.

Several factors have contributed to the rapid growth of pawning advances by the LFCs in recent years. Before the pandemic, LFCs primarily engaged in leasing facilities for vehicles and hire purchases as their core business activities. However, the restrictions on vehicle imports imposed by the government in March 2020 to restrain foreign exchange outflow in the country severely affected LFCs. A slowdown in domestic economic activities since 2021 resulting from multiple crises in the country further impacted these companies in several aspects. With the shrinking demand for vehicle financing, many LFCs diversified their loan portfolios toward pawning,[18] which appeared to be a lucrative business activity. The rising demand for pawning services by low- and middle-income households to meet their diverse financial needs during the crises also contributed to the rapid growth of pawning in the LFC sector.

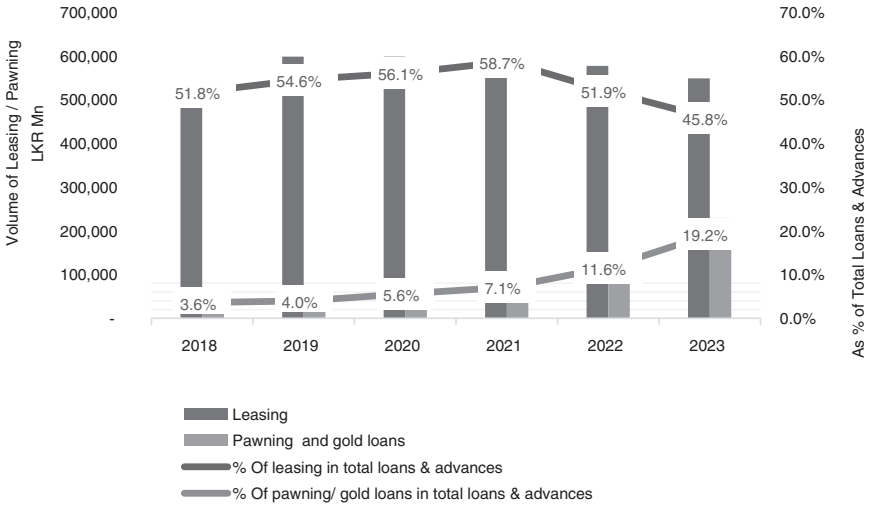
17 Authors' calculations based on data from CBSL, Annual Economic Review 2023.

18 Central Bank of Sri Lanka. (2023). *Financial Stability Review 2023*. Colombo: Central Bank of Sri Lanka.

As shown in Figure 6.7, the share of pawning in the total loan portfolio of the LFC sector has spiked from 6.8 % in 2020 to 19.2% in 2022, when the share of leasing has shrunk since 2020. As such, the expansion in the pawning business has helped the LFCs to minimise the adversities they faced due to the vehicle import ban and the multiple crises impacting their loan portfolios.

There has been significant growth in pawning advances by formal financial institutions, especially since the pandemic.

Figure 6.7
Pawning/Gold Loans vs Leasing by the LFC Sector



Source: Calculations based on data from CBSL, Annual Economic Review 2023.

While the diversification of loan portfolios by many LFCs and increasing demand for short-term finances by households fuelled the rapid growth of pawning in recent years, several other factors, including the salient features of this unique financial product have also contributed to its continuing popularity among lenders and borrowers. These are discussed in detail in the next section.

6.5 Features that Make Pawning Attractive to Lenders and Borrowers

Overall, KIIs with banks and LFCs revealed several features of pawning that have made this service attractive to lenders and borrowers. Pawning or gold-backed loans are secured loans, where the borrowers pledge gold jewellery as collateral, and these support FIs in mitigating the risks associated with lending. In case of default, the respective lending institution can liquidate the gold item (by auctioning it) to recover the outstanding loan amount, thereby mitigating the default risk. Moreover, as gold is a highly liquid asset, it can be converted into cash within a relatively short time, making it more attractive than other collateralised loans.



Accessing pawning facilities also does not require additional documentation or personal guarantors. The simplicity of the procedure allows the lending institutions to carry out a greater number of transactions per day. Hence, the transaction cost of pawning is less compared to other forms of loans. Moreover, offering pawning facilities allows formal FIs to cater to a diverse customer base beyond their traditional clients, including individuals who are not eligible for other types of loans due to a lack of collateral or a steady source of income to enable regular repayments. By offering a convenient and accessible borrowing option to these clients, banks and LFCs can build customer loyalty and expand their customer base. Moreover, given the reasonably high interest rates and high demand for pawning, most FIs recognise pawning as a lucrative business opportunity.

In addition, formal FIs have been offering pawning on flexible terms and conditions, which toohave made this product more attractive to households, particularly those from low- and middle-income groups. Unlike regular loans granted from FIs, pawning does not require a credit check, which makes it accessible to people with low or no credit history with formal FIs. This product also involves flexible loan repayment methods compared to other types of loans. Periodical or monthly repayments are not compulsory in pawning. Rather, borrowers can repay the loan amount and the due interest at any time within the stipulated loan period. This also suits the borrowers with no regular income. In the event a borrower is unable to settle the full loan amount by the end of the loan period, many FIs like banks and LFCs allow borrowers to pay it partially or pay only the due interest amount and rollover the loan for another period (one year, six months or three months depending on the original loan period). If a borrower cannot pay at least the interest amount by the end of the due period, they are often given a grace period by many banks before auctioning the gold item. In addition, unlike a regular loan facility from a bank, defaulting on a pawning or gold loan typically does not impact the borrower's credit history.

Another important feature of pawning that has made it attractive to households is that it allows borrowing for any purpose and does not necessitate disclosing the purpose of borrowing. Such confidentiality in pawning can be appealing to households seeking privacy in their financial transactions while allowing them to borrow for their diverse needs – e.g., purchasing food, paying medical bills, for children's education, or even repaying an existing loan/lease – that is not often allowed under other loan products offered by FIs. Furthermore, pawning allows obtaining cash without lengthy approval processes and personal guarantors as mentioned before, making it better suited to meet emergency/ short-term financial needs.

Table 6.1
Key Features of Pawning/Gold Loans Provided by Banks and LFCs

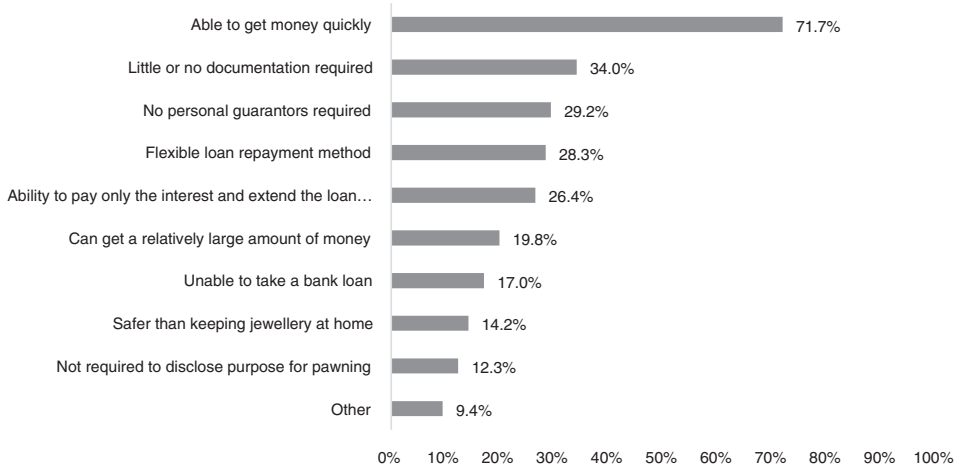
Eligibility criteria	Over 18 years of age. Have a valid form of identity. Have a gold item that meets the criteria for pawning eligibility.
Duration/loan term	For pawning - 12 months. For gold loans - 1, 3, 6, and 12 months depending on the lending institution.
Interest rate	13.5–15.5% per annum as of June 2024 (varies by institution and loan duration).
Pawning/gold loan advance	Loan advance per sovereign depends on the Loan-to-Value (LTV) ratio of the lending institution and the world market price of gold. The amount can also vary by the quality/the sovereign of the gold item (whether 24K or 22K).
Repayment method	No compulsory monthly instalments. The loan amount + interest can be paid anytime within the stipulated period.
Purpose of loan	Flexible.
Renewal/extension of loan period	The loan period/loan term can be extended for another term by paying at least the due interest amount.
Default process	In the event a client fails to pay at least the interest before the due date, banks generally send a notice letter (or three notice letters by some banks) to the customer followed by a grace period, before auctioning the items. The procedures may vary by institution.

Source: Based on KIIs with selected banks and LFCs.

These were further confirmed by the findings of the rapid survey that revealed several reasons why households prefer pawning over obtaining traditional types of loans from FIs to meet their financial needs. While many respondents cited multiple reasons, the ability to access money quickly through pawning was the main reason highlighted by around 72% of the respondents (Figure 6.8). The absence of additional documentation and personal guarantor requirements were other key reasons highlighted by 25-35% of the respondents. As expected, the flexibility in loan terms and repayment methods were also highlighted as reasons for households' preference for pawning over other loans. Interestingly, about 17% of the respondents used pawning because they could not access loans from FIs. Notably, most of them were relatively low-income households so it is plausible that their income levels did not qualify them for bank loans. However, some households had outstanding loans from multiple banks, perhaps making them ineligible to obtain further loans from banks. Moreover, not

having an age cap (maximum age limit) for borrowers accessing pawning facilities as opposed to other forms of loans, was another reason mentioned by some consumers. Interestingly, around 14% of households perceived pawning gold jewellery and letting it be at a bank as a safer option than keeping it at home.

Figure 6.8
Household Preference for Pawning Over Traditional Loans



Source: Authors' calculations based on an IPS rapid survey on pawning.

Despite the widespread use of pawning by households and increasing pawning exposure by FIs in recent years, several areas need attention to protect both lenders and borrowers. These are discussed in the next section together with conclusions and policy implications.

6.6 Conclusions and Policy Implications

As discussed in the chapter, pawning has become one of the most popular coping strategies used across all income groups and geographical settings to meet the diverse financial needs of households. In the current context of concerns over rising household debt levels due to adversities caused by multiple crises in the country, pawning services offered by formal FIs can be considered an important financial tool that enables households to meet additional monetary needs while minimising the risk of being over-indebted. Compared to many other loan products offered by FIs, pawning is a low-risk financial product for both borrowers and lenders. The flexible conditions offered by many formal FIs, such as extensions to loan terms by simply accepting the due interest amount help substantially reduce the risk of default and over-indebtedness among borrowers. However, upon defaulting on the loan in the worst-case scenario, the borrower loses the pledged gold item, depleting the available stock of assets to rely on during future emergencies.

From the financial inclusion perspective, pawning can be considered a 'unique' financial instrument that has contributed to financial inclusion in the country through increased access to formal FIs by

households from low-income groups who tend to rely on semi-formal and informal sources such as cooperative societies and microfinance providers for their credit needs. Previous studies have shown that one of the key reasons for low-income groups accessing formal FIs like banks, is to obtain pawning facilities.[19] Pawning has driven some formal sector institutions like banks and LFCs to broaden their client base by attracting somewhat different segments of society that have previously not been part of their clientele.

Given the high demand for pawning and its highly profitable nature for lenders, this collateralised loan product has gained increasing attention among formal FIs in recent years. Significant growth in pawning advances by LFCs was observed, following the restrictions on vehicle imports affecting their core business of leasing. While the expansion of pawning services by FIs in recent years has been largely positive thus far, some potential risk areas requiring further attention remain.

Pawning can be considered a 'unique' financial instrument that has contributed to financial inclusion in Sri Lanka through increased access to formal financial institutions by households from low-income groups.

The volatility of gold prices is one of the key risks associated with pawning. Gold price fluctuations in the global market affect local gold prices, which in turn, can have a significant impact on lending institutions in the event of falling gold prices. Following a sharp decline in gold prices, borrowers can default on their gold-backed loans since it may no longer be profitable for them to settle the loan and recover the pawned items. This occurred in 2012-2013 when the volatility in the global gold market caused a drop in gold prices, resulting in an increase in non-performing loans at many banks. The non-performing loans concerning pawning in the banking sector saw a huge leap from LKR 4.8 Bn to LKR 61.5 Bn from 2012 to 2013, respectively.[20] This implies the potential risk associated with overconcentration of gold-backed loans by FIs. In November 2023, Fitch Ratings cautioned on increased collateral price risk for Sri Lanka's finance and leasing companies.[21] As such, the LFCs had to temporarily cut back their exposure to gold-backed lending in the first quarter of 2024 following a drop in local gold prices.

To minimise the risks posed to lending institutions due to gold price fluctuations and prevent the over-accumulation of gold when gold prices fall, it is important to maintain a lower loan-to-value (LTV) ratio. A low LTV ratio reduces the riskiness of transactions for the lending institutions engaged in gold-backed loans, as the pawning advance/ loan amount is much less than the value of their gold asset.[22] However, currently there is no regulatory cap on the LTV ratio concerning pawning in Sri Lanka. As such, lending institutions can adjust their LTV according to market conditions. For instance, given the high demand for pawning, lenders may increase the LTV to surpass their competitors and attract

19 Tilakaratna, G., & D. Hulme. (2015). Microfinance and Multiple Borrowing in the Microfinance Sector in Sri Lanka: Another Micro-Credit Bubble in South Asia? *South Asia Economic Journal, 16* (1) 46-63.

20 Central Bank of Sri Lanka. (2013). *Financial System Stability Review 2013*. Colombo: Central Bank of Sri Lanka.

21 Fitch Ratings. (2023). *Rising Gold-Backed Loans Elevate Risks for Sri Lankan Finance Companies,* https://www.fitchratings.com/research/non-bank-financial-institutions/rising-gold-backed-loans-elevate-risks-for-sri-lankan-finance-companies-20-11-2023

22 Central Bank of Sri Lanka. (2023). *Financial Stability Review*. Colombo: Central Bank of Sri Lanka.

clients. Nevertheless, it can expose lending institutions to a higher level of risk, leading to increasing non-performing loans and high defaults in the event of a price drop in the global gold market.

Furthermore, interviews with some banks/LFCs revealed that there is a risk of accepting stolen articles. This is a concern for institutions since if they accidentally approve a pawning transaction involving stolen items, the institution is obligated to present the items to the authorities if a court order is issued, thus losing their collateral. There have also been cases where imitation gold or plated articles reached institutions engaged in pawning. Although the weight and grade of these items are found to be acceptable at the time of the transaction, their counterfeit nature is revealed when they are auctioned out.[23]

Despite the rising demand for pawning among households, pawning is not without risks to clients, especially when accessing informal and semi-formal sources such as pawnshops or pawning centres. Although the prominence of these sources seems to have fallen in recent decades due to the competition from formal institutions, a sizeable share of pawning transactions is still carried out through them. However, concerns remain about exploitation when pawning via some informal pawnshops compared to formal institutions such as banks and LFCs. For example, some pawnshops charge significantly higher interest rates than formal institutions, although some may offer higher advances and accept lower karat gold items. However, the high interest rate often implies a greater borrowing cost for the client, which may contribute to their inability to settle the loan on time, especially among low-income groups. While most formal institutions provide their clients with flexible conditions such as loan extensions and further grace periods even after sending 'red notices', pawnshops do not seem to be lenient. This can result in households losing their valuables, depleting their asset base to rely on in times of need.

There is still much scope for enhancing financial literacy among low-income groups to help them make more prudent financial choices.

The CBSL has identified the need to establish a prudential regulatory framework to curb exploitative money lending, including unregulated pawnbroking activities.[24] The proposed Microfinance and Credit Regulatory Authority Act is envisaged to regulate these service providers and protect the clients. However, there is still much scope for enhancing financial literacy among low-income groups to help them better understand loan conditions, interest rates, etc., to help them make more prudent financial choices.

23 Daily Mirror. (2020, March 06). *Fake Jewellery Pawned at Rural Bank for LKR 348,000*, https://www.pressreader.com/sri-lanka/daily-mirror-sri-lanka/20200306/281848645654091

24 Central Bank of Sri Lanka. (2019). *Annual Report 2019*. Colombo: Central Bank of Sri Lanka.

JOBS AND HUMAN CAPITAL

7. Access to Quality Education

7.1 Introduction

Sri Lanka's education sector has previously received recognition for its achievements in high school enrolments. However, this feat is currently being contested on several fronts. The macroeconomic budgetary restrictions and political volatility have led to ongoing structural changes and low investments in the sector, impeding its growth. Furthermore, the workplace's skill requirements are constantly evolving due to technological advancements, which is driving up the need for a wider range of abilities from the industry than in the past. In addition, several disasters, including the recent coronavirus (COVID-19) pandemic's prolonged impacts have disrupted the sector's operations. Lastly, flaws in human resource capacity and resource constraints have restricted the sector's ability to respond to these emerging challenges.

As addressed later in the chapter, the sector currently performs well in providing education until the end of the lower secondary school cycle; nevertheless, system-wide improvements must occur in many other areas to keep pace with the changing educational landscape. Most crucially, the sector falls short of equal access to special education and underprivileged students at the primary and lower secondary grades and low participation in upper-secondary and higher education levels. Furthermore, the most current assessment of the sector shows deficits in learning outcomes at all levels of schooling against national and international norms. Generating conveniences as well as complexities, technological advancements have fundamentally enhanced access to education services through information and communication technology (ICT) and have also compounded the disparities in educational access and attainment, respectively. Worryingly, only the more affluent students are beneficiaries of this due to the high cost of devices and data. This was particularly demonstrated during the COVID-19 pandemic when the country resorted to remote teaching as a means of delivering continuous education amid social distancing.

Against this backdrop, this chapter examines the issues facing Sri Lanka's educational system and the existing legislative landscape and recommends adjustments to enhance results. The chapter mainly focuses on the general education sector, although it recognises the importance of the tertiary and pre-school sectors.

7.2 Present Challenges Facing the Education Sector: Evidence from Data

This section analyses current gaps in meeting the aim of quality education for all in Sri Lanka.

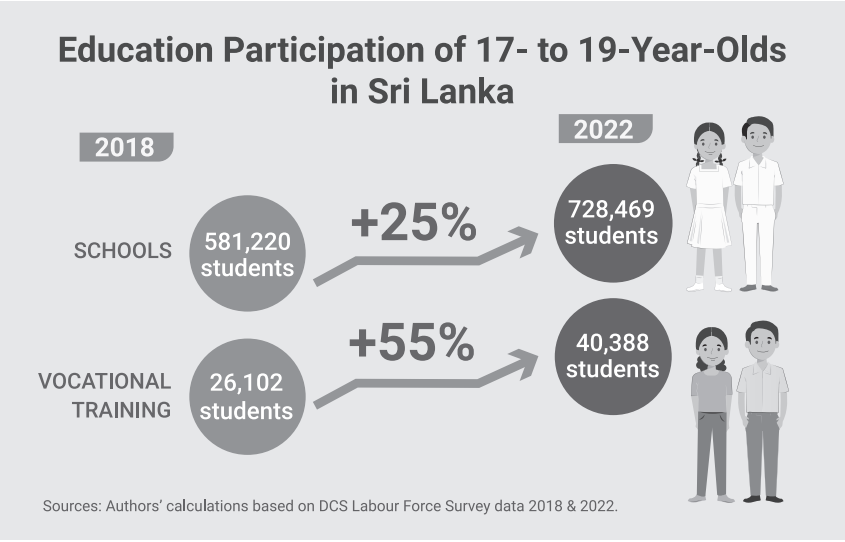
7.2.1 Gaps in Access to Education

The Household Income and Expenditure Survey (HIES) conducted by the Department of Census and Statistics (DCS) is the primary data source for determining educational access. Nevertheless, considering that the most recent HIES is from 2019, and as Sri Lanka has experienced significant external shocks since then, the information included in HIES 2019 may no longer be reliable. Therefore,

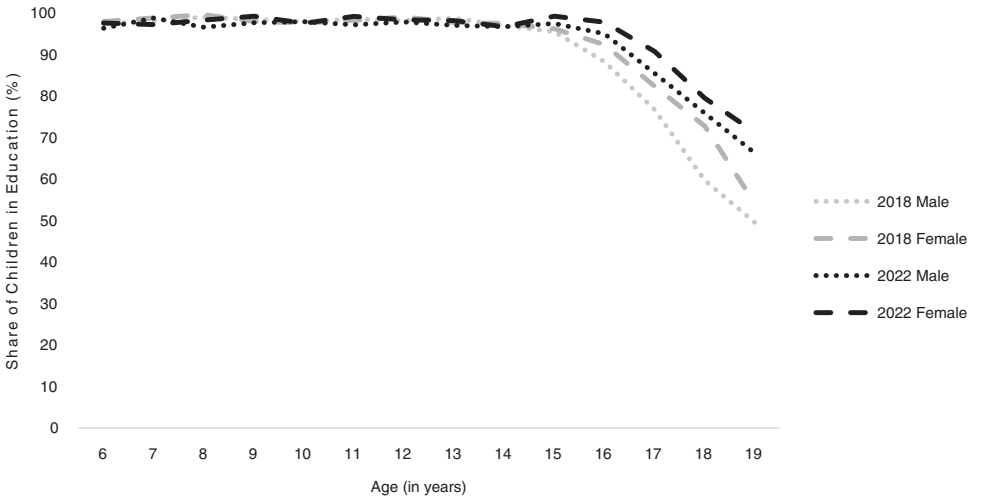
although it is not ideal, disparities in educational access are analysed using the DCS's Labour Force Survey (LFS).

Enrolment rates are the most commonly used measure of educational access. However, LFS data alone cannot be used to produce this indicator. Alternatively, educational participation in children of various age groups,[1] is associated with enrolment. In other words, enrolment is linked to children's participation in school throughout different age groups. Disparities in educational engagement are more prevalent among older children (see infographic), notably those aged 15 to 19 years. There is strong education participation until close to the compulsory education age of 16 years, after which participation rates drop rapidly. According to LFS data, in 2022, 98.3% of 15-year-olds participated in education, compared to 88% of 17-year-olds and 68.9% of 19-year-olds. Other noteworthy investigation findings include that girls have greater participation rates than boys. In 2022, among 16-year-olds, girls had a 2.9 percentage point higher rate of educational participation than boys. This disparity widened to 5.3% for 17-year-olds.

Additionally, education participation rates have improved substantially between 2018 and 2022. For example, the education participation rate for 16-year-olds increased by 6.2 percentage points during the said period. Between 2018 and 2022, the number of 17-19 year-old students in schools rose notably by 25% and those in vocational training institutions grew by 55%. Moreover, delays in national exams have led to a rise in school enrolments, keeping students in school for extended periods. The 13-year guaranteed education programme (launched in 2017), which established a new vocational subject stream in selected schools, enabled students who fail the Ordinary Level (O-Level) exam to continue their education in one of the schools offering the vocational stream. This paved the path for young people to drop out of school and pursue vocational education and is probably one factor contributing to the uptick in vocational training enrolment.



1 This includes education participation in not only schools but also other educational institutions, such as vocational training institutions and universities.



Note: The above analysis indicates the share of children currently in education at each age.
Source: Compiled with LFS data 2018 and 2022 by the DCS.

School attendance in the compulsory age group: In Sri Lanka, children must attend school until the age of 16.[2] As seen in the infographic, the school attendance of children in the compulsory age is not 100%, albeit very close to it. According to the latest Education Sector Development Plan (ESDP 2020-2025),[3] one major cause for this disparity is a lack of educational opportunities for children with disabilities and those from isolated locations and low socio-economic backgrounds. The LFS collects information on children with different types of special needs and about their educational participation. However, this information is unreliable due to limited observations on such children. The only key source to obtain information on the education participation of children with disabilities is the Population Census. Regrettably, the latest available Population Census which took place in 2012, exhibits a dearth of relevant and reliable information. A report commissioned by the United Nations Children's Fund (UNICEF) in 2016 warns that close to a quarter of children aged 5-14 with disabilities are excluded from mainstream education.[4]

Close to a quarter of children aged 5-14 with disabilities are excluded from mainstream education.

In addition to children with different types of disabilities, another group of children who miss out on education during the compulsory age group are the highly vulnerable. For example, education opportunities are less for children in the estate sector and they start to participate less in schooling shortly after the primary school cycle (see figure 7.1). According to LFS data, in 2022, the educational

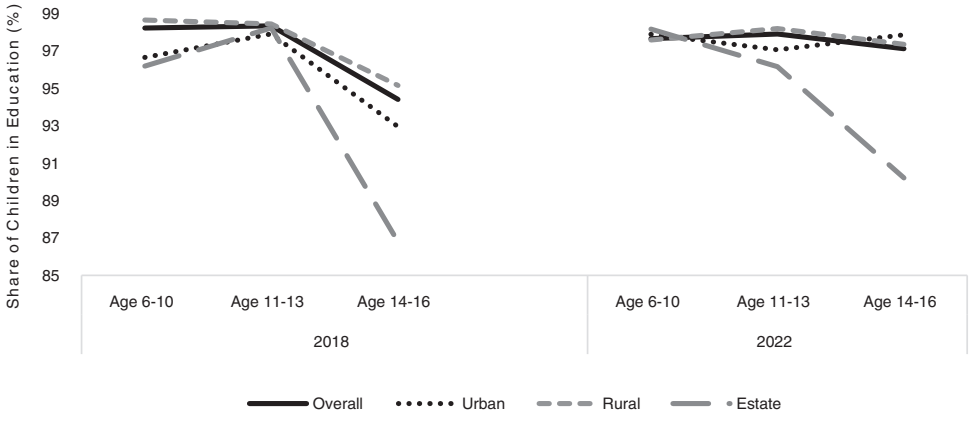
2 National Committee for Formulating A New Education Act for General Education. (2024, May 19). *New Education Act for General Education in Sri Lanka.* https://nec.gov.lk/wp-content/uploads/2017/12/Towards-a-New-Education-Act.pdf

3 Ministry of Education. (2020). *Sri Lanka: General Education Sector Development Plan (2020 - 2025).* Battaramulla: Ministry of Education.

4 Grimes, P., & Dela Cruz, A., (2021). *Disability-Inclusive Education Practices in Sri Lanka.* Kathmandu: United Nations Children's Fund Regional Office for South Asia.

participation rate of 14-16-year-olds in the estate sector was 90.2%, compared to 97.1% for the whole population. However, on the positive side, the gap in education participation rates between children in the broader population and those in the estate sector has shrunk from 2018 to 2022. For the same period, the discrepancy in education participation rates between the total population and the estate sector for 14-16-year-olds declined from 7.6 to 6.9 percentage points.

Figure 7.1
Education Participation by Sector, 2022

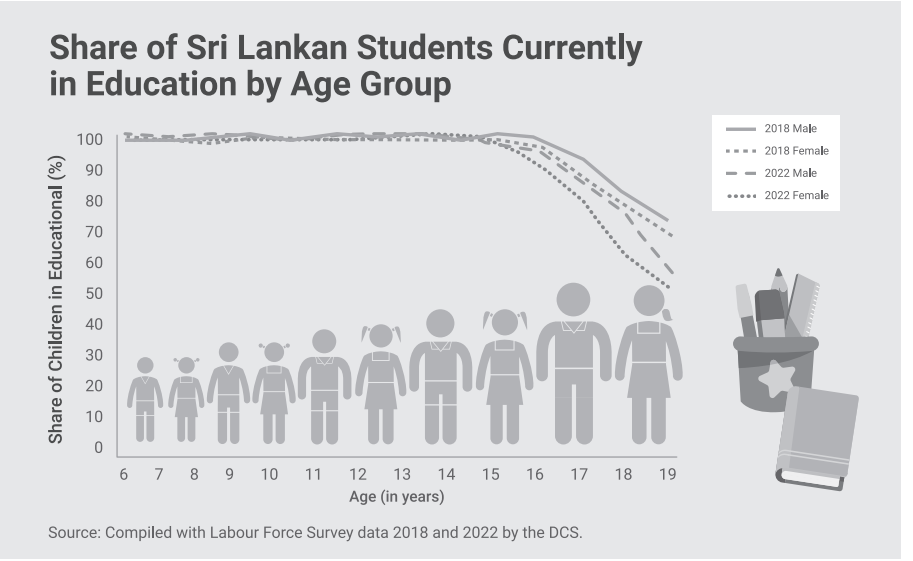


Source: Own calculations using LFS 2018 and 2022 data.

School attendance past the compulsory age group: A recent publication by the Institute of Policy Studies of Sri Lanka (IPS) highlights that technological changes are rapidly transforming the future of work.[5] Changes occur in multiple and impactful ways – with skill demands rising in the labour market and new remote job opportunities opening up. Also, to be competitive in the global market and as part of their formula for success, countries are increasingly looking for innovations for which highly skilled workers are vital. In this setting, improving access to education beyond the higher levels of education is essential to be up-to-date with these changes.

Figure 7.2 allows the disparities in education participation across diverse population groups for students aged 17 to 19 years, i.e., the schoolchildren beyond the compulsory education age, to be examined in some depth. This is also where the largest deficiency in education participation described earlier is observed.

5 Arunatilake, N, & Karunanayake, C. (2019). 4IR and the Future of Work. In *Sri Lanka State of the Economy 2019, Transforming Sri Lanka's Economy in the Fourth Industrial Revolution.* Colombo: Institute of Policy Studies of Sri Lanka.



Source: Compiled with Labour Force Survey data 2018 and 2022 by the DCS.

Based on the data, the overall education engagement among those aged 17 to 19 years grew by 12 percentage points between 2018 and 2022, and the growth is observed in most population groups considered (see Figure 7.2). Girls have greater educational participation rates (EPRs) than boys. Though this disparity narrowed slightly during 2018-2022, as EPRs climbed for both girls and boys, the growth was greater for boys. The EPR in the estate sector is lower than in the urban and rural sectors.[6] During the same period, EPRs have grown in the estate sector, albeit at a lower rate than in the urban and rural sectors. Thus, it has yet to help close the gap.

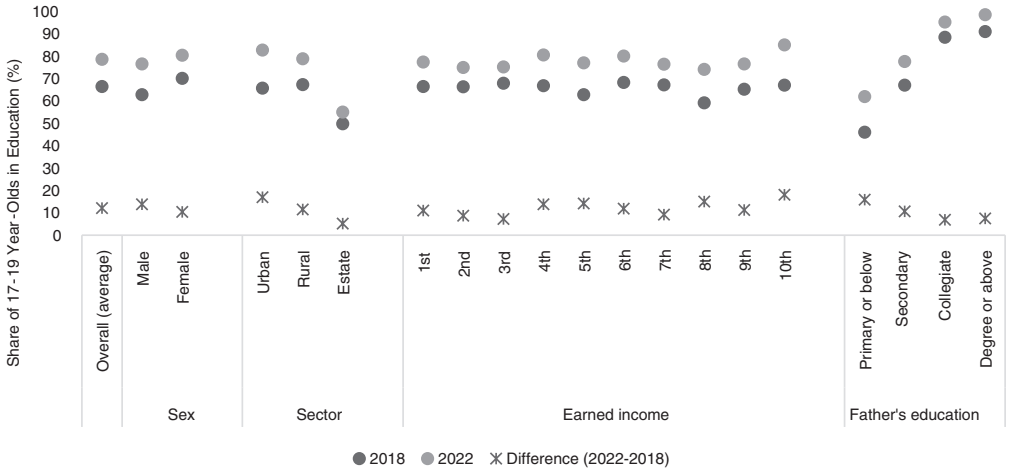
As seen in the data, there is no clear pattern in EPRs across wage-income deciles.[7] Education participation rates increased for children in all wage-income deciles in 2022 compared to those in 2018. The highest growth occurred for children in the top-wage-income decile, but as mentioned before, no obvious pattern can be discerned across lower-wage-income deciles. Finally, higher EPRs were evident in children with more educated fathers;[8] nevertheless, EPRs rose more for kids whose fathers had less education, minimising the gap in EPRs across children with fathers who had different levels of education. As explained later in this chapter, one main reason for the growth in EPRs was the greater participation of children in the newly introduced vocational stream. Children of low-skilled fathers may be more attracted to continuing education through the vocational stream along this path rather than pursuing more academic subject streams.

6 Although the education participation rate is slightly higher in the rural sector, compared to the urban sector this difference is not statistically significant.

7 In the LFS, only a wage income is observed.

8 Since wage income is not a perfect indicator of the socio-economic stratum of a household, the father's educational attainment when examining children's participation in school was also looked at. It is presumed that children from higher socio-economic strata are those whose fathers have more education.

Figure 7.2
Education Participation of 17-19-year-olds, by Population Groups



Note: It is difficult to calculate net or gross enrolment rates using information available in LFSs. The above analysis indicates the number of children currently in education at each age.

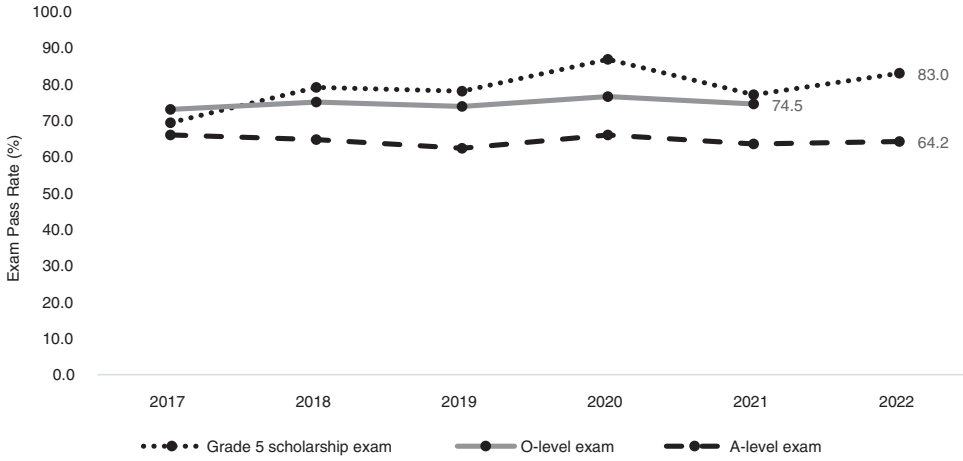
Source: Own calculations using LFS 2018 and 2022 data by the DCS.

7.2.2 Gaps in Learning Outcomes

Apart from the aforementioned discrepancies in educational accessibility, the education sector is also beset by inequalities in learning results. However, a lack of data makes analysing inequalities in educational achievement challenging. Although not ideal, national-level exam pass rates are accepted and used to assess children's learning outcomes across educational cycles. As such, this is not a realistic indicator of education delivery in schools because not all children take national-level assessments, and national exam pass rates do not accurately reflect the country's educational sector performance. One disadvantage of this measure is that children from less affluent households are proportionately less likely to be represented in national-level exams since they are less likely to participate.[9] Furthermore, given the existing academic culture in the country, many children receive private tutoring in preparation for national tests, so educational outcomes cannot be entirely credited to the system. Moreover, children from lower-income households might not have as many possibilities to get additional assistance with exam preparation. After interpreting the results given below, these factors should be considered when considering the overall picture.

9 Arunatilake, N., & Jayawardena, P. (2011). Equity in Education and Health Services in Sri Lanka: In Son, H.H., Equity and Well-Being: Measurement and Policy Practice (1st ed.). *Routledge.*

Figure 7.3
Trends in Exam Pass Rates



Note: The pass rates indicate the share passing of all taking the exam. The pass marks for each exam are as follows. Grade 5 pass rate – 35%; Ordinary Level (O-Level) – eligible for Advanced Level (A-Level), and A-Level – eligible to enter university. Data for the 2022 O-Level pass rate are not available. A-Level pass rates for 2019 and 2020 are for those taking the new syllabus.

Source: Ministry of Education. (2023). *The Progress 2023 and the Way Forward 2024.* Battaramulla: Ministry of Education.

The grade 5 scholarship exam results, which pupils take after finishing their primary school cycle (i.e., grades one to five), show room for development. Only 83% of children who took the exam in 2022 scored over 35% (see Figure 7.3). These disparities in educational performance persist at the secondary level, as denoted by the results of the Ordinary Level (O-Level) and Advanced Level (A-Level) exams,[10] administered at the end of the lower and upper secondary school cycles (i.e., grades 6 to 11 and 12 to 13, respectively). In 2021, of those taking the O-Levels, 74.5% qualified for A-Levels.[11] In the same year, around 63.5% of pupils taking the A-Levels received qualifying grades for university. As mentioned earlier, these pass rates are available only for those taking the exam. A large share of children opt out of the exam due to a lack of preparedness. On top of this, the Sri Lankan university system can only accommodate approximately 30,000 students (roughly 23,000 internal and 7,300 external), and only 20% of those who qualify can continue to tertiary level education in public universities. As a result of not passing the exams at various levels, the share of youth aged 20-24 years who

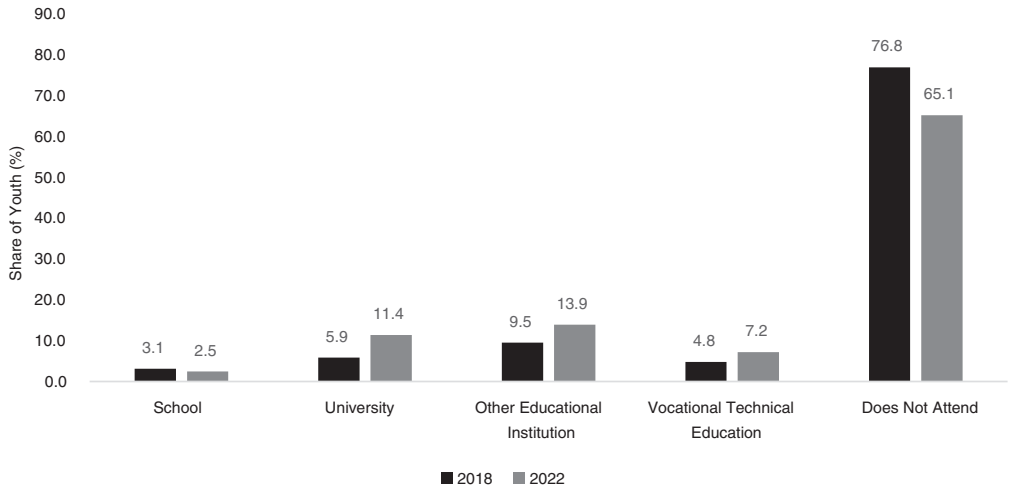
The share of youth in vocational or technical education activities is only 7.2%. In comparison, a large share of youth do not participate in any educational activity. Although this share has dropped considerably from 76.8% in 2018 to 65.1% in 2022, it is still very high.

10 General Certificate of Education (G.C.E.) at the O-Level and A-Level, respectively.

11 Data for 2022 is not available for O-Level pass rates.

engage in university education is small (see Figure 7.4). The share of youth in vocational or technical education activities was also only 7.2%. In comparison, a large share of youth do not participate in any educational activity (see Figure 7.4). Although this share has dropped considerably from 76.8% in 2018 to 65.1% in 2022, it is still very high. These figures point to the need for additional emphasis on encouraging lifelong learning. Further, some youth are engaged in general schooling, even in the 20-24 age group. This is partly due to delays in holding exams, evaluating performance and releasing marks. The situation worsened during COVID-19 when the national exams had to be postponed to ensure that children could cover educational syllabuses before taking the exam. The delays thus started have continued to date, even four years after the onset of COVID-19.

Figure 7.4
Education Activities of Youth Aged 20-24



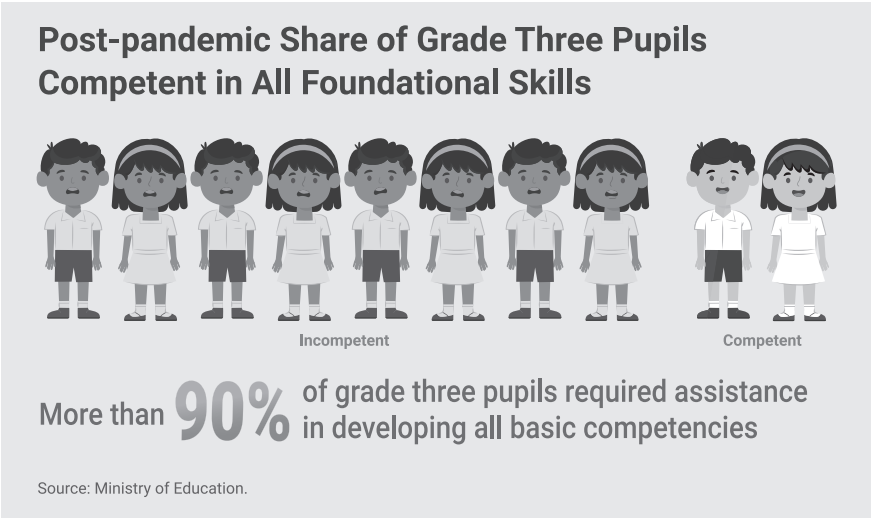
Source: Own calculations using LFS 2018 and 2022 data.

Given the interdependence of Sri Lanka's economy with the rest of the world, the education system must ensure that the students' performance in the country can be benchmarked globally. A study by the National Education Research and Evaluation Centre (NEREC), which assessed the educational outcomes of Sri Lankan children (who completed grade 8 in 2019) using international standards, revealed that students' English language and Mathematics skills require substantial improvements.[12] The study included a provincial-level representative sample of around 13,000 pupils, including coverage for girls and boys, schools with different mediums of instruction (e.g., Sinhala and Tamil), and types of schools (i.e., 1AB, 1C, Type 2 and Type 3).[13] The results show that the average test score was 34 for English and 24 for Mathematics. According to NEREC, these marks show that most

12 This section was drawn from the Ministry of Education (MOE)- National Education Research and Evaluation Centre (2024, April 18), Sri Lankan Students' Readiness for International Assessments.

13 Type one schools cover grades from 1 to 13 or 6 to 13. Of these, 1AB schools offering all subject streams for A-Levels, while 1C schools only offer Commerce or Arts subject streams for A-Levels. Type 2 schools have classes only up to grade 11. Schools can cover classes from 6 to 11 or 1 to 11. Type 3 schools are primary of junior schools with classes only up to grade 5 or 8.

students have not accomplished the expected learning outcomes in Mathematics and English. This poor score is primarily due to teaching-learning techniques that focus on the outcomes rather than the process of gaining results.[14] The international assessments require students to find answers as well as demonstrate how they arrived at the result or the conclusion. Furthermore, a considerable proportion (80% for English and 89% for Mathematics) received less than 50 marks out of 100, demonstrating that children in the country have low English and Mathematics aptitudes compared to worldwide standards. The results show that females, children who attended 1AB schools, children from the Western, North Western, and Southern regions, and children from better-resourced schools scored higher on both tests, albeit marginally. This study confirms the findings of earlier national-level studies. In other words, this reveals that although students in Sri Lanka have relatively easy access to basic and lower secondary school, it does not always transfer into better learning outcomes.



School closures during COVID-19 have further affected the learning outcomes of children. Research was conducted in 2021 and 2022 to measure the achievement levels of foundational skills of grade 3 children following COVID-19, utilising an island-wide representative sample of 10,000 children.[15] The study assessed the competency in 48 foundational skills covering four fields of literacy and six fields of numeracy. The findings disclose that over 90% of pupils required assistance in developing all basic competencies. Nutrition levels, preschool attendance, home and school learning settings, and the mother's education all impacted learning.

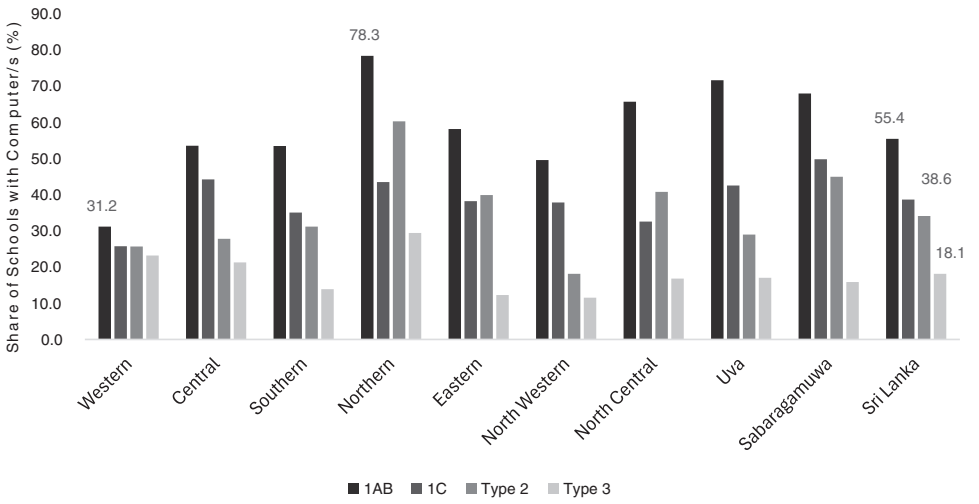
14 Based on the interview with officials conducting the NEREC study.

15 This section draws from assessment of achievement level of foundational skills in literacy and numeracy of grade 3 Students in Sri Lanka from the MOE.

7.2.3 Gaps in Access to Information and Communication Literacy

Given the changing socio-economic environment and the necessity of computer literacy for accessing services and information required for everyday living and increasing job efficiency, the education sector emphasises boosting children's computer literacy. The high cost of devices and data is a major obstacle to deploying ICT for teaching and learning. The LFS 2022 shows that, although a high share (94.2%) of 17 to 19-year-olds can use computers for educational activities, only 16.4% own a computer or laptop. Further, only 21.5% of them had used the internet in school in the year preceding the survey. This indicates that although students are computer literate, their ability to use it in learning is limited due to a lack of access to devices. One key reason for the low usage of computers in schools would be the limited availability of devices (Figure 7.5). The availability of computers varied widely across school types and provinces. Around 55.4% of 1AB schools had at least one computer for every 25 students, whereas only 18.1% of Type 3 schools could give comparable computer access. Surprisingly, 1AB and 1C schools in the Western province had the lowest access, which could be partly attributable to crowding in these schools.

Figure 7.5
Share of Schools with at Least One Computer Per 25 Children



Note: Data is for 2018.
Source: Ministry of Education. (2020). *Annual Performance Report.* Battaramulla: Ministry of Education.

7.3 Education Sector Development Challenges and Opportunities[16]

So far, the chapter has focused on the most significant challenges and achievements in Sri Lanka's general education system. The rest of the chapter will assess the education sector development outcomes based on the four thrust areas introduced for this purpose by successive Education Sector Development Plans (ESDP (2013-2017) and ESDP (2010-2025)),[17] against the performance of the Ministry of Education (MOE), based on the Ministry's Annual Performance Reports (APRs).[18] The thrust areas are:

1. Provide equitable education for all children
2. Improve the quality of general education
3. Improve stewardship and service delivery of general education
4. Enhance evidence-based education policymaking and planning

These strategic objectives are backed by several initiatives to modify the teaching and learning process and enhance children's skills to meet the needs of today's economic and social environment. Simply, its success lies in pedagogy requiring concerted efforts, education delivery on the part of teachers and learning outcomes on the part of students. Each area attempts to improve on challenges in the education sector based on measurable key performance indicators (KPIs). Furthermore, the programme outlines measurable goals to be met over time (see Table 7.1). In addition to the targets given in the latest ESDP for 2025, those set out by ESDP 2013-2017 for 2017 are also presented as a benchmark to monitor progress over time. Table 7.1 shows many targets set for 2017 have not been achieved, and the 2020 revision has downgraded the targets set for 2025. The one exception is the number of students undertaking Science or Technology in A-Levels. Due to the start of the Technology stream in schools, the share of students engaged in the A-Level Science and Technology stream has grown from 30% in 2014 to 35.1% in 2022 and stands close to the 40% target.[19]

An exception is the number of students undertaking Science or Technology at A-Levels. Due to the start of the Technology stream in schools, the share of students engaged in the A-Level Science and Technology stream has grown from 30% in 2014 to 35.1% in 2022 and stands close to the 40% target.

16 Information obtained from these documents have been verified and validated by officials from the MOE and the NEC.

17 Ministry of Education. (2013). *Education Sector Development Framework and Programme (2013-2017)*. Battaramulla: Ministry of Education.

18 Ministry of Education. (Various Years). *Annual Performance Report*. Battramulla: Ministry of Education. These will be referred to as Annual Performance Report (APR) followed by the year of the report.

19 *Ibid*.

Table 7.1
Key Performance Indicators

	Target		Achievements[a]				
	2017[b]	2025[c]	2018	2019	2020	2021	2022
Retention of students until grade 11 (%)	100	96	88.5	91.2	87.2	n.a	n.a
O-Level pass rate (%)	81	75	75.1	73.8	75.1	74.5	
A-Level student participation in:[d]							
Science and Technology combined (%)	40	40		33	32.1	32.9	35.1
Science (%)	n.a.	n.a.	n.a	n.a	21.1	22	23.6
Technology (%)	n.a.	n.a.	n.a	n.a	11.0	10.9	11.5
Commerce (%)	35	33	n.a	n.a	21.4	21.7	21.0
Arts (%)	25	27	n.a	n.a	43.2	42.7	41.0
A-Level pass rate (%)	>64	70	64.7	62.4	66.0	63.5	64.2
Professionally qualified teachers (%)	90	n.a	82.9	78.8	n.a.	77.7	82.3
Government expenditure on education (% of GDP)	6	Reasonable level	1.86	1.93	n.a.	1.85	1.52

Note: N.a. – Not applicable.
a. Refers to the share of students in different subject streams out of the total number of students in A-Levels.

Sources: b.Ministry of Education. (2017). Annual Performance Report. c. Ministry of Education. (2010). Sri Lanka: General Education Sector Development Plan (2020 - 2025). d. Ministry of Education. (Various Years). Annual Performance Report.

7.3.1 Improving Access to Education

The first thrust area, which focuses on providing equitable learning opportunities to all children, comprises several components. One of its goals is to provide free education and guaranteed educational participation up to the secondary level. This is combined with additional efforts to make learning more appealing and results-oriented, such as focusing on learning settings, career coaching, and counselling. This section also focuses on enhancing children's health and nutrition, which is emphasised as essential for retaining kids in school and helping them learn more efficiently.

As seen in Table 7.1, one main KPI in assessing access to education is improving school attendance in grade 1 and ensuring retention of those students until the end of the compulsory schooling age of 16 (i.e., grade 11). The original target set at 100% in 2017 has not yet been achieved and accordingly, the target had to be downgraded to 96% in ESDP (2020-2025). The net primary admission rates marginally decreased from 95.4% in 2018 to 95% in 2020. The retention of students up to grade 11 also fell from 88.5% in 2018 to 87.2% in 2020 (see Table 7.1).

Under the ESDP 2020-2025, the main difficulty in retaining children in the compulsory age group is identified to be poverty, disparities in resource allocations across schools, learning difficulties and disabilities, and lack of parental interest. Disaster risks and related disruptions to schooling are flagged concerns. The APR of 2023 shows the main challenges facing the education sector in the 2018-2020 period related to COVID-19 and related nutritional and psychological issues faced by students and their families. These issues were exacerbated during the economic crisis in 2022. According to a

survey done by the World Food Programme, due to coping strategies, 68% of the 2,137 surveyed households reduced the quantity and quality of food consumed.[20] In this regard, welfare programmes assisting families to send children to school are crucial.

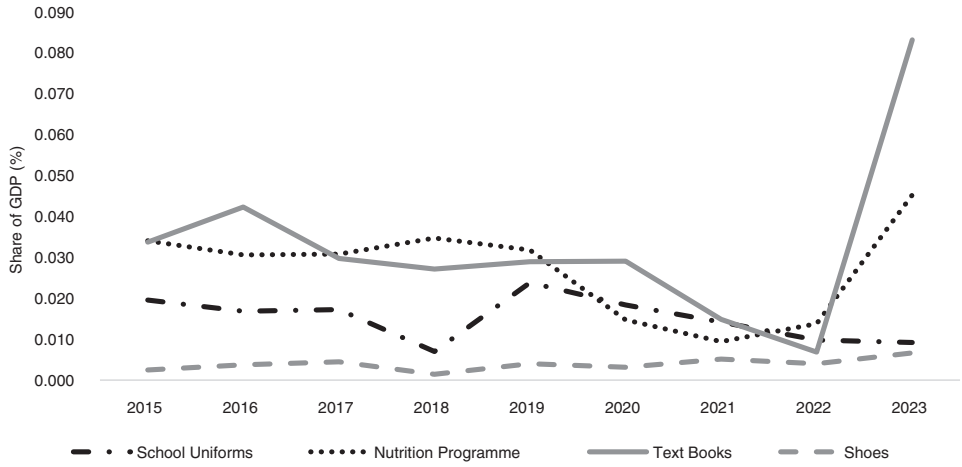
The key strategies of this programmme include improving access to quality schools, improving education facilities for special needs students and expanding access to non-formal education so that students who drop out of the system have a mechanism to re-enter the system. Emphasis is also given to expanding education welfare activities according to needs and improving the health of school children. Interestingly, this programme focused on strengthening disaster risk management to minimise education losses due to disasters even before the COVID-19 pandemic. The ESDP (2020-2025) also recognises the need to narrow the disparities between different types of schools to improve access to quality education. However, the economic crisis in 2022 created significant unanticipated upheavals in the education sector. Transport issues due to fuel shortages resulted in the closure of schools re-opened after the pandemic. Although attempts were made to continue education activities using remote methods, this was also more challenging than during the pandemic due to prolonged power cuts.[21] Thus, the delays and exam losses created consequences that continue to this day. The most noticeable of these is the prolonged delay in conducting national exams. Even the O-Level exam scheduled for December 2022 was only held in May 2023. Similar delays were observed in the grade 5 scholarship exam and A-Level exams, affecting educational operations. Although several initiatives have started to reduce inequality across schools, these have not been implemented consistently. For example, as seen in Figure 7.6, the welfare programmes already in place were also hampered due to limited resources in the 2019-2022 period spanning the COVID-19 pandemic and the economic crisis period. As seen, the public finance for welfare initiatives in the education sector has declined from 2019 to 2022. Optimistically, these have seen some revival in 2023, partly due to increased donor funding. For example, according to the APR 2023 under the Contingent Emergency Response Components (CERC) programme of the World Bank as an emergency response measure following the COVID-19 pandemic, Sri Lanka received support for the School Nutrition Programme in 2022 and 2023. Further, the World Food Programme and Save the Children supported the school nutrition programme. In light of the above, the sustainability of this programme will depend on the availability of long-term funding.

Over time, many initiatives have been launched to either narrow disparities in the quality of schools or improve access to quality education. Those attempting to improve access to quality schools for more students include the '1,000 National Schools' initiative and the 'Nearest School Best School' initiative. In addition, programmes for improving access to education for children from diverse backgrounds include an initiative to improve schools for minority students (see Box 7.1). These initiatives are discontinued or reshaped occasionally, making it difficult to assess their progress.

20 This section was drawn from Annual Report (p 127), Central Bank of Sri Lanka (2023).

21 *Ibid*.

Figure 7.6
Government Expenditure on Welfare (% of GDP)



Source: Compiled using data from the MOF, Annual Report 2022.

Box 7.1
Progress of Selected Education Policies

13-year guaranteed education policy

The *'13-Year Guaranteed Education Policy'* was implemented in 2017 to ensure that every student received 13 years of education following their enrolment in schools. Under this policy, a new vocational subject stream was introduced in selected schools enabling students to continue their education based on their interests and abilities irrespective of their results (pass or fail) at the G.C.E. O-Level examination. Furthermore, public and private institutions identified in consultation with the Ministry of Skill Development and Vocational Training, were coordinated to incorporate vocational subjects and a programme has been established to provide practical training opportunities for students from the vocational stream. Programme implementation included training of teachers, and provision of physical facilities (e.g., new buildings, renovation of classrooms, provision of smart interactive boards, sports equipment, aesthetic equipment, ICT and agricultural equipment and wi-fi facilities. The programme also pays attention to promoting school health and nutrition, providing facilities for teaching children with special needs, improving the attractiveness of school premises, and strengthening career guidance.

Unlike many other recent policies in the country, this policy was sustained despite regime changes. Over time, the programme has enhanced coverage to 525 schools by 2022. The number of students benefitting from the initiative has also increased to 5,340 in 2020. The most recent National Education Policy Framework (NEPF 2023) also reiterates providing access to all children irrespective of socio-cultural backgrounds or ability level. However, the document does not specify the number of years for which this is guaranteed.

Policy on raising national schools to 1,000

To boost access to high-quality education, the Cabinet accepted a plan to expand the number of national schools to 1,000. As a result, the country's national school count grew from 353 in 2018 to 396 by 2022.[a] This effort aimed to improve facilities for specific subjects and ICT in selected schools. The schools were selected to include minority-student schools. Despite being implemented, the initiative halted midway. As a result, less than 1,000 schools have been promoted to the rank of national schools. This initiative included steps to create and grow national schools, such as improving school quality, physical resources, and teacher capability.

However, according to the latest NEPF 2023, all schools will be provincial schools. How the programme will be changed with this new framework is yet uncertain.

Nearest school is the best school (2016)

The project was implemented but discontinued halfway through. However, the schools initiated under this programme have been continued and are currently being sustained with available resources. For example, the sanitary facilities in schools were aimed to be upgraded in schools chosen for this initiative in the 2016-2020 period. But the *Nearest school is the Best School* nomenclature is no longer promoted as a project.

Estate and Tamil medium school development projects

This project was launched with assistance from the Indian government (for estate schools) and Korea International Assistance (KOIKA). Here, the focus was to assist schools with children who performed poorly at the O-Levels and A-Levels from 2016 to 2020. The programme components included the development of facilities in these schools and improving the capacity of principals and educational officers serving these schools. The programme continues, but filling subject-teacher shortages in Tamil medium schools remains an urgent challenge.

Sources: Ministry of Education. (Various Years). *Annual Performance Report.* Battaramulla: Ministry of Education; Ministry of Education. (Various Years). *Sri Lanka: General Education Sector Development Plan (2020 - 2025).* Battaramulla: Ministry of Education; Cabinet Committee. (2023, September 1). *National Education Policy Framework Sri Lanka,* https://moe.gov.lk/wp-content/uploads, Findings based on key informant interviews.

7.3.2 Improving Quality of Education

The second thrust area involves raising educational standards. This thematic area focuses on modernising education, enhancing primary education, expanding access to Science, Technology, Engineering and Mathematics (STEM) subjects and English, and developing soft skills. To put these aims into reality, much attention is placed on enhancing teacher quality, improving student assessment, modifying national curricula to suit the changing labour market, embracing digital-based teaching and learning, improving learning outcomes, increasing pass rates at O- and A-Levels, encouraging ICT literacy, altering the structure of educational attainment by extending access to Science and Commerce streams of education, and increasing the share of teachers with professional credentials (see Table 7.1). The KPIs mentioned under this thrust area include improving learning

outcomes in core subjects at grades 4 and 8, improving achievements at national exams, increasing the availability of professionally qualified teachers, and making A-Levels more STEM-oriented.

Learning outcomes in core subjects such as language and Mathematics in grades 4 and 8 are an indicator of the quality of the educational system. It assesses the learning achievements of a randomly selected group of pupils in the country, representative of different types of students. The NEREC monitors students' learning outcomes. These assessments reveal inequalities in children's learning outcomes across provinces and school types. One goal in the second thrust area is to enhance students' learning outcomes (see targets in Table 7.1). Although this is the ideal method of assessing the quality of education, the NEREC assessment tests for grades 4 and 8 have not been done in the last several years, making it impractical to use this measure.

The student achievements at the national exams are also a KPI under this thrust area. Results show that exam achievements have stagnated over the past several years. The O-Level pass rates have remained around 75%, while the A-Level pass rates have remained around 65% (see Table 7.1). The performance in Mathematics is the key cause for not being eligible to sit for A-Levels. The O-Level Mathematics pass marginally increased from 68.3% in 2018 to 70.5% in 2020. Another crucial subject is English, which helps pupils advance in the job market. Like Mathematics, performance in English climbed relatively higher, from 54.9% in 2015 to 65.8% in 2020, but there is still much potential to progress. Despite progress at O-Levels, the share of students eligible for university education based on their A-Level results remained around 63-66% from 2018 onwards.

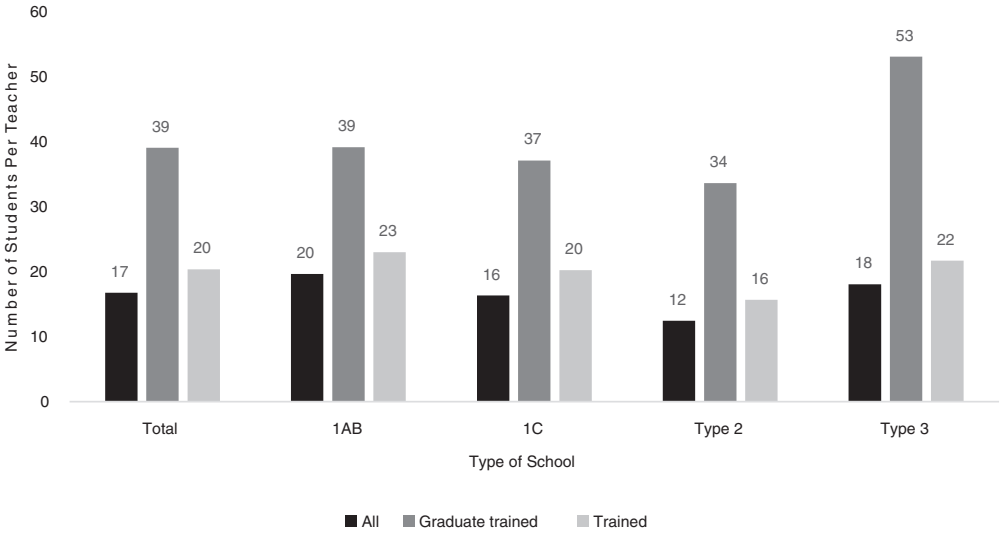
This thrust area aims to enhance access to STEM graduates to meet the increasing demand for these subjects in the country. As a share of students in A-Level classes, the percentage of students in the Commerce and Arts streams has remained constant or has slightly reduced; in contrast, the share of students in the Science and Technology stream shows an uptick over the 2019-2022 period. One key insider from the MOE discloses that this upturn is partly due to the increase in the university intake of students from the Technology stream, which has increased in popularity. According to another key insider, the overall increase in education participation of older students aged 15-19 could be due to the 13-year guaranteed education policy of enabling children to continue their higher education in the newly introduced vocational stream regardless of their O-Level results. Unlike the other subject streams, the vocational stream is more practical, providing possibilities for hands-on industrial experience. However, in the absence of conclusive evidence, this may explain the closing of the male-female divide in upper secondary education enrolment and promote education involvement among children from low socio-economic backgrounds.

This thrust area also seeks to improve the availability of quality teachers in classrooms. As seen in Figure 7.7, the overall students-per-teacher ratio of 17 in Sri Lanka is lower than the average for middle-income countries, but the ratio of 39 students per graduate-trained teacher is much higher.[22] These averages hide rural-urban disparities in teacher availability and shortage of teachers in some subject areas. The lack of a proper mechanism in place for deploying teachers also affects teacher availability.

22 In 2016, the average for middle-income countries was 24 for primary education and 18 for secondary education (United Nations Conference on Trade and Development (UNCTAD) 2016, Development and Globalisation Facts and Figures, Geneva: UNCTAD, page 28).

Further, the lack of motivation among teachers for on-the-job training and using technology in the teaching process is a challenge in modernising teaching methods. Improving the learning outcomes is made arduous by unattractive teaching methods, the lack of relevance of the curriculum concerning the labour market, and overreliance on the exam-oriented education system.

Figure 7.7
Students per Teacher, by Type of Teacher



Note: Trained - both graduate and non-graduate trained teachers; Graduate-trained - trained teachers with a degree.
Source: Compiled using data from the MOE, Annual Performance Report 2023.

Other related IPS' research also reveals similar findings that smaller schools, which are more visited by children from low-income families are underfunded, which affects their exam results. For example, there was found to be a significant shortage of qualified and trained instructors to teach English, Mathematics, and Science subjects in rural and smaller schools at times, the latter lacking the least facilities. This discrepancy is exacerbated by the unequal distribution of subject-qualified teachers and principals among schools. A study conducted using School Census data and a multivariate modelling technique shows that these differences and absenteeism of instructors in rural small schools correlate to low exam results for students from these schools.[23]

One objective of these thrust areas is to improve computer literacy. Keeping up with technological advancements is no longer an option but essential. Countries with more sophisticated systems in place, with relatively greater resources and technical capabilities, are already leveraging technology to their advantage. Unless developing countries such as Sri Lanka keep pace with these changes, they risk slipping behind. However, selective technological adoption without regard for equality

23 Abayasekara, A., & Arunatilake, N. (2018). School-level Resource Allocation and Education Outcomes in Sri Lanka. *International Journal of Educational Development,* 127-141.

considerations may exacerbate existing disparities in educational access. As seen in Figure 7.5, the availability of computers in schools for educational purposes is quite low, and it varies across different types of schools and geographical locations. For example, only 55% of 1AB schools, on average, had a computer for every 25 students for educational purposes. This number drops to as low as 18% for Type 3 schools. Moreover, these statistics do not reflect the quality of the internet services available to schools, which is also necessary for using ICT for education. Unless access to these resources improves, it will be impossible to incorporate information and technology resources for teaching and learning.

LFS 2022 data suggest that over 90% of children can perform educational activities using a computer. However, only 21.5% of 17-19-year-olds have used the internet in school during the 12 months before the survey. According to the APR 2023, following COVID-19, the MOE has taken several steps to improve the availability of computers and internet facilities in schools, developing teacher capacity. Also, various programmes were launched to encourage students to use computers, such as the 'Creative Teacher' and 'Young Computer Science' competitions. In addition to the above, according to the same source, students are given opportunities for self-learning using ICT under the E-Thaksalawa learning management systems (LMS).

Technology is deployed not only to keep up with innovations but also to find low-cost solutions to persistent problems in the education sector. The E-Thaksalawa is a step towards this.

An analysis of the MOE's APRs reveals that the education sector underperforms due to many factors. Most critically, the resources available to schools throughout the country are unequal. Despite many measures, such as increasing the number of national schools, discrepancies in access to facilities between schools persist. Concurrently, as previously stated, the unequal distribution of qualified teachers, and a shortage of subject-trained teachers impede efforts to improve educational quality. This is especially a matter of concern in rural underprivileged schools. Teacher shortages are high in institutions that offer education in the Tamil medium in rural areas. These issues are exacerbated by a lack of accommodation facilities for teachers in rural areas, limited transportation to rural schools, and issues prevailing in the current system on teacher transfers. The economic crisis in 2022 and the fiscal constraints faced by the country are also deterrents to the sector's development. Table 7.2 shows that implementing many of the proposed initiatives to address the above-mentioned issues relies on donor funding.

Consequently, the implementation of these initiatives is hampered if they do not receive adequate financial support. Technology can come to the rescue of some of the underfunded programmes. A recent study by the IPS suggests that Asia's technology is deployed not only to keep up with innovations but also to find low-cost solutions to persistent problems in the education sector (see Box 7.2). The E-Thaksalawa of the MOE is a step towards this. Studies should be done to identify other areas where technology use can reduce the implementation costs of proposed programmes.

Box 7.2
Using Technology to Fill Gaps in Access to Quality Education for Vulnerable Groups

Interest in incorporating technology into education has surged, especially after the COVID-19 pandemic underscored the necessity of distance learning and highlighted the role of technology in strengthening the resilience of education systems. As such, education technology (EdTech) facilitates the teaching-learning process through deploying various technological tools. Examples of EdTech include LMS, educational apps, e-learning platforms, educational games, and education management information systems (EMIS), among others.

One main benefit of EdTech, as highlighted by the research, is its ability to cater to the diverse needs of different vulnerable groups, such as children with disabilities and rural children, at a lower cost. Below are some successful examples of such EdTech initiatives in Asia:

'WonderTree' in Pakistan offers therapeutic exercises for children with special needs using Augmented Reality (AR)-based games, addressing the educational needs of children with a range of motor and cognitive challenges, including Autism, Down Syndrome, and Global Development Delay. It helps a marginalised group of children and thus is a true representation of technology working to promote inclusiveness and equitable access to quality education. 'WonderTree' is a private tech startup that collaborates with international organisations, NGOs, the private sector, and the public sector.

'OLabs' (Online labs for schools) in India targets children from underprivileged schools by making lab resources available readily (anytime) and remotely (anywhere) to students with no access to physical labs or where equipment is not available in their schools due to scarcity or cost. This initiative is an example of using technology to improve access to education infrastructure by enabling typically overlooked students in rural schools to compete with students in better-equipped schools, thus bridging the gaps in access to quality education. OLabs was pioneered by Amrita CREATE,[a] and was funded by the Ministry of Electronics and Information Technology in India through a research grant.

'Nenasa TV' in Sri Lanka is a satellite-television-based EdTech initiative aimed at bridging the urban-rural gap in access to education. It enables schools and students in underprivileged regions, which lack resources such as qualified teachers, education infrastructure, and internet access, to receive educational content through its TV channels available in both Sinhala and Tamil languages. This is a public-private partnership (PPP) initiated and funded by the Dialog Foundation, in collaboration with the MOE in Sri Lanka. The educational content of Nenasa is provided by the MOE, while Dialog handles technology-related aspects.

'Class Saathi' in South Korea and India is a Bluetooth clicker-based smart classroom solution that makes formative assessment easy and fast, without any requirements for an internet connection or electricity, thus catering to rural schools. It provides bluetooth-enabled clickers for each student with an accompanying application (app) that can be managed through a dashboard. The seed funding for Class Saathi was provided by Samsung Ventures in 2017 and two years later, Class

Saathi was successfully piloted in India in 2019. As a product of Samsung C lab, the company raised United States Dollars (USD) 2.5 million (Mn) in Series A funding to expand operations to India.

Note: a. Amrita CREATE is an educational technology initiative pioneered by Amrita Vishwa Vidyapeetham, a multi-campus, multi-disciplinary, research-intensive private-deemed university in India.

Sources: Vithanage, H., Arunatilake, N. Wanigasinghe, L. & Seneviratne, B. (2023). *Ed-tech Landscape and Challenges in Asia and the Middle East and North Africa (Occasional Paper No. 89).* Southern Voice, https://southernvoice.org/ed-tech-landscape-and-challenges-in-asia-and-mena/; Vithanage, H. (2024, January 24). *Ed-tech for Marginalised Children in Sri Lanka: Insights from MENA and Other Asian Countries.* Talking Economics, https://www.ips.lk/talkingeconomics/2024/01/24/edtech-for-marginalised-children-in-sri-lanka-insights-from-mena-and-other-asian-countries/

7.3.3 Improving Governance of Education

The third theme in the rolling ESDPs is improving education governance and providing educational services. Under this theme, attention is given to the provision of greater decision-making powers and autonomy to schools. Functions under this umbrella include expanding the number of qualified professionals in the education system, improving productivity (both efficiency and effectiveness) at all managerial levels through the provision of essential physical and human resources, operating schools as cost-effective centres, and enhancing the quality of all agencies within the education system.

This theme's key strategies/initiatives include strengthening school management and financing through decentralised school-based management, implementing the Enhanced Programme for School Improvement (EPSI), establishing a school quality assurance system, strengthening school management at various levels, and building capacity.

Under the medium-term KPIs under this thematic area, by 2025, all schools are to have successfully implemented EPSI, thereby promoting the improvement of cognitive and socio-emotional skills; in addition, 400 individuals with postgraduate degrees will have been added as SLEAS officers (SLTES) officers,[24] and curricular developers, several schools will have boosted their School Education Quality Index (SEQI) by 5%, and several zones will be operating effectively as top service delivery centres.

In terms of the progress achieved so far, approximately 80% of the plans for implementing the EPSI and the Training of Trainers (ToT) in collaboration with the Provincial Departments of Education have been completed by 2020, and 83% of schools have achieved the SEQI level by 2022. On the brighter side, with foreign funding, several capacity building programmes have also been conducted in the sector. In addition, considerable progress has been made in developing the Management Information System (NEMIS) for supporting the education planning, monitoring and development process.

However, despite these achievements, there is more distance to go and still much to achieve under this theme. The funding limitation due to the 2022 economic crisis has slowed down the development of governance in the education sector. Table 7.2 shows that many initiatives aimed at improving the availability of or access to information on the education sector, human resource development, and

24 SLEAS stands for Sri Lanka Education Administrative Service, and SLTES stands for Sri Lanka Teacher Educators Service.

strengthening institutional capacity are critically underfunded. According to the APR 2022 of the MOE, empowering and strengthening the school supervision process, school-based management, and education administration and management at zonal, divisional, provincial and national levels continue to remain as future goals to be achieved. Furthermore, digitising the educational administrative process, and introducing new information systems and an 'Office Automation System' to zonal education offices are also targets yet to be achieved. Additionally, while the existence of vacancies in all services of the education system creates hindrances to the qualitative development of education, filling such vacancies is also a systematic challenge. Addressing the same needs to be prioritised. Importantly, although making data-driven decisions is crucial, collecting data for some indicators to track performance is challenging due to the lack of a systematic data collection mechanism in Sri Lanka.

7.3.4 Improve Evidence-based Education Policymaking and Planning

The fourth and final thrust entails evidence-based policymaking, planning, and research, as well as results-driven monitoring and assessment. In addition, establishing linkages with other fields that are pertinent to education and informing the public about the state of the educational system are the duties assigned to this thrust area.

In many countries, the authorities have agreed on a specific policy document to govern educational progress. However, aside from the Acts and regulations and the Education Ordinance of 1939, Sri Lanka lacks a comprehensive up-to-date legal education policy framework to guide policy development in the sector. As a result, policy changes occur often in response to government shifts and political forces. The National Education Commission (NEC) Act No. 19 of 1991 mandates that recommendations on education policy formulation be made to the President. Yet, proposals for formulating education policies have been drafted by several bodies over the years,[25] and none of these policies have been fully implemented. However, these policy documents have been used in parts by the MOE and the National Institute of Education (NIE) to develop the rolling education Sector Development Plans. In addition, APR 2022 highlights that delays in obtaining Cabinet approval, which is a must for implementing policies, have delayed progress in education sector policies. The National Education Policy Framework (NEPF 2023) proposes to overcome this issue by freeing the MOE from administrative functions and delegating it full authority for policy formulation.[26] The NEPF 2023 also envisions the abolition of the NEC and replacing it with a National Advisory Committee for Education. Such moves to restructure the education sector have been attempted previously but failed due to lobbying by groups with different political outlooks and vested interests. The ability of the implementors to consider the demands of those resisting and addressing their concerns will ultimately determine the effectiveness of the planned reforms. Also, the suggested reforms can only be implemented by

25 Some examples of these include: Proposals for a National Policy Framework on General Education in Sri Lanka, Prepared by the National Education Commission in 2003; New Education Act for General Education in Sri Lanka, compiled by National Committee for Formulating A New Education Act for General Education appointed by the Minister of Education in 2009; National Policy on General Education in Sri Lanka, prepared by National Education Commission in 2016; National Education Policy Framework 2020-2030, prepared by the National Education Commission 2020; National Education Policy Framework for Sri Lanka, prepared by a Cabinet sub-committee in 2023.

26 At present, the MOE is responsible for administrating National Schools. Under the new framework, all schools will be provincial schools.

repealing and altering existing Acts of Parliament (for example, the Act establishing the National Education Commission Act No. 19 of 1991). Likewise, obtaining parliamentary support in the current political context is uncertain.

The inconsistencies in the policies and funding also impair sector development (see Box 7.1). For example, the 'Nearest School is the Best School (2020)' policy serves as an instance where implementation halted midway due to changes in government, political influences, and the subsequent discontinuation of its budgetary allocations. Similarly, the '13-Year Guaranteed Education Policy' (2017), which has been in place since 2017, suffers inconsistent fiscal provisions. The lack of data makes it further challenging to assess the efficacy of various educational strategies, as does monitoring and evaluating policy achievement against identified targets. Regardless of the policy inconsistency, the sector has gone forward under the medium-term ESDPs. The ESDP comprises medium-term, results-driven education sector development plans, as well as annual action plans.

Box 7.3
Political Volatility and Changes to the Education Sector

The volatile political environment in the country has a devastating effect on education policy formulation and implementation. During the past nine years, there have been eight Ministers of education, of which five have served for less than one year:

Minister of Education	Start Date	Duration
Akila Viraj Kariyawasam	12/01/2015	3 years, 287 days
Wijeyadasa Rajapakshe	29/10/2018	47 days
Akila Viraj Kariyawasam	20/12/2018	336 days
Dullas Alahapperuma	22/11/2019	264 days
G. L. Peiris	12/08/2020	1 year, 4 days
Dinesh Gunawardena	16/08/2021	245 days
Ramesh Pathirana	18/04/2022	21 days
Susil Premajayantha	20/05/2022	To date

Note: The Ministry was known as the Minister of Education and Higher Education.
Source: (Minister of Education (Sri Lanka), 2024) verified with (MOE, Various Years).

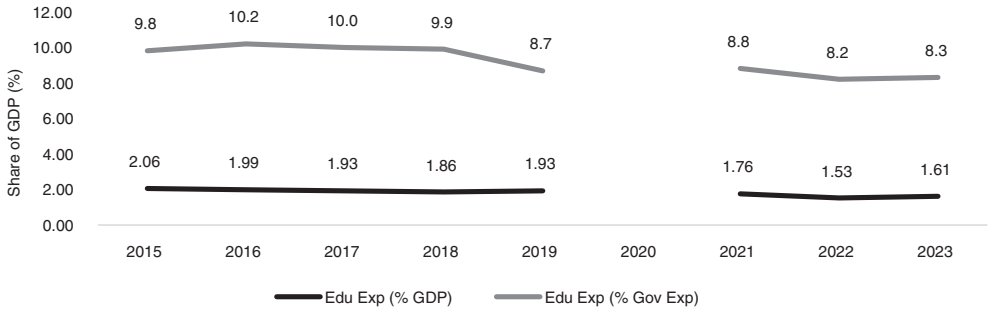
The structure of the Ministry and its institutional composition have also changed from time to time. Important departments, commissions and institutions such as the Departments of Provincial Education (DPE), NIE, University Grants Commission (UGC), NEC, and vocational training institutions were sometimes part of the MOE, while at other times these functioned with other Ministries. Such constant changes disrupt the strategic planning and implementation of policies and monitoring, evaluation and development of the sector.

The performance of the education sector is also affected by the country's general political and economic environment. The political instability the country experienced in the past several years, has resulted in frequent changes to the structure of the government. As seen in Box 7.3, the sector has had eight ministers of education over the last eight years, and only two of them have served for more than a year. Along with the changes to the Ministers of Education, the organisational structure of the sector has changed. This results in undue delays in developing education policies, implementing them, and monitoring their outcomes. Also not having demarcated functions for institutions falling under the purview of the MOE has seen the formulation of multiple education policies, which are not implemented comprehensively.

The education sector has had eight Ministers of Education over the last eight years, and only two of them have served for more than a year. Along with the changes to the Ministers of Education, the organisational structure of the sector has changed. This results in undue delays in developing education policies, implementing them, and monitoring their outcomes.

The government's restricted fiscal capacity that exacerbated during the 2022 economic crisis, has had a range of effects on the development of the education system. For one, the funds available to the sector have abated over the years hampering investments in the sector. Not only is the availability of sufficient budgets required, but also a smooth cash flow for appropriate policy execution amid fiscal fragility remains prevailing issues. Due to the government's further constrained financial limits, earmarking of funds from the Treasury to the sector is unpredictable.[27] This makes it tough to implement policies effectively. Furthermore, even after monies are allocated, red tapes impede the process and speedy execution – i.e., regulation requires that educational institutions follow lengthy government procedures to use the deployed/allocated funding.

Figure 7.8
Total Government Expenditure on Education



Source: Compiled based on Sri Lanka: General Education Sector Development Plan (2020 – 2025) by the MOE 2020.

27 Arunatilake, N., & Jayawardena, P. (2010). Formula Funding and Decentralised Management of Schools—Has it Improved Resource Allocation in Schools in Sri Lanka? *International Journal of Educational Development*, 30 (1), pp. 44-53.

Although the need for educational resources has expanded over time, public spending on education has shrunk in recent years. From 2018 to 2022, government spending on education fell as a proportion of total government spending (from 10% to 8.2%) and as a percentage of gross domestic product (GDP) from 1.93% to 1.52%. Although these trends have reversed in 2023, the increase is marginal. Given that GDP contracted by 8.7% in 2022, this is a reduction in the absolute value of public educational investments. Furthermore, hyperinflation in 2022, as well as a steep rise in imported items due to a surge in exchange rates, have also raised the prices of educational inputs, deteriorating the purchasing power of funding available for education. The national accounts of Sri Lanka reveal that from 2021 to 2022, the household expenditure on education rose by 26.5% in nominal terms, indicating a considerable increase in household expenditure on education.[28] Figure 7.6 depicts that the welfare benefits given to school children have also reduced since 2019, possibly due to COVID-19 and the subsequent economic crisis in 2022.

The inadequacy of government funds for developing education in the country amid fiscal fragility with a crisis-hit economy is a major deterrent to the sector's development. This sector benefits from various reputed donors, including the World Bank, Asian Development Bank (ADB), and UNICEF, Korea International Cooperation Agency, Japan International Cooperation Agency, and the United Nations Development Fund (UNDP). Although some programmes have received adequate funding to implement identified projects, others are inadequately funded (see Table 7.2).

Table 7.2
Adequacy of Funding for Education Development

Funding Adequacy	Development Component
Adequate funding	Primary education, non-formal education, special education, inclusive education, social cohesion, peace education, enhanced Programme for school improvement.
Underfunded	Curriculum development, teacher education, teacher development, career guidance, student counselling, assessments, testing and evaluation, quality assurance, inspection, health and nutrition, languages, second national language, Social Science subjects.
Critically underfunded	Science, Mathematics, English education, ICT, digital education, textbooks, learning materials, Technology education, 13 years guaranteed education, religious, sports, aesthetic, co-curricular activities, human resource development, continuous professional development, capacity building, training, infrastructure, facilities, resources, policy, planning, monitoring and data management.

Source: Compiled based on Sri Lanka: General Education Sector Development Plan (2020 – 2025) by the MOE 2020.

28 The corresponding increase from 2022 to 2023 was 22%.

7.4 Conclusions and Recommendations

The education sector in a country has a critical developmental role in preparing children for the world of work and productive lives. Sri Lanka is committed to providing equitable access to quality education for all children as a signatory of the Sustainable Development Goals (SDGs). This chapter assessed the performance of the sector since 2017 and to identify knowledge, capacity and policy gaps. This section provides recommendations for the future.

In the compulsory education age (up to age 16), the main gap in access to education lies among the highly vulnerable children. Sri Lanka successfully provides access to over 90% of children in the compulsory age group. Nevertheless, children with special needs, children in rural areas such as the estate sector and marginalised communities, and children from poor socio-economic backgrounds are still not fully engaged in education during this age group. Outside of the compulsory education age, low education participation in upper secondary, tertiary and vocational training sectors is a major challenge. Improving participation in higher levels of education and vocational training is crucial for improving productivity in the country and driving innovations that will improve the competitiveness of Sri Lanka's economy. Today, the need is not only to ensure that all finish general education but also obtain tertiary level vocational or university education. The biggest challenge facing Sri Lanka's education sector is students' low learning achievement levels compared to expected demand. Although the problem is well understood, the different attempts to improve learning outcomes have not been successful so far.

The sector well recognises this fact in the education sector's medium-term development plans. Although various initiatives have already commenced to address this issue, lack of funding, shortage of qualified teachers, issues with deploying teachers to areas where they are needed the most, and lack of funding to implement programmes have decelerated progress in this area. Further, many welfare measures started by the government to assist children from low socio-economic backgrounds are hampered by a lack of public funding.

In the current macroeconomic environment, it is unlikely that the sector will receive additional government funding. Under the ESDP (2020-2025), many local and international donors have come forward to assist the sector. But, to receive such assistance, the sector needs to increase visibility to the critical needs of the education sector. The above-explained programme has already implemented plans to improve education information. It is vital to ensure better information on gaps in education provision is highlighted to draw the attention of donors.

Education technology has been successfully used in different parts of Asia to help special needs children, improve access to quality education for children in rural areas, and improve children's learning outcomes. Contrary to the general belief, such initiatives could sometimes be accomplished by lesser resources requiring relatively lower funding (see Box 7.2). The MOE already has some EdTech initiatives in place (e.g., E-Thaksalawa). Mechanisms should be put in place to expand these initiatives, as informed by different programmes taking place worldwide.

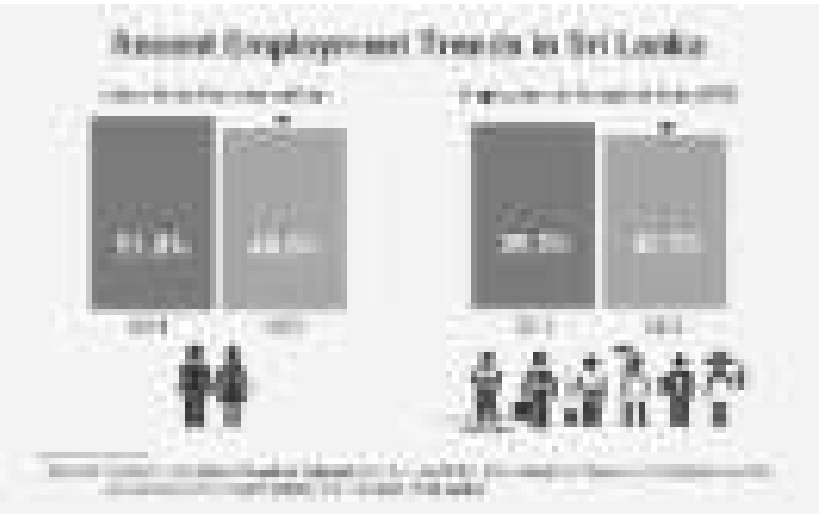
Technological advancements are continually changing the needs of the education sector. However, the sector's current governance and management structure does not support rapid change. Furthermore,

the unpredictable political structure and frequent structural changes in the MOE impede the sector's efficient operation and prevent the assessment of its successes and failures. To ensure the long-term viability of education reforms, educational institutions must be streamlined and established as permanent structures. Granting more authority as well as accountability to this newly constituted Ministry is vital to ensure policymaking remains steadfast so that regime changes do not impair the sector's core duties and management. Such changes at the broad level must be implemented through a consultation process that includes various actors who can be adversely affected by proposed changes so that the change can be politically, economically, and universally acceptable.

8. Labour Market Challenges: Quality Employment and Decent Work

8.1 Introduction

Sri Lanka has faced a tumultuous confluence of crises since 2019, profoundly impacting its labour market and the quality of employment. From the tragic Easter Sunday bombings of 2019 to the unprecedented challenges posed by the coronavirus (COVID-19) pandemic in 2020-2021 and the subsequent economic turmoil of 2022-2023, the country has grappled with a series of setbacks that have reverberated across its employment landscape, including further exacerbating existing vulnerabilities and testing the resilience of the workforce.



These crises have left deep scars on the labour market, which is evident in various indicators. For instance, the Labour Force Participation Rate, which measures the proportion of the working-age population (aged 15 years and over) either employed or actively seeking employment, declined from 51.8% in 2018 to 48.6% in 2023.[1] Additionally, the employment-to-population ratio (EPR), which indicates the percentage of the working-age population that is currently employed, dropped from 49.5% in 2018 to 46.3% in 2023, with a significant impact on the employed population.[2] Furthermore, 45.8% of employed individuals are estimated to have experienced a pay/allowance cut or income loss, with 48% facing a reduction in working hours.[3] These worsening labour market trends have further spelled trouble for household welfare, raised poverty levels sharply and left households impoverished due to a fall in their purchasing power, driven by high inflation and losses in wages and employment.

1 Central Bank of Sri Lanka. (2023). *Annual Economic Review 2023*. Colombo: Central Bank of Sri Lanka.

2 Author's calculation based on Labour Force Survey (LFS) (2018) by the Department of Census and Statistics (DCS) and the Annual Economic Review (2023) by the Central Bank of Sri Lanka (CBSL).

3 Department of Census and Statistics. (2023). *Household Survey on Impact of Economic Crisis - 2023*. Battaramulla: Department of Census and Statistics.

In light of these challenges, the compounding crises of recent years have significantly deteriorated the quality of employment in Sri Lanka, amplifying existing labour market issues and heightening job insecurity, uncertainty, and hardship for many workers. Addressing these challenges requires concerted efforts to enhance employment quality while simultaneously fostering the creation of decent work opportunities. Quality employment is pivotal not only for ensuring the economic security and well-being of individuals but also for bolstering the overall stability and development of the country. These become even more critical facets in a post-crisis context, not only to mitigate the long-term effects of crises but also to ensure labour markets can combat future shocks. As such, this chapter endeavours to comprehensively examine Sri Lanka's employment landscape, delving into issues pertaining to the quality of employment and the need to create decent and sustainable employment opportunitiesfor the well-being and economic security of all individuals.

8.2 Present Challenges in the Labour Market: Evidence from Data

Over the past few years, the pandemic and the economic crisis have impacted Sri Lanka's three main economic sectors – agriculture, industry, and services – in different ways and magnitudes. External shocks affected different sectors with distinct vulnerabilities, which significantly impacted the outcome of the labour market.

The agriculture sector, while the least affected compared to the other two sectors, was not immune to disruptions. An abrupt ban on chemical fertilisers in 2021, aimed at promoting organic farming, led to a substantial drop in agricultural output. In contrast, the industry sector was severely impacted both by the pandemic and the economic crisis. Lockdowns, travel restrictions, and global supply chain interruptions during the former led to factory closures and the downturn in manufacturing output, especially in the textile and apparel industry. The 2022 economic crisis further deepened these challenges with the services sector, the largest contributor to Sri Lanka's gross domestic product (GDP), experiencing varied impacts across the two crises as retail trade and tourism were the hardest hit in 2020 while the economic crisis shifted the impact to financial services.

8.2.1 Rising Labour Market Inactivity[4]

The differential impacts on the agriculture, industry, and services sectors during the crises have had profound implications for the labour market. Despite the initial anticipation of a significant surge in unemployment growth during the crisis period spanning from 2019 to 2023, the reality in Sri Lanka's labour market unfolded differently. Instead, the adjustment in the labour market was marked by a decline in the growth of unemployment. However, a striking contrast emerged in the labour market during 2019-2023, highlighting a shift in labour market dynamics towards greater labour market inactivity (see Figure 8.1).

Notably, the unemployment rate for the working-age population peaked at 5.5% in 2020, primarily

4 This analysis is based on- International Labour Organization. (2023). *Statistical Brief: Sri Lanka's Labour Market during the Economic Crisis 2022-23.*

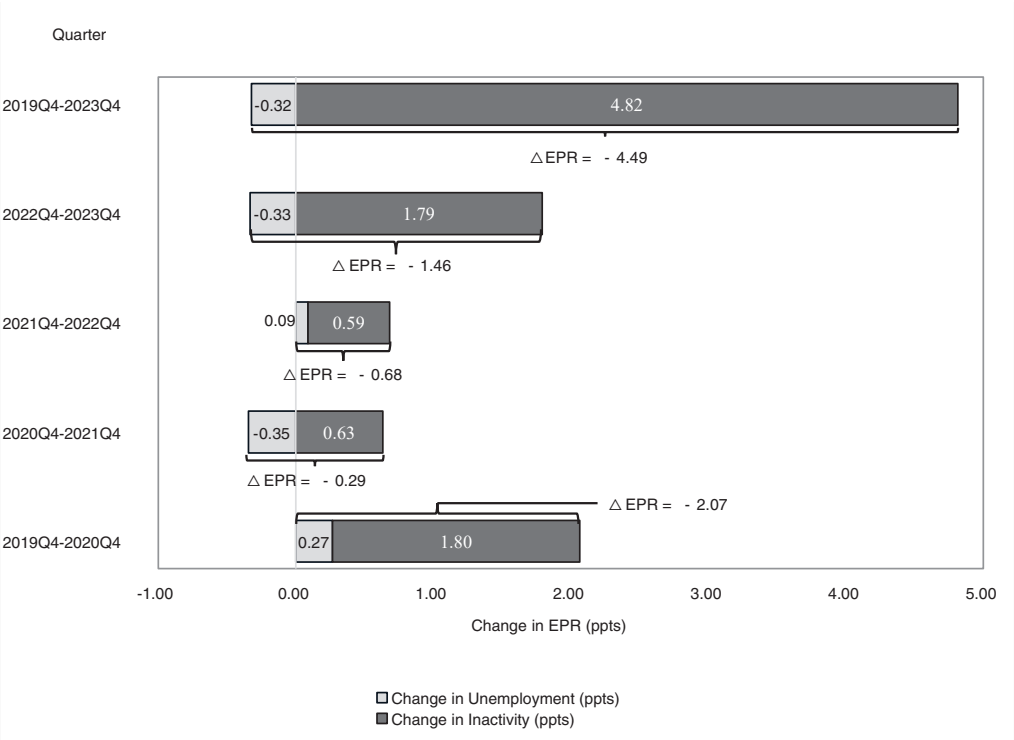
attributed to the pandemic's disruptive effects.[5] However, quarterly data indicates a promising trend, with the unemployment rate dropping to 4.3% in the fourth quarter of 2023. However, an alarming trend arises regarding the reduction in the EPR, primarily associated with a surge in labour market inactivity. The EPR decreased to 45.1% in the fourth quarter of 2023. Decomposing the EPR into changes in unemployment and labour market inactivity reveals a strong relationship between employment shifts and inactivity patterns. During the pandemic's peak (Q4 2019-Q4 2020), a 2.07 percentage point decline in the EPR in Sri Lanka predominantly stemmed from a 1.80 percentage point increase in the inactivity rate, compared to a mere 0.27 percentage point increase in the unemployment rate (see Figure 8.1). This trend showcases a decline in changes in unemployment post-pandemic – i.e., a substantial drop in the EPR primarily attributable to a surge in the change in labour market inactivity rate. For instance, the decline of 4.49 percentage points in the EPR from Q4 2019 to Q4 2023 was primarily driven by an uptick in inactivity, regardless of the decline in changes in unemployment.

Adjustments in the labour market were marked by a decline in the growth of unemployment. However, a striking contrast emerged in the labour market during 2019-2023, highlighting a shift in labour market dynamics towards greater labour market inactivity.

This rise in inactivity can be attributed to several potential factors. The main reason could be the disruptions in education and training programmes, which have likely delayed workforce entry for many youths, exacerbating skill mismatches and further contributing to labour market inactivity. Additionally, during economic crises, lower-skilled workers may face heightened job insecurity and may be more susceptible to layoffs as companies prioritise retaining or hiring workers with the skills necessary to navigate the changing economic environment. Consequently, these workers may find it challenging to secure re-employment opportunities, contributing to the overall increase in labour market inactivity. These combined factors have contributed to the notable rise in the inactivity rate, overshadowing the decline in changes in unemployment.

5 The analysis uses data from LFS (2020), LFS (2022) and Quarterly Bulletins, DCS.

Figure 8.1
Decomposition of EPR into Unemployment and Labour Market Inactivity[6]



Note: Calculations are based on analysis conducted by the International Labour Organization (ILO). According to the ILO (2023), the changes in the EPR can be broken down into changes in unemployment and inactivity using a simple decomposition: Working-age population = Employment + Unemployment + Inactivity, which can be transformed into $-\Delta(E/WAP)_t=\Delta(U/WAP)_{t+}\Delta(I/WAP)_t$, where Δ denotes change from t to t+1, WAP = working-age population, E = employment, U = unemployment, and I = inactivity.

PPTs denote percentage points.

Source: Author's calculations using LFS Quarterly Reports (Various issues), DCS.

8.2.2 Declining Labour Productivity and Employment Growth[7]

Labour market productivity growth, output per worker, employment growth, and wages are interrelated and critical indicators of employment quality, reflecting how efficiently labour is utilised. When employment in a sector grows faster than its overall economic expansion, productivity tends to decline. This occurs because the additional workers may not contribute efficiently to output, deteriorating productivity and potentially lower wages. Conversely, when employment growth lags behind sectoral expansion, productivity tends to rise as the existing workforce becomes more efficient, which can result in higher wages.

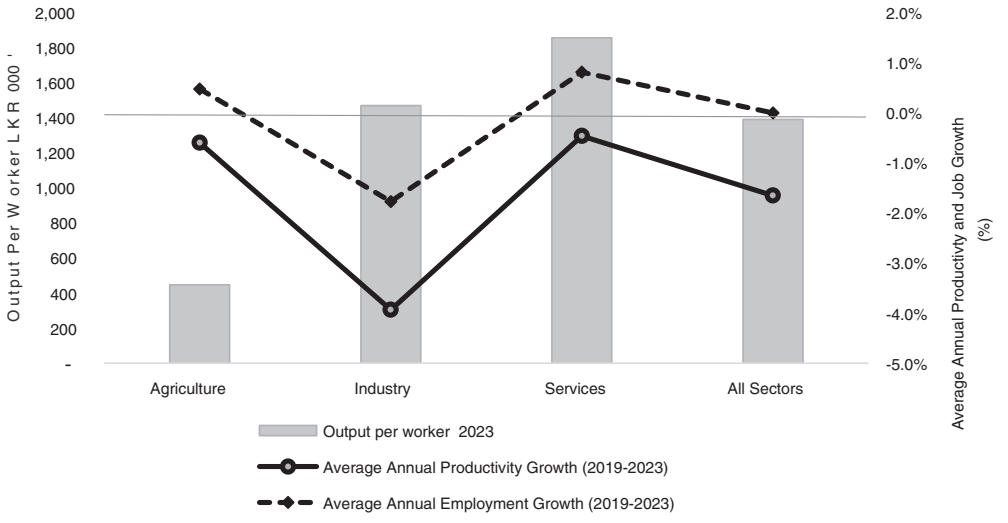
6 Based on -International Labour Organization. (2023). *Statistical Brief: Sri Lanka's Labour Market during the Economic Crisis 2022-23*, https://www.ilo.org/media

7 In this analysis, employment growth refers to the increase in main jobs only, as this measure was taken considering the data availability for the year 2023. Additionally, the employment growth in this analysis does not signify an increase in job vacancies or open positions within the labour market.

However, the period 2019-2023 has seen concerning trends in productivity across major sectors in Sri Lanka (Figure 8.2). The agriculture sector, for instance, exhibited lower output per worker in 2023 compared to the other sectors, with an average annual productivity growth of -0.6% and employment growth of 0.48% over the same period (Figure 8.2). This imbalance indicates that while the sector has added jobs, it has not done so efficiently, resulting in lower productivity and potentially stagnant or declining wages. Given that around 26% of the employed population engages in agriculture, this low productivity raises alarms not only for the economic well-being of agricultural workers but also for food security and poverty alleviation efforts. In contrast, the industry sector showed relatively high output per worker in 2023 despite experiencing a sharp decline in productivity growth, averaging -3.9% annually, and a -1.8% reduction in employment annually from 2019 to 2023 (Figure 8.2). This suggests that although the sector has been shedding jobs faster than it grows, other factors have collectively strained the sector's efficiency and competitiveness. Consequently, this has exacerbated the decline in productivity, leading to falling wages despite reduced employment. Looking ahead, the industry sector faces a formidable task in reversing these trends. Without strategic interventions to stabilise raw material supplies and manage input costs, labour productivity is likely to face continued downward pressure, potentially impacting wage growth and overall economic performance.

Meanwhile, the services sector demonstrated the highest output per worker in 2023, slightly negative at -0.5% average annual productivity growth and an average annual employment growth rate of 0.8% from 2019 to 2023 (Figure 8.2). The employment growth relative to productivity suggests that the sector has grown its workforce without considerable harm to productivity. This balance likely supports more stable or even increasing wages, as the efficiency of the existing workforce is maintained while accommodating new workers.

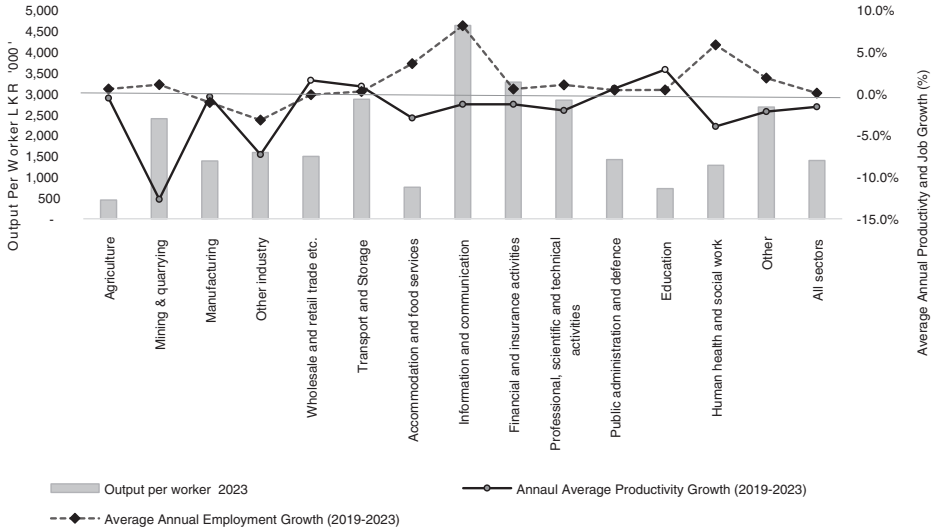
Figure 8.2
Output Per Worker, Labour Productivity Growth and Employment Growth by Main Sectors, 2019-2023



Source: Author's calculation based on LFS Quarterly Reports 2023, DCS and Annual Economic Review 2023, CBSL.

Figure 8.3

Output Per Worker, Labour Productivity Growth and Employment Growth by Sub-sectors, 2019-2023



Note: Other industry includes, Construction, Electricity, Gas, Steam and Air Conditioning Supply, Water Supply, Sewage, Waste Management and Remediation activities (public utilities 1 and public utilities 2). Other denotes Administrative and Support Service activities, Activities of households as employers, Real Estate activities, Arts, Entertainment and Recreation, and Activities of extraterritorial organisations and bodies.

Source: Author's calculation based on LFS Quarterly Reports 2023, DCS and Annual Economic Review 2023, CBSL.

The agriculture sub-sector and all industry sub-sectors showed a declining trend in average productivity growth between 2019 and 2023, highlighting the gravity of challenges in labour utilisation and efficiency. However, a glimmer of hope emerges from the service sub-sectors, with service sub-sectors such as wholesale and retail trade, transport and storage, education, and public administration and defence recording positive average annual productivity growth rates during this period (Figure 8.3).

In the manufacturing sector, average productivity growth slightly declined by -0.4% annually, while average employment decreased by -1.1% annually from 2019 to 2023. Initially, the pandemic impacted the manufacturing sector due to weaker external demand but it began to recover in 2021, However, it contracted again during the economic crisis. This decline was mainly due to a shrinkage in global demand for the manufacture of textiles, wearing apparel, and leather-related products, causing both output and employment to fall. Figure 8.3 shows that other industry sectors, including the construction sector and public utility sectors, experienced a significant decline in productivity growth, averaging -7.3% annually, and employment dwindling by -3.2% annually from 2019 to 2023. The major reason for this decline is the collapse of the construction sector.

Regarding the service sub-sectors, although all service sector sub-sectors except wholesale and retail trade recorded positive average employment growth for the period of 2019-2023, only four sub-sectors showed average positive productivity growth: wholesale and retail trade, transport and

storage, education, and public administration and defence. The wholesale and retail trade sector experienced positive average productivity growth of 1.5% annually, alongside a slight decline in average employment growth of -0.2% annually from 2019 to 2023. However, the pandemic and economic crisis decelerated the output growth in this sector. Employment levels likely contracted as businesses were forced to scale down operations or close permanently on the back of increased operational costs and reduced consumer spending power.

The accommodation and food services sector has shown a decline in productivity growth, averaging -3.0% annually, while experiencing a substantial employment growth rate of 3.5% annually from 2019 to 2023. This sector is likely to show continued recovery and growth in both output and employment as tourism recovers, potentially improving productivity as the industry stabilises and adapts to the post-crises environment.



Among all the subsectors, the Information and Communication (ICT) sector has the highest output per worker and the highest employment growth. However, the average productivity growth between 2019 and 2023 is -1.3% is concerning. Between 2019 and 2022, the ICT activities grew strongly, showing high positive average labour productivity, higher output per worker, and employment growth, standing out among all the other subsectors as a beacon of productivity and efficiency. The work-from-home (WFH) and learning-from-home arrangements adopted by most workplaces and educational institutions helped. However, in 2023, the ICT sector contracted by -13.2%,[8] although employment levels grew by 10% compared to 2022.[9] Consequently, the average labour productivity of the sector for the period of 2019-2023 turned negative. The declining output of this sector is worrisome as it has the potential to generate more employment opportunities and become the backbone of the service industry, facilitating a service-led economy.

8 Central Bank of Sri Lanka. (2023). *Annual Economic Review*. Colombo: Central Bank of Sri Lanka.

9 Author's calculations based on LFS Quarterly Reports (2023), DCS.

One major challenge it faces is the removal of the IT sector's Value Added Tax (VAT) exemption along with a VAT increase to 18%, which raises the prices of hardware and locally developed software, impacting the competitive pricing of the local industry. As such, increasing the operating costs of IT businesses, especially startups, could pose a significant risk to the industry. Consequently, there is a risk of companies, including local startups, moving abroad to avoid paying high taxes, which would slow down the digitalisation of the country.

The financial service sector shows the second highest output per worker among all the subsectors. It has experienced a decline in productivity growth, averaging -1.3% annually, with modest employment growth of 0.5% annually from 2019 to 2023. Despite registering a marginally positive annual average increase in employment, the banking industry has had negative employment growth since 2020.[10] The potential reasons for this could be increased migration and retirements in the said sector.

8.2.3 Declining High-skilled Employment

The ongoing technological transformation like automation, robotics, and artificial intelligence (AI) is reshaping the employment landscape and reorganising the global labour market.[11] This shift is reducing the sustainability of low-skilled jobs as computers and machines increasingly take over tasks previously performed by low-skilled workers. It will also increase the demand for high-skilled occupations and human-only abilities that cannot be automated. The polarities caused by this transformation also pose challenges for high-skilled workers, who must adapt to both existing job roles and new jobs emerging out of these advancements. The high-skilled jobs are classified under the ILO occupation codes: ISCO 1 (Managers, Senior Officials, and Legislators), ISCO 2 (Professionals), and ISCO 3 (Technicians and Associate Professionals). A key characteristic of high-skilled occupations is the first-level or higher tertiary education requirement to perform the tasks involved.[12]

As lower-skilled jobs become obsolete or trivial, creating high-skilled occupations becomes increasingly vital. One method to guarantee access to stable employment is to invest in these professions. In Sri Lanka, about 20% out of the total workers were in high-skilled occupations in 2023 (4.0% Managers, 7.3% Professionals, 8.6% Technicians and Associate Professionals).[13] However, compared to more advanced countries like the United States (USA), the United Kingdom (UK), and Singapore, the share of high-skilled workers in Sri Lanka is relatively low (Figure 8.4).

In many advanced countries, the share of high-skilled workers has increased from 2018 to 2022-23, while in Sri Lanka, this share has decreased from 23% to 20% during the same period.

10 Author's calculations based on LFS (2020-2023), DCS.

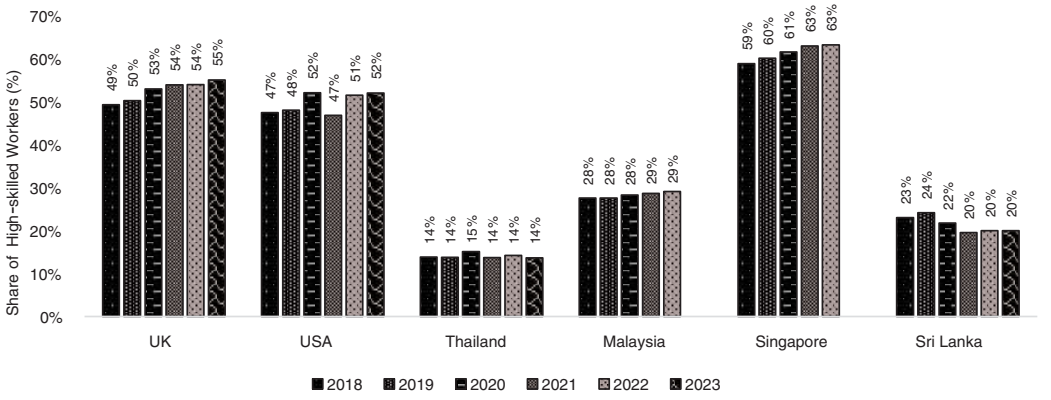
11 Arunatilake, N. (2019). 4IR and the Future of Work in Sri Lanka. In *Sri Lanka: State of the Economy 2019* (pp. 73-95), Colombo: Institute of Policy Studies of Sri Lanka.

12 Arunatilake, N., & Ranasinghe, S. (2022). Improving Access to Decent Work. In *Sri Lanka: State of the Economy 2022* (pp. 101-120), Colombo: Institute of Policy Studies of Sri Lanka.

13 Author's calculation using LFS Quarterly Reports (2023), DCS.

Notably, in many advanced countries, the share of high-skilled workers has increased from 2018 to 2022-23, while in Sri Lanka, this share has decreased from 23% to 20% during the same period (see Figure 8.4).

Figure 8.4
High-skilled Workers as a Share of Total Employed



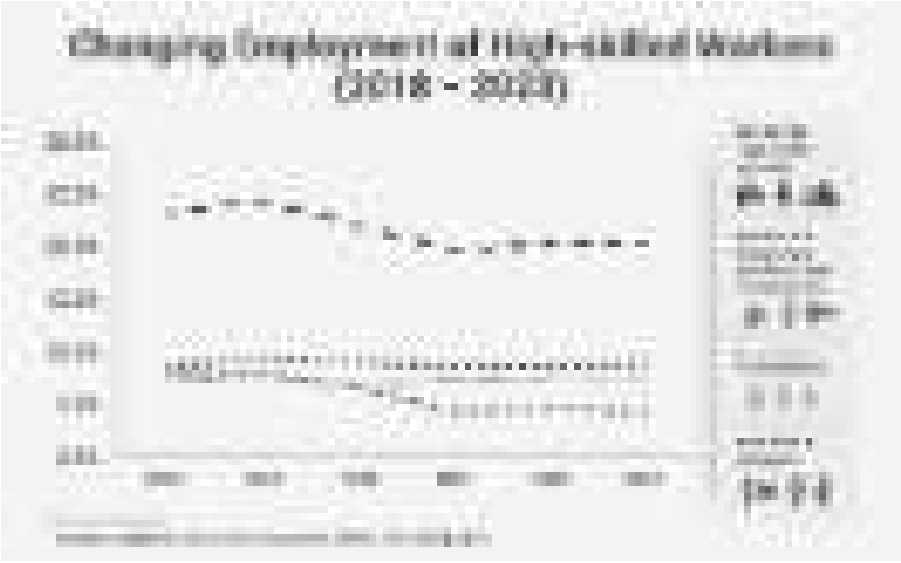
Note: Data for the year 2023 is not available for Malaysia and Singapore.
Source: Author's Compilation based on International Labour Organization Statistics (ILOSTAT) data.

This declining share of high-skilled workers is mainly due to the decrease in the share of Managers, Senior Officials, and Legislators. The shares of Professionals and Technicians and Associate Professionals out of the total employed did not fluctuate significantly from 2018 to 2023. However, the situation for Managers, Senior Officials, and Legislators is different (see infographic). In 2018, the share of Managers, Senior Officials, and Legislators out of the total employed was 8%,[14] but it had halved to 4% in 2023.[15]

In 2018, the share of Managers, Senior Officials, and Legislators out of the total employed was 8%, but it had halved to 4% in 2023.

14 Based on LFS (2020), DCS.

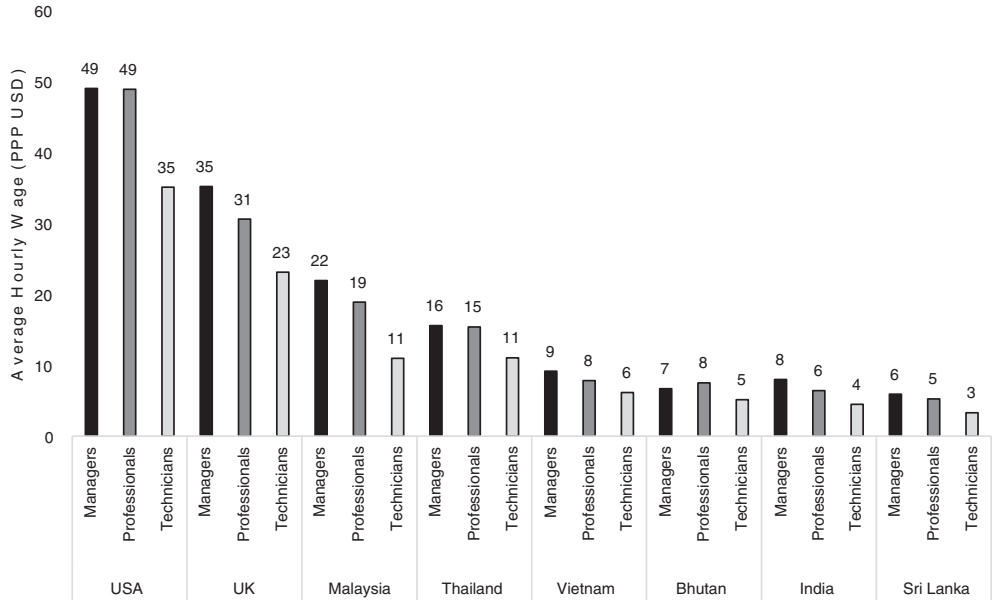
15 Author's calculation using LFS Quarterly Reports (2023), DCS.



One possible reason for the decline in the share of managers among the total employed is emigration caused by the disruptions of the pandemic and economic crisis over the past few years. There is ongoing discussion in the labour market about the migration of high-skilled workers in Sri Lanka and the potential brain-drain problem that may arise from this trend. Major industries have also claimed that they are losing key talent and executives due to the consequences of the pandemic and economic crisis.

One reason for the growing trend in emigration is the erosion of real wages and poorer living standards. This is also applicable to high-skilled workers. Figure 8.5 shows the average hourly wage in PPP USD for high-skilled workers in 2022. The average hourly wage for all high-skilled occupational groups is higher in advanced countries like the US and the UK, and in developing countries like Malaysia, Vietnam, Bhutan and India against the average nominal hourly wage for high-skilled workers in Sri Lanka. Therefore, especially during crises, high-skilled workers often feel compelled to seek opportunities elsewhere.

Figure 8.5
Average Hourly Wages (PPP USD) of High-Skilled Workers, 2022



Note: The wages in the graph are expressed in currency purchasing power parities, United States Dollars (PPP USD). This measure was used to adjust for differences in price levels between countries, providing a more accurate comparison of purchasing power and living standards across different regions. Using currency PPP USD ensures that the wage figures reflect the true economic value of earnings, eliminating the distortions caused by varying exchange rates and cost of living differences.

Source: Author's compilation based on the ILOSTAT.

8.2.4 Declining Access to Decent Work

Ensuring access to decent work is fundamental for improving the quality of employment and promoting inclusive growth, social justice, and sustainable development. Decent work provides fair wages, safe working conditions, and opportunities for personal and professional growth. However, not all jobs meet these criteria, and during periods of economic instability, the disparity between job availability and job quality can become more pronounced. Decent work, encompassing full and productive employment, rights at work, social protection, and the promotion of social dialogue, is hard to measure but essential for ensuring that all workers have fair and equitable employment opportunities.

Before delving into access to decent work as indicated by formal full-time employment, it is important to examine access to any kind of employment and how it has changed over recent years. As shown in Figure 8.6, the EPR – the share of employed individuals within the working-age population – varies widely across different demographic groups. It is highest for males and individuals in the prime-age group (25-49 years), while it is lowest for youth (15-24 years) and females. As discussed at the beginning of this chapter, the EPR has declined over the last few years.

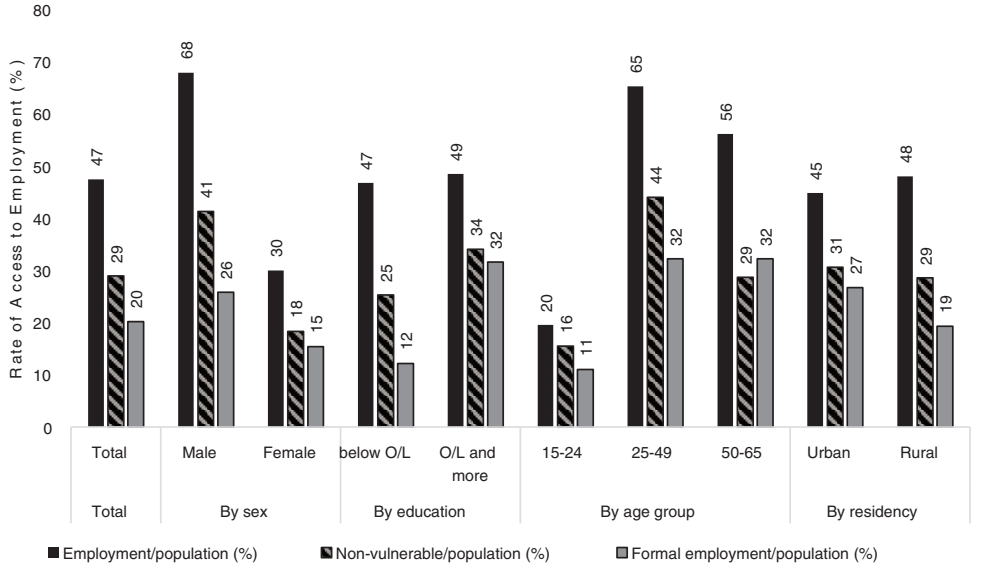
Notably, the EPR for males declined by 3 percentage points (from 71% in 2018 to 68% in 2022),[16] while for females it declined slightly by 1 percentage point (from 31% in 2018 to 30% in 2022). The EPR for the prime-age group (25-49 years) remained unchanged, but for youth (15-24 years), it declined by 4 percentage points (from 24% in 2018 to 20% in 2022).

The ILO defines vulnerable employment as comprising self-employment and contributing family work. In contrast, non-vulnerable workers are those who are either employers or employees and are not solely dependent on the income earned from their economic activity for wages, thus enjoying more secure work. Therefore, the non-vulnerable EPR reflects the extent to which individuals in the labour force have access to more secure and relatively stable job arrangements. As illustrated in Figure 8.6, there is a significant gap between the share of employed individuals and those in non-vulnerable employment. While 47% were employed in the total population, only 29% had access to non-vulnerable employment, indicating an 18% gap. This gap is the highest among older workers (50-65 years) at 28% and males at 27%. However, the overall gap between the shares of employed individuals and those in non-vulnerable employment has slightly declined from 19% in 2018 to 18% in 2022. For each demographic group shown in Figure 8.6, this gap either declined or remained the same. Importantly, this decline in the gap is not necessarily a positive indicator, as it resulted from a decline in the EPR rather than an improvement in non-vulnerable employment. Therefore, it indicates that rather than reflecting an improvement in more stable and secure jobs, it signifies a broader decline in overall employment.

Regarding formal employees, these are non-vulnerable workers whose employers contribute towards a provident fund on their behalf. According to Figure 8.6, only 20% of the working-age population were in full-time employment, with access to full-time employment highest among those educated to Ordinary Level (O-Level) and above, prime-age workers (25-49 years), and older workers (50-65 years). However, there was no sharp decline in formal employment in 2022 against that of formal employment (which was 20%) in 2018. The decrease with a decline of just 1 percentage point, was only observed among youth (15-24 years) and those with education below O-Level.

16 The figure for 2018 is drawn from Arunatilake, N., & Ranasinghe, S. (2022). Improving Access to Decent Work. In *Sri Lanka: State of the Economy 2022* (pp. 101-120). Colombo: Institute of Policy Studies of Sri Lanka.

Figure 8.6
Access to Different Types of Employment



Note: Employees in (a) a registered organization (b) institutes maintaining formal written accounts (c) institutes having more than 10 regular employees are considered formal employees. Employed persons who are not own account workers or contributing family members are in non-vulnerable employment.

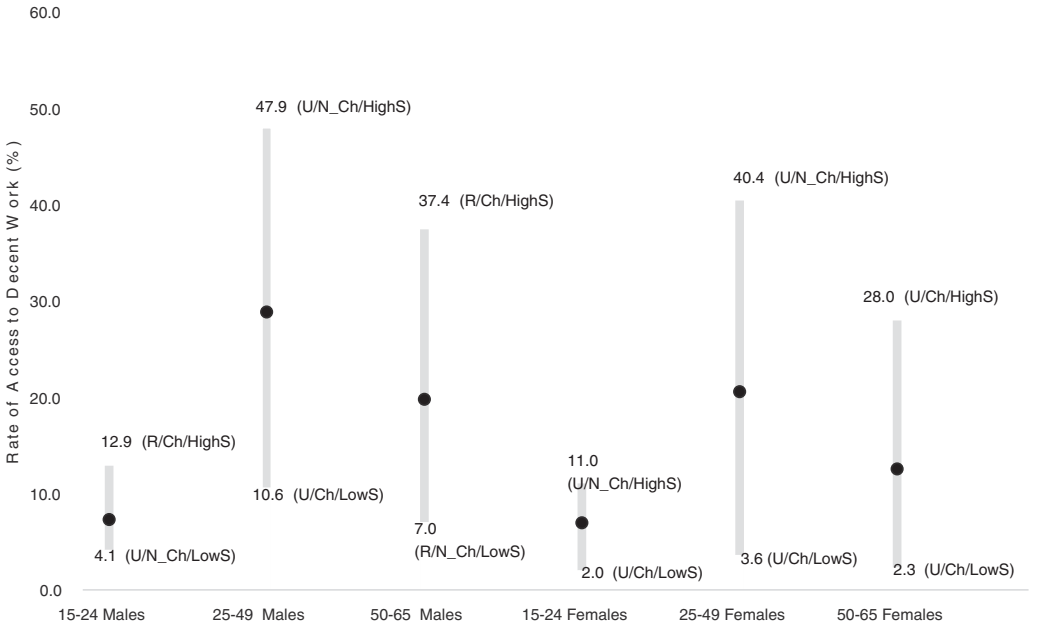
Source: Author's compilation based on LFS 2022, DCS.

One proxy measure to assess decent work is formal full-time employment.[17] Using this proxy, the Institute of Policy Studies of Sri Lanka (IPS) provided an extensive analysis of how access to decent work changes based on various demographic and socio-economic factors, using data from the LFS 2018.[18] However, the pandemic and associated multiple crises might have altered access to decent work, and thus, understanding its trajectory over the crises period is crucial. As an extension to the IPS' previous study, a tree analysis has been carried out using the same methodology with LFS 2022 data (Figure 8.7).

17 United Nations Economic and Social Commission for Asia and the Pacific. (2018). *Inequality of Opportunity in Asia and the Pacific: Decent Work.* United Nation Economic and Social Commission for Asia and the Pacific (ESCAP).

18 Arunatilake, N., & Ranasinghe, S. (2022). Improving Access to Decent Work. In *Sri Lanka: State of the Economy 2022* (pp. 101-120), Colombo: Institute of Policy Studies of Sri Lanka.

Figure 8.7
Gaps in Access to Decent Work, by Gender and Age Group



Note: Decent Work is defined to be formal full-time employment as employees.
Figures can be described as follows: The lines indicate the range in access to decent work, where the lowest point shows the group with lowest access and the highest point indicates the share with the most access. The circle shows the average access. U-Urban; R-Rural; Ch- Household with children; N_Ch – Household without Children; HighS-Education O-Levels or higher; LowS-Education O-Levels or Lower. The access to decent work of male, and female populations in each age group were assessed across residence (Urban or Rural), Level of Education (O-Levels or Higher, Without O-Levels) and Household characteristics (Households with and without children).

Source: Author's calculation using LFS 2022, DCS.

People often tend to cope by adopting detrimental survival strategies, such as taking up informal or vulnerable and subsistence work. These negative coping mechanisms can erode progress in improving decent work, with impacts that could last for many years.

According to results, it is evident that access to decent work has generally decreased between 2018 and 2022. For instance, prime-age men who are high-skilled, living in urban areas, and in households with children had the highest access to decent work at 52.9% in 2018. However, in 2022, the highest access of 47.9% was recorded for prime-age men who are high-skilled, living in urban areas, and in households without children. Hence, the highest access for prime-age men has dropped by 5 percentage points during the 2018-2022. One of the main reasons for this decline in access to decent work is the economic crisis and the pandemic. These crises forced people to quickly adapt to a new reality, where job prospects are limited, incomes have been eroded by inflation, and opportunities for a better future are increasingly rare. In such situations, people often tend to cope by

adopting detrimental survival strategies, such as taking up informal or vulnerable and subsistence work. These negative coping mechanisms can erode progress in improving decent work, with impacts that could last for many years.



It is important to note that, similar to 2018, prime-age males (aged 25-49) have the highest average access to decent work, followed by older males (aged 50-65) and prime-age females. Although prime-age males still have the highest access to decent work, the gap between the group with the highest access (47.9% for high-skilled urban males living in households without children) and the group with the lowest access (10.6% for low-skilled urban males living in households with children) is considerably large. This suggests that policies should focus on improving education levels in urban communities and enhancing access to decent work, especially targeting urban populations severely impacted by the economic crisis and the pandemic.

Moreover, for older males (aged 50-65), there is a sharp decline in access to decent work. In 2018, the highest access for older workers was 48% (high-skilled, urban, living in households with children).[19] In 2022, the highest access recorded for males aged 50-65 was 37.4% (high-skilled, rural, living in households with children), indicating a 10.6 percentage point decline. This decline can be attributed to the pandemic and economic crisis, which intensified pre-existing vulnerabilities faced by older workers in the workforce. Older males, already navigating age-related obstacles in securing employment, might have found themselves particularly vulnerable. Limited opportunities for retraining or upskilling, coupled with potential age discrimination, make it arduous for older workers to access decent work opportunities.

19 Access to decent work for males aged 50-65 (high skilled, urban, living in household with children) is 33% in 2022.

In the case of prime-age females, like the 2018 results, high-skilled urban women in households without children had the highest access to decent work (40.4%), while low-skilled women in households with children had the lowest access (3.6%). This analysis shows that education and affordable childcare facilities can help improve women's access to decent work. It is notable that high-skilled urban women, depending on whether they live in a household with children or not, experience a large variation in access to decent work. For instance, high-skilled urban women in households without children have an access rate of 40.4%, while those in households with children have only 27.3% access.

This situation contrasts with prime-age males, where no significant variation exists in access to decent work based on whether they live in a household with children or not. For example, the access rate for high-skilled urban prime-age males in households without children is 47.9%, while it is 47.1% for those in households with children. This suggests that living in a household with children does not significantly impact men's access to decent work, as most childcare responsibilities are borne by females, affecting their access to decent work.

The comparison between access to decent work in 2018 and 2022 reveals further intriguing gender dynamics. In 2018, high-skilled urban women without children enjoyed the highest access at 43.3%, which declined to 40.4% by 2022 – a relatively modest drop of 2.9 percentage points. However, this decline is considerably lower compared to the 5 percentage point decrease in access for prime-age males, highlighting the disproportionate impact of multiple crises on male employment opportunities. Contrary to the common assumption that women suffer more from economic crises, the findings suggest that the decrease in women's access to decent work during such periods tends to be less pronounced than that of men. This discrepancy can be attributed to several factors. Women often prioritise safety, stability, and long-term career prospects over immediate income gains, emphasising the significance of decent work conditions. In contrast, the relatively higher decrease in prime-age males' access to decent work during crises is primarily due to their higher likelihood of engaging in informal or vulnerable employment. During crises, men often face pressure to rapidly secure alternative sources of income to support themselves and their families, which can drive them to accept lower quality or less secure job opportunities. Additionally, cultural norms that prioritise men as primary earners and breadwinners may further force men to engage in any available work, irrespective of the quality or stability of the employment. This increased susceptibility to low-quality employment among men during crisis periods underscores the urgent need for targeted interventions to be in place to address vulnerabilities and promote inclusive economic recovery for all genders. It's also imperative to underscore that women display a stronger inclination to enter the labour force

A relatively higher decrease in prime-age males' access to decent work during crises is primarily due to their higher likelihood of engaging in informal or vulnerable employment. During crises, men often face pressure to rapidly secure alternative sources of income to support themselves and their families, which can drive them to accept lower quality or less secure job opportunities.

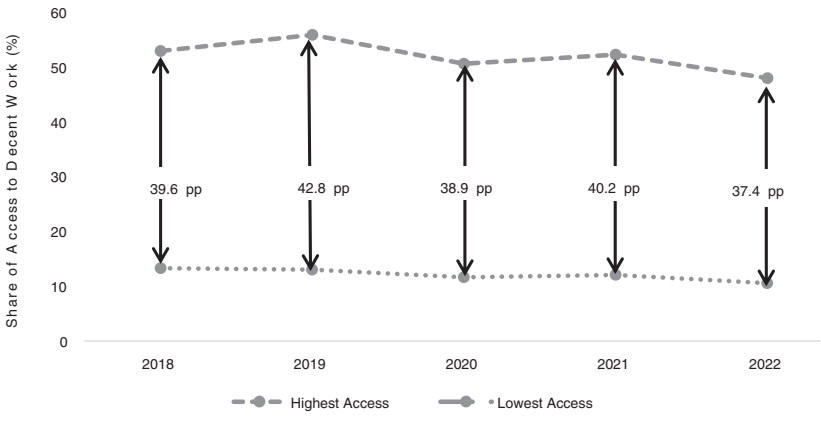
when favourable work conditions are available. Unlike men, who may swiftly transition into informal or vulnerable employment during times of crisis, women prioritise safety, stability, work-life balance (WLB), and long-term career prospects. This emphasis on decent work conditions highlights the importance of enhancing labour standards and workplace environments to attract inactive female labour into the job market.

The gaps in access to decent work were relatively low among other population groups, such as young males and females, although there was a noticeable decline in the average access to decent work in these groups by 2022. Particularly striking is the decline among young males, where the group with the highest access to decent work witnessed a decrease of 10.3 percentage points compared to 2018. In contrast, for young females, the decline was only 0.6 percentage points. This trend could be attributed to an increase in youth inactivity and young males transitioning into more vulnerable occupations than females. Generally, individuals aged 15-24, both males and females, are predominantly engaged in education, suggesting a lower immediate need for employment.

Box 8.1
The Paradox of Diminishing Access to Decent Work

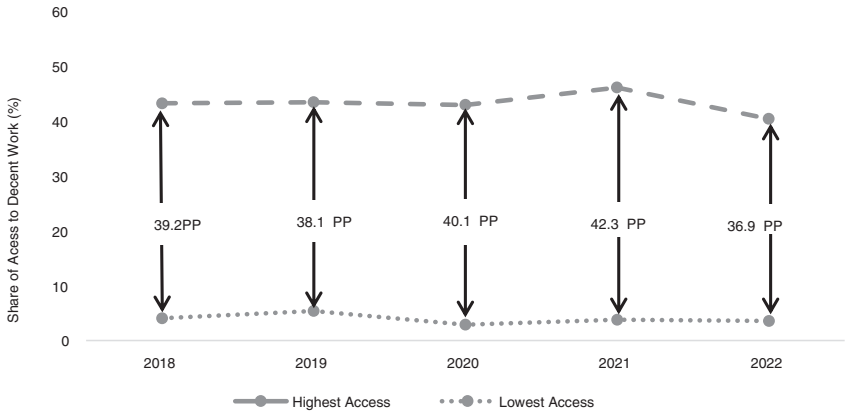
Given the significant variation among different sub-groups in access to decent work for prime-age males and females, it is intriguing to explore how their access to decent work evolved from 2018 to 2022. A noteworthy shift occurred during this period, as illustrated by Figures a and b, revealing a perplexing trend. While a reduction in the gap occurred between the groups with the highest and lowest access to decent work, albeit with slight fluctuations compared to 2018, it is essential to delve deeper into the implications of this change.

Figure a.
Changes in Access to Decent Work for Prime-Age Males (Aged 25-49)



Note: Decent Work is defined to be formal full-time employment as employees.
Source: Author's calculation using LFS (2018-2022), DCS.

Figure b.
Changes in Access to Decent Work for Prime-Age Females (Aged 25-49)



Note: Decent Work is defined to be formal full-time employment as employees.
Source: Author's calculation using LFS (2018-2022), DCS.

For prime-age males, the gap narrowed from 39.6 percentage points in 2018 to 37.4 percentage points in 2022, and for females, it eased from 39.2 percentage points to 36.9 percentage points during the same period. However, this reduction in the gaps does not necessarily indicate progress towards equality; rather, it hints about a concerning trend of diminishing access to decent work overtime. This paradox of diminishing access raises profound questions about the sustainability and integrity of socio-economic conditions in Sri Lanka.

Decent work is more than just statistic; it represents the cornerstone of human dignity and societal well-being. When access to decent work declines for any subgroup of society, it signifies a systemic failure to uphold principles of fairness and inclusivity. The major factors contributing to this paradox in Sri Lanka could be the impact of the economic crisis and associated changes in the labour market. The economic crisis has worsened existing vulnerabilities and inequalities, leading to widespread job losses, reduced incomes, and increased inactivity. While efforts to stabilise the economy were essential, these often came at the expense of workers' rights, resulting in lower real wages and job security, especially for low-skilled and vulnerable groups.

A multifaceted approach is imperative to address the paradox of diminishing access to decent work. Promoting skill development and lifelong learning initiatives tailored to the needs of the labour market can enhance employability and enable individuals to adapt to changing economic conditions, with a focus on accessibility for vulnerable groups. Strengthening labour market institutions, including labour laws and collective bargaining mechanisms, is crucial for protecting workers' rights and ensuring decent work conditions. As Sri Lanka gradually recovers from the economic crisis, one effective strategy to bolster the strength and resilience of the workforce is by providing comprehensive skill training programmes, job coaching, and better access to finance. These initiatives not only improve employability but also empower Sri Lankans to transition into

higher-quality jobs. By investing in human capital development, the country can cultivate a skilled workforce capable of thriving in diverse economic environments. Every crisis presents a hidden opportunity, and this transformative period can be leveraged to cultivate a more resilient and productive workforce.

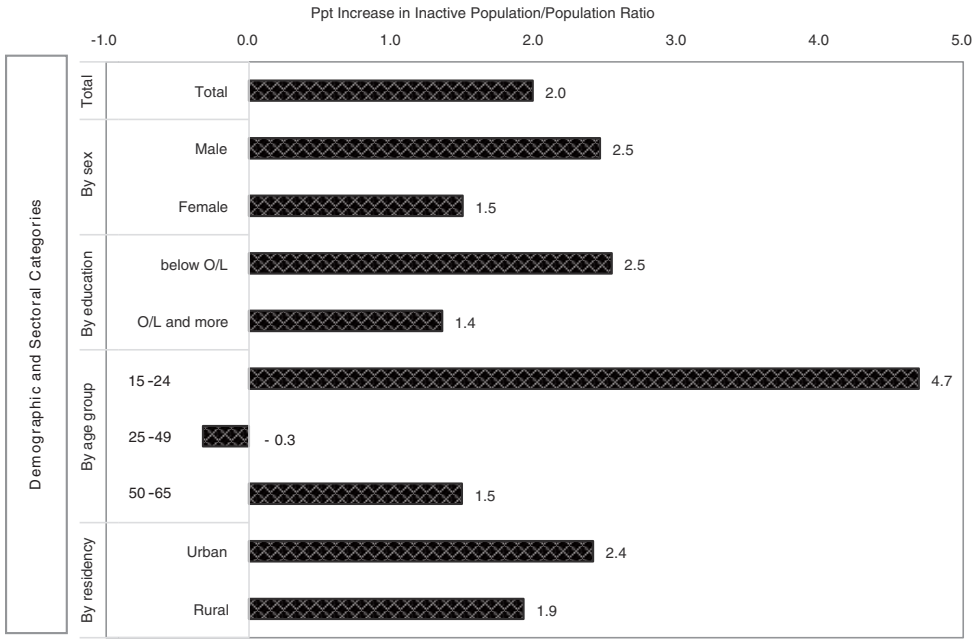
Concurrently, fostering economic growth through targeted policies that prioritise job creation in sectors with high potential for productive employment, such as the Information and Technology (IT) sector, is essential. Investing strategically in these sectors not only creates immediate job opportunities but also establishes the groundwork for sustainable economic development. The IT sector, for instance, drives innovation and productivity gains while offering a wealth of opportunities for career advancement and economic mobility. By aligning recovery efforts with sectors that generate productive jobs and contribute to economic diversification, Sri Lanka can build a robust economy that benefits all segments of society.

8.3 Policy Recommendation for Action

8.3.1 Revitalising Sri Lanka's Labour Market

As discussed at the beginning of this chapter, one of the primary challenges confronting Sri Lanka's labour market is the surge in labour market inactivity during the crises period. This issue is particularly severe among youth aged 15-24, who saw an increase in inactivity by 4.7 percentage points from 2018 to 2022 (Figure 8.8). This indicates a growing disengagement of youth from the labour market. Additionally, the increasing inactivity is more pronounced among males and individuals with lower educational attainment (below O-Level), highlighting the need for targeted educational and employment interventions for these groups (Figure 8.8). Urban areas also experienced a higher rise in inactivity than rural areas, suggesting that urban-specific strategies may also be necessary.

Figure 8.8
Percentage Change in Inactive Population in Sri Lanka by Demographics, 2018-2022



Note: Ppt denotes percentage points.

Source: Author's calculation based on LFS (2018 and 2022), DCS.

Promoting Technical and Vocational Education and Training (TVET) is crucial to address the increased inactivity among youth. The TVET system has undergone significant changes in recent years, with the introduction of the 'National Policy on Technical and Vocational Education 2018' and a new 'National Development Plan' for the TVET sector. This development plan aims to establish a robust vocational education system that meets national, regional, and global standards. It focuses on providing access to technical and vocational education for vulnerable and disadvantaged youth, ensuring they acquire the skills needed for the labour market, among others.

Over the past few years, the establishment of TVET centres and programmes has been a positive step towards increasing access to vocational education. However, despite the high demand in national and international labour markets, there remains a public misconception about the availability of highly paid salaries and job opportunities for TVET graduates.[20] This misguided perception leads to lower recognition for vocational education, affecting the acknowledgement of TVET graduates. Currently, a 13-year schooling programme under the vocational stream allows students who failed the O-Level examination to continue schooling for two more years, learning subjects related to selected occupations in the TVET sector. However, discouragement persists due to beliefs that vocational education lacks recognition.

20 Gamage, P., Herath, D., Kaluarachchige, I., & Hewapathirana, A. (2022). *Attracting Sri Lankan Youth to Technical and Vocational Education.* Colombo: Chartered Institute of Personnel Management.

As a remedial action, it is important to abolish this misconception about TVET jobs through public awareness campaigns. Increasing awareness of vocational education should also start at the school level, motivating students towards the TVET sector. To attract more youth to TVET education, it is vital to improve the quality of training to match the current market trends and encourage TVET trainers to conduct quality programmes using the latest technologies and novel teaching methods. Continuous curriculum updates to match evolving market demands are also essential.

It is necessary to understand that improving skills and knowledge and promoting entrepreneurship are appropriate ways to create more chances for sustainable long-term employment. Concurrently, it is also important to implement short-term job creation to address the pressing issue of inactivity and the decline in employment. Short-term employment opportunities can effectively address youth inactivity exacerbated by disruptions in education and training. These jobs provide immediate work experience and income, assisting young people in bridging the gap between education and long-term employment. Engaging in these jobs also offers practical skills training and professional development, addressing the skill mismatches that have become more pronounced due to educational disruptions. By engaging in short-term employment, youth can build their resumes, expand their professional networks, and gain a clearer idea of their career interests, making them more competitive in the labour market. This proactive approach lowers inactivity rates and paves the way for smoother/ seamless transitions into sustainable, long-term careers.

Given the current economic conditions in Sri Lanka, it will not be feasible to create short-term jobs supported by the government. Hence, exploring alternative strategies to stimulate economic activity is essential. One possible way is to promote remote work and the gig economy, especially among the youth. The gig economy and remote work offer flexible employment opportunities. Encouraging participation in freelancing platforms and offering digital skills training can make workers more competitive in the global gig economy. Additionally, implementing seasonal employment schemes in sectors such as tourism and retail can provide immediate job opportunities.

Productivity and employment levels across most economic sectors have witnessed a decline, but interventions in key sectors such as agriculture and IT are essential. Despite the agriculture sector's low productivity growth, it remains crucial to the economy as a major employment provider. However, earnings from agriculture are low and the sector is highly prone to various shocks and disasters. Most workers in the agriculture sector are low-skilled, making it unlikely for them to access high-skilled jobs in the short term. Therefore, the government must prioritise raising the agriculture sector productivity by boosting investment in technology, infrastructure, skill development programmes, and market linkages to enhance their earnings.

Although the private sector mainly drives the ICT sector, the government has been proactive in implementing initiatives to enhance private sector efforts, with the goal of promoting growth and encouraging innovation in the sector. Within the TVET system, a substantial number of students enrol in ICT-related courses. Despite these strides, several gaps persist within the ICT sector policies. By 2025, the ICT sector expects to expand its workforce to 300,000,[21] but currently comprises only around

21 Information Communication Technology Agency. (2023). *Lighting Digital Youth Bootcamps,* https://www.icta.lk

78,000 workers.[22] This disparity highlights much potential for employment growth in the industry, yet the critical issue lies in the lack of requisite skills. Particularly crucial are the quality and relevance of ICT training programmes. While public institutions excel in imparting fundamental knowledge, these often fall short in delivering the advanced soft skills demanded by employers. Conversely, private institutions, though stronger in soft skills development, lag behind in other critical areas. Insufficient collaboration between educational institutions and the industry stifles efforts to bridge this divide, underscoring the urgent need for robust partnerships and internship programmes.

Several suggestions should be considered to surmount these obstacles and propel the ICT industry forward. Enhancing the quality and dynamism of the TVET curriculum stands paramount, necessitating periodic updates and diversification to keep pace with technological advancements. A comprehensive training programme for educators could elevate teaching standards and imbue trainers with industry-relevant skills, ensuring a more adept workforce. Soft skills development must also feature prominently in the curriculum to cultivate well-rounded professional's adept at communication, teamwork, and problem-solving.

In addition to challenges related to skill development, recent taxation policies pose significant threats to the IT sector in Sri Lanka. Removing VAT exemptions and imposing an 18% VAT on IT-related products and services are likely to escalate operating costs, particularly for startups. This could disincentivise such companies to continue business within Sri Lanka, instead lure them to relocate abroad, attracted by more favourable tax environments. Such a move risks disrupting the government's DIGIECON 2030 policy framework, which aims to position Sri Lanka as a digital economy hub and boost ICT exports. To address these challenges, it remains crucial to maintain VAT exemptions for IT-related products and services to nurture a favourable business environment for both startups and established firms. Strengthening tax regulations to ensure fairness among all digital service providers, whether domestic or foreign, is essential for sustaining growth in the digital economy.

In the manufacturing sector,[23] significant government efforts have been directed towards enhancing vocational training and developing industry-specific skills. Campaigns designed to promote industrial jobs and change societal perceptions have also been launched. Despite these initiatives, the sector continues to face a critical shortage of skilled workers, especially in textiles and apparel. This issue is exacerbated by the poor quality of skills among vocational training graduates, as well as challenges related to inadequate compensation, poor working conditions, and insufficient safety measures in manufacturing plants. To address these problems effectively, it is essential to better align vocational training programmes with industry needs, improve infrastructure and safety standards, and sustain efforts to promote industrial jobs.

In the mining sector, licensing reforms have been introduced to simplify regulatory processes, and policies have been developed to support sustainable development. Amendments to the Mines and Minerals Act aim to foster responsible mining practices. However, the sector encounters several obstacles, including short-term mining permits that discourage long-term investment,

22 Authors calculations based on LFS Quarterly Reports (2023), DCS.

23 The information presented in this section, as well as the following sections, is derived from key informant interviews (KIIs) with officials from various Ministries, along with data sourced from official websites and reports.

limited technological advancement, a small pool of industry experts, and a constrained domestic market. Addressing these issues requires streamlining mining permit durations to attract long-term investors, expanding training programmes to build industry expertise, and promoting technological advancements and infrastructure development.

The accommodation and food service sector has been targeted with ambitious goals under the Strategic Plan for Sri Lankan Tourism 2022-2025, which focuses on increasing tourist arrivals and foreign exchange earnings through improved infrastructure, skill development, and streamlined visa processes. Nevertheless, the sector struggles with inadequate employee skills, low female participation, negative societal perceptions of tourism careers, a large informal segment, and insufficient infrastructure. To enhance sector performance, it is crucial to update training programmes to meet market demands, increase apprenticeships and practical training opportunities, improve sector perceptions through targeted campaigns, upgrade infrastructure, and extend free visa policies to additional countries.

Public administration sector has seen efforts to digitalise services through e-governance initiatives and improve efficiency via public sector reforms. Despite these advancements, slow digital adoption due to a lack of knowledge, skills, and digital trust remain significant challenges. Promoting digital adoption and improving digital literacy among public sector employees through targeted development programmes are essential for overcoming these barriers. In the education sector, the National Education Policy Framework 2023-2033 has been implemented with a focus on curriculum reform, textbook updates, teacher training, and digitalisation, alongside increased teacher recruitment. However, the continuous departure of teachers from the profession presents a significant challenge. To address this, introducing performance-based pay systems to incentivise teachers, improving teaching quality, and enhancing student outcomes are crucial.

The health sector has taken measures such as increasing doctor intake and temporarily raising the retirement age to 63. Despite these efforts, challenges remain, including ongoing migration of health workers, delays in appointing returning doctors trained abroad, and inadequate working conditions. Developing a comprehensive strategy on health worker mobility and migration, reducing casualisation of work, and extending non-monetary incentive schemes are vital to addressing these issues. In the finance and insurance sector, the CBSL has promoted mergers and acquisitions and encouraged digital banking, alongside boosting digital financial literacy. However, sector consolidation and digitalisation pose risks of job redundancies and losses. Implementing retraining and redeployment programmes and redesigning jobs to integrate digital tools effectively are crucial for ensuring a smooth transition.

8.3.2 Fostering High-skilled Employment

Countries worldwide actively strive to increase the share of high-skilled workers to foster knowledge-based economic development. Similarly, successive governments in Sri Lanka have strongly emphasised developing a knowledge-based economy. To achieve this goal, it is crucial to expand knowledge-based industries that generate high-skilled employment opportunities within the country. This approach is essential for effectively integrating educated individuals entering the labour market, particularly those with tertiary education qualifications. As conventional jobs diminish or become obsolete due to rapid technological advancements, future job growth is expected to occur primarily in high-skilled sectors.[24] Thus, creating such employment opportunities ensures that fresh knowledge entering the labour market is effectively utilised.

In the current Sri Lankan context, it is imperative not only to create high-skilled employment opportunities but also to retain current high-skilled workers in their occupations. Despite policies aimed at job creation and skill development, continued migration of high-skilled workers could undermine these efforts. Recently, a government circular granting five-years of no-pay leave for public officers, allowing them to spend time either in or out of the country without affecting their seniority or pension, inadvertently encouraged migration among public sector officers, particularly in 2023. During the economic crisis, many high-skilled workers applied for this leave; if denied, they resigned and migrated, underscoring the severity of the issue. To mitigate this trend, the government is attempting to implement measures to retain skilled professionals while respecting individuals' rights to migrate.

Looking ahead, providing competitive salaries and benefits to high-skilled workers in Sri Lanka remains crucial. Currently, the average nominal hourly wage for high-skilled workers in the country is low compared to both developed and developing nations (see Figure 8.5). As living costs escalate and quality of life declines, high-skilled workers may increasingly view emigration as a means to secure a stable and prosperous future for themselves and their families. Offering higher salaries and benefits makes it more appealing for them to stay in their home country, as it acknowledges and rewards their expertise and contributions.

8.3.3 Enhancing Access to Decent Work

The COVID-19 pandemic and subsequent economic crisis have seen backsliding in the efforts made so far to improve access to decent work in Sri Lanka. Over the period from 2018 to 2022, the country experienced a plunge in access to decent work, exacerbating pre-existing challenges in the labour market. As the economy gradually recovers, the imperative of increasing access to decent work becomes more pressing than ever, not only for economic stability but also for social cohesion and sustainable development.

Central to enhancing access to decent work is the enhancement of overall job quality. Instituting policies that ensure fair and liveable wages for all workers is paramount, especially during crises when workers' real wages have substantially deteriorated. Furthermore, promoting policies that foster

24 Arunatilake, N., & Vithanage, H. (2023). Decent Jobs and Sri Lanka's Labour Market Conditions. In *Sri Lanka: State of the Economy 2023*, Colombo: Institute of Policy Studies of Sri Lanka.

a healthy WLB is imperative. Measures such as flexible working hours, paid leave, and workplace practices with work-life harmony are crucial in attracting and retaining a diverse and productive workforce. Such initiatives contribute not only to employees' well-being but also to overall productivity and organisational success.

As discussed earlier, the sharp decline in access to decent work for prime-age men during times of crisis is often exacerbated by pressures to quickly secure alternative sources of income and cultural norms prioritising men as primary breadwinners. This increased vulnerability to low-quality employment highlights the need for targeted interventions to promote inclusive economic recovery and improve job opportunities for men. One feasible solution involves developing vocational training programmes specifically geared towards male-dominated sectors such as agriculture, fisheries, and construction. These should focus on providing practical skills and certifications aligned with industry needs, enhancing men's employability and access to decent work. Furthermore, incentivising formal employment through targeted incentives for businesses can encourage the adoption of formal employment contracts with benefits like social security and paid leave. Supporting entrepreneurship among men by offering mentorship, training, and financial assistance can also foster job creation and economic growth within male-dominated sectors. Additionally, expanding access to affordable education and vocational training programmes, particularly for marginalised communities like rural workers and youth, can further enhance men's participation in formal employment.

It is crucial to recognise that despite the plunge in access to decent work for men, women still face even lower access to decent work. A recent IPS study highlights the legal, social, and infrastructural barriers that hinder women's access to decent work, including discrimination in the workplace, unfriendly working conditions, and wage gaps.[25] Improving access to affordable and quality transportation and childcare facilities, along with implementing regulations to reduce explicit and implicit workplace discrimination, can enhance women's participation in the labour market. Regulation minimising discrimination and legal reforms that eliminate gender biases in legislation can further facilitate females' access to decent work.

It is imperative to underscore that women display a stronger inclination to enter the labour force when favourable work conditions are available. Unlike men, who may swiftly transition into informal or vulnerable employment during times of crisis, women prioritise safety, stability, WLB, and long-term career prospects. This emphasis on decent work conditions highlights the significance of enhancing labour standards and workplace environments to attract inactive female labour into the job market. Policymakers and employers can achieve this by offering fair wages, legal protections, opportunities for career advancement, and accommodations for caregiving responsibilities. Additionally, addressing gender-specific barriers such as discrimination and cultural norms that limit women's opportunities is crucial for promoting gender equity and fostering inclusive economic growth. Therefore, improving decent work conditions serves as a pivotal strategy for unleashing the untapped potential of inactive females and advancing gender equality in the workforce.

25 Arunatilake, N., Lakmini, F., Madurawala, S., Vithanage, H., & Kiringoda, K. (2024). *Women's Access to Decent Work in Sri Lanka - Addressing Context-specific Barriers*. Partnership for Economic Policy, https://portal.pep-net.org

Highlighting the importance of legislative reform, the New Employment Act proposed by the Ministry of Labour and Foreign Employment is currently in the draft stage. This proposed legislation aims to introduce new improvements and changes to the labour market landscape while facilitating decent work for all individuals, as outlined in Box 8.2.

Box 8.2
Transforming Labour Laws: The Proposed Employment Act of Sri Lanka

Sri Lanka stands at a critical juncture in its economic and social development, with the need for comprehensive reforms in its labour laws becoming increasingly apparent. The existing framework, fragmented across multiple legislations and inadequately equipped to address modern challenges, requires a holistic overhaul to ensure the promotion of decent work and economic growth. To meet the evolving needs and create a more equitable and sustainable labour market, the Ministry of Labour has embarked on a comprehensive review of Sri Lanka's labour laws, culminating in the proposed Employment Act.

The Act seeks to position Sri Lanka competitively on the global stage while streamlining administrative processes to enhance efficiency for both employers and employees. Moreover, the Act underscores a commitment to fostering equity and fairness in industrial relations, aiming to rectify imbalances within the current system and ensure the protection of rights for all parties involved, including employers, employees, and trade unions.

Key changes include the introduction of legal provisions to prevent discrimination in employment and workplace harassment, aligning with international conventions such as the Convention on Violence and Harassment (C190). Moreover, the Act introduces new legal provisions focusing on occupational safety, health, and welfare, reflecting a commitment to ensuring the well-being of employees in the workplace. Additionally, the Act removes existing restrictions on gratuity payments and introduces a 1 ½ payment method for male night workers, aiming to enhance fairness and equity in compensation practices. Furthermore, the Act addresses disparities in working terms and conditions, mandates written appointment letters for all employees, and introduces a five-day week and flexible working hours to accommodate diverse needs. It also introduces provisions for paternity leave, regulation of part-time employment, and rights and duties of employees WFH, reflecting the evolving nature of work arrangements. Other notable reforms include the establishment of a National Remuneration Council, provisions to address unfair labour practices, and the introduction of an e-wages system.

The proposed Employment Act of Sri Lanka not only aims to address the existing gaps and inefficiencies in labour laws but also strives to significantly enhance the overall quality of employment, thereby promoting the principles of decent work. In this regard, the Act's provisions to prevent discrimination and promote inclusivity in the workplace play a crucial role. By explicitly prohibiting discriminatory practices based on factors such as gender, ethnicity, or disability, the Act ensures that all individuals have equal access to employment opportunities, regardless of their background or personal characteristics.

Furthermore, the Act also indirectly promotes women's access to decent work. By introducing robust legal provisions to prevent workplace discrimination, harassment, and sexual violence, the Act creates a safer and more equitable work environment for women. The establishment of a social security system that includes maternity benefits, workers' health, and compensation in case of unemployment reduces the financial burden on employers, thereby encouraging them to hire more women. Additionally, by clearly defining part-time and full-time work and ensuring that part-time workers receive appropriate benefits, the Act supports the quality and security of part-time employment, which many women seek. Introducing a five-day workweek and abolishing the five-year service requirement for gratuity benefits further enhances job mobility and attractiveness for women.

Moreover, the Act's emphasis on promoting flexibility and WLB aligns closely with the principles of decent work. The Act introduces measures such as flexible working hours, part-time employment, and the right to WFH. These provisions not only empower workers to better balance their professional and personal responsibilities but also contribute to higher levels of job satisfaction and well-being. By allowing workers greater control over their work schedules and arrangements, the Act enables them to achieve a better WLB, which is essential for maintaining their physical and mental health and overall quality of life.

Furthermore, the Act's focus on promoting occupational health and safety reflects a fundamental aspect of decent work. The Act introduces new legal provisions on occupational safety, health, and welfare, aligning with international standards and conventions to enhance workplace safety measures. By mandating employers to prioritise the health and safety of their employees and providing them with the necessary resources and support to do so, the Act contributes to creating a safer and more secure work environment. In addition to these measures, the Act also introduces provisions aimed at promoting fair labour practices and strengthening workers' rights. By regulating unfair labour practices by both employers and trade unions, the Act ensures that workers are treated fairly and equitably in the workplace. Moreover, the Act's provisions on the establishment of a National Remuneration Council and the introduction of an e-wages system aim to ensure that workers receive fair and adequate compensation for their work, thereby reducing the risk of exploitation and poverty.

Overall, the proposed Employment Act represents a comprehensive and proactive approach to improving the quality of employment and promoting decent work in Sri Lanka. By addressing key issues such as discrimination, WLB, occupational safety, regulations on part-time employment, and fair labour practices, the Act seeks to create a more inclusive, equitable, and sustainable labour market where all individuals can enjoy meaningful and fulfilling employment opportunities. Through its holistic approach and emphasis on promoting social justice and human rights, the Act lays the foundation for a more prosperous and equitable society, where the principles of decent work are upheld and respected for all workers.

Source: Based on KIIs with officials from the Ministry of Labour and Foreign Employment, and also data from official websites and reports.

8.4 Conclusion

Sri Lanka's labour market faces numerous challenges that significantly hinder economic growth and social stability. These include rising labour market inactivity, declining productivity, decreased high-skilled employment, and reduced access to decent work. Addressing these complexities requires urgent attention and strategic interventions. One of the most pressing issues is the surge in labour market inactivity, especially among youth, necessitating a multifaceted approach to handle the issue. Enhancing the TVET system is crucial to equip young people, particularly those with lower educational attainment, with relevant skills. Efforts to promote TVET careers through educational campaigns and short-term job creation initiatives can help mitigate inactivity, providing valuable work experience and skill development opportunities. Additionally, supporting remote work and gig economy participation can stimulate economic activity and improve employment prospects.

Declining productivity and employment pose significant challenges, particularly in sectors like agriculture and construction. Low productivity in agriculture calls for increased investment in technology, infrastructure, and skills development to improve worker earnings and living standards. Similarly, addressing productivity issues in the construction sector requires streamlined training programmes, standardised hiring practices, and better integration of women into the workforce. Despite progress in the ICT sector, gaps in skills development and recent tax policies threaten competitiveness. Enhancing vocational training quality, maintaining favourable tax regimes, and strengthening industry-academic partnerships are crucial steps to overcome these challenges.

The decline in high-skilled employment is a barrier to Sri Lanka's goal of a knowledge-based economy. Investments in education, research, and innovation are essential to foster a skilled workforce capable of thriving in advanced industries. Measures such as promoting collaboration between sectors, establishing innovation hubs, and offering targeted skill development programmes are key towards achieving progress in this regard. It is also essential to retain talented workers by offering competitive pay and benefits to quell the brain drain and promote the growth of homegrown talent. The need for broad solutions requires urgent attention since different demographic and socio-economic groups experience a decline in access to decent work. Policies that enhance job quality, ensure fair wages, support flexible working arrangements, and invest in skill development are essential to attract and retain a diverse and productive workforce. These efforts are crucial for promoting inclusive economic recovery and improving labour market inclusivity in Sri Lanka.

9. Rationalising Public Sector Employment

9.1 Introduction

Sri Lanka is at crossroads. Despite improving economic prospects, recovery remains ambiguous. The transition from debt to transformative economic growth requires hardcore policy reforms, as Sri Lanka's economic crises stem from pre-existing vulnerabilities, policy missteps and external shocks.[1] Debt must be restructured and the emphasis on austerity provides limited support for economic transformation. As a result, the recovery and rebound largely depend on the government's efficiency in implementing a reform agenda.

Debt must be restructured and the emphasis on austerity provides limited support for economic transformation. As a result, the recovery and rebound largely depend on the government's efficiency in implementing a reform agenda.

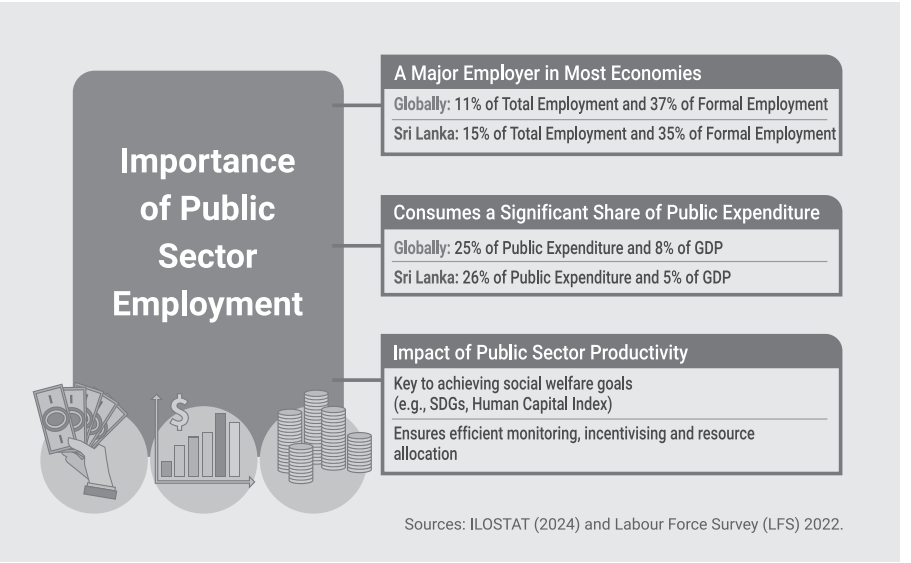
Improving public sector productivity – doing more with less – has become a key policy priority in the post-pandemic world,[2] and this is no exception for Sri Lanka. The public sector is a major employer in most economies. Globally, the public sector accounts for 11% of total employment and 37% of formal employment.[3] For Sri Lanka, these stood at 15% and 35%, respectively, as per the Labour Force Survey (LFS) 2022 conducted by the Department of Census and Statistics (DCS). Public expenditure accounts for a quarter of gross domestic product (GDP) globally and the wage bill is around 8% of GDP. For Sri Lanka, these stood at 19% and 3% of GDP in 2023, respectively.

Social welfare indicators like the Sustainable Development Goals (SDGs) and the Human Capital Index rely on a well-functioning public sector. Also, the productivity of the public sector is crucial for efficient monitoring, incentivising and resource allocation. However, challenges remain in measuring public sector productivity due to the non-availability of market transactions for public goods and services, market imperfections, the complex nature of the public sector and time lags between investment in inputs and the realisation of outputs. The theoretical and empirical evidence does suggest that the public sector may be less productive than the private sector in making productivity gains, mainly due to the inherent nature of public services as opposed to stronger private sector incentives.

1 International Monetary Fund. (2023). *Sri Lanka: Request for an Extended Arrangement Under the Extended Fund Facility-Press Release; Staff Report; and Statement by the Executive Director for Sri Lanka.* Washington, D.C.: International Monetary Fund.

2 Somani, R. (2021). *Public-Sector Productivity (Part 1) Why Is It Important and How Can We Measure It?* Washington, D.C.: World Bank; Baig, F. A., Han, X., Hasnain, Z., & Rogger, D. (2021). Introducing the Worldwide Bureaucracy Indicators: A New Global Dataset on Public Sector Employment and Compensation. Public Administration Review, 81(3), 564-571.

3 This section is drawn from- International Labour Organization. (2024). *Who Powers the Public Sector?* ILOSTAT, https://ilostat.ilo.org/blog/who-powers-the-public-sector/ (ILOSTAT is the global reference for international labour statistics, by the International Labour Organization (ILO)).



In the Sri Lankan context, where the public sector performance is constrained, rationalising public sector employment is inevitable. Therefore, the main aim of this chapter is to examine the optimal wage and employment policy that supports a productive and efficient public sector in Sri Lanka. In a context where public sector wages and salaries absorb a high share of fiscal revenues, the government has been compelled to temporarily freeze wage increases despite growing demands for salary hikes. It also raises the question of whether the public sector truly deserves a pay rise. Firstly, this is important given that despite the government's role as an employer to a large public sector in Sri Lanka, empirical discussions in this regard are quite limited. Secondly, in view of continuing debates on the role and size of government in driving development, an analysis of whether government size matters in economic recovery is also important.

The rest of the chapter proceeds by identifying historical trends and challenges in Sri Lanka's public sector. It then discusses an optimal wage policy that is in line with macroeconomic stability, given the wage-price spiral risks. Thereafter, an analysis of the optimal size of the public sector follows, with a concluding section highlighting policy recommendations to create a productive public sector in Sri Lanka.

9.2 Trends and Challenges in the Public Sector

The public sector typically delivers essential services like education, healthcare, transportation, etc., and employs nearly 11% of the labour force globally.[4] In high-income economies, 25% of essential workers are employed in the public sector, while this is only 3% in low-income countries. A clear deviation exists between the economic activities of the public and private sectors. Public sector engagement in non-market and market services is 52% and 20%, respectively, while it is 15% and

4 This section is drawn from ILO. *Who Powers the Public Sector?* 2024, ILOSTAT, https://ilostat.ilo.org/blog/who-powers-the-public-sector/

32% for the private sector. The distribution of public sector employment varies significantly across regions and income levels. High-income economies have a larger public sector employment share of around 16%, while low-income countries have lower shares of around 6.7%. Geographically, the Arab states have the largest share (24.5%) in the public sector, while the lowest share (7.3%) is to be found in Africa. After the pandemic, most countries witnessed a decrease in public sector employment.

Teaching (70%) and defence (6%) are the most prominent occupations in the public sector. The age distribution in the public and private sectors is relatively similar. However, the share of highly-educated individuals and female employment is significantly higher in the public sector than in the private sector. Despite equal access to decision-making, women are still underrepresented at all levels of decision-making in the public sector worldwide. Unlike the private sector, the public sector jobs are generally secure and stable. However, the average working hours is higher and could be 49 or more hours per week and the gender wage gap is much less significant in the public sector.

In the Global Competitiveness Index, Sri Lanka is ranked 85/137 and the 'inefficient government bureaucracy' is identified as the most problematic factor for doing business.

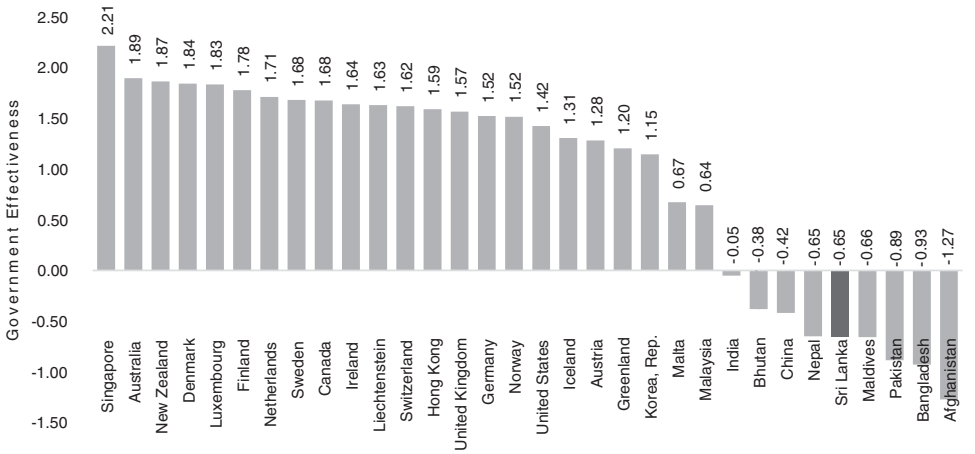
The public sector plays a critical role in a country's perceived quality of governance. In the World Bank's Worldwide Governance Indicators (WGI), government effectiveness is defined as a measure that "reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies."[5] Accordingly, as depicted in Figure 9.1, Sri Lanka's governance performance is considered poor with a score of -0.65 (in a range of -2.5 (weak) to 2.5 (strong)). In the Global Competitiveness Index, Sri Lanka is ranked 85/137 and the 'inefficient government bureaucracy' is identified as the most problematic factor for doing business.[6] Likewise, Sri Lanka ranked 99/190 in the Ease of Doing Business Index, in which the enforcing of contracts, paying taxes and registering property are the three key factors that hinder business regulation and enforcement.[7] Although, with limitations in these international rankings, which are often largely opinion or perception-based, these do suggest scope for improvement exists, viz., peer comparisons.

5 Kaufmann, D. & Kraay, A. (2023). *Worldwide Governance Indicators* (www.govindicators.org).

6 World Economic Forum. (2017). *Global Competitiveness Index* 2017–2018. Geneva: World Economic Forum.

7 This section is drawn from World Bank (2020). Economy Profile Sri Lanka: Doing Business 2020, World Bank.

Figure 9.1
Government Effectiveness, 2022



Notes: The WGI measures broad patterns in perceptions of governance across countries (200) and over time. The WGI features six aggregate governance indicators over the period 1996–2022: voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law and control of corruption.

Source: Kaufmann, D. & Kraay, A. (2023). *Worldwide Governance Indicators* (www.govindicators.org).

In Sri Lanka, governments often act as an employer of last resort where a relatively high ratio of the public sector to total employment probably leads to duplication of functions across increasing inefficiencies and wastage of resources. Sri Lanka's public sector is administered mainly under the Ministry of Public Administration and Management (PUBAD). The public sector comprises three administrative levels: central (national), provincial and local (sub-national) and includes different institutions such as line ministries, departments and statutory boards. Public sector employees are categorised into four different levels of hierarchy: primary (22%), secondary (70%), tertiary (4%), and senior (4%), where the current composition shows most employees belong to primary and secondary levels (Table 9.1).

Public sector employees are also categorised into three types of services: all island services (6 services), combined services (7) and other services (1). All island services represent the 'senior' most category while the remaining two services – combined and other – are arranged into primary, secondary and tertiary levels. The six all-island services include the Sri Lanka Administrative Service (SLAS), Sri Lanka Engineering Service (SLES), Sri Lanka Accountants' Service (SLACS), Sri Lanka Planning Service (SLPS), Sri Lanka Scientific Service (SLSS) and Sri Lanka Architectural Service (SLARCS). The seven combined services include Sri Lanka Information and Communication Technology Service, Government Translators' Service, Sri Lanka Librarians' Service, Development Officers' Service, Management Service Officers' Service, Combined Drivers' Service, and Office Employees' Service. The Sri Lanka Technological Service belongs to the 'other' service category.

Table 9.1
Composition of the Public Sector

Level	Posts/Services
Primary level	Primary Grade: Unskilled
	Primary Grade: Semi-skilled
	Primary Grade: Skilled
Secondary level	Management Assistant: Non-technical
	Management Assistant: Technical
	Supervisory Management Assistant
	Associate Officer
	Sri Lanka Teachers' Service
	Other posts of Nurses' Service/ PSM Service and Para Medical Service except Special Grade of the same services.
	Sub Inspector of Police in Police Service and other regulatory services and other posts equivalent to the status of the same.
Tertiary level	Field/ Office Based Officers
	Management Assistant – Supra Grade
	Sri Lanka Principles' Service
	Special Grade of Nurses' Service/PSM Service/Para Medical Service
	Registered/ Assistant Medical Officers
	Inspector of Police/ Chief Inspector of Police in Police Service and other regulatory services and posts equivalent to the status of the same.
Senior level	Executive Level
	Medical Officer
	Senior Executive/ Medical Consultants
	Secretary of the Ministry and other posts receiving the same salary
	Legal Officer
	Additional Solicitor General/Legal Draftsman
	Solicitor General
	Attorney General

Notes: The staff officers are recruited to tertiary and senior levels posts.

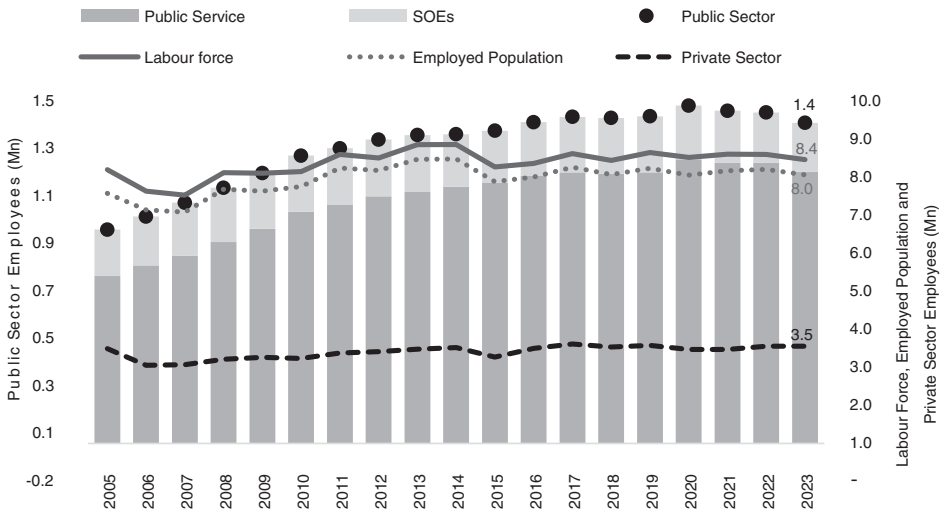
Source: PUBAD (2017, December 7). *Public Administration Circular: 32/2017.*

Sri Lanka's public sector stands at 1.35 million (Mn) (15% of total employment), with a large majority belonging to public service (85% or 1.14 Mn) and the balance employed in state-owned enterprises (SOEs) (15% or 0.21 Mn) as depicted in Figure 9.2. By comparison, the private sector is nearly three times the size of the public sector, with 3.5 Mn employees (or 45% of total employment).

In 2023, public sector employment underwent a slight decline of 2.9% compared to the previous year. This was mainly due to the suspension of new recruitments and reduction in new cadre positions as per the government's decision on public expenditure curtailment. As a result, the cadre utilisation rate has declined from 81% in 2022 to 77% in 2023. From 2005 to 2019, however, the average cadre utilisation rate was as high as 89%, with the highest rate of 96% in 2011. Similarly, the growth in

approved cadre during 2005-2019 was noticeably high at 44%, while it was only around 3% during 2020-2023. Yet, the public sector to population ratio of 1:17 during 2005-2019 remains relatively the same at 1:16 during 2020-2023. The main reason is that despite the necessity for public sector rationalisation, all governments continued to make new recruitments. The recruitment of graduates in large numbers as development officers is one such initiative implemented by many governments with no strategic basis followed in the recruitment/placement, etc. For instance, in 2020, the national policy framework on 'Vistas of Prosperity and Splendour' spelt out a programme to employ 50,000 graduates and 100,000 low-income people in the public sector.

Figure 9.2
Public Sector Employment



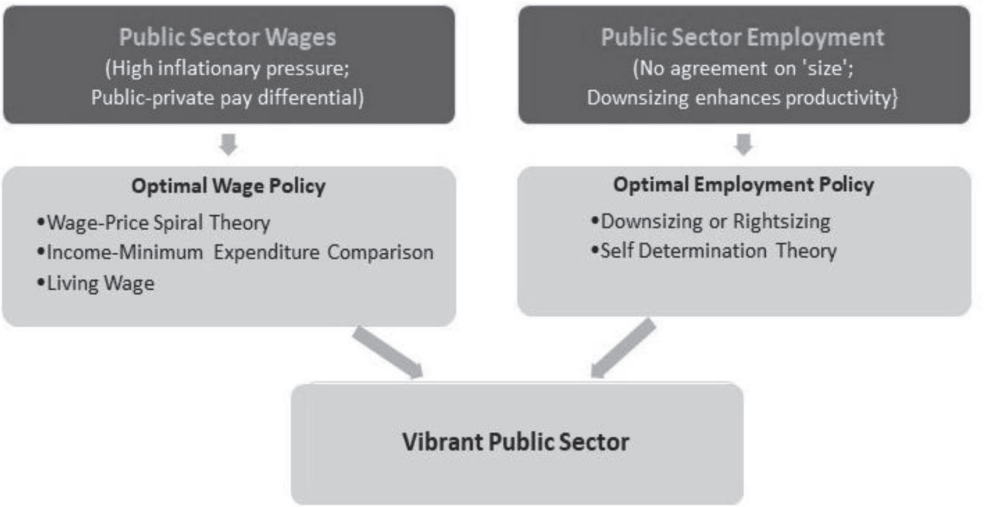
Sources: LFS, DCS; Ministry of Finance. (2022). *Annual Report.* Colombo: Ministry of Finance.

Since independence, various reform initiatives have been implemented to create an administrative system that is supportive of the economic, political and social change process the country has embarked on. The key reform initiatives implemented during the 1950s and 1960s include establishing the 'organisation and methods unit' and the 'public enterprises', introducing the Language Act of 1956, abolishing the Ceylon Civil Service and creating a unified Administrative Service. During the 1970s and 1980s, the PUBAD and several other institutions were established to delegate decision-making authority. During the 1990s and 2000s, financial management reforms, the re-establishment of an independent Public Service Commission, and the creation of a Management Assistant Service were implemented. Public sector rationalisation is, however, still unachieved owing to the ad hoc nature of reform formulation with no recognition of political and economic realities. For instance, the Wanasinghe Report of 1987, which recommended a 20% reduction in employment, was not a success owing to the then political and economic factors.[8]

8 Wanasinghe, S. (1994). Activating the Administrative Reform Process in Sri Lanka. *Research Studies: Governance Series No. 1.*

Box 9.1 sets out the research framework adopted to address issues surrounding an optimal wage and employment policy for the public sector in Sri Lanka.

Box 9.1
Research Framework: Rationalising Public Sector Employment



Sources: Tareq, S., Simone, A., Wane, A., Kashiwase, K., & Nassar, K. (2013). *Public Expenditure Rationalisation. The Eastern Caribbean Economic and Currency Union: Macroeconomics and Financial Systems*, 159; Forner, V. W., Jones, M., Berry, Y., & Eidenfalk, J. (2020). *Motivating Workers: How Leaders Apply Self-Determination Theory in Organisations. Organisation Management Journal*, *18*(2), 76-94; Alvarez, J. B., Hansen, N., Huang, Y., Pugacheva, E., & Sollaci, A. (2022). *Wage-Price Spirals: What is the Historical Evidence?* IMF Working Paper.

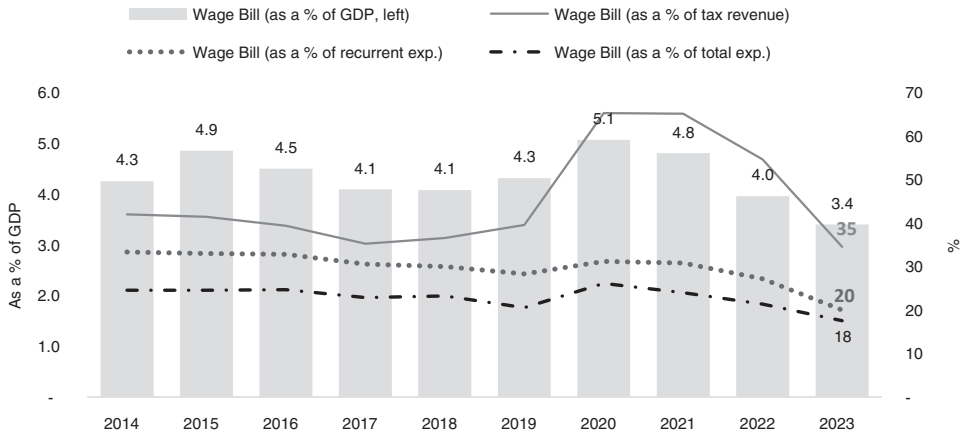
9.3 Optimal Public Wage Policy: Does the Public Sector Deserve a Pay Rise?

Successive waves of strikes by various trade unions demanding a pay hike for public sector workers from a broad range of sectors is indicative of deep discontent at government efforts to keep pay increases under check as it attempts to meet stringent fiscal targets. Despite continuing strikes, the government has refused to consider a pay hike in 2024 and responded by increasing the Cost of Living Allowance (COLA) of Sri Lankan Rupees (LKR) 7,800 by LKR 10,000 from January 2024. This is to be made as a partial payment of LKR 5,000 from January to March 2024 and the full payment of LKR 10,000 from April 2024 onwards. From January 2025, the outstanding allowance will be paid in three equal instalments. The Budget 2024 also proposed to increase the COLA of pensioners by LKR 2,500 to LKR 6,025. From July 2024, all Executive Officers are to be paid a special monthly allowance of LKR 25,000 replacing the special allowance paid on the basis of service. However, an adjustment at some point is likely, where all available options will need to be considered.

9.3.1 Public Sector Wage Bill

From an aggregate perspective, Sri Lanka's public wage bill on average accounted for almost 5% of GDP during the period 2000-2023 (Figure 9.3). The highest share of 6.3% was observed during 2006-2007. This is mainly due to a wage increase in 2007 as per the 2006 Budget proposals, an increase in the COLA (from LKR 1,750 to LKR 2,125) and upward revision of salary scales as per the Public Administration Circular No. 06/2006 (IV) of August 2006. Since then, it shows a decreasing trend and recorded the lowest level of 3.4% of GDP in 2023. The public wage bill absorbed 35%, 20% and 18% of tax revenue, recurrent expenditure and total government expenditure, respectively, in 2023.

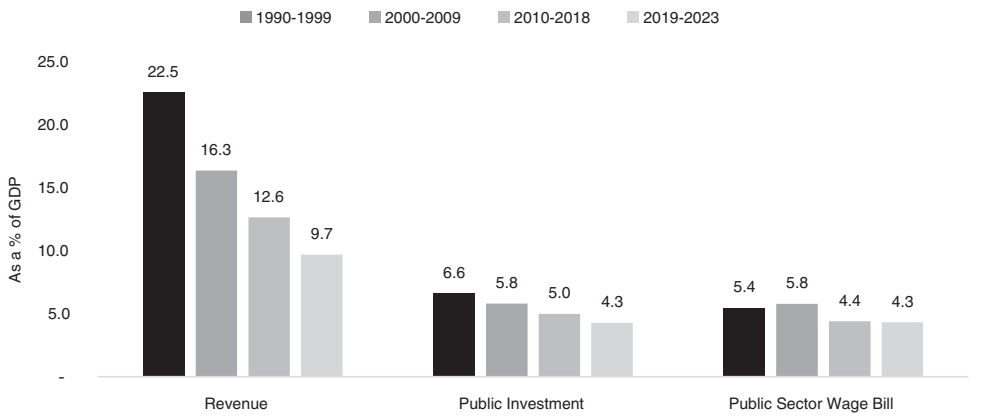
Figure 9.3
Public Sector Wage Bill



Source: Annual Reports (Various years), Central Bank of Sri Lanka (CBSL).

Figure 9.4 shows that in general, government revenue, public investment and the public wage bill decreased sharply over the period 1990-2023. The drop in the public wage bill as a proportion of total government expenditure during 2019-2023 was broadly due to increased spending on social protection (as a consequence of the pandemic and economic crisis), the surge in interest expenditure (as a consequence of the sovereign debt crisis) and government's policy decision to freeze public sector recruitment and wage increases in 2022.

Figure 9.4
Revenue and Public Expenditure (1990-2023)



Source: Central Bank of Sri Lanka. (2023). *Annual Report.* Colombo: Central Bank of Sri Lanka.

9.3.2 Public-private Wage Differential

It is often argued that public sector employment is preferred (queuing hypothesis). Since independence, public sector jobs were associated with lifetime employment, pension benefits (non contributory) and are not performance/output driven. By contrast, despite having higher pay and perks, private secor jobs are viewed as more demanding, performance driven and vulnerable to job termination. As a result, those employed in the private sector and earning higher pay are known to voluntarily resign and join the public sector when the government announces the unemployed graduate job placements, etc. This is explained as queuing behaviour for 'good jobs'. Even today, public sector jobs are viewed as good jobs due to its very nature of stability, lower work effort, attractive benefits and lower risks. However, these benefits have attracted a lot of controversy. For instance, the private sector considers the duty-free incentives on vehicle imports for every five years to be unfair. Therefore, rationalising the public sector should be aimed at reforming public sector recruitment and wage policies to discourage this queuing attitude. This should consider removing the benefits associated with the 'good jobs' and improving the protection of the less desirable jobs in the private sector.[9]

For effective public sector rationalisation, understanding the existence of public-private wage differential is fundamental. A public wage premium (deficit) exists when public sector wage levels are high (low) relative to levels for comparably skilled private sector workers.[10] In Sri Lanka, private sector wages are significantly higher than the public sector across similar educational levels in 2017, 2018 and 2021 for instance (Figure 9.5). Further, higher educational qualifications appear to result in higher salaries. Thus, it is common to observe that workers with a degree or postgraduate qualification receive the highest salaries in both public and private sectors. However, acquiring higher levels of education tends to be more beneficial for private sector employees than in the public sector.

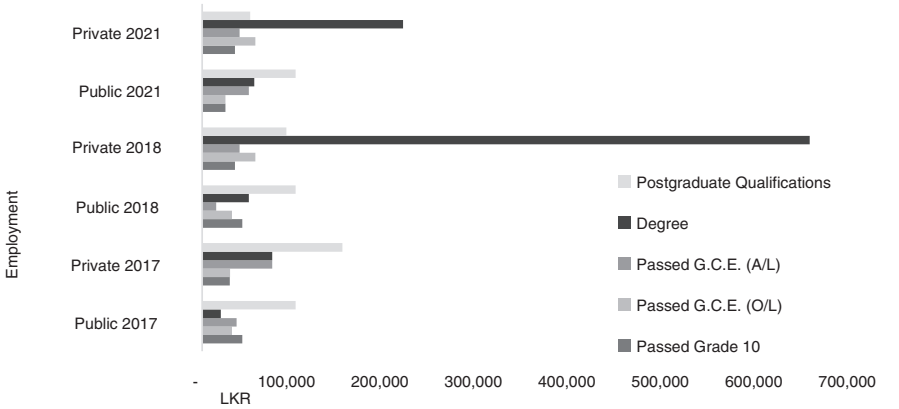
9 Rama, M. (2003). The Sri Lankan Unemployment Problem Revisited. *Review of Development Economics, 7*(3), 510-525.

10 Abdallah, M. C., Coady, M. D., & Jirasavetakul, L. B. F. (2023). *Public-private Wage Differentials and Interactions Across Countries and Time*. International Monetary Fund Working Papers, *23/63*.

For instance, a private sector employee with a degree or postgraduate qualification can obtain 2-13 times larger salary than a public sector employee with a similar qualification. In general, the private sector salaries are higher than the public sector. Thus, suggets the existence of an obvious public-private wage differential, although some variations could exist across sectors, education levels, age categories, etc.

There exists an obvious public-private wage differential, although some variations could exist across sectors, education levels, age categories, etc.

Figure 9.5
Public-private Pay Differential, by Education Level



	Public 2017	Private 2017	Public 2018	Private 2018	Public 2021	Private 2021
Postgraduate Qualifications	100,000	150,000	100,000	90,000	100,000	51,510
Degree	20,000	75,000	50,000	650,000	55,850	215,000
Passed G.C.E. (A/L)	36,800	75,000	15,000	40,000	50,000	40,000
Passed G.C.E. (O/L)	32,000	30,000	32,000	57,000	25,000	57,000
Passed Grade 10	43,000	29,500	43,000	35,000	25,000	35,000

Notes: Based on a comparison of maximum gross monthly salary, including allowances of public and private sector employees for 2017, 2018 and 2021. The public sector includes employees in both the government and semi-government institutions.

Source: LFS 2017, 2018 and 2021, DCS.

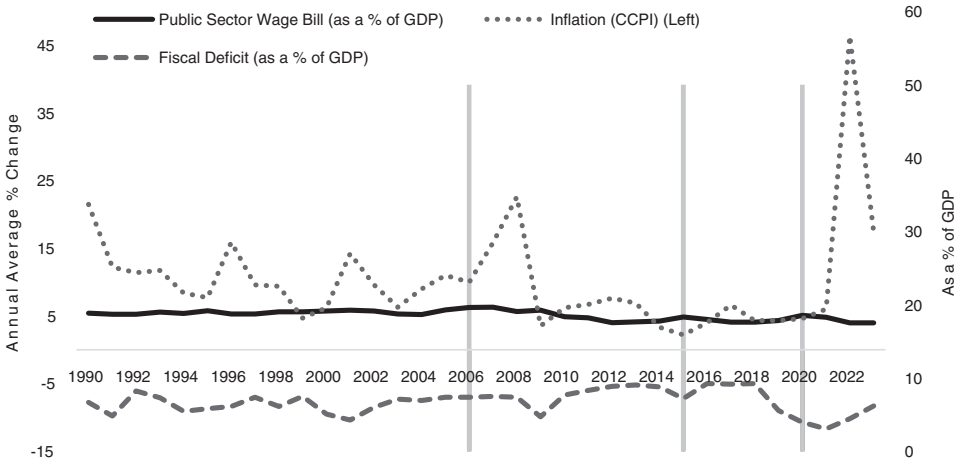
However, this finding must be interpreted cautiously. The above analysis is based on maximum salaries for three years and it has not considered other fringe benefits of the public sector like pension benefits, vehicle permits, local/foreign training and higher education opportunities etc. The pension benefit of public sector employees alone accounts for almost 80% of their last pay. Sri Lankans have a high life expectancy (76 years in 2017). Hence, all public sector employees are eligible for a fairly high-fixed income for a considerably long period of 10-15 years on their retirement and this can be extended to beneficiaries on death. This invisible premium, the present value of the pension benefit, is estimated to be around 27%-40% of the monthly salary of a public sector employee.

9.3.3 Risks of Contributing to Macroeconomic Instability

Public sector salaries are much less flexible than those of the private sector, which varies greatly over time. Sri Lankas' crisis-hit economy faced severe inflation during 2022-23 and whilst inflation rates have dropped sharply, the upsurge in price levels means a real erosion of salaries and wages. The increased tax rates have further reduced disposal incomes, and as such, the demand for pay hikes – by both public and private sectors – is not without justification.

The public sector wage bill could trigger macroeconomic instability by widening the fiscal deficit and raising inflation. Figure 9.6 shows the relationship of public sector wage bill to the fiscal deficit and inflation during 1990-2023. The public sector received three salary hikes in 2020, 2015 and 2006. The 2020 salary hike added to fiscal pressures (as well as tax cuts that contributed to the economic crisis). The 2015 salary hike was partly held responsible for high imports (especially vehicle imports) and subsequent balance of payment (BOP) pressures and economic instability (followed by the 2016 IMF programme). Similarly, in 2006, there was instability following large recruitments and salary hikes as fiscal pressures mounted.

Figure 9.6
Public Sector Wage Bill on Fiscal Deficit and Inflation (1990-2023)

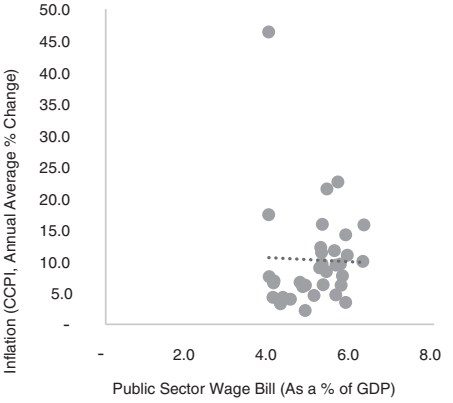


Source: Central Bank of Sri Lanka. (2023). *Annual Report.* Colombo: Central Bank of Sri Lanka.

Figure 9.7a
Correlation of Public Sector Wage Bill and Fiscal Deficit (1990-2023)



Figure 9.7b
Correlation of Public Sector Wage Bill and Inflation (CCPI) (1990-2023)



Source: Central Bank of Sri Lanka. (2023). *Annual Report.* Colombo: Central Bank of Sri Lanka.

During 1990-2023, public sector wage and fiscal deficit shows a weak but significant correlation (-0.3020) (Figure 9.7a). In contrast, a negligible correlation exists between public sector wages and inflation (-0.0279) (Figure 9.7b). Accordingly, the public sector wage bill has significantly impacted the widening of the fiscal deficit but not inflation. A study conducted for the period 1959-2008 using an autoregressive lag model for Sri Lanka identified public sector wage expenditure as a factor in the deficit-inflation relationship.[11] Hence, a more comprehensive empirical analysis is needed to understand the precise implications of public sector wage bills on inflation.

Early concerns indicated that pay hikes would generate another high inflationary episode. In this context, given the relatively large number of public sector workers, it is vital to understand if a public sector pay hike would give rise to inflation – i.e. whether fear of a wage-price spiral is a legitimate claim. A wage-price spiral is defined as an episode where at least three out of four consecutive quarters see accelerating consumer prices and rising nominal wages.[12] Even in advanced economies, a small minority of such episodes were followed by sustained acceleration in wages and prices. As the labour markets are much tighter in these economies, wages do not tend to be sticky.[13] Although there is no historical proof of a wage-price spiral, it is likely that increased compensation in the public sector will eventually lead to comparable incidents.

9.3.4 Income and Estimated Minimum Expenditures

This section compares monthly income to a minimum expenditure benchmark to gauge the public sector pay rise demand. This benchmark is based on the DCS's estimation of the minimum monthly expenditure requirement as of March 2024. Six types of non-pensionable allowances were considered

11 Ekanayake, H. K. (2012). The Link Between Fiscal Deficit and Inflation: Do Public Sector Wages Matter. *Australia South Asia Research Centre, 14,* 1-34.

12 Alvarez, J. B., Hansen, N., Huang, Y., Pugacheva, E., & Sollaci, A. (2022). *Wage-Price Spirals: What is the Historical Evidence?* IMF Working Paper.

13 Duval, M. R. A., Duval, R., Ji, Y., Li, L., Oikonomou, M., Pizzinelli, C., & Tavares, M. M. (2022). *Labour Market Tightness in Advanced Economies*. IMF; Barattieri, A., Basu, S., & Gottschalk, P. (2014). Some Evidence on the Importance of Sticky Wages. *American Economic Journal: Macroeconomics, 6*(1), 70-101.

appropriate in calculating the monthly gross salaries. They are the cost of living (LKR 12,800), uniform allowance (LKR 2,500), transport allowance (LKR 50,000), telephone allowance (LKR 1,850-5,000), professional/executive allowance (LKR 3,000-15,000) and language allowance (LKR 1,500).

Table 9.2 shows the gross monthly salaries (minimum and maximum) of selected service categories for all four levels of the public sector (primary, secondary, tertiary and senior). The salaries were extracted from the Administration Circular: 03/2016 of the PUBAD. These salaries were then evaluated against the minimum expenditure benchmark published by the DCS. To fulfil the basic needs of a single person, LKR 17,014 is required and for a family of four, it is LKR 68,056. The analysis uses the expenditure benchmark for a family of four.

Figure 9.8 shows that the minimum monthly wages of all four employee levels are below the expenditure benchmark of LKR 68,056. The gap between income and expenditure ranges from LKR 1,291 (senior) to LKR 31,006 (primary). Within the maximum wages, only the primary level employees are drawing salaries below the expenditure benchmark (LKR 13,766).

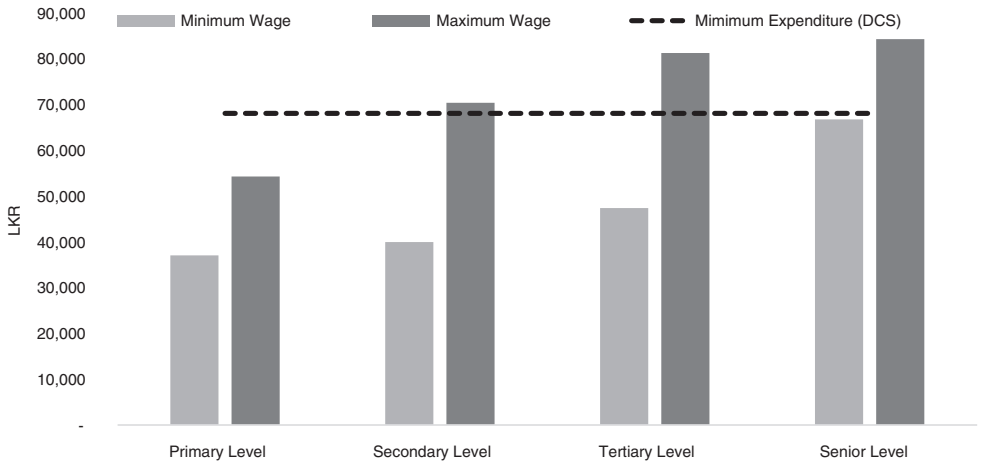
Table 9.2
Variation in Public Sector Wages

Service Category	Salary Code	Minimum (LKR)	Maximum (LKR)
Primary level			
Primary Level Unskilled	PL 1-2016	24,250	36,410
Primary Level Semi-skilled	PL 2-2016	25,250	38,450
Primary Level Skilled	PL 3-2016	25,790	38,990
Secondary level			
Management Assistants Seg 2	MN 1-2016	27,140	45,540
Management Assistants Seg 1	MN 2-2016	28,940	47,990
MA Supervisory Non-tech.Tech	MN 3-2016	31,040	57,550
Tertiary level			
Field/Office-based Officer Seg 2	MN 5-2016	34,605	63,460
Field/Office-based Officer Seg 1	MN 6-2016	36,585	65,440
Management Assistants Supra	MN 7-2016	41,580	68,425
Senior level			
Executive	SL 1-2016	47,615	110,895
Medical Officers	SL 2-2016	52,955	104,355
Senior Executive/ MO Specialist	SL 3-2016	88,000	120,400
Secretaries	SL 4-2016	98,650	133,750

Notes: Minimum and maximum public sector wages are given as the gross monthly salary excluding non-pensionable allowances to primary, secondary and tertiary level employees ranging from LKR 12,800 to 15,300. This is LKR 18,800-84,300 for senior level employees.

Source: Based on Administration Circular: 03/2016, PUBAD.

Figure 9.8
Comparing Public Sector Monthly Salaries and DCS's Minimum Expenditure Requirement



Note: In the comparison, it is assumed there is only one public sector employee in a family.

Sources: Author's calculation based on the Administration Circular: 03/2016, PUBAD and the minimum expenditure requirement published by the DCS.

The secondary-level salaries are just above the benchmark, with a gap of LKR 2,294. A majority of the public sector employees (92%) belong to either primary or secondary levels. The positive margin for maximum wage-earners is in the range of LKR 2,294 to 16,244. Accordingly, the employees at all levels are affected, while the minimum wage-earners are the most affected. The ability of senior-level executives to meet their basic needs may take precedence over meeting other demands, such as recreational, etc. Thus, it is evident that a large majority of public sector employees have fallen behind revised cost-of-living estimates.

The DCS's minimum expenditure threshold was then compared to an income, including the present value of the pension benefit (27% and 40% of monthly salary) (Figures 9.9a and 9.9b). Accordingly, the public sector employees who are eligible to receive the maximum pension benefit are the most advantageous (Figure 9.9b). This indicates that regardless of the need for a salary hike, public sector employees are still better off with their pension entitlement.

However, the estimation of DCS monthly expenditures has several limitations. To begin with, DCS's definition of basic needs is unknown and might be far from real as the calculations are based on the Household Income and Expenditure Survey (HIES) 2019. Thus, the monthly expenditure estimation ignores the changing consumption patterns between 2019 and 2024. Further, this expenditure estimation includes only the basic needs. As living means something beyond basic needs to live a decent life, the demand for a pay hike is foreseeable.

In terms of living in a developing country, the standards of living for the majority are far below that in advanced economies. The 'living wage' is a concept that recognises the importance of living a 'decent life' for all. The living wage, the income level necessary to secure a decent standard of living, is an

important economic yardstick of income adequacy. The ILO recognises living wage as a basic human right. Elements of a decent standard of living include food, water, housing, education, health care, transport, clothing, and other essential needs, including provision for unexpected events.[14]

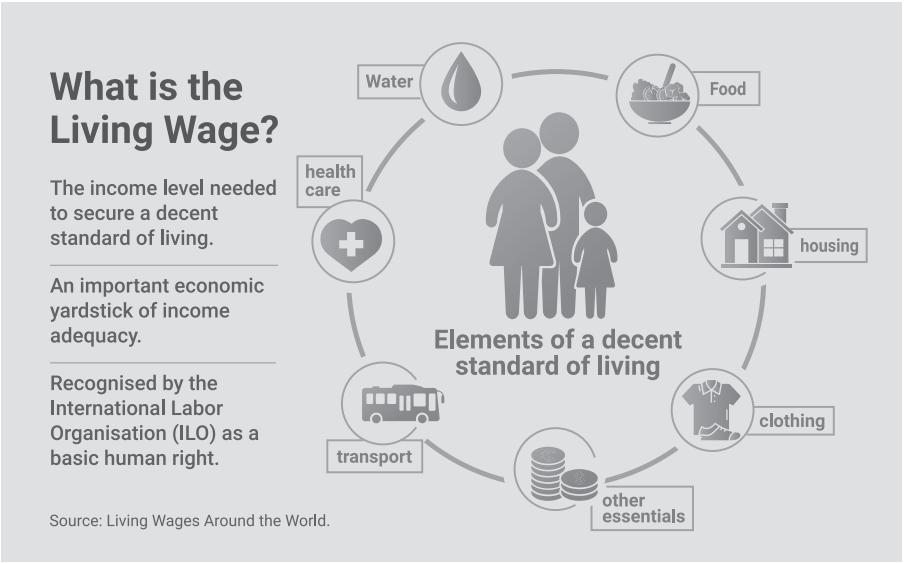


Figure 9.9a
Public Sector Monthly Salaries and Pension Benefit of 27%

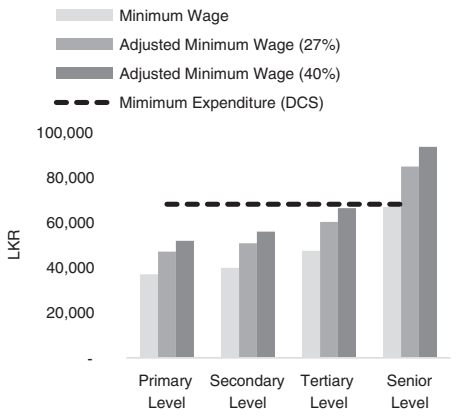
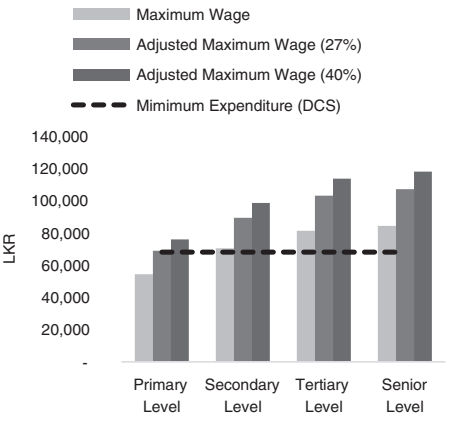


Figure 9.9b
Public Sector Monthly Salaries and Pension Benefit of 40%



Source: Author's calculation based on the Administration Circular: 03/2016, PUBAD and the minimum expenditure requirement published by the DCS.

14 Anker, R., & Anker, M. (2017). Manual for Measurement. In *Living Wages Around the World*. Cheltenham: Edward Elgar Publishing.

9.4 Optimal Employment Policy: Is the Government Size Too Large?

It has often been argued that Sri Lanka's large public sector needs rationalisation to allow higher salaries for high skilled individuals and improve productivity and efficiency in service delivery. Paying high salaries to an inefficient large public sector is a waste of scarce resources. Therefore, higher wages are justifiable when the public sector is right-sized and provides efficient services as demanded in the private sector, and for tax payers at large who finance this higher public sector pay. Furthermore, in countries with low public sector wage inequality, raising wages reduces corruption.[15] However, if wages are highly unequal, raising wages could increase corruption. Furthermore, rapid and unexpected increases in public sector wages could have negative implications on macroeconomic stability. Therefore, higher pay is justifiable only if it comes with the rationalisation of the workforce.

Paying high salaries to an inefficient large public sector is a waste. Therefore, higher wages are justifiable when the public sector is right-sized and provides efficient services as in the private sector, who finances this higher public sector pay.

9.4.1 Operational Challenges in the Public Sector

Enhancing efficiency necessitates a total overhaul of the public sector after a thorough, methodical examination of its financial and administrative functions. A necessary first step is to implement significant changes to the outmoded practices. These modifications should match present and future challenges in changing local and global socio-economic settings. This section focuses particularly on operational challenges in the administration of the public sector. This includes four elements: recruitments, placements and transfers, promotions and capacity development.

Need-based recruitment: Currently, hiring practices in the public sector seldom reflect shifts in regional and international labour markets. Public sector cadre creation and management lacks transparency and accountability. A basic requirement is to modify employment following evolving demands. This entails hiring competent personnel and laying off redundant employees. Yet, the red tape in public service regulations make adjusting government employment difficult. Therefore, the cost of laying off redundant workers is high and the government might find it challenging to declare an employee redundant.

The employment adjustment requires encouraging public sector employees to switch to private sector jobs. However, the pension plan is a strong disincentive to moving from the public to the private sector. This basically lowers attrition rates, which limits the opportunity to modify employment. The absence of provisions to terminate underperforming employees makes it difficult to lay off employees based on performance. Yet, a combination of wage freezes, voluntary resignations and retrenchment could be considered.

15 Demirgüç-Kunt, A., Lokshin, M., & Kolchin, V. (2023). Effects of Public Sector Wages on Corruption: Wage Inequality Matters. *Journal of Comparative Economics, 51(3), 941-959.*

Placements and transfers: Staff placements and transfers are another matter that causes controversy in the public sector. Despite the larger size and having proper placement and annual transfer schemes, malpractices seem to be normal. Urban areas and certain sectors attract the most employees, while peripheral areas are the least preferred. Thus, critical services often suffer from staff shortages. For instance, the low and declining pupil-teacher ratio for primary and secondary schools shows that job placement has not followed a systematic approach nor accounted for shifting demographic patterns. With economic development, countries experience reduced pupil-teacher ratios (e.g. in China and Singapore) while Sri Lanka still has considerably higher ratios (Table 9.3).

Table 9.3
Pupil-teacher Ratio in Asia

	Pupil-teacher Ratio, Primary			Pupil-teacher Ratio, Secondary		
	1990	2010	2018	1990	2010	2018
Bangladesh	63	47	30	27	28	35
China	22	17	16	15	15	13
Malaysia	20	13	13	19	14	11
Pakistan	41	40	44	19	29	20
Thailand	20	17	17	16	29	26
Sri Lanka	29	24	22	19	18	18
Singapore	26	18	15	19	16	11

Notes: Pupil-teacher ratio is the average number of pupils per teacher (in primary or secondary school). A higher ratio is indicative of a shortage of teachers.

Source: Word Development Indicators, World Bank.

Although, no empirical evidence is to be found in Sri Lanka, a study conducted in Sweden in 2023 shows that the probability of acquiring a job in the public sector is 5-6% higher when a parent is employed in a high-ranked government position.[16] Although, the parental effect is smaller at the national level, it substantially increases at sub-national levels. The placements and transfers are affected in a similar manner, leading to overstaffing in certain sectors and professions.

Institutional fragmentation, which leads to growing uncertainty among employees, is another key factor that can be attributed to failure in implementing proper placement and transfer schemes. Frequent changes in the institutional structure mean there is no certainty over the number or the existence of a particular institution over time. During 2010-2024 in Sri Lanka, there were four different governments,[17] but nearly 50 changes in ministerial portfolios.[18] These changes are critical due to several factors such as the high administrative costs, the increased uncertainty, the duplication of functions, the loss of historical knowledge, and the disruptions on workflow.

16 Wittberg, E. (2023). The Intergenerational Transfer of Public Sector Jobs: Nepotism or Social Reproduction?. *Working Paper Series, QoG The Quality of Government Institute.*

17 During 2010-2024 (to date), there were four different governments: President Mahinda Rajapaksa (2005-2014); President Maithripala Sirisena (2015-2019); President Gotabaya Rajapaksa (2020-2022); and President Ranil Wickramasinghe (2022-2024).

18 Verité Research. (2020). *A Rational Method for Cabinet Formation in Sri Lanka: A White Paper.* Colombo: Verité Research.

Merit-based promotions: Rewarding performance and specialised skills is a must. Sri Lanka's public service promotions are often based on seniority, with little or no space for performance-based promotions.[19] For example, workers in all-island services can be promoted based on seniority without performance assessment as the basis. Formal performance evaluations, when pursued, are either highly subjective or give similar performance ratings to most workers. It has been claimed that "the entire public service both at national and provincial levels has deteriorated over the last five decades due to excessive political interference in appointments, transfers and promotions".[20] As a result, professionalism, meritocracy and careerism are all on the decline.

Managing a merit-based public service as opposed to political patronage and nepotism, provides many benefits. Promoting people based on their family networks, political affiliations or social status is a form of corruption and misuse of public funds. Instead, promoting employees with the right skill-set improves performance and reduces corruption.[21] Meritocracies are assumed to be less responsive to political influences and quickly adapt and respond to emerging challenges, much like the private sector. This also helps maintain transparency. China, Singapore and New Zealand are some of the best examples of professional and meritocratic public service leading countries toward economic prosperity.[22]

In addition, Sri Lanka's public sector wages are rigid or compressed when compared to that of the private sector. When there is high compression, highly skilled workers in the public sector are underpaid, while unskilled workers are overpaid. Due to wage compression, it is challenging to draw and keep highly qualified employees in the public sector. Also, low compression ratios are linked with corruption.[23] These factors have led to rigid civil service employment practices preventing the hiring and retaining of qualified staff in key areas.

Capacity development: For any country, capacity development of the public sector should be a priority. However, it is unclear whether the existing capacity development programmes in Sri Lanka's public sector are appropriate to the emerging economic conditions. Capacity development should go beyond simple knowledge transfers to managing public affairs successfully in critical situations. Hence, capacity development should be an ongoing process for the agility of the governments.

The prime focus of the public sector is to be proactive, innovative and diligent in managing public affairs. Hence, a systems-thinking approach to policymaking is fundamental to support effective governance.[24]

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19 United Nations Development Programme. (2020). *Colombo Development Dialogues: Public Sector Modernisation, 2020.*

20 Transparency International Sri Lanka. (2014). *Public Service and the Public Service Commission of Sri Lanka.* Colombo: Transparency International Sri Lanka.

21 Cortázar, J. C., Fuenzalida, J., & Lafuente, M. (2016). Merit-based Selection of Public Managers: Better Public Sector Performance. *An Exploratory Study;* Dahlström, C., Lapuente, V., & Teorell, J. (2012). The Merit of Meritocratisation: Politics, Bureaucracy, and the Institutional Deterrents of Corruption. *Political Research Quarterly, 65*(3), 656-668.

22 Bardhan, P. (2020). The Chinese Governance System: Its Strengths and Weaknesses in a Comparative Development Perspective. *China Economic Review, 61*, 1-6.; Quah, J. S. (2018). Why Singapore ...Works: Five Secrets of Singapore's Success. P*ublic Administration and Policy, 21*(1), 5-21.; Duncan, G., & Chapman, J. (2012). Better Public Services?: Public Management and the New Zealand Model. *Public Policy, 7*(2), 151-166.

23 Van Rijckeghem, C., & Weder, B. (2001). Bureaucratic Corruption and the Rate of Temptation: Do Wages in the Civil Service Affect Corruption, and by How Much?. *Journal of Development Economics, 65*(2), 307-331.

24 *Governments Need to Learn, Adapt and Respond in New Ways - This is How Capacity Development Can Help* (2022, May 7), https://www.weforum.org/agenda/2022/03/governments-need-to-learn-adapt-and-respond-in-new-ways-this-is-how-capacity-development-can-help/

This approach was practiced during the pandemic where education, digitalisation, international travel, diplomatic affairs, etc., were interlinked to overcome the public health crisis. As such, the public sector employees need to improve their expertise in a multitude of areas including access, filter and understand knowledge, and manage emerging challenges successfully. Thus, following a systems-thinking approach and avoiding compartmentalisation helps better decision making and resource utilisation. Sri Lanka's public service comprises several varied services specialised for different technical expertise. This structure sometimes increases work compartmentalisation, reducing the effectiveness in the systems-thinking approach.

9.4.2 Future Challenges Facing the Public Sector

To reach transformative economic growth, the public sector readiness to meet future challenges is crucial. These challenges include rapid technological advancements, demographic changes, sustainability and budget constraints and workforce development. Thus, the public sector future-readiness depends on how effectively the government addresses these challenges.

Digital technology: Digitalisation plays a crucial role in improving operational efficiency. Flexibility, speed and tailored solutions for public services are in high demand and can only be delivered via digital technology. Therefore, using emerging technologies like artificial intelligence (AI) and machine learning should be encouraged. However, the public sector needs appropriate upskilling for better outcomes.

In the current context, the digitalisation of the public sector needs much emphasis. As per the DCS data, public sector digital skills are quite limited. In 2016, public sector employees' awareness on basic computer skills like using computers, internet and emails was 66%, 56% and 36%, respectively. Despite a few success stories like issuing revenue licenses, passports, national identity cards, etc., so far, the public sector digitalisation efforts have been far from successful. Resistance to change, employees' age, and rigidity in salary structures are some of the main impediments in this regard. High-skilled professionals are hesitant to join the public service due to lower salary scales. Thus, the success of digitalisation depends largely on the degree to which these context-specific issues are addressed.

Demographic changes: Sri Lanka's population is ageing fast, more rapidly than most other developing economies.[25] In light of these changes, the age composition is markedly shifting from a pyramid to a pillar shape. The share of the working-age population (those aged 15-64) in the total population is declining, and the absolute number of the working-age population will also start to drop by 2030. These trends call for more emphasis on the need for increased and altered healthcare services, social services and urban infrastructure.

As such, the national development priorities need apt and timely adjustments to address these new trends. Thus, the public sector focus should be on providing smart-city technologies and telehealth services, etc., which would be in high demand in the future.

25 Asian Development Bank. (2019). *Growing Old Before Becoming Rich Challenges of an Ageing Population in Sri Lanka*. Manila: Asian Development Bank.

Sustainability and limited budgets: Budget constraints are common in the post-pandemic world. For Sri Lanka, the situation is even worse due to debt vulnerability. The public sector bears a key responsibility for sustainable financial and debt management. Prudent debt management, strong ties to the global financial system, and greater availability of alternative financial resources are vital to reduce debt vulnerability. Hence, the public sector should be attentive to adopting sustainable strategies like managing debt at safe debt thresholds, modernising the national financial system to match the global financial architecture and creating a conducive environment to attract innovative financial modalities.

Workforce development: The public sector must increasingly be equipped to face new policy challenges and greater uncertainty. Thus, it needs to adapt recruitment processes, capacity development programmes, performance management and incentive schemes and promotions to upskill/reskill the workforce with the new trending skills.

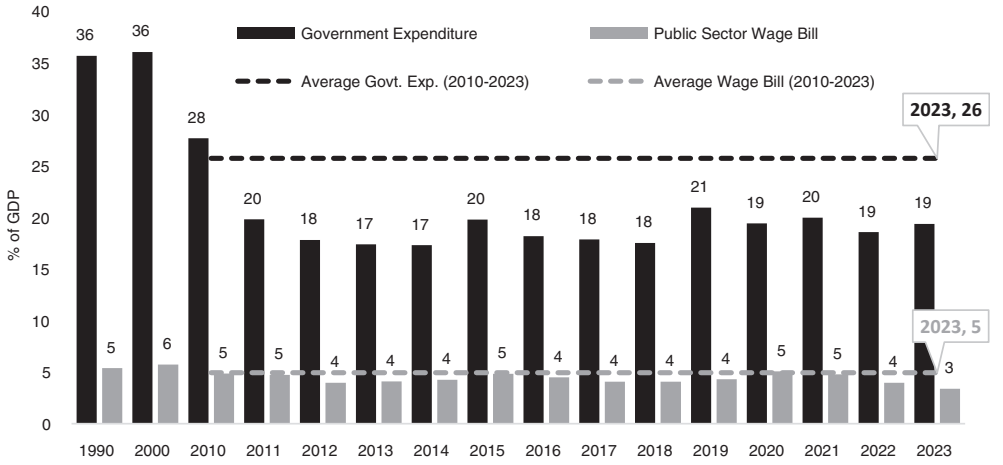
Thus, recruitment and promotion should follow a transparent, open and merit-based procedure. This new skill-set in capacity development should essentially include skills pertaining to data management, data privacy and cybersecurity risks. Creating a learning culture and environment is useful to prevent hierarchical negligence and adverse influence on skilled workers.

9.4.3 Rationale for Downsizing or Rightsizing

Despite the importance of the public sector as an employer of labour, the responsiveness of wages and employment to increased productivity is stonewalled to avoid social and political backlashes. However, rationalising the public sector seems inevitable to ensure a faster and more sustainable economic recovery for crisis-hit Sri Lanka. Critically, it is required to support fiscal consolidation efforts and generate favourable labour market effects in the medium- to longer-term through competitiveness and efficiency gains. Thus, maintaining a right-sized public sector cannot be ignored any longer. Downsizing or rightsizing is a commonly used strategy for employee retrenchment to achieve efficiency gains in both public and private organisations. This section analyses whether this strategy is pragmatic to enhance public sector productivity in Sri Lanka.

Government expenditure matters for economic growth. When the government takes up a bigger share of the economy, it ‘crowds out’ investment and export growth through higher interest and greater exchange rate volatility in a resource-constrained environment. Thus, managing government expenditure is crucial for rebalancing growth towards investment and exports. Productive spending is good for growth. However, with increased spending, the benefits tend to decline and the marginal cost of taxation also rises. This can lead to an inverted U-shaped relationship between government expenditure and growth. Thus, the larger the size of the government, the lower the prospects for growth and vice versa. In Sri Lanka, government expenditure as a share of GDP has been on a declining trend since 2010 while the spending on salaries and wages remains stable (Figure 9.10). Thus, it is not only total government expenditure but also the expenditure components that may need a rebalancing.

Figure 9.10
Evolution of Government Expenditure and Public Sector Wage Bill, 1990-2022



Source: Annual Reports (Various years), CBSL.

Both the level and type of taxes can undermine economic growth, hence, fiscal strategy should also aim to restrain the growth of unproductive spending rather than increasing taxes in the medium- to longer-term to maintain fiscal health. An effective and efficient public sector not only reduces the need for tax but also maximises the effect of spending on the government's priorities, including economic growth. This means hard spending choices need to be made. All public sector interventions need to demonstrate that their contribution to the government's priorities outweighs funding costs. It also means a renewed focus on efficiency – not only doing the right things but doing them in the right way and economically. This is likely to involve being open to new service delivery models, including using the private and non-governmental organisation (NGO) sectors where it is apt or reasonable to do so. Thus, building a reputation for integrity and independence in the public sector is crucial to recruiting and retaining professionals who are committed to doing a good job.

Efficiency gains from public employment reform arise when public sector activity partially competes with the private sector (in producing individual, non-collective public goods, like in the education or health sectors). A decrease in public hours worked to produce substitutable products can lead to the private sector crowding-out public jobs. Further, when public sector activity complements private sector productivity, the efficiency of the public sector is crucial in the provision of such goods or services.

Reforms in the public sector that target structural adjustments have a greater influence on raising productivity. Maintaining wage bill savings is advised in countries with high fiscal consolidation needs. When the public sector claims a pay rise amidst serious concerns over productivity enhancements, downsizing is clearly a means of achieving better pay and higher productivity. Therefore, increasing wages would be justifiable only for the right-sized productive employees.

9.4.4 Rationalising Employment for Better Wages

The intended purpose of rationalisation is to improve public sector productivity. Effective downsizing can also help increase incentives for public sector employees. It was earlier pointed out that a public sector pay rise is justifiable as the cost of living has surged, but the magnitude and financing modality of this wage increase need further assessment. There are two options to meet this requirement. First, the government can reduce the size of the public sector or reduce unproductive government expenditures and use these savings for salary increases.

Effective downsizing can help increase incentives for public sector employees.

In 2022, the public sector of 1.39 Mn absorbed a wage bill that amounted to 4% of GDP. Taking 2022 as the benchmark, Table 9.4 proposes three scenarios of pay rises (10%, 20% and 30%) for three levels of the downsized public sector. Accordingly, 30% downsizing allows a 30% pay rise, accounting for 3.6% of GDP. Moreover, downsizing allows higher pay rises while lowering the share of the public sector wage bill to GDP. The expected productivity calls for cuts to the bottom bulk rather than higher up the scale.

Table 9.4
Possibilities for Public Sector Wage Increment

Rate of Downsizing	Public Sector Employment (Mn)	Wage Bill (As a % of GDP)		
		10% Pay Rise	20% Pay Rise	30% Pay Rise
Benchmark: 2022	**1.39**			
Scenario 1: 10% downsizing	1.25	3.9	4.3	4.6
Scenario 2: 20% downsizing	1.11	3.5	3.8	4.1
Scenario 3: 30% downsizing	0.97	3.0	3.3	3.6

Notes: The downsizing is more applicable to primary and secondary grades, as these constitute 92% of the public sector. The estimation uses the year 2022 as the benchmark.

Source: Author's calculation based on CBSL data.

Laying off employees is challenging. Yet, countries like Malaysia, Singapore and New Zealand are good examples of how an efficient public sector drives countries toward economic prosperity.[26] Both Malaysia and Singapore follow the philosophy and techniques of New Public Management (NPM). Thus, public administration is characterised by meritocracy, status, a strong generalist administrative elite, a clear system of performance and financial accountability, and an uncompromising commitment to combat different forms of corruption. In New Zealand, the public sector is only a meagre 0.07 Mn for 5.1 Mn population. Public sector reforms in New Zealand include corporatising and privatising SOEs; introducing performance-related individual contracts for senior staff; increasing departmental

26 Khalid, S. N. A. (2008). New Public Management in Malaysia: In Search of an Efficient and Effective Service Delivery. *International Journal of Management Studies*, 15, 69-90.; Sarker, A. E. (2006). New Public Management in Developing Countries: An Analysis of Success and Failure with Particular Reference to Singapore and Bangladesh. International Journal of Public Sector Management, 19(2), 180-203.

management autonomy; changing financial management and reporting requirements, including moving from input-based to output-based reporting; using strategic planning in public investment; and departmental decoupling, including promoting policy-operations and funder-provider splits.[27] Thus, it is proposed to conduct a systematic analysis of sector-wise or institutional-wise employment reviews prior to implementing these reforms. This is critical to ensure that any reform effort stands a good chance of successful implementation.

The public sector reforms often fail due mainly to the lack of understanding of what motivates people and drives change. Motivation is an essential element in public administration as it depicts how the employees and stakeholders are led to achieve goals and objectives. Motivation could be either extrinsic or intrinsic. Extrinsic motivations – reward and punishment – can drive behavioural change. Instead, unlocking intrinsic motivation – inherent satisfaction – is generally recognised as a stronger driver of behavioural change toward efficacy and success. Extrinsic motivators could sometimes crowd out intrinsic motivation, triggering much worse outcomes.

The 'Self Determination Theory' (SDT) describes that people have natural psychological requirements for autonomy, competence and connectedness, which must be met to support internal drive and well-being.[28] A supportive work environment that builds on these fundamentals enhances public service motivation and job performance.[29] Applications of SDT have shown its relevance and potential in enhancing motivation and performance of the public sector. The SDT explains why a policy that promotes autonomous or independent choice for behaviour change is often more effective than the use of coercion, especially when evaluating policy on a broad level with a long-term perspective. The SDT is poorly explored in the Sri Lankan public sector. Using SDT as a work motivation approach would be significant in implementing appropriate changes in systems and practices in the public sector.

The absence of market forces leads to weak or misaligned incentives. Relying on the altruism of public servants alone cannot drive improvement. Thus, the new public management reforms should bring stronger and better incentives into the public sector. This should be achieved through two main mechanisms. First, the importation of private sector practices to the workings of public administrations, including performance indicators (e.g. targets) and performance management (e.g. regulators and delivery units); and second, the introduction of quasi-markets such as choice for 'consumers' (usually on quality rather than price) and competition between providers, often including private and third sector organisations.

However, the radical changes might adversely affect employees' psychological well-being. A study based on Sweden's public sector shows that the process of rationalisation and change was of concern to employees. During the process, employees show relatively high levels of anxiety and symptoms

27 Goldfinch, S. (1998). Evaluating Public Sector Reform in New Zealand: Have the Benefits been Oversold?. *Asian Journal of Public Administration, 20*(2), 203-232.

28 Forner, V. W., Jones, M., Berry, Y., & Eidenfalk, J. (2020). Motivating Workers: How Leaders Apply Self-Determination Theory in Organisations. *Organization Management Journal, 18*(2), 76-94.

29 Papadopoulou, M. I., & Dimitriadis, E. D. (2019). Factors Affecting Motivation in the Public Sector under the Context of Self-determination Theory and Public Service Motivation: The Case of the Hellenic Agricultural Insurance Organization (HAIO). *International Journal of Economics and Business Administration* VII (Issue 4):112- 135.

of being 'worn out'. The rationalisation process is stressful for employees, and highlights the need for systematic long-term planning for smooth implementation.[30]

9.5 Policy Recommendations: Creating a Vibrant Public Sector

Rationalising government wages and employment appear necessary to contain the deterioration of public finances and enhance productivity. Implementing cost-cutting measures affecting the government wage bill may have adverse short-term macroeconomic effects, yet, these can yield medium- to longer-term benefits due to possible competitiveness and efficiency gains through their impact on labour market dynamics. While cost-cutting in the wage bill could lead to output losses and higher unemployment, however, such adverse macroeconomic effects are likely to be felt only in the short run.[31] Demand for enhanced efficiency and effectiveness requires cuts in government spending. Appropriately designed government wage bill moderation could indeed produce positive dividends to the economy. Relevant fiscal-structural reforms can reinforce these gains. This chapter provides some valuable insights for rationalising the public sector in Sri Lanka.

Sri Lanka's public sector effectiveness is well below that of emerging and advanced economies. Though not politically very attractive, the importance of rationalisation cannot be disregarded anymore if the country needs a productive public sector. The four main recommendations for rationalising the public sector are to streamline administrative operations, provide swift pay rises, downsize the public sector and address the barriers that lead to policy failures.



Source: Living Wages Around the World.

30 McHugh, M. (1998). Rationalisation as a Key Stressor for Public Sector Employees: An Organizational Case Study. *Occupational Medicine, 48*(2), 103-112.

31 Pérez, J.J., Aouriri, M., Campos, M., Celov, D., Depalo, D., Papapetrou, E., … Rodríguez, V. M. (2016). The Fiscal and Macroeconomic Effects of Government Wages and Employment Reform. *Banco de Espana Occasional Paper, 1607*.

Introducing a new public management approach in improving administrative operations is a must. This includes addressing challenges in the existing system and taking precautionary measures to better cope with future challenges. The key elements of concern are adopting need-based recruitment procedures; placement and transfer to follow systematic approaches; encouraging merit-based performance and continuous capacity development. For future-readiness, the public sector needs to be equipped with digital skills, adjust to national development priorities considering the changing demographic patterns, explore innovative alternative financing mechanisms to ensure sustainability and adopt continuous workforce development to face new policy challenges and greater uncertainty.

The public sector appears in need of an immediate pay rise to withstand the increased cost of living driven by inflationary pressures and the economic downturn given that most are finding it hard to meet at least the minimum expenditure requirements under present circumstances. Financing the increased spending gap is, however, a concern.

To enhance productivity, having a public sector of right-size is encouraged. Downsizing the public sector would help achieve efficiency gains and better ways to incentivise the remaining cadre.

To ensure that the policy reforms are implemented successfully, the government needs to create an environment that is supportive in adopting changes. The use of intrinsic motivation to better adapt to the 'change' and streamlining incentives to match performance is vital. Using performance indicators and introducing quasi-markets like in the private sector are identified as effective strategies that would help create a competitive and productive public sector in Sri Lanka.

10. Economic Crises and Navigating Brain Drain Challenges

10.1 Introduction: Economic Crises and Migration

The number of global international migrants has steadily increased over the past decade, rising from 221 million (Mn) in 2010 to 281 Mn in 2020. With 'livelihood crises' identified as one of the most serious potential risks in the coming decade,[1] millions of individuals are already migrating across borders in pursuit of better economic opportunities. However, the decision to migrate could be influenced by a multitude of factors, both economic and non-economic.

In the literature, classical theories of migration have been central to comprehending why people migrate, with various dimensions such as economic, political, social, cultural, demographic, and ecological factors. Since recently, economic crises have often acted as powerful catalysts for migration. On the one hand, people may be 'pushed' to leave their home countries due to worsening economic situations or political instability. On the other hand, they may be 'pulled' towards destinations that promise better opportunities, such as higher wages, quality healthcare, or education systems. For instance, despite Greece gaining European Union (EU) freedom of movement in 1988, a notable increase in migration did not surface until its 2009 economic crisis, which triggered substantial migration that impacted Greek society and economy for over a decade. Similarly, in the case of the Philippines, frequent economic crises have prompted mass labour migration to regions like the Middle East, East Asia, and North America and since the 1970s, the Philippines implemented policies to promote emigration as a means to boost the economy.[2]

Thus, migration is often embraced by countries facing economic difficulties to reduce domestic unemployment and increase foreign remittances. Labour migration impacts both sending and receiving countries. For instance, positive outcomes on a sending country encompass alleviated labour market pressure, enhanced skill development, and reduced poverty levels. Conversely, negative consequences in the country of origin include brain drain – i.e., the out-migration of trained and talented individuals resulting in a depletion of skills resources. The severity of brain drain in sending countries varies based on the level of development and its economic context. For instance, the departure of skilled professionals may not significantly affect certain sectors if the gaps are filled by incoming talent. But if the loss of human capital translates to labour market-wide issues with a permanent loss of human capital, it can hinder innovation and weaken key sectors such as healthcare and education. Additionally, the departure of skilled workers may exacerbate the shortages in these critical fields, leading to further challenges. Therefore, many countries, especially developing ones, struggle to curb brain drain. For example, India has emerged as a major source of immigrant physicians and nurses globally, with large numbers of Indian-trained professionals employed in countries like the United States (US), United Kingdom (UK), Canada, and Australia. While countries like the UK have

1 This section was drawn from- Global Risk Report 2022, Chapter 4: *Barriers to Migration*, https://www.weforum.org/publications/global-risks-report-2022/in-full/chapter-4-barriers-to-migration/

2 Asi, M. M. B. (2017, July 12). *The Philippines: Beyond Labour Migration, Toward Development and (Possibly) Return*, https://www.migrationpolicy.org/article/philippines-beyond-labor-migration-toward-development-and-possibly-return

actively encouraged Indian health worker migration to address shortages, India has introduced policies to control the country's out-migration of its healthcare workers amidst domestic shortfalls.[3] Similarly, in the Philippines, labour migration was initially perceived as a temporary measure, but the country now faces shortages of skilled individuals, especially health care workers,[4] exacerbating the brain drain issue, which remains a prominent topic of debate. Indeed, during the coronavirus (COVID-19) pandemic, the Philippine government temporarily blocked the emigration of healthcare workers to protect local services, raising dissatisfaction amongst many professionals and highlighting the often conflicting policy choices such as those between brain drain and remittances from workers abroad.[5]

The severity of brain drain in sending countries varies based on the level of development and economic context of the sending country. The departure of skilled professionals may not significantly affect certain sectors if the gaps are filled by incoming talent. But if the loss of human capital translates to labour market-wide issues with a permanent loss of human capital, such a loss can hinder innovation and weaken key sectors such as healthcare and education.

Sri Lanka is no exception. In recent times, the COVID-19 pandemic and the economic crisis that peaked in 2022 saw a hike in out-migration. The multiple crises also affected the out-migration of skilled workers owing to job losses, lower disposable incomes and a fall in the availability of quality job opportunities,[6] raising concerns about the lack of skilled-workers and professionals, especially related to sectors like healthcare and information and communication technology (ICT). Therefore, it is timely to look at the multifaceted ways in which brain drain can affect Sri Lanka given its inherently complex phenomenon with benefits and challenges. Within this context, this chapter employs a qualitative research design to gain in-depth insights on the dynamics of migration, brain drain, and its implications for Sri Lanka, by taking the ICT sector as a case study.

10.2 Sri Lanka's Recent Migration Patterns

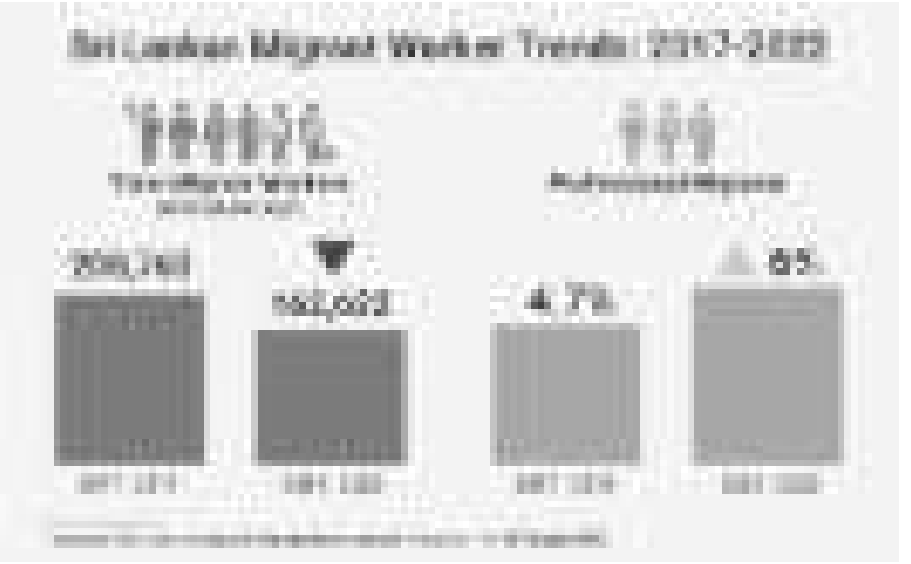
Labour migration has always been an integral part of the Sri Lankan economy, where the outflow of workers contributes to offset the pressure on unemployment. Their remittances act as a well-targeted social protection mechanism for households at the micro level and contribute to the foreign currency earnings at the macro level.

3 Walton-Roberts, M., & Irudaya Raja, S. (2020, January 23). *Global Demand for Medical Professionals Drives Indians Abroad Despite Acute Domestic Health-Care Worker Shortages*, https://www.migrationpolicy.org/article/global-demand-medical-professionals-drives-indians-abroad#:~:text=India%20has%20been%20the%20world's,country%20gained%20independence%20in%201947

4 World Economic Forum. (2022, January 11). *Global Risks Report 2022: Chapter 4. Barriers to Migration - Nowhere To Go*, https://www.itv.com/news/2023-04-13/the-philippines-brain-drain-as-nurses-flock-to-the-nhs

5 *Philippines to Lower Bar for Nurses as Low Pay Drives Many Abroad,* https://www.ctvnews.ca/health/coronavirus/philippines-stops-doctors-nurses-health-workers-from-going-abroad-1.4891422

6 Gunatilaka. R., & Chandrasiri. S. (2022). *The Labour Market Implications of Sri Lanka›s Multiple Crises*. Colombo: International Labour Organization.



According to recent data from the Central Bank of Sri Lanka (CBSL), total departures for foreign employment in 2023 reached 297,656, averaging 24,805 per month. Of them, nearly 70% of departures for foreign employment were concentrated in the skilled category (as per the revised employment classification by the Sri Lanka Bureau of Foreign Employment (SLBFE)).[7] This revised categorisation makes it difficult to capture and highlight the issue of brain drain over time.

Further, data gaps exist as many skilled migrants do not register with the SLBFE, suggesting that the actual number leaving the country is likely higher than those reflected in SLBFE data. The SLBFE data only reflect those who have registered, but a large number of skilled migrant workers may leave without such formalities. The post-pandemic recruitment modalities have changed drastically, where many individuals now secure employment abroad through personal networks, such as family, friends, or community contacts, bypassing recruitment agents. These new trends are facilitated by the latest visa regimes in some countries, which allow potential migrants to pursue job opportunities by initially travelling on visit visas and then switching to a work visa once in the destination country. Due to these factors, including a lack of awareness or understanding about the benefits of registration with the SLBFE, the official statistics only capture a portion of the actual number of Sri Lankans seeking foreign employment. Anecdotal evidence suggests that a vast number of migrants, particularly skilled or professional migrants, depart outside the framework of the SLBFE. For example, from January to April 2023, over 700 doctors, including medical consultants, are said to have left Sri Lanka. Causing further concern for the healthcare sector, some of them supposedly left without formal permission or informing medical authorities of their departure.[8] As such, they are unlikely to have registered with the SLBFE.

7 The SLBFE has updated their classification system to include only skilled and low-skilled workers, discontinuing the previous categories of professional level, clerical and related, middle level, skilled, semi-skilled, and low-skilled.

8 Mudugamuwa, M. (2023, April 2). *Skilled Migration: About 700 Doctors Left Lanka in 2022*. The Morning, https://www.themorning.lk/articles/1yq9JtU80fv2ya5w10Xl

Alternative data sources indicate that since the economic crisis in 2020, there has been a rise in the number of Sri Lankan professionals seeking foreign employment and as a result, many sectors are now facing skill shortages. A surge in Sri Lankan applicants for international medical-licensing exams, such as the Australian Medical Council (AMC) exam has been noted over the past two years. According to AMC annual reports, Sri Lankan applications for AMC portfolios tripled from 222 in 2020-21 to 725 in 2021-22, making Sri Lanka the second-highest country in terms of applicants.[9] The departure of medical professionals has led to a critical shortage, with only half the required number of consultants employed in the sector in Sri Lanka. Many doctors continue to remain overseas without fulfilling their commitment to return to Sri Lanka after overseas training, exacerbating the problem.[10] These shortages and related implications were one reason for restricting healthcare professionals from benefiting from the five-year no-pay leave scheme for public sector workers introduced in 2022 (Public Administration Circular: 14/2022).

Alternative data sources indicate that since the economic crisis, there has been a rise in the number of Sri Lankan professionals seeking foreign employment and as a result, many sectors are now facing skill shortages.

Along with the health care sector, the university system faces a sizeable shortage of lecturers in Sri Lanka, with only around half of the required 11,900 lecturers currently employed.[11] The number of lecturers in the system was approximately 6,300 as of January 2023, with an additional 500-600 academics are said to have left the country over a seven-month period thereafter. Notably, the brain drain affects both state and private universities, as lecturers from state universities also teach in the country's top private institutions. Another sector that was severely impacted by the brain drain during 2022-23 was ICT. Industry stakeholders believe that 10,000 professionals have migrated during the crisis period,[12] with the brain drain jeopardising the target of achieving United States Dollars (USD) 3 billion (Bn) in export revenues from the ICT sector by 2024.

As outlined above, this rise in the departures of professional workers has contributed to a growing concern about the issue of brain drain from Sri Lanka. Additionally, a growing trend of young individuals leaving Sri Lanka for foreign education contributes to a major drain of talent from the country. Interestingly too, brain drain concerns exist in an environment that actively promotes labour migration as a mechanism to rapidly overcome one of the key manifestations of the economic crisis – i.e., foreign currency shortages.

9 Australian Medical Council. (2022). *Annual Report: Financial Year 2021-22*, https://www.amc.org.au

10 Ministry of Defence, Sri Lanka. (2023, December 20). Doctor's Brain Drain: Health Security Concern in Sri Lanka, https://www.defence.lk/Article/view_article/27725

11 Daily News. (2023, August 22). SL Facing Massive Brain Drain in University System, https://www.dailynews.lk/2023/08/22/local/87268/sl-facing-massive-brain-drain-in-university-system/

12 This section was drawn from a newspost: Nearly 10,000 ICT professionals migrated during crisis period – CSSL (2022, December 3). AdaDerana.lk : https://www.adaderana.lk/news/86571/nearly-10000-ict-professionals-migrated-during-crisis-period-cssl



10.3 Migration of ICT Professionals from Sri Lanka: A Case Study

10.3.1 Economic Significance of the ICT Sector

With over 500 companies,[13] Sri Lanka's ICT sector is multifaceted, ranging from hardware or software resellers/vendors, hardware or software manufacturers, system integrators – focusing on the local market or global outsourced operation – IT-enabled services (ITES), business process outsourcing (BPO), universities and IT training institutions, etc.[14] This diversity has resulted in highly nuanced implications of brain drain experience in the sector. This section explores the ICT brain drain experience since the economic crisis in 2020 by relying on qualitative data collected from 10 stakeholders and secondary information.

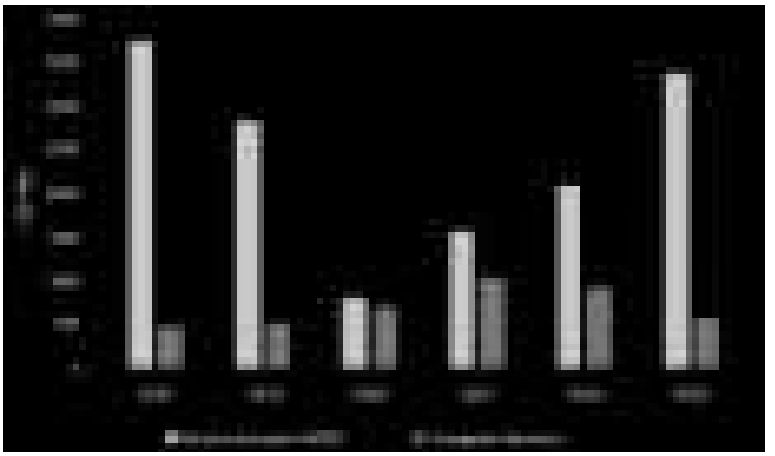
At the start of the pandemic era, in 2020, the ICT sector was one of the leading foreign currency earners, with a notable surge in export earnings from computer services propelled by the evolving landscape of the 'new normal'. The net returns from the ICT sector soared from USD 519 Mn in 2019 to USD 714 Mn in 2020. In 2021, the ICT sector continued its upward trajectory with a healthy expansion in exports of computer services, totalling a net income of USD 1,028 Mn. However, the momentum faltered in 2022, marked by a general slowdown in global outsourcing and significant layoffs among technical-level employees, causing earnings from the industry to fall to USD 933 Mn.[15] The overall importance of computer services revenues within the balance of payments (BOP) can be understood in relation to the overall services account earnings, especially in the post-pandemic era (Figure 10.1).

13 ICT Industry Information-Service Providers in Sri Lanka, https://www.srilankabusiness.com/ict-services/about/

14 Based on a blog by Dr. Sanjiva Weerawarana, titled Understanding the (Sri Lankan) IT Industry, on January 27, 2016.

15 This section drawn from - Annual Reports (2020, 2021, and 2022), CBSL.

Figure 10.1
Net Service Incomes and Net Revenue from Computer Services



Source: Author's compilation using Annual Reports (2019, 2022, and 2023), CBSL.

Over the years, the industry has been ranked high in many international indexes such as the inclusion at rank 30 in Gartners' 30 Leading Locations for Offshore Services and ranked sixth in Asia Pacific. Furthermore, Sri Lanka has been awarded the 'Offshore Destination of the Year' by the National Outsourcing Association in 2013, 2014 and 2019, ranked 11th in the A.T. Kearney's Global Services Location Index (GSLI) in 2017 against financial attractiveness, people skills and availability, and business environment, and ranked 12th in the top-ranking destinations in IBM Global Location Trends Report.[16] The Sri Lankan ICT sector is a mixture of local and foreign clients or companies. Currently companies are found to be from the US, UK, Australia, Norway, Sweden, Canada, the Netherlands and India. Furthermore, the industry's global clientele, too, is spread worldwide. As such, the Sri Lankan ICT sector and its workforce are well integrated with the global market.

Thus, the ICT sector is a prime illustration of the risks of brain drain due to its large economic contribution and extensive involvement in both local and global markets. The departure of skilled professionals not only affects the sector directly but also hampers Sri Lanka's overall economic recovery and growth prospects.

10.3.2 Anatomy of ICT Brain Drain

Migration for employment has been a common factor among ICT sector employees globally. As pointed out in the World Development Report (WDR) 2021,[17] the brain drain of ICT professionals has been taking place over the years and a large number of ICT graduates from upper middle-, lower middle- and low-income countries migrate to high-income countries, mainly due to disparity in salaries between countries. Professionals often receive significantly higher pay abroad, which

16 Export Development Board, Sri Lanka. (n.d.). Sri Lanka - ICT / BPM Destination of Choice, https://www.srilankabusiness.com/ict-services/sri-lanka-destination-of-choice.html

17 World Bank. (2021). *World Development Report 2021: Data for Better Lives*. Washington, D.C.: World Bank.

strongly incentivises them to seek better financial prospects elsewhere.

The ICT sector is a prime illustration of the effects of brain drain due to its large economic contribution and extensive involvement in both local and global markets. The departure of skilled professionals not only affects the sector directly but also hampers Sri Lanka's overall economic recovery and growth prospects.

The above also holds true for Sri Lanka within the ICT industry, which was persistently highlighted in the qualitative interviews. For instance, respondents noted that there has always been migration of workers in the ICT sector and that the industry has been very resilient and robust. Migration has been common among ICT professionals for various reasons, such as the high global demand for ICT skills and the availability of a ready supply of Sri Lankan professionals with highly marketable and transferable ICT skills. The education system, together with the ICT sector in Sri Lanka have provided the necessary qualifications, skills and experience for ICT professionals to be capable of competing in the global labour market. At the same time, the global ICT presence within the Sri Lankan market, the ability of Sri Lankan professionals to work with foreign clients, the exposure to foreign assignments and foreign companies – while working in Sri Lanka have paved the way for their high demand. However, migration within the ICT industry is also very much determined by the cyclical ups and downs of the global market. As noted by respondents, when the Sri Lankan economic crisis occurred, a heavy demand existed globally for ICT workers, but the demand can be very volatile.

Apart from the cyclical highs in departures of ICT sector workers for foreign employment, the pandemic and subsequent economic conditions during 2022-2023 further propelled out-migration from the industry. Parallel to out-migration, ICT sector workers' mobility was seen within Sri Lanka, where many moved from one company to another during 2020-2022 or formed their start-ups after working within one company.

Qualitative information suggests that among ICT professionals, mid-career professionals with 3-5 years of experience in the ICT field, aged 25-40, have a high tendency to migrate. This age cohort, particularly mid-career professionals, is driven by a sense of urgency to secure their future by reaching a more prosperous country earlier in their careers. These sentiments were exacerbated by concerns about corruption, lack of transparency, and overall governance issues, all of which young professionals were keen to avoid in Sri Lanka. Information collected for this analysis also shows that political instability and new tax regulations have further contributed to these motivations to migrate. The introduction of Personal Income Taxes (PIT) into an industry which was previously tax-free has resulted in professionals being mostly affected as they are now taxed at 36%.

The industry identifies these professionals as crucial middle layers within organisations, with experience and skills vital for their companies. By working in these crucial roles within a globally integrated ICT sector in Sri Lanka, such professionals have acquired as well as signalled their globally transferable skill sets. This has made mid-career professionals from Sri Lanka's ICT sector to be in

high demand in the global market. This pattern, seen in all companies interviewed, regardless of the size, organisational structure or area of speciality, also serves as a pull factor that makes their departure from the local market quite easy.

For younger professionals, a great push factor was the peer and parental pressure towards migration. Similarly, family pressure is seen towards migration where young professionals with more experience were motivated to seek better prospects for their children in foreign countries. These pressures that were high during 2022-2023 still exist, especially among young professionals at mid-level career and skill attainment. Apart from the rise in ICT professionals seeking work opportunities abroad, a high number of ICT professionals also migrate under student visas as postgraduate students. However, they are highly unlikely to return to Sri Lanka once their studies are completed, as student visas are sought as an interim path for employment and subsequent citizenship overseas. Thus, the promise of better economic prospects and a deep-seated naturalised idea that "the grass is much greener in the West" drive such talent away much faster during a crisis.

The spike in migration following the pandemic also coincided with the advancements in digital technology and the popularisation of the 'Work from Home' (WFH) culture, which enabled ICT professionals to work from various locations. This flexibility encouraged countries with strong technology sectors to actively seek skilled workers from other countries by offering remote or hybrid work arrangements.[18] This has led to a new trend of 'virtual brain drain', where the worker physically remains in their home country, while contributing to the gross domestic product (GDP) of another country. The widespread use of the WFH concept has led professionals to enjoy placements in companies abroad and earn wages in foreign currencies without the extra burden of migrating. This also provides the wage earner with a higher standard of living as they will be spending foreign earnings in local currency and remaining in their home setting.

10.3.3 Impacts of Brain Drain on the ICT Industry

The departure of a trained and skilled professional from a firm leads to many challenging impacts. Similarly, when such professionals leave the country and the sector, at times, the implications go beyond the firm and the sector and have spillover effects on the economy. Over the past couple of years, a high number of skilled ICT professionals have left ICT companies, with migration accounting for a considerable portion of the departures. One ICT company respondent quantified that approximately 75% of the staff turnover in the firm was due to brain drain. The issues related to brain drain from the ICT sector, as highlighted in qualitative data, are discussed below.

One of the key implications of brain drain is finding replacement personnel with niche skills comparable to those leaving. This problem has been identified by companies across-the-board including top ICT companies, global companies, companies that were slowly moving from small scale to large scale and companies that were solely product-based, solely service-based or a mix of both. Out-migration was a common topic among this diverse cross-section of companies.

18 Metin, Furkan., & Ertan, Hatice. (2022). The Brain Drain of IT Professionals: Register Evidence of Non-Return Graduates from Türkiye. *Bogazici Journal*. 36. 10.21773/boun.36.2.2. In Tansel, A., & Güngör, N. (2003, April 1); "Brain drain" from Turkey: Survey evidence of Student Non-return. *Career Development International*, 8(2), 52-69. https://doi.org/10.2139/ssrn.441160

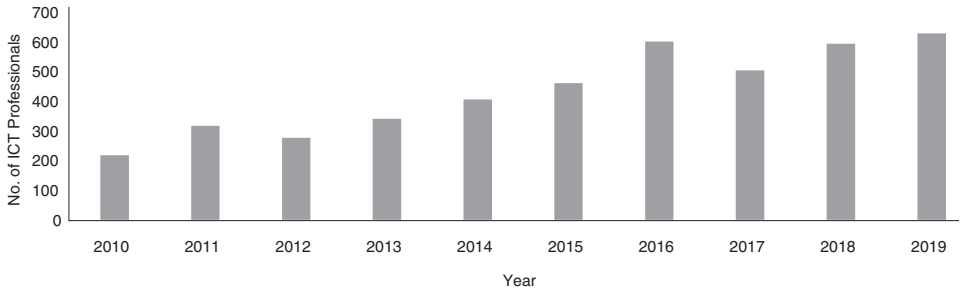
But at the same time, despite having some skills, ICT companies were accustomed to outsourcing niche skills that they lacked. While migration was depleting the skills in ICT companies, the simultaneous shortage of niche skills in the labour market further compounds the problem, making it challenging for firms to find suitable candidates within the local talent pool for replacements. While there may still be an adequate supply of talent for some roles, the scarcity of individuals with expertise in specialised areas poses a significant obstacle. This also shows a skills mismatch in the sector. Respondents from key informant interviews (KIIs) have identified that finding niche skills in software development aspects, though hard, is relatively less challenging compared to aspects such as "DevOps and other IT-related system engineering roles". While finding replacements for niche talent is common problem across the industry, the extent to which out-migration has impacted companies differ largely depending on the scale of their business, the type of services provided and the organisational structure. Some strategies adopted by firms to address this include managing with in-house resources – i.e., retraining/repurposing existing personnel as well as attracting new talent. However, as noted by respondents, this strategy involves some degree of interruption to the company's operation but is mostly managed without major implications on the clients or their products and services. Similarly, ICT companies with larger teams spread across many countries have synergies to mix skills across branches in other countries as a strategy to face brain drain. This strategy, in a way, has been comparable to a virtual inward migration of talent/or outsourcing a component of the process to an employee.

The spike in migration following the pandemic also coincided with the advancements in digital technology and the popularisation of the WFH culture, which enabled ICT professionals to work from various locations. This flexibility encouraged countries with strong technology sectors to actively seek skilled workers from other countries by offering remote or hybrid work arrangements. This has led to a new trend of 'virtual brain drain', where the worker physically remains in their home country while contributing to the GDP of another country.

Within organisations, the exodus of experienced professionals has led to a loss of valuable knowledge, especially given the industry practice of relying on tacit knowledge rather than explicit documentation – i.e., in many cases, knowledge gained is not explicitly documented but rather resides with individuals themselves. When an experienced professional departs, they take with them a significant portion of this tacit knowledge, leaving behind a gap that is challenging for the firm to fill. Therefore, the departure of experienced professionals requires not only finding replacements but also developing strategies to preserve and transfer tacit knowledge within the organisation to ensure a seamless operation of ongoing projects. At the same time, the departure of experienced persons depletes the quality and quantity of role models or mentors within an organisation to guide and develop young talent.

In addition to the above-discussed firm-level micro implications, there are sector-wide implications,, where the departure of professionals results in the local talent pool diminishing, create challenges in finding suitable replacements and hinder the sector's growth potential. The ICT Skill Gap Analysis Report released by the ICT Industry Skills Council (ICTISC) shows a significant out-migration with rising numbers over the years (Figure 10.2). During 2010-2019, out-migration accounted for 4,375 departures from the ICT sector. This contrasts with the recent data on migration during the crisis, which accounts for an estimated 10,000 ICT professionals. In 2019, about 50% of the migrants in that year migrated for higher level jobs such as software engineers and computer programmers. This migration happened when the ICT sector in 2020 was expecting a skill-gap of 248,517 in two years.[19]

Figure 10.2
Trends in Out-Migration



Source: ICT Skill Gap Analysis Report, ICTISC.

As such, challenges stemming from both talent shortage and high turnover rates within the market lead to a 'talent war', where demand exceeds supply, resulting in inflated costs for hiring and potential dissatisfaction among internal team members when wage disparities take place between new incoming and continuing talent. Inflated wages have also become an issue for maintaining similar or the same level of salaries across the board, with industry stakeholders noting problems arising as a result. Despite these challenges, organisations have managed to navigate disruptions with in-house resources and newly attracted talent. However, the operation has not been without interruptions, underscoring the ongoing impact of brain drain on Sri Lanka's ICT industry.

10.3.4 Strategies to Remain Resilient

Fast-tracking: A strategy used by most companies is fast-tracking fresh recruits and continuing talent, and enabling the fresh recruits and those continuing in lower layers to fill in the gap in skills that have arisen due to the migration of professionals in the middle layer with 3-5 years of experience in their respective skill areas. For these strategies, some companies provide training and mentorship for everyone entering mid-level (skill and experience-wise) to fill in the talent lost due to out-migration. One stakeholder explained their strategy, that due to brain drain, they promote the junior level

19 *Skill Gap Assessment of the ICT Sector in Sri Lanka*, https://www.tvec.gov.lk

employees to senior and senior level employees to the lead level with leadership training programmes. Moreover, some companies have identified the potential of fresh ICT graduates, who can easily be trained and mentored within companies for future roles when hired as interns.

Challenges stemming from both talent shortage and high turnover rates within the market lead to a 'talent war', where demand exceeds supply, resulting in inflated costs for hiring and potential dissatisfaction among internal team members.

Minimising flight risk: Simultaneous to attracting new talent, certain companies are also focused on detecting those who are at a higher 'flight risk' to provide them with specific upskilling or training that help them prosper within the current companies and decrease the push factors that promote their departure from the company/Sri Lanka.

These initiatives focus on developing junior-level employees to take on higher responsibilities and grow within their roles, specifically to 'nurture talent in-house'. To achieve this, companies have provided on-the-job training as well as up-skilling employees through training and certification. Additionally, some companies have introduced policies where senior team members have dedicated time to mentor and guide junior employees, and pay extra attention to giving due recognition to mitigate any feelings of being left behind and unappreciated and to motivate employees to stay longer with the company.

Factoring in potential brain drain into timelines: Moreover, to minimise the impact on ongoing projects from resignations, some companies have pre-emptively acknowledged the disruption it can cause to project timelines, scope, and costs. This has been crucial in adapting to stresses due to brain drain. In this context, strategies such as allocating additional hours to manage the resulting workload amidst staff issues during the project planning phase have been one strategy adopted. This approach aims to minimise the impact of staff turnover on project continuity and overall productivity and could require everyone to commit to some additional hours to manage any extra work. Additionally, companies have worked towards fostering a collaborative work environment where managers and employees work together towards common objectives instead of managers restricting themselves to giving instructions for workers/second level to carry out. The ethos is that everyone puts in the maximum effort towards a pre-defined plan that has been communicated.

Allowing remote working: Another solution that emerged from the qualitative interviews was adapting to the remote work arrangement by implementing a hybrid work model – where work takes place both on and off-site – allowing employees to continue contributing to the organisation from abroad even after departure from Sri Lanka and the firm, especially if they migrate as students. However, challenges arise when employees leave for higher education, especially among young graduates, as working and studying full-time is challenging. When employees pursue further education, particularly advanced postgraduate degrees, they often face constraints that prevent them from continuing their employment. Consequently, organisations must address this challenge by finding replacements for departing employees and adapting their workforce strategies to accommodate the educational aspirations of their workforce.

Moreover, some individuals who migrate may still work for the organisation through 'work benches' which is a classic example of platforms that support remote work arrangements, enabling collaboration with individuals located in various geographical locations. This also suggests that such platforms facilitate collaboration with external developers or teams, allowing the organisation to leverage external expertise when needed. This outsourcing arrangement could provide firms with access to specialised skills or resources that may not be available internally. According to KIIs, certain stakeholders find this type of new modalities to be very efficient, for they deliver on time due to the inbuilt rating mechanisms in these platforms. As such, the higher cost of using such platforms is offset by the efficiency benefits they bring. This is, in essence, a reverse flow of virtual brain drain.

Making compensation more attractive: In terms of compensation and benefits, companies have faced challenges such as high inflation and significant currency depreciation. During such times, many companies within the industry have pegged the salaries to the USD. This was done to buffer salaries from depreciating their real values, given that some employees, particularly those tied to foreign companies, preferred salaries in USD. Despite limitations in USD earnings, most companies have tried to provide competitive salary increases to address talent retention.

However, big companies with a workforce exceeding 1,000 employees have found it hard to peg salaries to the USD due to financial reasons. Such large companies have also faced challenges in matching the rising market wages that smaller companies offer when hiring experienced talent. Despite offering such higher wages, smaller companies at times have faced both a shortage of such experienced and niche talent to recruit as well as a gap in talent expected by firms and those possessed by the recruits.

Overall, it is imperative to distinguish between reactive and proactive retention strategies in the context of addressing brain drain. For instance, reactive strategies include fast-tracking and enabling lower-level employees to fill skill gaps. In contrast, proactive strategies involve developing junior-level employees for higher responsibilities, and proactively addressing potential talent loss by offering competitive salaries. Moreover, proactive approaches tend to yield higher success rates, as these involve identifying potential flight risks among employees through analytics and intervening before they pursue opportunities elsewhere.



10.4 Tackling Brain Drain in the Recovery Phase

The themes related to brain drain discussed in the ICT sector are not exclusive to it. Rather, it affects various sectors, leading to the loss of tacit knowledge, shortages of niche skills, widening skills gaps and increased hiring costs in all affected industries. Importantly, the decision to migrate often stems from economic instability, political issues, and social pressures. Addressing these systemic issues through comprehensive policies is essential to mitigate brain drain across all sectors. Similarly, firm-level proactive approaches are necessary to retain the skills, while reactive approaches are needed to fill the skill gap.

10.4.1 Addressing Skill Gaps, Retaining Talent and Expanding Opportunities

Enhance the local talent pool: To compensate for brain drain, it is important to focus on enhancing the local talent pool. Despite the ongoing migration trends supported by accelerated professional and student visa categories, the skill gap is expected to increase. However, increasing the quantity of graduates in formal education alone may not suffice, as finding individuals with the right talent remains challenging.

Similar to the ICT sector, human capital development in other sectors, especially the health sector, is primarily undertaken within Sri Lanka. Yet, all sectors face significant global demand for such skilled professionals, resulting in a substantial outflow of talent as professionals seek better opportunities abroad. Consequently, while the country invests heavily in training professionals, other countries, too, often gain benefits, leading to challenges in retaining skilled labour and addressing domestic needs effectively. Thus, these recommendations are segmented by short- to medium-term versus long-term efforts for retaining and developing talent.

Acknowledging the inevitability of migration and brain drain, efforts should focus on mitigating its impact while simultaneously addressing the critical shortage of professionals. Therefore, in the short- to medium-term, efforts should be made to raise awareness among youth about the potential training and skills development needs and opportunities. Similarly, employment opportunities. (both in Sri Lanka and abroad) in specific fields with a high risk of brain drain in Sri Lanka, need to be highlighted with the view to increase new entrants to these fields. The expansion of human capital with the intention of migration can lead to brain gain when the supply of such developed human capital is greater than the demand from overseas, and the excess can contribute to the local economy.

Thus, in the short-term, prioritising intensive training programmes and targeted upskilling initiatives can swiftly bridge existing skill gaps in critical sectors. These initiatives should be tailored to address specific industry demands, ensuring a rapid response to immediate workforce gaps. Furthermore, there is a need to rethink the educational pathways and certifications required for entry into demanding fields. Rather than being fixated on traditional qualifications such as degrees, education and skills development systems should also include alternative certification pathways such as multiple levels of National Vocational Qualifications (NVQ) and Recognition of Prior Learning (RPL). Such pathways can easily and quickly top up credentials of talent to fill in skills gaps created due to brain drain and provide a more accessible route for individuals who may have stopped formal schooling at a younger age and can no longer access traditional educational pathways for human capital development.

Additionally, a huge untapped potential exists in experienced and skilled personnel without full qualifications. Therefore, Sri Lanka should harness the potential of interns and apprentices. In the short-term, to address the current talent shortage, the private sector can sponsor skill development initiatives such as offering apprenticeships. Meanwhile, the government can guide private sponsors by providing information on available opportunities, highlighting areas with skill gaps, and identifying specific needs within the industry.

In the long-term, it is advised to prioritise equity when expanding the pool of local talent by giving everyone access to resources and education. This will help to keep a larger pool of individuals interested in as well as the ability to support the local economy in Sri Lanka. This could involve establishing greater support systems for institutes outside of major cities, ensuring they receive greater government backing and access to quality education and skills development resources.

Moreover, looking ahead, a more sustainable approach involves overhauling Sri Lanka's education system to better align with evolving industry demands. This entails a strategic emphasis on STEM education,[20] and research programmes, laying the foundation for a skilled workforce to be equipped to meet future challenges. These efforts could also include involving overseas Sri Lankans talented in their specific fields in a mechanism for 'giving back' to Sri Lanka. Collaboration between industry professionals, government authorities, and educational institutions is essential to implement these recommendations effectively.

Improve the effectiveness of existing mechanisms for talent retention: As evident from the ICT sector case study, talent retention within the country can take either the form of reactive or proactive approaches. Reactive approaches are widely seen in the healthcare sector, such as medical doctors

20 STEM denotes Science, Technology, Engineering and Mathematics areas of study.

being tied to a bond when seeking foreign training or making healthcare professionals ineligible for the five-year no-pay leave scheme for public sector workers to go abroad. If Sri Lanka is to continue with financial bonds or rules and regulations as a mechanism to retain talent, it is important to make the bond amount commensurate with the public investment already made in developing the talent seeking foreign entry. As long as the bond amount is lower than the value of the human capital investment made by the state, law-abiding talent would aim to pay up the bond and leave Sri Lanka, making the retention intention of the mechanism ineffective. Similarly, as long as the punishment for violating the bond is lower than the potential gain from violating the bond, and the probability of getting caught violating the bond is low, the risk-taking type of talent will be motivated to leave Sri Lanka, disregarding the bond. As such, if Sri Lanka aims to retain human capital development through rules, regulations and bonds, it is critical to first appropriately value and set the bond amounts plus rules and regulations appropriately. Secondly, it is important to develop institutional capacity and mechanisms with a high probability and credibility to identify and punish violators of such rules, regulations and impose bonds to effectively retain talent.

At the same time, there are limited broad-based proactive mechanisms to retain talent in Sri Lanka. The talent retention strategies in the ICT sector show that upward mobility within a firm is a key proactive strategy to improve employee satisfaction and talent retention. As such, it is important to develop an environment for firms to grow, expand, and provide greater opportunities for its workers. At the same time, as seen in the ICT sector, it is important to encourage a culture where the private and public sector enables a fast-track of employees' upward mobility. This is especially a barrier to retaining public sector talent, where public sector rules and regulations and seniority norms often hinder new or junior recruits' promotions or salary increments. For instance, traditionally, medical professionals stagnate for several months before their post-internship medical appointments are finalised by the Management Service Commission. In this context, it is important to develop an enabling environment in public and private sector employment for wages, wage increments, professional development and promotions (professional upward mobility) to be handled efficiently using a productivity-based mechanism instead of a seniority-based one.

Securing talent amidst political and economic uncertainty: The recent high cost of living amidst the high taxes is cited as a significant factor contributing to the migration of workers, including in the information technology (IT) sector. Many high-income earners resisted the government's move to collect taxes from those earning over Sri Lankan Rupees (LKR) 100,000 a month, leading to widespread protests. As was evident from ICT sector experts, all professionals emphasise the importance of transparency in government spending, stating their willingness to contribute taxes if they can see how the funds are being utilised. Thus, creating trust would be an important proactive measure. Professionals who perceive their contributions as meaningful and impactful will likely remain in the country. Thus, Sri Lanka can encourage investment and retention of skilled professionals through improved transparency.

Attracting more investment opportunities: To proactively address the brain drain, attracting investments that encourage job creation and economic expansion within the country is crucial. These investments should be channelled towards creating opportunities for professionals to excel locally, thereby minimising the incentives for migration and providing avenues for returning individuals to contribute.

For this, Sri Lanka must have sound infrastructure, a talent pool, and political stability to facilitate such endeavours. This underscores the necessity of recognising the challenges and limitations in scaling businesses within Sri Lanka. For instance, local governments in China have implemented special policies to attract overseas Chinese students, including establishing pioneering parks for overseas Chinese students. Sri Lanka needs to actively articulate its competitive advantages, including that of the IT sector, as stakeholder feedback indicates a lack of awareness of Sri Lanka as a destination for IT/business process management (BPM).

By enhancing infrastructure convenience, such as improving transportation networks, accommodations, and other amenities, Sri Lanka can make itself more appealing to potential investors. For example, the Colombo Port City offers investment prospects across multiple industries, which act as a pivotal hub that facilitates connections between Sri Lanka and global markets. Additionally, by showcasing the country's attractiveness as a tourist destination, the potential as a lucrative market for businesses can also be highlighted, particularly those that are directly and indirectly connected to tourism.

10.4.2 Facilitating Returnees and Diaspora Engagement

Sri Lanka has a vast, untapped opportunity to enhance its talent pool by proactively engaging with its overseas Sri Lankans (OSL). By implementing policies and initiatives aimed at facilitating OSL's return, such as streamlining flexible immigration policies and enhancing the dissemination of relevant information, can contribute to enhance the talent pool in Sri Lanka.

The current return and reintegration support provided in Sri Lanka caters minimally to professionals returning or those returning after a long stay overseas. Qualitative interviews did point to some successes, where assistance with practical matters like taxes, housing, and domestic help was provided to professionals to facilitate their return. Some of the success stories of those who have returned to Sri Lanka after working abroad or studying abroad underscore the potential for returning migrants to contribute to the local economy. In the face of rising anti-immigrant sentiments abroad, particularly in Western countries, such initiatives could induce more Sri Lankan professionals, including those with significant experience and financial stability, to consider returning home. They can bring valuable skills and expertise from working abroad at prestigious companies. Therefore, creating welcoming and supportive programmes to encourage these returnees to contribute to local industries can help mitigate the effects of brain drain and foster economic growth in Sri Lanka. For example, the existence of major ICT companies in Sri Lanka that return migrants started is a key example that brain drain can in fact, be turned into a long-term investment source if duly handled.

Indeed, a notable feature during stakeholder interviews was that out-migration can sometimes be seen as a blessing if handled correctly. Since migration is a personal choice, retaining such talent is difficult. For example, as experienced by the ICT industry, regardless of the many attractive strategies ranging from financial to fringe benefits to retain these workers, some left the country. It can be suggested from an optimistic perspective that with proper interventions where necessary, these same professionals can one day become investors or open up the Sri Lankan industry for future investors through networking. Efforts to encourage permanently settled professionals to engage in industries in Sri Lanka and facilitate knowledge sharing through established professional associations should

be encouraged at the industry level. The importance of facilitating such networks and maintaining contacts with the diaspora was emphasised during qualitative interviews as a means of compensating for the loss of talent happening now.

10.4.3 Opening up to Inward Migration

Countries globally are competing to attract talented individuals, and many are actively pursuing changes in immigration policies to facilitate the entry of foreign workers who possess highly sought-after skills and expertise. By allowing skilled migrants to fill critical gaps in sectors facing shortages, Sri Lanka can ease the pressure on local resources. This ensures that essential services, such as healthcare and IT, remain adequately staffed and operational, contributing to overall societal well-being.

In the past, opening up the Sri Lankan labour market to inward migrants has attracted considerable opposition from professional organisations. Notably though, most stakeholders expressed a more positive inclination towards allowing foreign talent or allowing inward migration to address the gap in the Sri Lankan ICT market. At present, Sri Lanka imposes limitations on market access for foreign professionals, permitting the employment of foreign personnel only in cases of demonstrated local labour shortages. Medical specialists are allowed to work in Board of Investment (BOI)-approved hospitals under strict registration processes. The accounting profession, modelled after the British system, is regulated by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka). Generally, foreigners are unable to provide accounting services in Sri Lanka. Hence, currently, Sri Lanka lacks a comprehensive mechanism to verify credentials if foreign workers are allowed to come in. As such, regulating this qualification verification process effectively is crucial if inward labour migration is to be pursued in Sri Lanka.

As such, Singapore's approach is one potential model to consider, where skilled individuals from different countries are allowed to enter the local industry while ensuring regulation and priority for Singaporean citizens. For instance, in the mid-1990s, facing declining comparative advantages and economic challenges, Singapore shifted towards attracting high-skilled migrants to develop a knowledge-based economy. The Singaporean government aimed to become a global talent hub and established policies to attract, assimilate, and retain high-skilled workers. This shift in policy led to significant growth in the non-resident workforce and the assimilation of migrants, contributing to Singapore's economic transformation.[21]

Thus, Sri Lanka should conduct a labour market assessment to identify sectors with shortages and carefully open them up. Establishing a regulatory framework for inward migration is crucial, including protections for local workers and recognition of foreign qualifications.

21 Pan, J., & Theseira, W. (April 2023). *Immigration in Singapore: Background paper to the World Development Report 2023: Migrants, Refugees, and Societies,* https://thedocs.worldbank.org

10.5 Conclusion

As discussed above, economic crises profoundly impact migration patterns, triggering significant movements of skilled professionals seeking better opportunities abroad. This phenomenon raises critical questions about the permanence of human capital loss and how a country mitigates its effects. As evident in the foregone discussion, labour migration has long been an important phenomenon in the Sri Lankan economy and brain drain has been a part of it. However, the peaks and troughs of labour migration and brain drain are driven by local push factors and global pull factors. Regrettably, in the case of Sri Lanka, around 2022, all possible push factors within Sri Lanka converged with the socio-political and economic crisis and coincided with the pull factors associated with the rebound of the global economy after the COVID-19 pandemic. This led to a significant depletion of skilled and talented workers from the economy.

By mid-2024, official reports indicate that the severe out-migration of talent in some skill categories has stabilised and a reverse trend is emerging. For instance, there is an increase in the number of medical professionals such as consultant doctors, specialist doctors, nursing officers, and technical officers returning to Sri Lanka.[22] Subsequent reports note that the exodus of medical doctors has reemerged as an issue, where "nearly 400 specialists have left in the past two years, which was becoming a 'huge problem' for the Sri Lankan health sector."[23] This reflects the point that often claims of brain drain or a reversal of it are not representative of an overall trend. Rather, they reflect a sudden surge, which underscores the importance of data. The current data gaps hinder attempts to understand the extent of the initial trend of brain drain or its more recent developments. Together, these issues highlight the need for comprehensive data collection and analysis to inform effective policy responses.

In this context, the ICT sector emerges as a compelling case study to illustrate the complexities of skilled migration and its implications for national development. The issues faced and strategies adopted by the ICT sector in the face of brain drain provide ample guidance to other sectors challenged by brain drain. It suggests the importance of short-term more reactive policies to rapidly address the challenges faced by brain drain. But in the medium- to long-term, skills and talent retention and minimisation of brain drain call for more proactive strategies – and not limited to firm-wise strategies but more broad-based ones. These include improved macroeconomic fundamentals to facilitate economic growth, the upward mobility of talent within their occupations as well as improvements to the overall quality of life in Sri Lanka.

22 News briefing by Deputy Director General (Medical Services) Dr. G. Wijesuriya in Colombo on March 12, 2024. https://www.dailymirror.lk/top-story/Migrated-doctors-return-easing-shortage-concerns/155-278718

23 Director General of Health Services, Dr. Asela Gunawardena,in Colombo on July 1, 2024. https://www.dailymirror.lk/top-story/Health-Ministry-in-limbo-as-exodus-of-doctors-makes-a-comeback/155-286123

COMPETITIVENESS AND PRODUCTIVITY

11. Sri Lanka in RCEP: Harnessing Regional Integration for an Export-led Economy

11.1 Introduction

Emerging from Sri Lanka's post-2020 economic crisis, joining free trade agreements (FTAs) was chosen as the second-best option for trade liberalisation for export-led growth. The skyrocketing of the external debt-to-export ratio to 428% in 2020 clearly indicates Sri Lanka's unsustainable macroeconomic trajectory. Although early signs of growing external debt vulnerabilities began to appear post-2006 – with the external debt-to-export ratio increasing to a high but manageable level of 260% in 2012 with a debt service-to-exports ratio at a still relatively low 15.5% in the same year – appropriate measures to manage these rising vulnerabilities were ignored. By 2020, the debt service-to-exports ratio had steeply risen to 38%.[1]

Even when following a debt restructuring exercise, emerging consensus exists over the important role of export growth for sustainable economic growth and debt management for Sri Lanka. However, political and economic constraints impede the room for ambitious and comprehensive across-the-board trade reforms that foster such export growth.[2] Amidst this backdrop, a key means of implementing reforms has been through phased tariff liberalisation using selective FTAs.

Sri Lanka's expressed willingness to join mega-regional trade agreements like the RCEP and CPTPP is indicative of its ASEAN-oriented overall trade policy preference.

Sri Lanka's expressed willingness to join mega-regional trade agreements like the Regional Comprehensive Economic Partnership (RCEP) and Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) is indicative of its Association of South East Asian Nations (ASEAN)-oriented overall trade policy preference. The RCEP is a comprehensive trade agreement between ASEAN economies.[3] The CPTPP is more ambitious and deep, replacing the Trans-Pacific Partnership (TPP) after the United States (US) pulled out of the deal. If Sri Lanka's long-term ambition is accession to CPTPP, a more pragmatic and rational initial step would be joining the RCEP (see Box 11.1).

In light of the above, this chapter evaluates Sri Lanka's rationale for joining RCEP while identifying the challenges in meeting the necessary tariff liberalisation commitments. In addition, based on a comprehensive analysis of existing tariffs and trade patterns, sectors that would gain and lose from joining RCEP are identified. In this step, the basket of products with offensive interest for Sri Lanka is also identified for each RCEP economy. Despite the inclusion of services and investment sectors

1 World Bank. (2023). International Debt Statistics database, https://www.worldbank.org/en/programs/debt-statistics/ids

2 Wijesinghe, A., & Dissanayake, C. (2023). Finding the Narrow Corridor: Reforms for Export-led Growth (Ed.). In *Sri Lanka State of the Economy 2023*. Colombo: Institute of Policy Studies of Sri Lanka.

3 Includes ASEAN countries (Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam) and five ASEAN+1 FTA partners (Australia, China, Japan, New Zealand and the Republic of Korea).

under RCEP, the focus is exclusively on goods trade because of analytical constraints. The chapter is set up as follows: First, it presents Sri Lanka's economic rationale for joining the RCEP. Next, the analysis identifies industries with offensive and defensive interests against each RCEP member nation based on a thorough examination of current tariffs, exports, imports, and Sri Lanka's sectoral labour force. The challenges of tariff liberalisation – including revenue loss, a higher trade deficit, influence on the labour market by sector, and impact on domestic output – are covered in detail. A concluding section addresses policy proposals.

11.2 RCEP in the Global FTA Landscape

The inception of the RCEP took place in 2012 at the ASEAN Leaders' Summit, in which ASEAN foreign partners – Australia, China, Japan, South Korea, and New Zealand – and India also attended. In the negotiation process, no country was given leadership in constituents of the agreement, irrespective of the heightened geopolitical tension and the US trade war against China. The absence of political acceptance of the leadership of China or Japan – the economic powerhouses in the region – was resolved by the ASEAN leadership in the negotiations process.[4] Nearly every element of the RCEP framework was from ASEAN's past trade agreements. Each chapter had two co-leads; one from ASEAN and one from ASEAN's foreign partners.

A possible China-centricity in the RCEP – in geopolitical sense – was counterbalanced by the presence of Japan. In addition, until India pulled out at the last moment in 2019, India participated in all rounds of negotiations from the launch to the early stages. India's decision to withdraw from RCEP was not only motivated by geopolitics but also based on the economic interests of India. The rules of origin (ROO) that would allow content to be cumulated from outside of India, the other RCEP countries' insufficient service commitments, India's protectionist interests in the domestic food sector, and India's difficulty in accepting cross-border movement of people were possible reasons for the withdrawal.[5]

The RCEP is a comprehensive regional trade agreement (RTA), yet falls short of the more ambitious CPTPP in a few but sensitive areas like provisions for labour rights and environmental safeguard measures. The broad objectives of the agreement are to establish a modern, comprehensive, high-quality, and mutually beneficial economic partnership framework; progressively liberalise and facilitate trade in goods among the members; progressively liberalise trade in services among the members with substantial sectoral coverage; and create a liberal, facilitative, and competitive investment environment in the region.[6]

The RCEP members agree to lower tariffs on goods, implement trade facilitation, open up service sectors, and enhance the business environment through regulations covering areas such as

4 Petri, P. A., & Plummer, M. (2020). *RCEP: A New Trade Agreement that will Shape Global Economics and Politics*. Order from Chaos [BLOG].

5 Sharma, S. K., Narayanan, G. B., Dobhal, A., & Akhter, R. (2023). Evaluating the Reasons for India's Withdrawal from RCEP: A General Equilibrium Analysis. *The Indian Economic Journal*, 71(3), 508-531; Elms, D. K. (2021). Getting RCEP Across the Line. *World Trade Review*, 20(3), 373–380.

6 New Zealand Foreign Affairs & Trade. (n.d.). *Legal Text: Regional Comprehensive Economic Partnership Agreement*, https://www.mfat.govt.nz/assets/Trade-agreements/RCEP/RCEP-Agreement-Legal-Text.pdf

intellectual property protection, government procurement practices, and e-commerce. The RCEP is described as a 'living agreement' because it sets the stage for ongoing negotiations to introduce changes if the agreement does not deliver the intended positive outcomes.[7] More importantly, the negotiation process and implementation are characterised by a unique 'ASEAN way' allowing for pragmatism and flexibility.

From the outset, the RCEP was built based on an established set of FTAs between the ASEAN economies and their dialogue partners. These were incentivised to unify various trade agreements in the region as the proliferation of FTAs created a potential negative effect on trade growth from the so-called 'noodle bowl' effect. By 2012, the most important trade agreements in the ASEAN region were tagged 'ASEAN+1'. These agreements tied the 10 ASEAN economies with their dialogue partners like Australia, China, Japan, India, New Zealand, and South Korea, the so-called 'ASEAN Foreign Partners'. Unifying them into one common framework was considered mutually beneficial to lower trade costs in moving goods and services and generate substantial economic gains.

Box 11.1
Sri Lanka's Choice Between RCEP and CPTPP

The TPP was the centrepiece of US policy to 'Pivot to Asia', which was negotiated under the Obama administration with 11 other economies, including Australia, Canada, Japan, and Vietnam. Thereafter, President Trump pulled the US out of TPP, a move aligned with his campaign promise for a more protectionist trade policy. Despite the setback, other countries moved forward as CPTPP and signed the agreement in 2018.

Among the two-mega regional agreements, the CPTPP is more comprehensive in coverage and deep in tariff elimination. Once fully implemented, 99% of tariff lines among CPTPP members will be duty-free. The depth of tariff reduction in the RCEP is less ambitious than CPTPP, as the average coverage is 94% of tariff lines. The inter-country variation is sizeable as countries like Singapore have close to 100% tariff elimination while less-developed countries like Lao PDR, Cambodia, and Myanmar eliminate only up to 86-87%. Considering the manufacturing tariff lines, CPTPP eliminates all, but RCEP covers only 92% of the total. Although RCEP coverage on service liberalisation is narrow, CPTPP opens up 160 service sectors.

A common tariff concession rule applies to all members of CPTPP, but RCEP allows differential preferential treatment by country-pairs. However, agricultural safeguards are allowed in the CPTPP. For example, Japan applies a separate agricultural safeguard measure to import special agricultural products like beef from other countries. In contrast, by the end of RCEP's negotiation process, preparing 38 multiple tariff schedules required lengthy timelines to phase-out.a Australia, Brunei, Cambodia, the Lao PDR, Malaysia, New Zealand, Singapore, and Thailand have a single tariff schedule. China, Indonesia, the Republic of Korea, the Philippines, and Vietnam produced separate tariff schedules. The application of tariff differential is a complex process when production

7 Congressional Research Service. (2022). *Regional Comprehensive Economic Partnership (RCEP),* https://crsreports.congress.gov/product/pdf/IF/IF11891

occurs in multiple countries. Determination of the originating country is governed by specific clauses in each country's tariff schedules, which are complex and hard to administer.

A comparison between the two agreements shows that CPTPP is more comprehensive, less complex, and administratively easy. However, these features counteract negotiator's constraint, i.e., protecting domestic interest groups and minimising the labour force impact of tariff liberalisation. The flexibility to offer differentiated tariff schedules, maintaining about 15% of tariff lines in the uncommitted list of goods trade, and scope to protect service sectors will make RCEP the most feasible option for Sri Lanka politically and economically. The RCEP also offers flexibility for differential timelines and pathways to reduce tariffs, allowing Sri Lanka to phase-out tariff liberalisation for a longer period. Thus, the logical and feasible path towards CPTPP is through tariff liberalisation using RCEP for a period of 20 years as the starting point. This way, it allows Sri Lanka a less costly adjustment process.

Source: a. Elms, D. K. (2021). Getting RCEP Across the Line. *World Trade Review*, 20(3), 373–380.

Considering the perspective of Sri Lanka, it deviates substantially at this juncture as a potential accession partner. Sri Lanka is an outsider to the ASEAN+1 community, which adds to the complexity of negotiations. On a positive note, the country has successfully concluded FTAs with two ASEAN economies – Singapore and Thailand – while initial work for more trade agreements with Indonesia, Malaysia, Vietnam, and China is currently underway. Nonetheless, RCEP's diverse members with heterogeneous economic development levels and overlapping comparative advantages with Sri Lanka make RCEP a complex trade deal for Sri Lanka to join. It demands a meticulous analysis of the tariff liberalisation commitments Sri Lanka will have to undertake to modify the current incentive structure, the possible industries that would gain from RCEP membership, and the challenges brought on by the RCEP's trade liberalisation costs.

11.3 Joining RCEP: An Economic Case for Sri Lanka

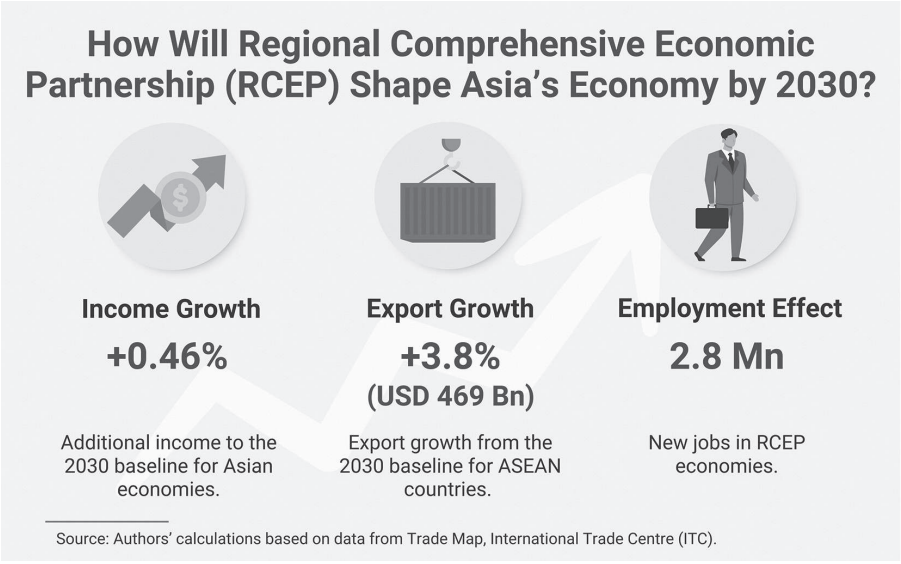
Sri Lanka has direct and indirect incentives to join RCEP. Direct incentives are potential macroeconomic benefits, including stable growth in gross domestic product (GDP), employment, and exports in extensive and intensive margins. Currently, Sri Lanka lacks a general equilibrium model to measure the direct impact of the macroeconomic effects.

Existing estimates of RCEP impacts on member economies show positive macroeconomic effects.[8] Import tariff reduction alone is estimated to increase the real GDP of RCEP countries by United States Dollars (USD) 54 billion (Bn). Lowering of ad-valorem equivalent tariff in service trade, increased logistic performance, and investment commitments suggest an additional rise in real GDP. With much optimism about the synergistic effects, RCEP is projected to add 0.06 to 0.39 percentage points of

8 Itakura, Ken. (2022). Impact of the Regional Comprehensive Economic Partnership (RCEP): A Global Computable General Equilibrium (CGE) Simulation. *Economic Research Institute for ASEAN and East Asia*.

real GDP growth annually to the baseline economic growth of RCEP economies from 2020 to 2035.[9] Increased trade in intermediate and service sectors is expected to transform into a higher trade volume.

Affirming the above, an Asian Development Bank (ADB) study also shows substantial gains from RCEP for its members.[10] Simultaneously, a comparison with CPTPP shows that the world economy, too, gains more from RCEP. The RCEP's outperformance of CPTPP is explained by the economic size of RCEP, baseline economic integration through ASEAN and ASEAN+1 trade arrangements, and higher intra-regional trade compared to CPTPP (Table 11.1), and the inclusion of bilateral liberalisation between South Korea, Japan, and China. The general equilibrium assessment reveals that RCEP will add 0.46% more income to the 2030 baseline in Asian economies. The projected real income effect on RCEP members is 0.6%.[11] The export increase from RCEP for ASEAN economies from the 2030 baseline will be 3.8% or amounts to around USD 496 Bn. The employment effect of RCEP on the RCEP economies is roughly 2.8 million (Mn) jobs, with employment and wage effects concentrated in more competitive countries like Vietnam. More importantly, the largest percentage gains of the income increase are expected in poorer countries – Cambodia, Lao PDR, and Myanmar – due to increased access to new regional supply chains. Likewise, joining RCEP will pave the way for Sri Lanka to join the regional supply chains.[12]



9 Itakura, Ken. (2022). Impact of the Regional Comprehensive Economic Partnership (RCEP): A Global Computable General Equilibrium (CGE) Simulation. *Economic Research Institute for ASEAN and East Asia*.

10 Park, C. Y., Petri, P. A., & Plummer, M. G. (2021). *Economic Implications of the Regional Comprehensive Economic Partnership for Asia and the Pacific* (No. 639). ADB Economics Working Paper Series.

11 Park, C. Y., Petri, P. A., & Plummer, M. G. (2021). The Economics of Conflict and Cooperation in the Asia-pacific: RCEP, CPTPP and the US-China Trade War. *East Asian Economic Review,* 25(3), 233-272.

12 *Ibid*.

Table 11.1
Comparison of Key Economic Indicators Between RCEP and CPTPP

Indicator	RCEP	CPTPP
Economic size (GDP current USD Bn)	29,459.9	11,667.8
Population (Bn)	2.3	0.5
Intra-regional trade	44%	16%
Sri Lanka's imports (Total USD Bn)	6.9	2.6
Sri Lanka's exports (Total USD Bn)	1.2	1.4
Trade deficit (USD Bn) (Exports LKA-Imports LKA)	-5.7	-1.2

Source: Authors' compilation using data from Trade Map and World Development Indicators (WDI).

While the above-explained projections of the RCEP members' economic advantages are promising, doubts remain about whether Sri Lanka will equally benefit from these. Notably, RCEP served to unify already tightly integrated economies on intra-regional trade in the region and their trade partners. For all these economies with existing trade agreements, baseline trade frictions were low, while the existing production networks were higher. As Sri Lanka lacks this base effect, its benefits will rely on the depth of tariff commitments and success in attracting investments to the country. In addition, the gains will materialise after a substantial time lag as developing trade linkages and joining manufacturing value chains typically take time. However, it is encouraging that the estimates discussed in the above-mentioned studies show that RCEP lowered manufacturing tariffs and non-tariff barriers in sectors like textiles, apparel and vehicles, generating higher sectoral gains. The sources of Sri Lanka's possible economic gains, namely export growth and employment from RCEP, depend on the coverage of tariff liberalisation on goods Sri Lanka produces with a comparative advantage, access to regional manufacturing value chains (RVCs), increased service trade, and further investment.

Sri Lanka's strongest economic case for joining the RCEP is the potential to link to members in the RVCs. Sri Lanka's stagnant product space around low-tech manufacturing, slow export growth, and declining value chain participation necessitate joining manufacturing value chains. Empirical studies provide strong evidence for RCEP's ability to foster and deepen RVCs among the members. Known as a 'value chain accelerator', the RCEP has encouraged both backwards and forward RVC involvement as well as the depth of RVCs. Significantly, an increased propensity is evident to 'produce for the region' and 'buy from the region' in China, Japan, and Korea.

Known as a 'value chain accelerator', the RCEP has encouraged both backwards and forward RVC involvement as well as the depth of RVCs. An increased propensity is evident to 'produce for the region' and 'buy from the region' in China, Japan, and Korea. Much notable RVC deepening has occurred in member countries' textile, apparel, leather, automotive, and food industries.

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Evidence exists for substantial gains in exports if RCEP partners eliminate tariffs for Sri Lanka. For instance, in the case of Sri Lanka-Thailand trade, it is estimated that a complete tariff elimination by Thailand would boost Sri Lanka's exports by 38% from the base year.[14] Estimates under a similar hypothetical scenario show that Sri Lanka will gain 42.3% more exports to China, increasing exports from USD 447.1 Mn in the base year to USD 636.1 Mn post-FTA (Figure 11.1). Although a complete elimination is unlikely, product-level results show that Sri Lanka stands to gain if offensive products are included in tariff cuts. For example, the Sri Lanka-Thailand Free Trade Agreement (SLTFTA) signed in 2024 covers only up to 85% of tariff lines in the tariff liberalisation plan. Still, Sri Lanka managed to get 94.5% of its offensive list covered in Thailand's tariff commitments (Table 11.2). Many of these products are not traded bilaterally by the time the SLTFTA was signed. Thus, if the expected export connections are made, Sri Lanka's exports will grow in extensive and intensive margins.[15]

Table 11.2
Distribution of Products in Sri Lanka's Offensive List As Per SLTFTA Concessions

Concessions Received from Thailand	Number of HS Codes (Eight-digit)[a]	Imports by Thailand in 2022	
		Value (USD Mn)	% of Total Imports
Uncommitted	25	3.6	4.2
Immediate concession	71	3.5	4.0
Phase-out	361	7.2	8.3
Total	457	14.4	16.5

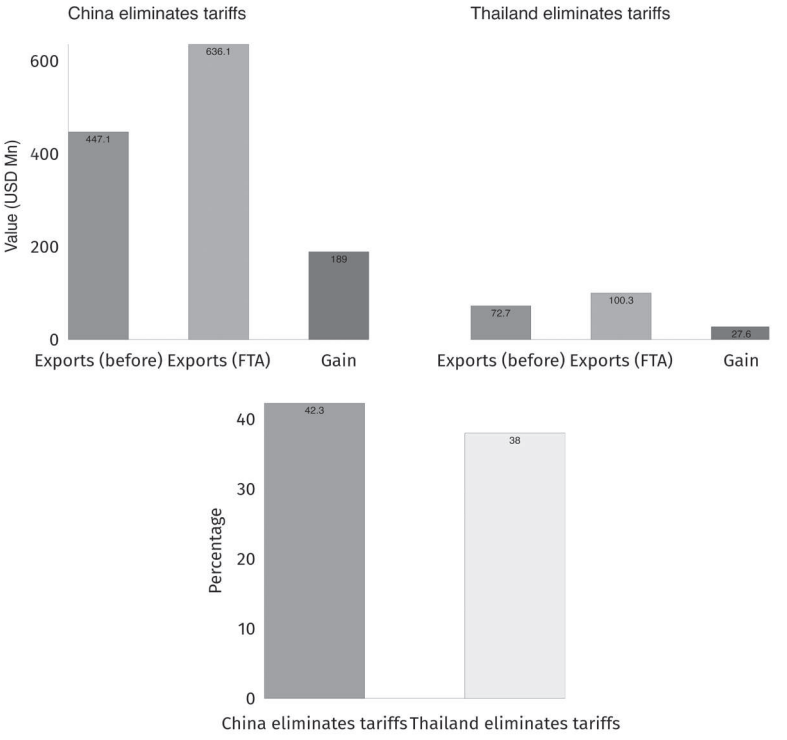
Note: a. HS codes denote Harmonised System codes.
Source: Authors' calculations.

13 Sun, K., Xiao, H., Jia, Z., & Tang, B. (2023). Estimating the Effects of Regional Value Chains of the RCEP in a GVC-CGE Model. *Journal of Asian Economics*, 88, 101647.

14 Wijesinghe, A., & Rathnayake, N. (2023). *Unveiling Trade Potential: An Ex-Ante Analysis of the Sri Lanka-Thailand Free Trade Agreement.* Colombo: Institute of Policy Studies of Sri Lanka.

15 Based on IPS Talking Economics blog -Wijesinghe, A. (2024). Unlocking Trade Potential: How the Sri Lanka-Thailand FTA Paves the Way for Enhanced Bilateral Trade.

Figure 11.1
Exports Impact from a Hypothetical Complete Tariff Elimination by China and Thailand on Sri Lanka



Source: Authors' estimates using partial equilibrium modelling.

A significant advantage of adopting FTAs is improved consumer welfare, despite being largely disregarded in Sri Lanka's trade policy discourse. This aspect might be particularly overlooked owing to concerns about the possible expansion of the trade deficit, the impact on domestic producers, and the uncertainty of the net welfare impact of the FTAs. However, tariff liberalisation with major manufacturing economies in the ASEAN region will positively affect consumer welfare. Quantifications of this effect are imperfect in the partial equilibrium setting. Instead, a general equilibrium model may estimate the net increase of consumer welfare by factoring in the multiplier effects coming from economy-wide linkages.

The indirect impact of RCEP on Sri Lanka is also sizeable, which will complement the amplification of the growth effect of RCEP. Crucially, RCEP provides a legally binding framework for Sri Lanka for a phased-out tariff liberalisation. As discussed previously, unilateral across-the-board tariff liberalisation is economically and politically challenging for Sri Lanka. Then, selective tariff liberalisation becomes the second-best option. To this end, RCEP provides an ideal legal framework due to its depth, coverage, and pragmatic approach to negotiations. The language of the legal text of RCEP and in-built review as well as phase-out commitments are binding compared to weak trade agreements in the South Asian region.

Sri Lanka has already notified its interest in seeking accession to RCEP. To materialise this, Sri Lanka will have to commit at least up to 85% of tariff lines for liberalisation (Table 11.3). There is a strong possibility that Sri Lanka will strategically use the remaining 15% to protect sensitive sectors and thereby maintain substantial domestic distortions lowering the real impact of RCEP.[16] However, lowering up to 85% tariffs will force Sri Lanka to remove protection, at least at the margin, selecting sectors with minimum output and labour force share. A boost in the manufacturing sector due to increased participation in RVCs also facilitates the further removal of protection in unproductive sectors as the labour force has an alternative sector to move to.

Table 11.3
Coverage of Tariff Liberalisation in RCEP: Percentage of Tariff Lines

Country	RCEP Tariff Elimination (%)
Brunei	98
Cambodia	87
Indonesia	91
Lao PDR	86
Malaysia	90
Myanmar	91
Philippines	91
New Zealand	92
Singapore	100
Thailand	90
Vietnam	89
Australia	98
China	89
South Korea	88
Japan	88

Source: Park, I. (2022). Comparison of the Regional Comprehensive Economic Partnership and Other Free Trade Agreements. *Regional Comprehensive Economic Partnership (RCEP): Implications, Challenges, and Future Growth of East Asia and ASEAN. Jakarta: Economic Research Institute for ASEAN and East Asia*, 45–82.

One additional feature of RCEP will further incentivise Sri Lanka to expand the scope of liberalisation after accession to the RCEP. The signed RCEP document is considered a baseline framework. The RCEP has a built-in review mechanism, which is set for five years at the start of the agreement and afterwards, every five years.[17] ASEAN's strong history of reviewing and improving ASEAN+1 trade agreements has led to broader and deeper coverage in subsequent reviews compared to the original agreements. Thus, Sri Lanka will have to periodically review the tariff structure and broaden its commitments to remain in the RCEP.

16 Based on IPS Talking Economics blog -Wijesinghe, A. (2024). Unlocking Trade Potential: How the Sri Lanka-Thailand FTA Paves the Way for Enhanced Bilateral Trade.

17 Elms, D. K. (2021). Getting RCEP Across the Line. *World Trade Review,* 20(3), 373–380.

Amidst the global rise in the strategic use of industrial policy amidst geo-economics tensions, ASEAN economies stand as strong supporters of the multilateral trade system. As a late-comer to manufacturing value chains, Sri Lanka's success depends on the global open trade system. With the emergence of RCEP, Asia now has a platform in place to discuss, plan, and respond to global changes and uphold trade rules for future benefit. Joining this vibrant regional trade community makes Sri Lanka a part of this pro-trade platform. The positive impacts of joining with ASEAN economies on Sri Lanka's trade policy reforms are already visible as Sri Lanka is committed to expanding its tariff cuts beyond customs duties to cover many tariff types like CESS, PAL, and SCLs.[18]

ASEAN's strong history of reviewing and improving ASEAN+1 trade agreements has led to broader and deeper coverage in subsequent reviews compared to the original agreements. Thus, Sri Lanka will have to periodically review the tariff structure and broaden its commitments to remain in the RCEP.

The associated efficiency loss from trade diversion was one of the main criticisms levelled at regionalism. Empirical trade research, however, indicates that deep trade agreements such as the RCEP create more trade than they divert. Deep trade agreements have a favourable impact on businesses' capacity to manufacture a broad basket of goods, participate in global value chains, and reach new customers. Investment guidelines help to attract and maintain foreign investment, while deep provisions on services and competition enhance global integration. Similarly, innovation capacity will be improved by the safeguards provided by deep agreements for intellectual property rights. These changes will help attract investments to Sri Lanka and position it within manufacturing value chains. Moreover, deep trade agreements contain a public good component.[19] For example, improvements in customs procedures, increased competition, and reduction of subsidies to domestic producers can be followed. Such improvements are not exclusive to the member countries of trade agreements; trade creation with other partners can also occur.

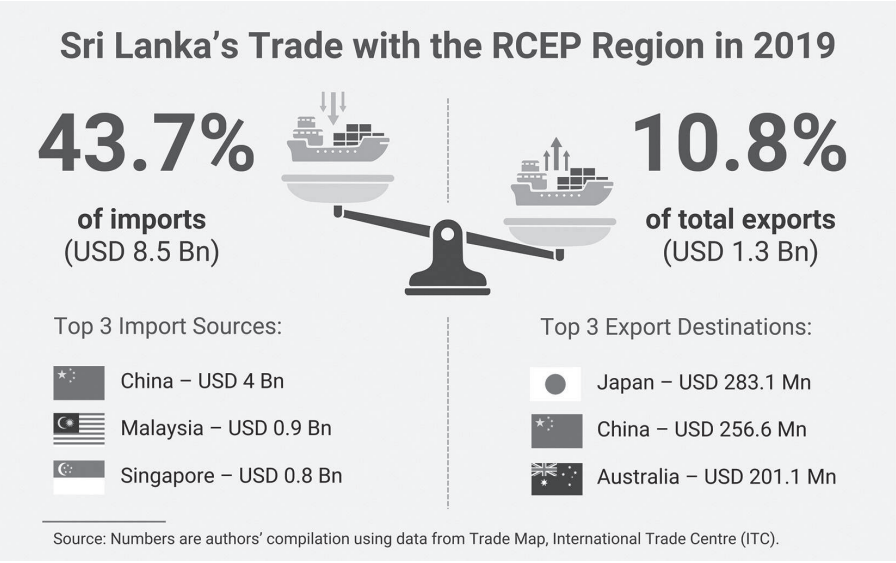
11.4 Complementarities and Potential for Gains in RCEP: Data Evidence

In 2019,[20] 43.7% or USD 8.5 Bn of Sri Lanka's imports were from the RCEP region. The top three import sources within the RCEP region were China, Malaysia, and Singapore, with import volumes of USD 4 Bn, 0.9 Bn, and 0.8 Bn, respectively. Revealing a larger trade imbalance, Sri Lanka's exports to the RCEP stood at USD 1.3 Bn or 10.8% of total exports. The top three export destinations in the RCEP were Japan, China, and Australia, with export volumes of USD 283.1 Mn, 256.6 Mn, and 201.1 Mn, respectively.

18 Export development cess (CESS), ports and airport levy (PAL) and special commodity levy (SCL).

19 Mattoo, A., Mulabdic, A., & Ruta, M. (2022). Trade Creation and Trade Diversion in Deep Agreements. *Canadian Journal of Economics/Revue canadienne d'économique*, 55(3), 1598-1637.

20 Relying on 2019 for disaggregated data was motivated by the post-2020 crisis impact on imports and exports. The year 2019 can be considered as a normal year. Whenever appropriate, most recently available data are used.



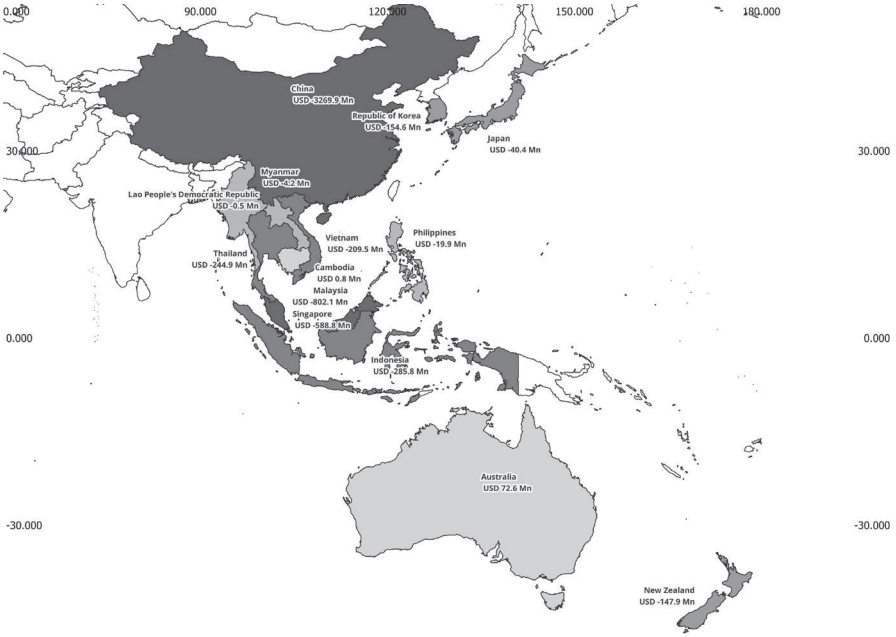
The imbalance in Sri Lanka-RCEP trade generates a large trade deficit for Sri Lanka. Over 95% of Sri Lanka's trade deficit is with RCEP, with more than half originating from trade with China (Figure 11.2). The deficit is contributed by raw material imports and electronics imports as RCEP is a significant import source of mineral fuel, fabrics, and electronics – generally categorised in HS chapters 84 and 85 (Table 11.4). Clearly, countries like China, Japan, Indonesia, Malaysia, and South Korea have a larger comparative advantage in these sectors.

Table 11.4
Top Five HS Chapters of Sri Lanka's Trade with RCEP (2019)

HS Chapter	Product	Exports (USD Mn)	HS Chapter	Product	Imports (USD Mn)
61	Articles of apparel	159.9	27	Mineral fuels	1,088.0
09	Coffee, tea, maté and spices	147.5	85	Electrical machinery	887.3
62	Articles of apparel	114.4	84	Machinery	824.8
40	Rubber and articles	90.0	60	Fabrics	427.4
53	Other textile fibres	46.2	39	Plastics and articles	258.4
	Rest of products	736.2		Rest of products	5,024.8
	Total	1,294.1		Total	8,510.6

Source: Authors' compilation using data from Trade Map, International Trade Centre (ITC).

Figure 11.2
Trade Balance of Sri Lanka with RCEP Countries: 2022

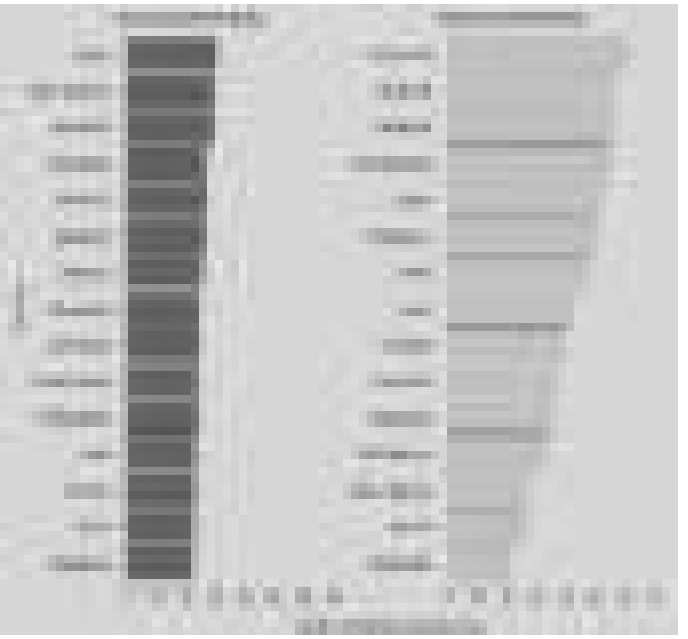


Source: Authors' Illustration using merchandise trade data from Trade Map, ITC.

As shown in Table 11.5, Sri Lanka's major exports to RCEP economies are its traditional exports, such as ready-made garments (RMG) (HS chapters 61 and 62) and tea (HS chapter 09). However, exports are not significantly concentrated in these traditional sectors. The top five sectors contribute only 43% of the total exports to the region. The rest contain relatively less common product lines of Sri Lanka. For example, imports and exports of rubies between Sri Lanka and Thailand form a major share of bilateral trade. Sri Lanka's key exports to Japan are ships and floating structures, while the major exports to Malaysia are machinery and mechanical equipment. These exports by Sri Lanka may result from investments from the export destination countries and backward linkage through which Sri Lanka secures raw materials for value addition. For example, Colombo Dockyard PLC, a leading producer of ships and other naval vessels in Sri Lanka, is a prominent investment from Japan. Similarly, mineral fuel exports to Singapore and grain milling products, mainly wheat (HS 110100), and exports to Cambodia illustrate value-added re-exports by Sri Lanka.

The primary cause of the disproportionately low exports to the RCEP relative to imports is the absence of export complementarity, or the complementarity between Sri Lanka's export profile and the import profile of the ASEAN area due to shared production structures (Figure 11.3). The ASEAN economies produce a combination of high-tech and low-tech manufacturing with a comparative advantage despite having a diverse export portfolio. Additionally, Sri Lanka and some ASEAN countries share a comparative advantage in certain low-tech, and labour-intensive industries, such as RMG.

Figure 11.3
Exports and Import Complementarity Between Sri Lanka and the RCEP Countries



Source: Authors' illustration using World Integrated Trade Solution (WITS) data.

Similar to Sri Lanka, most of the top 10 goods produced by Cambodia, Lao PDR, Malaysia, Vietnam, and Myanmar are scattered throughout the periphery of the product space, reflecting the production of low-tech manufacturing or primary products (Figure 11.4). Some of these countries have a revealed comparative advantage (RCA) for producing most products in the periphery, notably RMG. Cambodia shows nearly similar product space to Sri Lanka in its top 10 goods, showing comparative advantage and production concentration on RMG. Likewise, Thailand, the Philippines, China, South Korea, and Indonesia maintain both low-tech industries and high-tech manufacturing. This diversity is directly related to the growth stage of the ASEAN countries and determines their tariff structure.

Figure 11.4a
Product Space of Sri Lanka

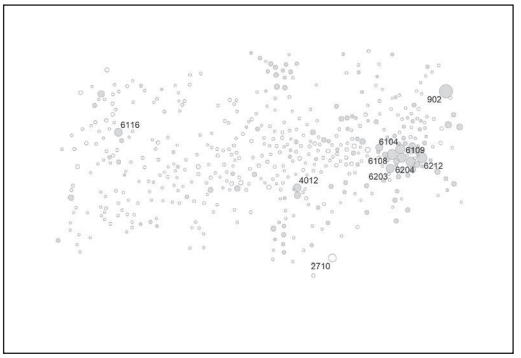


Figure 11.4b
Product Space of Australia

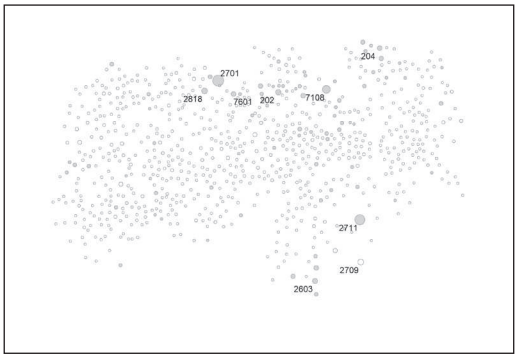


Figure 11.4c
Product Space of Cambodia



Figure 11.4d
Product Space of Myanmar

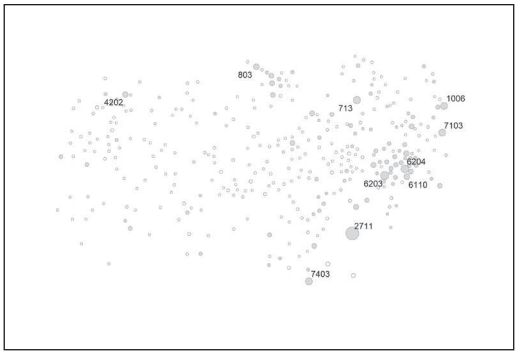


Figure 11.4e
Product Space of Thailand

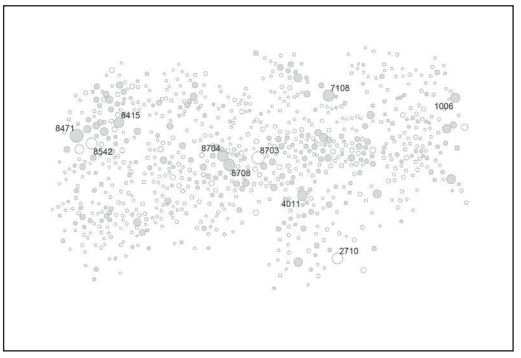


Figure 11.4f
Product Space of Vietnam



Source: Authors' calculation using tariff and trade data from WITS and Trade Map, ITC.

Table 11.5
Trade Weighted Applied Tariff by RCEP Countries on Sri Lanka's Exports: Apparels and Textiles (2021)

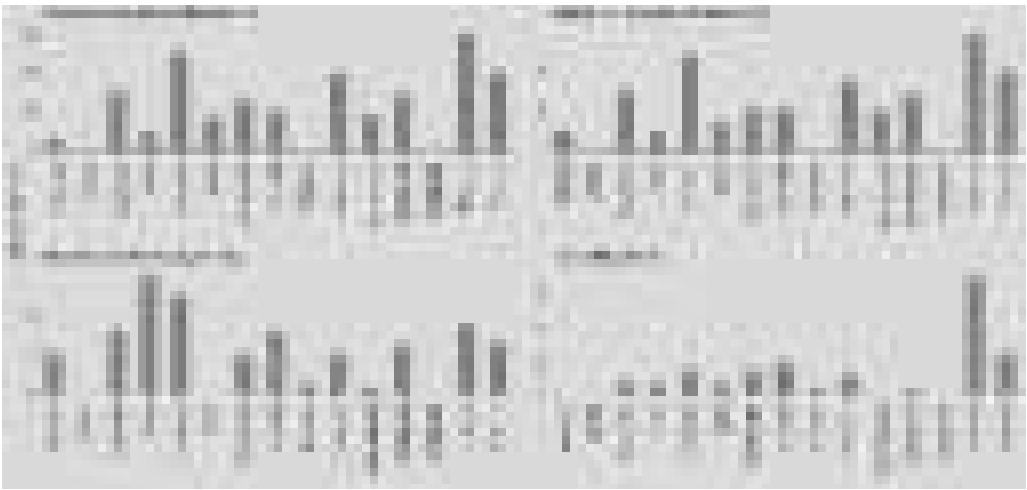
For Apparel Articles		Textiles (Fabrics)	
RCEP Country	Applied Tariff (%)	RCEP Country	Applied Tariff (%)
Australia	4.1	Australia	3.5
Brunei	0.0	Brunei	0.0
Cambodia	15.0	Cambodia	4.7
China	4.4	China	6.2
Indonesia	24.5	Indonesia	9.3
Japan	7.7	Japan	5.9
South Korea	11.5	South Korea	8.1
Lao PDR	10.0	Lao PDR	8.1
Malaysia	0.0	Malaysia	6.7
Myanmar	18.7	Myanmar	9.0
New Zealand	9.3	New Zealand	0.9
Philippines	14.6	Philippines	6.2
Singapore	0.0	Singapore	0.0
Thailand	29.9	Thailand	12.9
Vietnam	20.0	Vietnam	10.6

Note: Apparel Articles (HS chapters 61 and 62), Textiles (Fabrics) (HS chapters 60, 50, 52).
Source: Authors' calculation using tariff and trade data from WITS and Trade Map, ITC.

As shown in Table 11.5, Vietnam, Thailand, Myanmar, Indonesia, and Cambodia maintain high tariffs on ready-made apparel articles in HS chapters 61 and 62. Thailand and Vietnam have the highest tariffs for fabrics among the RCEP economies. Figure 11.5 shows that except for the highly developed RCEP member countries, others levy a significantly high tariff on the products exported by Sri Lanka with a comparative advantage. Due to the high tariffs on relatively competitive products, a reason to join RCEP for exports to potentially grow along the intensive margin is high, given that these sectors will be covered in the tariff cuts. As discussed in Box 11.2, RCEP countries lowered tariffs for the RMG sector and followed flexible ROO for non-originating raw materials like fabrics.

Due to the high tariffs on relatively competitive products, a reason to join RCEP for exports to potentially grow along the intensive margin is high, given that these sectors will be covered in the tariff cuts.

Figure 11.5
Chapter-level Tariffs by RCEP Countries on Sri Lanka's Exports: Selected Sectors
Sri Lanka Exports with a Comparative Advantage



Source: Authors' calculation using tariff and trade data from WITS and Trade Map, ITC.

Box 11.2
Tariffs for Intra-RCEP: RMG Trade

Within the RCEP, the RMG industry is characterised by diverse but well-organised trade relations. The well-developed economies in the grouping possess a comparative advantage in producing fabrics – the raw material used in the RMG industry. Low-tech and labour-intensive manufacturing countries like Cambodia and Vietnam use these inputs. About a quarter of the exported apparel by RCEP countries went to other RCEP countries in 2020.

The RCEP was expected to benefit the members by lowered tariffs rates for their exported products and flexible ROOs. The RCEP countries committed to lowering tariff rates to zero for the majority of textile and apparel products as immediate concessions. However, country specific phase-out schedules are complex. By the RCEP's design, some members have different tariff schedules for partner countries. For example, Japan will phase-out tariffs on chapters 61 and 62 differentially but will eliminate tariffs after 15 years for all the members.

The overall benefits for Sri Lanka's RMG sector, for instance, will thus depend on the tariff phase-out plans offered by the RCEP members to Sri Lanka. Sri Lanka got tariff concessions for most of the RMG in the RMG sector from the SLTFTA. Although Thailand placed 12 RMG products from Sri Lanka's offensive list in its uncommitted list, 130 offensive list products from HS chapters 61 and 62 will see tariffs phased-out. Out of these 130, Thailand did not import 68 products from Sri Lanka in 2022.

One major advantage for RMG industry is the flexible ROO of the RCEP, which only needs a tariff shift at two-digit HS level for non-originating materials. This implies that importing raw materials from anywhere in HS chapters 50-60 to finish products in chapters 61 and 62 is allowed using the RCEP preferential tariff. The flexible ROO of RCEP benefits Sri Lanka as it currently imports the bulk of fabrics and cotton from non RCEP sources like India, Pakistan, and the European Union (EU). For example, 43% of Sri Lanka's cotton imports were from India in 2022. Sri Lanka also imported 35% of fabrics (HS chapter 60) from India and another 10% from the EU and the United Kingdom (UK).

Source: Compiled by the authors based on multiple sources.

As Sri Lanka's competitively exported products face higher tariffs in the RCEP countries, Sri Lanka has an offensive interest in including these products for tariff phase-out. In trade negotiations, a prior understanding of such products is necessary. An analysis is required, as generally, commonly unknown products appear in the offensive lists. Sri Lanka's offensive list varies across each RCEP country. However, certain products are common to many destinations, including tea, rubber, fruits and nuts, apparel and clothing, textiles, miscellaneous edible preparations, nuclear reactors, electrical machinery, plastics, paper and paper boards, and leather. Table 11.6 shows the number of products in Sri Lanka's offensive lists against each RCEP country.[21]

Table 11.6
Number of Products in Sri Lanka's Offensive List against Each RCEP Member

Country	Number of Products at HS Six-digits
Australia	169
Cambodia	20
China	208
Indonesia	143
Japan	118
Republic of Korea	193
Lao PDR	01
Malaysia	37
Myanmar	24
New Zealand	139
Philippines	92
Thailand	160
Vietnam	106

Source: Authors' calculations using data from Trade Map, and WITS.

21 Sri Lanka does not have an offensive list for Singapore as Singapore imposes zero tariffs for all the products exported by Sri Lanka. Sri Lanka does not have an offensive list for Brunei as the criteria for the offensive lists are not met for any product exported to Brunei.

Based on product complexity, the offensive items are categorised into four groups: high-tech, medium-tech, low-tech, and medium-low-tech (Table 11.7). The bulk of the products fall into the low and medium-low categories because the existing product complexity of Sri Lanka's competitively exported products lies in low-tech manufacturing and agricultural products. However, Sri Lanka has about a quarter of products in the high-tech category. Mainly, these are products in HS chapter 85, like parts of integrated electric circuits, ignition wiring sets, transformers for electric circuits, and parts of electric sound or visual signalling apparatus. Negotiating tariff concessions for these products is necessary for Sri Lanka since these will have preferential access to the RCEP, which will boost exports and promote value chain activities.

Table 11.7
Number of Products under Technology Classification of Sri Lanka's Offensive List for RCEP Countries

Importer	High	Low	Medium-high	Medium-low
Australia	41	48	39	41
Cambodia	5	5	4	5
China	52	53	51	51
Indonesia	34	35	35	35
Japan	27	30	32	29
Korea, Rep.	48	49	37	57
Lao PDR	0	1	0	0
Malaysia	8	9	7	12
Myanmar	6	6	5	7
New Zealand	35	36	33	35
Philippines	22	23	24	23
Thailand	40	40	30	50
Vietnam	26	27	24	26

Source: Authors' calculations.

11.5 Accession to RCEP: Challenges for Sri Lanka

Crucial challenges for Sri Lanka include the expansionary effect of RCEP on Sri Lanka's already significant trade deficit, revenue loss, political economy constraints coming from lobbying by vulnerable industries, and impact on domestic jobs. It is noteworthy that when service liberalisation is considered, substantial challenges likely arise in the movement of natural persons. In addition, to negotiate the high number of bilateral discussions, Sri Lanka's institutional set-up will need to be upgraded and strengthened. In this section, only the major challenges are discussed in detail due to their relatively high significance.

Sri Lanka's imports from the RCEP nations will increase, contingent upon the extent of tariff elimination. The positive impact of tariff cuts on imports will be more pronounced with RCEP trade partners as RCEP

countries possess a comparative advantage in a vast number of products, the higher number of products imported by Sri Lanka and the higher import volume. Evidence shows that though Sri Lanka is anticipated to see a higher proportional growth in exports, this disproportionate base effect will widen the trade deficit. For example, under a full tariff liberalisation assumption, the trade deficit between Sri Lanka and Thailand is estimated to widen by 26%.[22] A similar analysis for China-Sri Lanka trade under full liberalisation assumption suggests that the trade deficit will widen by 4.3%.[23] But in this instance, it is important to proceed cautiously, given the relatively lower impact on the trade deficit.

Crucial challenges for Sri Lanka include the expansionary effect of RCEP on Sri Lanka's already significant trade deficit, revenue loss, political economy constraints coming from lobbying by vulnerable industries, and impact on domestic jobs.

The partial equilibrium estimates show that imports from China will go up by 8% under the full liberalisation assumption. It should be noted that partial equilibrium modelling provides an estimate for only the increase in the intensive margin – i.e., the increase of already imported products from China. Notably, most of the imported products in high volumes are under zero tariffs as these are raw materials or some electronic equipment like telephones. Thus, tariff elimination will not increase trade in these products. However, once tariff liberalisation takes place, Sri Lanka may start to import new products from China, significantly widening the trade deficit. Such an increase in imported products on the extensive margin is of higher probability given China's vast comparative advantage and domestic industrial policies. The impact on the extensive margin of trade is not estimated by the partial equilibrium modelling. Another caveat is that in partial equilibrium, the price effect comes from the reduction in customs duties. However, Sri Lanka commits to phasing out other tariffs, including CESS/PAL and SCL, which increases the potential trade creation effect. These additional effects are not factored in partial equilibrium modelling.

Since, in the best-case scenario, Sri Lanka's tariff liberalisation plan would need to cover at least 85% of the product lines, the revenue losses can be significant. Table 11.8 shows that tariff revenue from China can be USD 423 Mn as calculated for imports from China in 2022, factoring in all kinds of tariffs. Possible revenue loss is the combination of the forgone revenue due to tariff elimination and the forgone tariff revenue from trade diversion. By receiving preferential treatment, RCEP nations will grow their market share in Sri Lanka at the expense of exporters who are more competitive but must pay higher tariffs. An estimation of the impact of these dual forces can be done using partial equilibrium modelling. A partial equilibrium analysis estimates that Sri Lanka would lose USD 145.8 Mn in tariff income under the complete hypothetical scenario of all tariffs imposed on imports from China being completely eliminated. As described above, notably, revenue loss is estimated considering only the losses caused by eliminating customs duties. Other tariffs like CESS/PAL and SCLs are not incorporated due to analytical limitations. Thus, the actual tariff loss might be higher.

22 Wijesinghe, A., & Rathnayake, N. (2023). *Unveiling Trade Potential: An Ex-Ante Analysis of the Sri Lanka-Thailand Free Trade Agreement*. International Economic Series (16). Colombo: Institute of Policy Studies of Sri Lanka.

23 Wijesinghe, A & Rashmi, A. (Forthcoming). *A Product-level Impact of an FTA between China and Sri Lanka: PE Simulatins*, International Economic Series. Colombo: Institute of Policy Studies of Sri Lanka.

Table 11.8
Distribution of Imports by Sri Lanka from China Across Tariff Bands

Tariff Bin	Number of Products (HS Eight-digits)		Base Rate (Mean)	Imports		Tariff Revenue	
	#	%	%	Value (USD Mn)	%	Value (USD Mn)	%
[0,5)	649	15.5	0.7	1,005.6	28.5	18.3	4.3
[5,10)	721	17.2	5.4	714.6	20.3	40.4	9.5
[10,15)	880	21.0	10.2	755.5	21.4	77.1	18.2
[15,20)	112	2.7	15.7	105.0	3.0	16.7	3.9
[20,25)	152	3.6	20.3	74.9	2.1	15.0	3.6
[25,30)	259	6.2	25.2	131.8	3.7	33.3	7.9
[30,556]	1,248	29.8	45.2	569.1	16.2	222.6	52.6
NA	171	4.1	NA	166.0	4.7	NA	
Total	**4,192**	**100**	**123**	**3,523**	**100**	**423**	**100**

Source: Authors' calculations.

From the socio-economic and political point of view, labour force and domestic industry vulnerability to ASEAN manufacturing powerhouses is the most significant hurdle in opening up Sri Lanka to the RCEP. Increased consumer welfare, positive macroeconomic impacts, and newly generated jobs can be substantial benefits, though these are dispersed and materialise gradually. However, the impact of the labour force and industry is concentrated in geographical localities. In addition, as the tariff liberalisation will be known before the ratification, interest groups will lobby actively and swiftly. While a general equilibrium model will provide a net assessment of the labour market, a micro-simulation based on partial equilibrium estimates can be done to calculate the vulnerable employment in each sector as per the International Standard Industrial Classification-revision Four (ISICr4).[24] Greater import competition due to increased sector-wise imports might result in the displacement of workers in those sectors, as indicated by the employment embedded in increased imports (Table 11.9).

24 The employment vulnerability is measured following the method suggested in- Autor, D. H., Dorn, D., & Hanson, G. H. (2013). The China Syndrome: Local Labour Market Effects of Import Competition in the United States. *American Economic Review*, 103(6), 2121-2168.

Table 11.9
Sectors with the Highest Impact on the Labour Market from Increased Imports from China

ISICr4 Code	ISICr4 Description	Number of Employees (Based on LFS 2019 data)	Employment Embedded in Increased Imports	Domestic Output in 2019 (USD Mn)
2640	Manufacture of consumer electronics	428	14,329	0.2
2930	Manufacture motor vehicle parts	1,657	11,772	0.4
1701	Manufacture of pulp, paper and paperboard	1,288	1,169	2.6
2396	Cutting, shaping and finishing of stone	4,613	3,396	20.6
1622	Manufacture of builders' carpentry and joinery	58,015	38,958	2.6
2819	Manufacture of other general-purpose machinery	1,554	459	14.3
3250	Manufacture of medical and dental instruments and supplies	3,028	727	1.0
2511	Manufacture of structural metal products	22,674	4,175	32.9
2593	Manufacture of cutlery, hand tools and general hardware	7,232	1,182	17.4
3220	Manufacture of musical instruments	549	84	0.5
2630	Manufacture of communication equipment	867	132	5.3
2410	Manufacture of basic iron and steel	2,270	325	39.6
1020	Processing and preserving of fish, crustaceans and molluscs	6,582	885	87.9

Note: This table shows embedded employment of import creation at least accounting for 10% of the labour force in the sector. LFS – denotes Labour Force Survey.

Source: Authors' calculations.

Table 11.9 shows the possible heightening of labour force vulnerability in the manufacturing sector to increased imports from China if Sri Lanka eliminates tariffs. Sectors like the manufacture of consumer electronics, domestic appliances, bicycles, general purpose machinery, basic iron and steel, builders' carpentry and joinery, pulp paper and paperboard, processing of fish, parts and accessories of motor vehicles, electronic components and boards, and cutting and finishing of stones are among more vulnerable to import competition when the labour market impact is considered. The cumulative labour force in these sectors stood at 110,757, as per the LFS 2019 data compiled by the Department of Census and Statistics (DCS). In the wake of tariff elimination, these sectors may witness at least imports that possibly affect 10% of the existing labour force in the wake of tariff elimination. Sectors like the manufacture of consumer electronics, and parts and accessories for motor vehicles will face increased imports more than sufficient to displace the current level of employment of the sectors. However, these sectors are not producing a heavy output and employ around 2,000 workers.

A sizeable labour market impact is possible in sectors like the manufacture of builders' carpentry and joinery. The potential increase of imports in this sector may displace as much as 67% of existing workers.

When the above-discussed adverse impacts constrain the space for a tariff liberalisation plan, the original objective of removing domestic incentive distortions is likely to be sacrificed. For example, in the FTA with Thailand, Sri Lanka added 1,217 tariff lines to the uncommitted list. However, the latter represents 35% of imported value from Thailand (Table 11.10). In addition, all the tariff lines in ISICr4 sectors, like growing rubber, manufacturing of dairy, manufacturing of confectionary, and manufacturing of rubber tyres, are on the uncommitted list, effectively maintaining existing tariff protection. If Sri Lanka adopts a similar strategy, a qualitative change in the distortionary incentive structure will not materialise.

Table 11.10
Tariff Liberalisation Plan Under SLTFTA

Tariff Liberalisation Phase	HS Codes (HS Eight-digits)		Value (USD Mn) in 2022	
	Number	Percentage	Value	Percentage
Base rate is zero	1,429	17.5	35.95	12.3
Immediate	2,715	33.3	66.27	22.7
From year one	759	9.3	9.94	3.4
From year six	815	10.0	39.16	13.4
From year 11	816	10.0	26.3	9.0
From year 16	406	5.0	11.05	3.8
Uncommitted	1,217	14.9	103.88	35.5
Total	**8,157**	**100.0**	**292.55**	**100.0**

Source: Authors' calculations.

11.6 Conclusion and Recommendations

The trade policy reforms – including joining the RCEP – and the economic crisis overlap, and make trade policy reforms more challenging. The cost of tariff liberalisation will fall on domestic producers and the already severely economically stressed workers in the affected industries. The eroded purchasing power, increased tax burden, and low prospects of wage growth owing to the economic crisis inevitably spread scepticism on the trade liberalisation attempts and intensified the anxiety of workers on future job security. These conditions trigger intense political reactions against trade liberalisation attempts.

If a trade adjustment support programme is implemented, the fiscal burden will be higher in a crisis, as more workers might need government support. For example, with the sluggish growth of the industrial sector, the availability of employment to absorb the workers affected by trade liberalisation will be lower in the crisis period. Given these challenges, Sri Lanka needs to weigh the costs and

benefits of the RCEP and identify how the cost of trade liberalisation will be distributed to plan a gradual liberalisation.

Possible as well as positive macroeconomic effects and indirect incentives for a legally binding tariff liberalisation framework provide an economic and institutional case in favour of Sri Lanka to join RCEP. Although partial liberalisation is not ideal, joining RCEP and implementing a gradual trade liberalisation may foster manufacturing sector growth, providing policy space for more ambitious trade liberalisation in the future. The structural transformation will be facilitated if sustainable growth in the manufacturing sector is possible through joining the ASEAN RVCs materialises. Then long-standing distortions in the agriculture sector can be phased out with minimum labour force and social impacts. Removing incentive distortions will allocate domestic resources to more efficient sectors that foster sustainable economic growth, and increase Sri Lanka's competitiveness and resilience to face adverse shocks. This optimism can be clouded by the possible distributional and adjustment costs of liberalisation and the time taken to phase-out. Revenue loss, domestic labour market impacts, and domestic industry impacts are the major hurdles Sri Lanka face in tariff liberalisation for joining the RCEP.

However, the strategic use of an uncommitted list to maintain protection for lobbying industries will reduce the effectiveness of RCEP in lowering domestic distortions. In such a scenario, the expected positive economic impacts of RCEP will be significantly lowered. Sri Lanka can provide the phase-out period as the adjustment window for vulnerable industries to adjust.

Tariff revenue loss is a noteworthy factor, given that historically low government revenue was a key driver of the economic crisis. Given the unsustainable debt stock, currently, there is no fiscal space for Sri Lanka to compromise on revenue. A loss of revenue probably has a debilitating impact on delivering vital public goods and protecting vulnerable employment groups from liberalisation while intensifying the backlash against liberalisation. However, with recent tax reforms, domestic tariff revenue generation is improving, and optimistically, debt restructuring will bring debt servicing to a more manageable level. Although the tariff revenue loss might be large, the total impact does not materialise instantly. RCEP provides space for phased tariff liberalisation, which might extend over 20 years. In addition, joining RCEP is not going to happen abruptly. Sri Lanka plans to enter FTAs with some RCEP members as it works toward accession to RCEP. This gradual approach provides a way to soften the impact. Sri Lanka can prolong the liberalisation of revenue-sensitive tariff lines to a later phase. For example, about 50% of the potential tariff loss in a China-Sri Lanka tariff liberalisation comes from 95 tariff lines at HS eight-digits imported from China in a hypothetical tariff elimination by Sri Lanka.

Phasing out tariffs through an extended period also softens the blow on the labour market and industries. However, the strategic use of an uncommitted list to maintain protection for lobbying industries will reduce the effectiveness of RCEP in lowering domestic distortions. In such a scenario, the expected positive economic impacts of RCEP will be significantly lowered. Sri Lanka can provide the phase-out period as the adjustment window for vulnerable industries to adjust. However, given

the vast comparative advantage of the RCEP countries and the deeply entrenched high level of protection enjoyed by some domestic industries, it is unlikely that certain industries can survive and thrive under heavy import competition. Thus, Sri Lanka should plan a trade adjustment programme to facilitate a less costly transition from inefficient industries to efficient industries.

While the political constraints should be duly factored in when the tariff liberalisation plan is formulated, expediting in a way that the goal of removing incentive distortions is realised in the long run, is recommended. The RCEP provides Sri Lanka with a framework to do so while potential economic benefit acts like having in place a positive feedback loop to sustain trade reforms. Furthermore, Sri Lanka will be unable to maintain strategic protection indefinitely due to in-built review processes. Although RCEP has the flexibility for phasing out, producing country-specific tariff schedules, and maintaining about 15% of products in the uncommitted list, it ties countries to a legally binding commitment with space for periodic reviews. This kind of combination will assist Sri Lanka in deploying RCEP for a meaningful and phased-out liberalisation without slipping into ad hoc distortionary protection.

12 Navigating Emergencies and Building Resilience in Agriculture

12.1 Introduction

Sri Lanka experienced its worst-ever food price escalation in 2022. With overall inflation peaking at around 70% in September 2022, food price inflation was even higher to reach record levels of around 95%. Since then, food inflation has decelerated rapidly to near-zero levels by the end of 2023. Yet, Sri Lanka cannot see this as a respite since food prices have been continuously increasing with periodic fluctuations. For instance, food prices, as per the Colombo Consumers Price Index (CCPI) rose again to 3.8% in the first quarter of 2024 (Q1 2024) before declining and rising again by mid-2024.[1]

The current escalation of food prices, however, is not an isolated experience for Sri Lanka, but a global development affecting other countries in different capacities. However, the impact is more disastrous in developing countries like Sri Lanka where the bulk of household income is spent on food. Although 2022 records the peak of food price inflation in the country so far, this was not purely a sudden development. The stagnation of the agricultural sector over time can be attributed to a combination of local and global issues in recent years, as well as long-term structural challenges.

Moreover, this is neither an end nor a beginning of an era of high prices since fluctuations in food prices have been recurrent. The last such incident started in 2008 and those before were in 1972 and the late 1940s. The volatility has increased since Sri Lanka started to become more heavily dependent on the world market for food in the early 20th century and since then, this scenario recurred periodically with local and global challenges. Currently, the country is experiencing food price inflation due to domestic and international factors.

For instance, the Sri Lankan agriculture sector, particularly its food crop production sector, has been in a crisis for many decades due to several long-standing endogenous problems. Failure of the agriculture sector to adapt to these structural changes, particularly by enhancing the productivity of both land and labour has resulted in lacklustre performance, marked by declining productivity and falling farm incomes.

These negative consequences have been compounded by other challenges, such as high vulnerability to climate change impacts, which is one of the major external threats facing the agricultural sector. Local exogenous factors like the ongoing economic crisis and the chemical fertiliser ban (although lifted later), have added to delaying progress across the sector. Moreover, recent short-term exogenous factors such as the coronavirus (COVID-19) pandemic and the Russia-Ukraine war contributed to this quandary.

The impact of high food inflation has more dire consequences in developing countries like Sri Lanka where the bulk of household income is spent on food, as noted earlier. For instance, food comprises

1 Department of Census and Statistics. (2024). *Monthly CCPI-Food and Non-Food Groups*, http://www.statistics.gov.lk/InflationAndPrices/StaticalInformation/MonthlyCCPI/Inflation-FoodAndNonFood_Groups

26.2% of the CCPI basket and 39.2% of the National Consumer Price Index (NCPI) basket. Therefore, changes in food prices significantly affect people's well-being and quality of life.

Understanding the relationship between long-standing structural problems in agriculture and short-term crises is essential to creating a resilient, sustainable, and equitable agricultural sector. It supports informed policymaking, enhances economic stability, fosters sustainable development, and promotes social equity and environmental sustainability. Addressing these issues comprehensively is crucial to boosting the agricultural sector's resilience and recovery capabilities during crises, thereby making a sustainable contribution to overall societal well-being. However, whether the structural weaknesses in the agricultural sector exacerbate the impacts of short-term crises or these crises further deepen existing structural issues, is a critical policy discussion yet to be well understood. Against this backdrop, this chapter attempts to understand the long-standing structural challenges of the agriculture sector and its interrelations with short-term shocks that affect food prices. At the outset, the chapter presents conceptual insights into the agricultural sector's struggles and analyses the sector's structural issues. Thereafter, it examines responses to short-term crises and discusses the post-crises agriculture recovery in Sri Lanka. The final section concludes with recommendations for navigating through long-term agricultural reforms and short-term emergencies.

12.2 Mapping the Roots: Conceptual Insights into Agricultural Struggles

Sri Lanka's agriculture sector, particularly its food crop production sector, has been in a crisis for many decades. Both long-standing endogenous problems, as well as more recent short-term exogenous factors contributed to this issue.

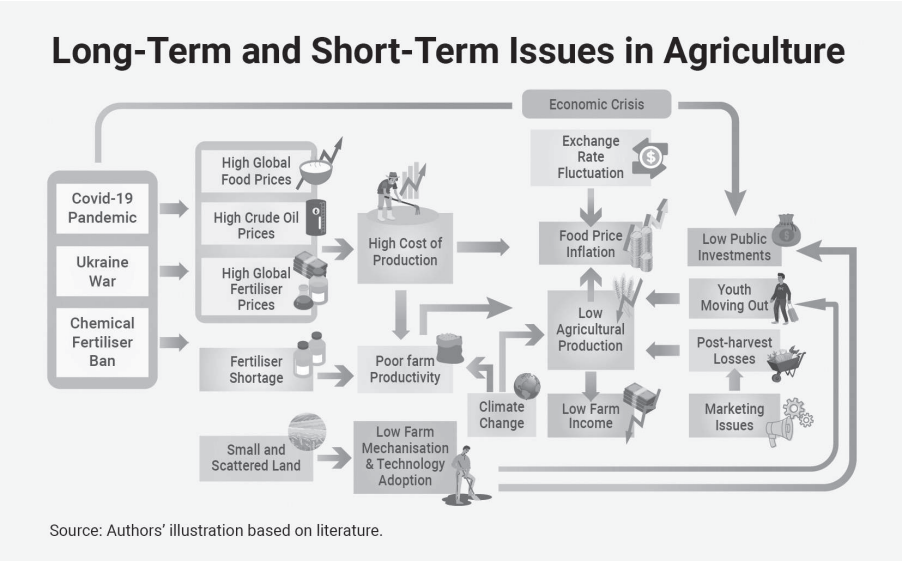
Sri Lanka's agriculture sector, particularly its food crop production sector, has been in a crisis for many decades.Both long-standing endogenous problems, as well as more recent short-term exogenous factors contributed to this issue.

Sri Lanka has been experiencing long-term trends – a shrinking agricultural sector in the overall economy and a declining share of the labour force in agriculture.[2] A failure to adjust to these structural changes by increasing the productivity of both land and labour has paved the way for disappointing performance across the sector, including declining productivity and falling farm incomes.

The infographic illustrates the long-standing issues and short-term crises impacts identified after careful assessment of the structural changes in the agriculture sector concerning the current context. It presents a generalised understanding of how low farm income and high food inflation have been the outcome of multi-sectoral development problems. The illustration also helps to better understand the interplay between long-standing structural issues and short-term crises. In this illustration, food price inflation is viewed as one important dimension of a larger development problem that reaches

2 Thibbotuwawa, M., Wijesinghe, A., Weeraratne, B., Arunatilake, N., Mallawaarachchi, & Wilson, C. (2023). *Development Context and Policy Challenges for South Asia's Agricultural Sector,* Background paper prepared for the workshop in Kathmandu, 12-16, June 2023 jointly sponsored by ACIAR and ABDI (based on https://www.aciar.gov.au).

across multiple sectors and social, political and economic institutions. Indeed, what Sri Lanka is experiencing today is not just a food crisis, but a multidimensional economic crisis, which aggravates food insecurity due to rising food prices and shortages threatening lives and livelihoods.



Source: Authors' illustration based on literature.

12.3 Persistent Problems: Unveiling Structural Issues in Agriculture

12.3.1 Small and Fragmented Land Holdings

About 51% of Sri Lanka's total land area of 6.56 million hectares (Mn ha) is under agricultural use, while 38% is under forest lands, including scrubs and grassland.[3] With an estimated population of 21.8 Mn (in 2021), the per capita agricultural land area is about 0.15 ha, indicating heavy pressure on land usage as land scarcity mounts. Due to the expanding population and demand for non-agricultural uses, land fragmentation results in non-viable small holdings. Many decisions on land use and management in Sri Lanka have been ad-hoc and not scientifically based. This has resulted in many land-related issues affecting agriculture, such as inappropriate uses, underutilisation of land, low productivity of the agricultural lands, destruction of water sources, shrinking of forests, human and wild animal attacks/conflicts, and frequent occurrence of natural disasters like landslides, floods, droughts, etc.[4] Moreover, land administration in Sri Lanka is governed by several operational laws, vested with different institutions and implemented without a sound coordinating mechanism. These make land administration increasingly challenging.

3 Land Use Policy Planning Department. (2018). *Major Land Use & Land Cover of Sri Lanka – 2018*, (based on https://www.luppd.gov.lk).

4 Thibbotuwawa, M. (2023). Reforming Land Policies for Economic Development in Sri Lanka. In *Sri Lanka: State of the Economy 2023*. Colombo: Institute of Policy Studies of Sri Lanka.

These further provide insights into the domestic food production sector and some of its problems. The extent cultivated under major food crops has been almost constant for the last few decades due to the lack of new arable land to be brought under agriculture. Rice is the only crop that saw a sharp increase in the cultivated extent over time.[5] This expansion can be attributed to considerable government backing on investments in irrigation infrastructure, guaranteed pricing and a generous fertiliser subsidy. The only other crops that saw continuous growth in cultivated areas were fruits and vegetables, mainly due to demand growth. The erratic medium-term fluctuations in other crops, such as pulses and cereals are the consequences of haphazard trade restrictions and subsequent relaxations introduced by various governments from time to time. The declining cultivated area for roots and tubers was followed immediately after the removal of import restrictions on rice and wheat, which are preferred substitutes for 'inferior' roots and tubers.

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12.3.2 Low Mechanisation and Poor Technology Adoption

Despite various attempts over the years, the level of mechanisation of agriculture in Sri Lanka is limited, partly due to a lack of clearly defined national mechanisation policy and strategy.[6] As revealed by a survey of 1,020 farm households by the Institute of Policy Studies of Sri Lanka (IPS) in 2020, machinery use in land preparation is common in most food crop farming with a significantly high use of tractors, ploughs, and harrows (Table 12.1). A good percentage of farmers use sprayers, and water pumps as well. Sprayers, water pumps and combined harvesters were used by a quarter to a third of farm households surveyed, while the least used machines are grain drillers and soil tillers. Their low ownership is possibly due to the excessive cost as perceived by farmers, which makes hiring more economical. Gaps in usage probably reflect the difficulty of hiring the required machinery for smallholder farmers due to high operational costs.

5 Food and Agriculture Organization. (2024). FAOSTAT, http://www.fao.org/faostat/en/#data/FS

6 Weeraratne, B., Senaratne, A., Thibbotuwawa, M., Arunathilake, N., Chandrasiri, J. and Weerasekera, H. (2021). *Policy Research in the Area of Agriculture Labour Markets*. Report prepared by the IPS for the Agriculture Sector Modernisation Project (ASMP) of the Ministry of Agriculture and the World Bank.

Table 12.1
Use, Ownership, and Knowledge of Agricultural Machinery

Machinery / Equipment	Use (% Households)			Ownership (% Households)			Knowhow (% Households)		
	All	Paddy	OFC	All	Paddy	OFC	All	Paddy	OFC
Tractors (Two-wheel)	40	42	38	13	15	11	66	68	87
Tractors (Four-wheel)	61	85	39	4	6	3	60	62	53
Plough/harrow	23	36	12	2	4	1	78	85	46
Grain drill/seeder	<1	<1	<1	<1	<1	<1	67	67	100
Cultivator	20	31	8	4	5	4	85	86	76
Soil tiller	1	1	<1	0	0	0	55	50	50
Fertiliser spreader	5	3	8	4	.9	7	72	50	76
Sprayer	33	27	43	25	17	37	85	80	88
Threshers	11	19	3	3	<1	<1	69	71	7
Water pumps	26	18	38	19	11	32	85	84	86
Combined harvester	24	42	7	<1	<1	<1	27	27	14

Note: OFC denotes other field crops.
Source: Authors' calculations based on IPS Agriculture Labour Survey (ALS), 2020.

The survey explored various alternative modern technologies to gauge the utilisation and understanding of advanced agricultural technology (Table 12.2). Compared to the use of agricultural machinery and equipment, the use of modern technology was even less across the sampled farmers. For example, the highest usage rates were reported for hybrid seeds and new crop varieties at 32% and 31%, respectively. Only 11% of the farmers use modern irrigation techniques, suggesting inefficient and unproductive management of irrigation water use in agriculture and inadequate funding for improving water use efficiency. The limited adoption of technology by farmers can be attributed to certain shortcomings in the agricultural extension system and government information dissemination mechanisms. These include factors such as an insufficient number of skilled extension staff and inadequate physical resources. The data further reveal relatively higher mechanisation and technology adoption for paddy farming than other crop cultivations. It also suggests that the unavailability of machinery and technologies developed specifically for the other crops and conditions in Sri Lanka remain as barriers.

Table 12.2
Usage and Knowledge of Modern Technology for Agriculture

Technology	% Households Using			% Households Known			% Households Like to Learn		
	All	Paddy	OFC	All	Paddy	OFC	All	Paddy	OFC
Smartphones for agriculture-related (weather, price alerts)	22	29	10	34	42	25	74	70	81
Drones for precision weed control/pest control/fertiliser application	10	15	0.4	26	31	22	73	70	79
Sensors to remotely monitor soil condition, water requirements, crop conditions	5	8	0.4	16	21	12	74	71	79
Satellite image techniques	3	4	0.4	14	16	12	72	69	77
New crop varieties	31	33	29	39	45	37	76	70	84
Hybrid seeds	32	26	45	43	44	46	76	72	82
New cultivation methods e.g.: controlled systems – polytunnels /rain shelters	3	2	6	22	18	28	75	72	81
New irrigation systems – drip/ sprinklers	11	2	23	30	23	38	75	72	81
New transportation/packing/storage systems	16	16	3	21	19	24	78	76	82

Source: Authors' calculations based on ALS, 2020.

The low level of mechanisation and adoption of modern technology in the agriculture sector in Sri Lanka is due to a combination of issues. The biggest issue perceived and personally experienced by farmers is the lack of sufficient capital which creates a 'ceiling effect' on mechanisation and adoption of modern technology. The issue is more prevalent among other field crop (OFC) farmers than paddy farmers as shown in Table 12.2. As reported by farmers, a considerable knowledge gap exists in technical aspects, including the use of machinery and technology. At the same time, the land size, its terrain, such as steepness, and a lack of confidence concerning the suitability of imported machines are also minor issues faced by farmers, particularly those cultivating OFCs.

12.3.3 Youth Moving Away from Agriculture

Youth involvement in agriculture has been waning. Low profitability, and poor access to resources and support services such as land, water, capital, extension, and markets have been identified in the literature as vital factors hindering youth from entering commercial agriculture.[7] In the said discussion, a snapshot perception survey of 160 respondents suggests that educated youth prefer to move away from agriculture and towards white-collar jobs. This is mainly because, with limited use of technology and innovations, agricultural employment is not perceived to provide social recognition and protection.

7 Hirimuthugodage, D. (2022). Youth Participation in Agriculture. In *Sri Lanka: State of the Economy 2022*. Colombo: Institute of Policy Studies of Sri Lanka.

Uncertainty and high risks associated with agricultural activities including inherent risks associated with weather patterns and pest and disease outbreaks, along with low profitability affecting the sector, are some other key factors that influence youth to move away from agriculture. Limited engagement of youth in agriculture could be attributed, in part, to challenges such as poor market access and limited access to essential resources such as finance, land, and technology.

Further analysis of labour force survey (LFS) data using multinomial logit results shows that education has a negative relationship with the participation decision in agriculture proving that youth with lower education levels, especially those who quit schooling at primary education levels participated more in agricultural activities than the youth who completed their higher education.[8] Youth with higher education levels, including those aiming for white-collar jobs, choose non-agricultural employment over agricultural employment. The results also point to the potential of part-time farming to draw youth to engage in agriculture relative to full-time farming. Mechanisation and accessibility of agricultural equipment help to minimise the hard work requirements of physical labour and attract youth to the sector. Land ownership and profitability are also very strong pull factors for youth agriculture sector participation.

12.3.4 High Post-harvest Losses

From the time that agricultural produce leaves the farm from distribution to storage and processing, it passes through multiple points in the value chain where valuable food produce is lost. Whilst it is important to understand how smallholder farmers can increase yields and production levels overall, addressing areas pertaining to food loss outside the farm can also lead to more resilient food systems. Value chains with efficient post-harvest handling systems have the potential to reduce waste and deliver high-quality fruits and vegetables. As value chains in developing countries become longer and involve a growing number of intermediaries, the likelihood of pre-consumer food loss is expected to rise. This is especially relevant in countries like Sri Lanka with inadequate storage facilities, poor road and rail infrastructure, and limited access to post-harvest technologies to protect the produce from pests, diseases, and decomposition. In this context, food loss incorporates the real loss of production output before it reaches the consumer, but also encompasses a loss in value resulting from quality reductions or the inability to store produce.

Currently, the post-harvest losses in Sri Lanka are falling in higher-value items (about 20-40%), with fruits and vegetables having losses of around 30-40% (See infographic, Ilmi Hewajulige (2022). Presentation at the Project Inception Workshop at IPS). However, the supply chain infrastructure, such as transit cold storage, pack houses, and collection centres that operate conjointly to enhance efficiency, is still in early development. The lack of market information to stakeholders along the value chain is another factor contributing to inefficiencies. Apart from price information, the lack of technical know-how, such as about standards and safety protocols is another aspect that has a cascading effect on the whole chain in terms of quantitative and qualitative losses.[9]

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8 Weeraratne, B., Senaratne, A., Thibbotuwawa, M., Arunathilake, N., Chandrasiri, J. & Weerasekera, H. (2021). *Policy Research in the Area of Agriculture Labour Markets*. Report prepared by the IPS for the ASMP of the Ministry of Agriculture and the World Bank.

9 Wijayasiri, J., Thibbotuwawa, M., & Hirimuthugodage, D. (2017). *Analysis of Cinnamon, Pepper and Cardamom Value Chains in Sri Lanka.* Colombo: Japan International Cooperation Agency (JICA).

Post-harvest Losses at Different Stages of the Marketing Chain (%)

Crop	Farmer	Collector	Wholesaler	Retailer	Total
Banana	5.3	7.6	3.2	14.1	30.2
Pineapple	7.2	8.5	2.9	12.5	31.1
Papaya	5.8	10.1	4.9	15.3	36.1
Mango	5.5	3.3	12.6	11.3	32.7

Source: Ilmi Hewajulige (2022).



12.3.5 Marketing Dilemma

Most value chains are fractured and many intermediaries involved in the value chains are often claimed to be the invisible hand. The supply chain also involves numerous participants, including farmers, input suppliers, marketing agents, transporters, wholesalers, and retailers, from the beginning to the end. This generates the setting for higher costs for transportation, loading, unloading, and packing. Higher profit margins for agricultural products for intermediaries have resulted in higher-end prices for consumers and very low profits for farmers in rural areas. Due to the extended value and supply chains, the freshness and quality of the agricultural products deteriorate. The inferior quality of most Sri Lankan farmgate products has been a serious issue in the present context of high-quality consciousness. A large proportion of the produce leaving the farmgate is of a quality far below the expected level at the high end of the supply chain. This is mainly attributed to poor weather conditions, low-cost processing technology, poor storage facilities, early harvesting habits and the small-scale nature of production.

The most intractable issue arising from the global market is public concern regarding food safety in industrialised countries that spawned increased and tightened public standards over the past two decades. Therefore, poor quality leads to a direct loss of potential exports and foreign exchange earnings. However, rapid and ongoing changes are occurring in domestic and export procurement systems, with the growing dominance of supermarkets, high-quality retail, bulk procurement by domestic manufacturing firms, and increased quality awareness in the global trading system. The food retail market in Sri Lanka has gradually evolved from fragmented local markets to centralised wholesale markets and eventually to the emergence of supermarkets. However, the impact of modern and restructured markets has had several repercussions on small-scale farmers who are unable to keep up with emerging marketing trends.[10] Under these circumstances, small-scale survive due to the

10 Thibbotuwawa, M. (2019). Smart Digital Farming in Agriculture: Status and Prospects for Sri Lanka. In *Sri Lanka State of the Economy 2019*. Colombo: Institute of Policy Studies of Sri Lanka.

government's direct and indirect support measures, such as guaranteed prices and trade protection measures and partly due to a lack of alternative employment opportunities in the non-farm sector. However, some of these are unsustainable, and misdirected measures to achieve self-sufficiency in domestic production could result in economic costs.

12.3.6 Policy and Institutional Issues

Sri Lanka has three tiers of government: national/central, provincial, and local authority and the mandates over the agricultural sub-sectors fall on several institutions in both the central government and provincial governments (see infographic). Overlapping responsibilities are seen among several Ministries, leading to potential conflicts and inefficiencies. For instance, both the Ministry of Agriculture and the Ministry of Irrigation are involved in water resource management in agriculture. Also, the Ministry of Plantation and the Ministry of Land may be involved in policies concerning land management. The devolution of responsibilities has led to a flawed agricultural service delivery structure particularly in extensions, weakening the linkage between technology generation and technology dissemination.

The lack of coordination between institutions adds another layer of complexity. Provincial Councils (PCs) are mandated to implement central government-designed programmes that sometimes compete with existing programmes and day-to-day operations of councils. Therefore, poor horizontal and vertical coordination among the multiple organisations involved in the planning, implementation, and monitoring of activities related to agriculture at the central, provincial, and local government levels, is a matter of serious concern. Resource allocation from the central government to the devolved structures, PCs, or local governments, is usually insufficient for agriculture sector activities. The lack of skilled human resource capacity in mandated areas relating to agriculture has also received renewed attention, particularly with the increasing trend in migration in recent times. The involvement of stakeholders, such as farmers, the private sector, and academia, is weak at all levels of planning, programming, implementation, and monitoring.

Institutional Landscape of Agriculture

Political Regime led by (President) →		Mahinda Rajapaksa		Maithripala Sirisena				Gotabaya Rajapaksa			Ranil Wickremesinghe	
Main Line Ministry	**Departments**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
M/Agriculture	D/Agrarian Development	Economic Development		√	√	√	√	SM/Paddy and Grains, Organic…			√	√
	D/Agriculture	√	√	√	√	√	√	√	√	√	√	√
	D/Animal Production and Health	Livestock & Rural Community Development		Rural Economic Affairs			√	SM/Livestock, Farm Promotion and Dairy and Egg Related Industries			√	√
M/Plantation Industries	D/Rubber Development	√	√	√	√	√	√	SM/Company Estate Reforms, Tea and Rubber Estates….			√	√
	D/Export Agriculture	Minor Export Crop Promotion		Primary Industries			Agriculture	SM/Development of Minor Crops Plantation…			√	√
	D/Cinnamon Industry Development	Not Exist										√
M/Fisheries	D/Fisheries and Aquatic Resources	√	√	√	√	√	Agriculture	√	√	√	√	√
M/Irrigation	D/Irrigation	√	√	√	√	√		√	√	√	√	√
M/Lands	D/Land Commissioner General	√	√	√	√	√	√	√	√	√	√	√
	D/Surveyor General	√	√	√	√	√	√	√	√	√	√	√
	D/Land Title Settlement	√	√	√	√	√	√	SM/Land Management, State Enterprises, Land and Property Development		√	√	√
	D/Land Use Policy Planning	√	√	√	√	√	√			√	√	√

Notes: M/= Ministry; D/=Department; SM/=State Ministry.

Source: Authors' compilation based on various sources.

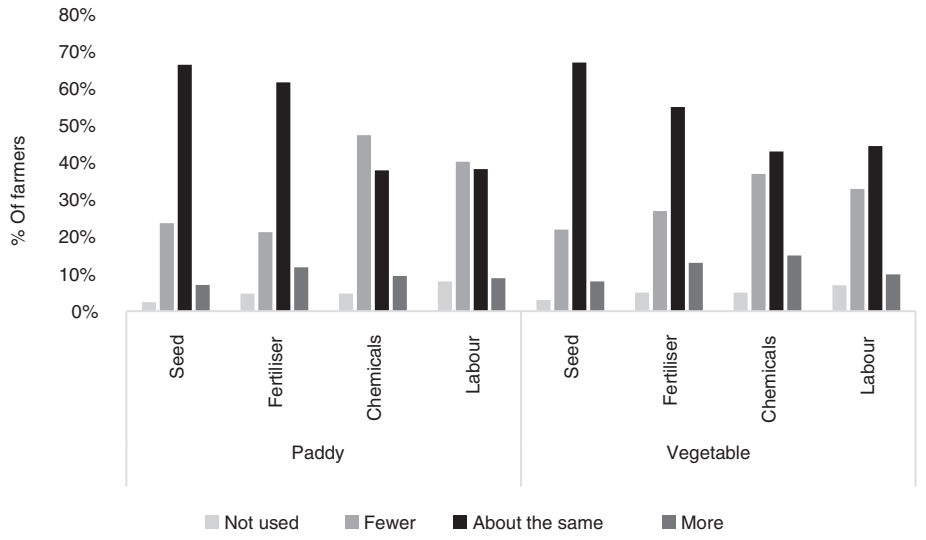
12.4 Responding to Short-term Crises

The economic crisis in Sri Lanka which heightened in 2022, is a multifaceted issue driven by several interrelated factors, including rising external debt, a foreign currency crisis, rising prices and shortage of essential goods, and political instability. Apart from the impacts of the COVID-19 pandemic and economic mismanagement, some other short-term internal and external factors including flaws in policymaking like the import ban on chemical fertilisers and the Russia-Ukraine war, respectively, further added to the 2022 crisis. Such short-term crises have profound and widespread impacts on the country's agriculture sector.

12.4.1 COVID-19 Pandemic: The Beginning of the Economic Crisis

The COVID-19 pandemic, which began in early 2020 and continued until 2021 caused considerable damage to agriculture and food security, highlighting the vulnerability of food systems in Sri Lanka. The farmers faced difficulties in accessing quality seeds, fertiliser, labour and other inputs and necessary equipment due to both the shortage and rising costs creating a decline in crop production and yields. Data from an IPS COVID-19 Farmer Impact Survey in 2021 (CFIS-2021)[11] suggest that about 54% of the paddy farmers and 33% of vegetable farmers had spent fewer days on farming than usual (Figure 12.1). About 24% and 22% of paddy farmers and vegetable farmers, respectively, used less seed than in the previous season. About 21% of paddy farmers and 27% of vegetable farmers used less fertiliser than normal. About 47% of paddy farmers used less chemicals and about 37% of farmers who cultivated vegetables used less of these chemicals. Some paddy and vegetable farmers did not have access to these resources.

Figure 12.1 Institutional Landscape of Agriculture



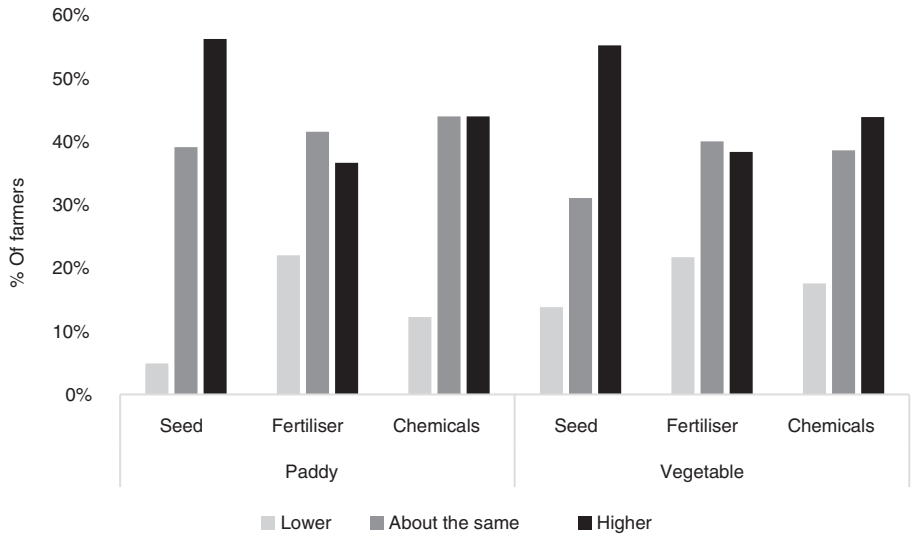
Source: Authors' illustrations based on CFIS-2021 data.

11 CFIS-2021 covered randomly selected 75 paddy farmers and 75 vegetable farmers from key agricultural districts that include Anuradhapura, Polonnaruwa, Badulla, Moneragala, Matale, Batticaloa, Ampara, Jaffna, Kilinochchi, Vavuniya, and Mullaitivu.

Moreover, problems with cash flow, which had been an issue in Sri Lankan agriculture even before COVID-19, significantly impacted farmers during the pandemic. As the survey data show, a sizeable proportion of farmers suffered due to the high cost of inputs. For example, more than 56%, 37% and 44% of paddy farmers had to pay relatively higher prices to buy seeds, fertiliser, and chemicals, respectively (Figure 12.2). Along the same vein, the corresponding figures for vegetable farmers are 55%, 38% and 44%.

Prices of agricultural products too began to rise. In 2020, the prices of vegetables and rice became uncontrollable due to the intervention of intermediaries, and maximum wholesale and retail prices were introduced for vegetables and rice varieties to control rising prices. However, some traders were still not selling rice at government-set prices, and thus some farmers were not getting a fair price. A perennial problem with the marketing of Sri Lanka's agricultural products is that intermediaries earn excessive prices at the cost of farmers due to various structural and operational deficiencies in the value chain. The same problem persisted during the pandemic.[12]

Figure 12.2
Input Prices During COVID-19 Against the Previous Season



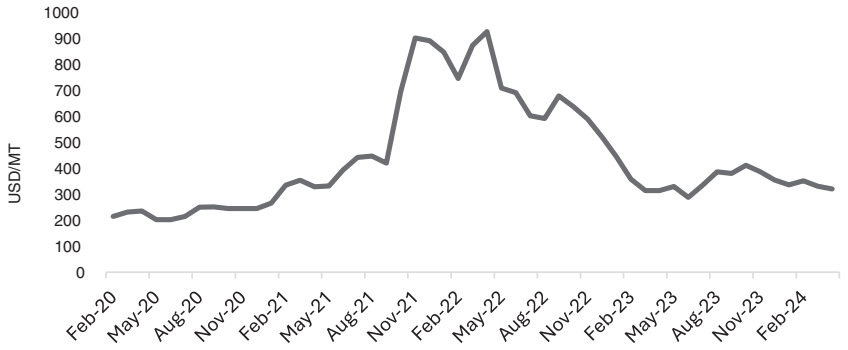
Source: Authors' illustrations based on CFIS-2021 data.

The continuous rise in fertiliser and crude oil prices in the global market also contributed to price hikes in both the input and output markets. The global fertiliser and crude oil markets faced substantial upheavals due to the COVID-19 pandemic, which affected production and logistics, and export restrictions from certain countries to ensure domestic availability further exacerbated the supply issues. Urea prices increased to an all-time high of United States Dollars (USD) 900/metric tonnes (MT) in November 2021 from less than USD 215/MT at the start of COVID-19 in January 2020

12 Thibbotuwawa, M., Senaratne, A., Dissanayaka, N., Samaraweera, R., Puspa Sharma, P., Kharel, P., Singh, D., & A. Gupta. (2021). *The Future of Food security in an Age of Pandemics: Building a Modern and Resilient Food System in Sri Lanka and Nepal*. Occasional Paper Series No: 73, Southern Voice Secretariat.

(Figure 12.3). At this point, government efforts proved to be insufficient in the face of this crisis. For example, even though price controls and government-purchase programmes provided some relief for consumers and farmers, the actors situated at the lower end of the supply chain continued to face challenges. Thus, the most vulnerable farmers failed to obtain inputs such as seed and fertiliser on time and were unable to sell their products – even at the unprofitable prices arising from exploitation by intermediaries.

Figure 12.3
Fluctuation of Global Urea Prices During COVID-19



Source: Index Mundi (n.d.). *Urea Monthly Price - US Dollars per Metric Tonne,* https://www.indexmundi.com/commodities/?commodity=urea

12.4.2 Chemical Fertiliser Ban: A Part of the Economic Crisis

While the country was recovering from the pandemic, the government imposed a ban on the importation of chemical fertilisers in May 2021. The ban was aimed at shifting conventional farming to entirely organic farming to make Sri Lanka the first country to achieve 100% organic status globally. Anecdotal evidence indicates that easing the foreign exchange burden of the COVID-19 pandemic has been another important reason behind the imposition of the ban.[13] The government replaced the import ban with a license requirement in July 2021, and then removed it altogether in November 2021 due to the issues faced by farmers and stiff opposition from diverse stakeholders.[14] However, the damage from this flawed policy decision had already occurred, which gave rise to a string of adverse events on domestic food production contributing to food shortages and food price inflation in 2021.

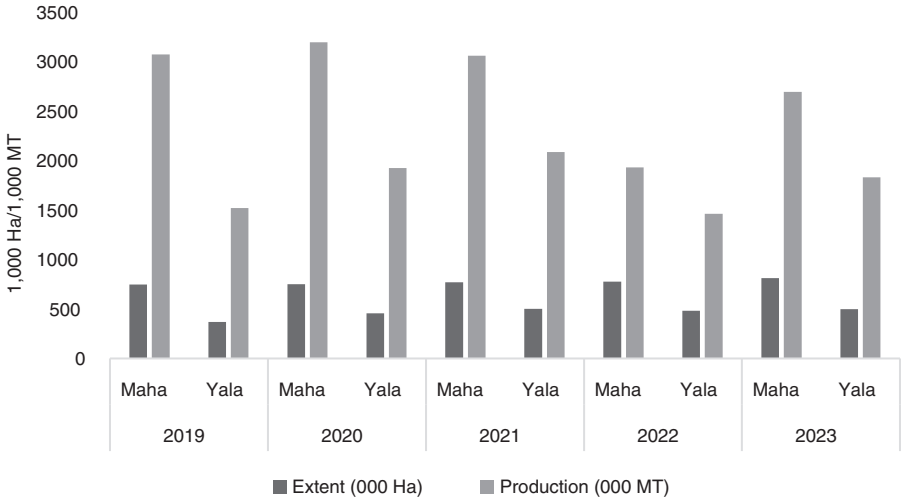
The impact of the chemical fertiliser ban was much higher than the impact of the COVID-19 pandemic on agricultural production. The Yala cultivation season in 2021 had started with the available fertiliser when the ban was imposed, and therefore, no observed impact was found on paddy cultivation relative to the previous Yala season. However, even with the lifting of the ban, both paddy production (37%) and paddy yield (34%) dropped significantly in the Maha 2022 season relative to the previous Maha

13 Weerahewa, J., Senaratne, A., & Babu, S. (2021). *Reforming Fertiliser Import Policies for Sustainable Intensification of Agricultural Systems in Sri Lanka: Is There a Policy Failure?* (No. 2445-2022-883).

14 Niwarthana, S.S., Dissanayake, N., Thibbotuwawa, M., & Rosairo, H. S. R. (2023). *The Impact of Chemical Fertiliser Ban on the Paddy Sector: Propensity Score Matching and Value Chain Analysis.* Research Paper #21. September 2023. Feed the Future. The US Government's Global Hunger and Food Security Initiative. Michigan: Michigan State University.

season even without any reduction of cultivated extent due to a shortage of fertiliser (Figure 12.4). The lack of knowledge concerning raw material handling, correct dosage, execution of organic fertilisers and insufficient exposure of extension officers to organic farming were also serious issues. A reduced harvest collection was experienced, particularly by small-scale collectors, adversely affecting their market operations while facing the risk of being eliminated from the industry in the face of increasing competition. The situation was similar across a wide range of agricultural products.

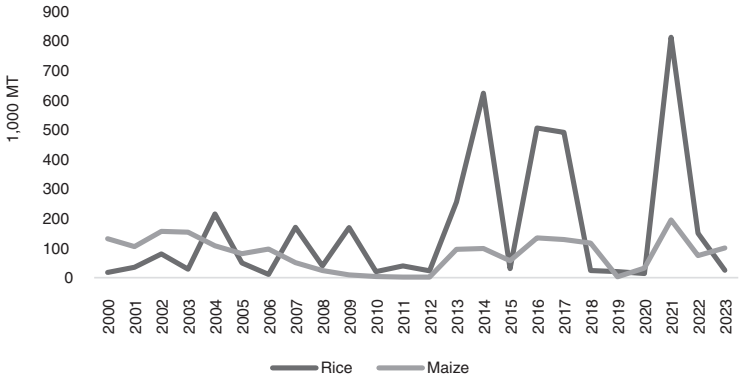
Figure 12.4
Changes in Paddy Production During the Chemical Fertiliser Ban



Source: Department of Census and Statistics of Sri Lanka. (2024). *Paddy Statistics,* http://www.statistics.gov.lk/Agriculture/StaticalInformation/PaddyStatistics#gsc.tab=0

Exorbitant fertiliser prices in the world market and export restrictions set out by fertiliser-producing countries following the COVID-19 pandemic exacerbated the problem further. The price of urea had risen sharply to an all-time high in November 2021 as previously noted, when the ban was lifted. This held severe implications for Sri Lanka's agriculture sector and food security, requiring the country to import and seek support from different countries to fill the production gap. Among these were rice imports estimated roughly at 812,000 MT and maize imports of 195,000 MT during 2021 (Figure 12.5).

Figure 12.5
Rice and Maize Import Fluctuation (1,000 MT)

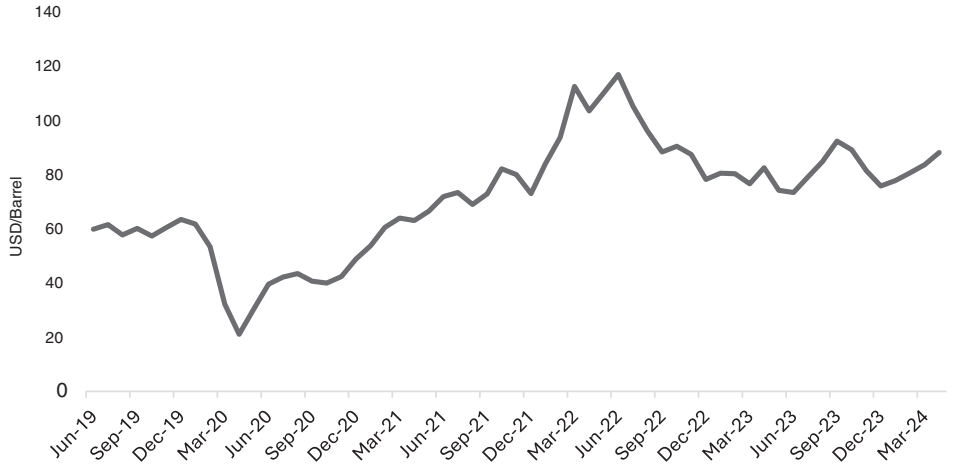


Source: Index Mundi. (n.d.). *Commodity Prices*. https://www.indexmundi.com/commodities/

12.4.3 Ukraine War: Adding to the Burden

After the COVID-19 pandemic outbreak and the chemical fertiliser ban in Sri Lanka, the Russia-Ukraine conflict emerged in February 2022. Its impact on Sri Lanka was felt primarily through fuel, fertiliser, and food prices, Sri Lanka being a net importer of these commodities. The subsequent volatility in global oil prices, rising international food and intermediate input prices, and high logistics costs, coupled with the compounded impact of a steep Sri Lankan Rupee (LKR) depreciation, contributed to food price increases. Following Russia's invasion of Ukraine, crude oil prices rose by 25%, from USD 94 per barrel in February 2022 to USD 117 per barrel in June 2022 (Figure 12.6). The oil price shock worsened Sri Lanka's economic woes due to its harsh impacts on several essential sectors of the economy.

Figure 12.6
Fluctuation of Crude Oil Prices

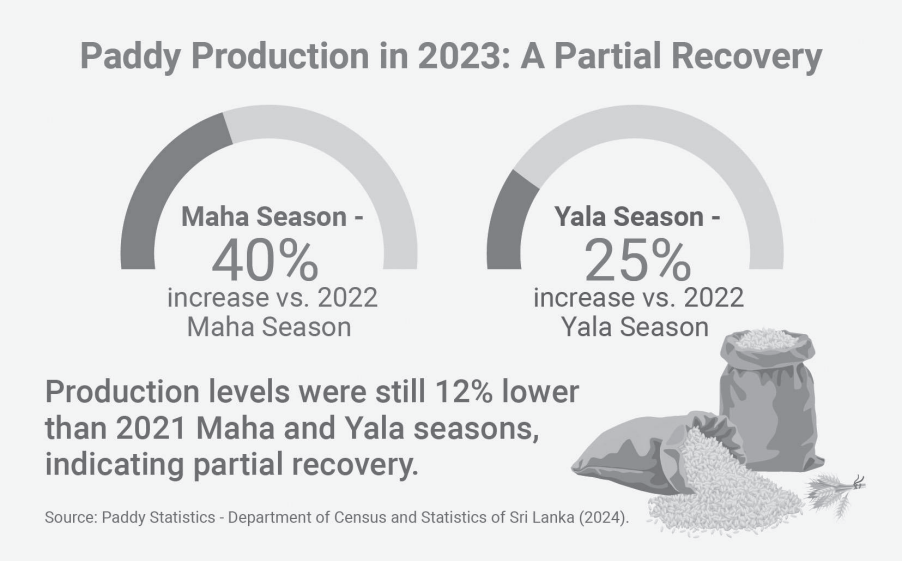


Source: Index Mundi. (n.d.). Crude Oil (Petroleum) Monthly Price - US Dollars per Barrel. https://www.indexmundi.com/commodities/?commodity=crude-oil

Similarly, following a decline in fertiliser prices by 17% after COVID-19, from USD 900/MT in November 2021 to USD 744 in February 2022, fertiliser prices started to surge following the Ukraine war. Urea prices rose by 24% to an all-time high of USD 925/MT in April 2022 from the pre-war price (see Figure 12.4). While Sri Lanka received in-kind and financial support from the US and India for fertiliser, the implications of continuing fertiliser shortages continued even in the Yala 2022 season, with a drop in production by 30% and the yield levels by 26% due to fertiliser shortages as discussed before. Further, Sri Lanka had to import a further 150,000 MT of rice from the world market despite the foreign exchange shortages that plagued the country. Russia and Ukraine account for about 9% of Sri Lanka's food imports annually, including 45% of its wheat requirement (in 2020). The cost of wheat reached its historical highest USD 522 per MT in May 2022, increasing by 34% from USD 390 per MT before the said invasion in February 2022.

12.5 Post-crisis Agricultural Recovery

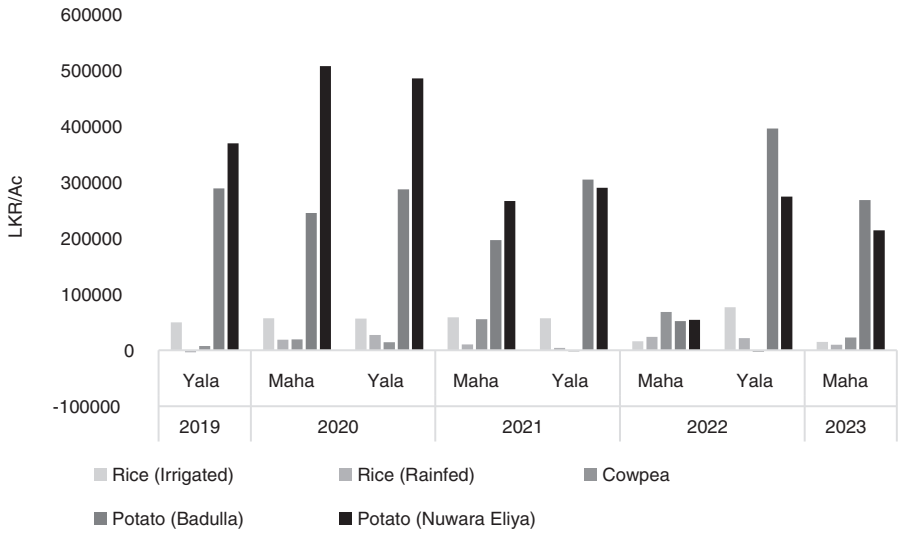
While the direct influence of COVID-19 has ended and the disruption from the import ban has been almost alleviated, both shocks along with the Ukraine war, have left lasting impacts on the economic foundation of the agriculture sector and farmer livelihoods. Global fuel and fertiliser prices have eased, but notably, the current price levels are still way above the pre-COVID-19 price levels. Following the surge in crude oil prices, prices started to decline from USD 117/barrel in June 2022 to USD 88/barrel in April 2024. Similarly, urea prices decreased to USD 320/MT in April 2024 from an all-time high of USD 925/MT in April 2022.



The impacts of these are clearly visible with the reversal of the declining trend of agricultural production. For example, the Maha and Yala seasons in 2023 recorded a 40% and 25% rise, respectively, in paddy production compared to the previous Maha and Yala seasons (See infographic). However, it should be noted that these production levels were still 12% lower than in the Yala and Maha seasons in 2021, showing signs of only a partial recovery. At the rate of 112 Kg/capita/year rice consumption, the total output of 4.5 Mn MT paddy in 2023 (equivalent to 2.8 Mn MT rice) is sufficient to feed the population for about 14 months. Therefore, no shortage of rice was observed and the imports also dropped from 150,000 MT in 2022 to the business-as-usual level of 25,000 MT in 2023 (see Figure 12.5). Farmer profitability has been marked by significant fluctuations during the last four years, driven by a combination of reasons such as supply chain disruptions, market price volatility, increased input costs, and government policies. Since mid-2021, some improvements in farm profits can be seen (Figure 12.7). Despite some recovery, ongoing issues such as high input costs and price volatility continue to challenge the profitability of many farmers.

While the direct influence of COVID-19 has ended and the disruption from the import ban has been almost alleviated, both shocks along with the Ukraine war, have left lasting impacts on the economic foundation of the agriculture sector and farmer livelihoods.

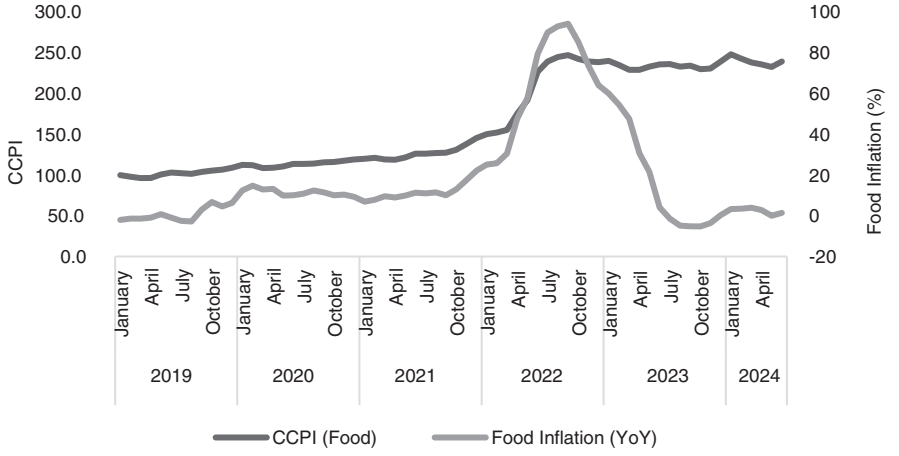
Figure 12.7
Fluctuation of Profitability: Yala 2019- Maha 2023



Source: Department of Agriculture, Cost of Cultivation Data (2019-2023).

The high volatility and significant inflation peaks of 2022 have stabilised and eased in 2023 with the implementation of effective policies and recovery in agricultural production (Figure 12.8). The same trend continues into 2024, albeit with occasional minor increases, reflecting overall better control over food prices. Despite the gradual drop in inflation, food price levels remain high, continuing to exert pressure on households.

Figure 12.8
Fluctuation of CCPI and YoY Inflation for Food



Note: YoY denotes year-on-year.
Source: Department of Census and Statistics of Sri Lanka. (2024). Colombo Consumer Price Index by Subgroups, http://www.statistics.gov.lk/InflationAndPrices/StaticalInformation/MonthlyCCPI/ColomboConsumerPriceIndexby_Subgroups

Interestingly, nominal and real producer prices of key selected crops have increased during recent periods, showing that food inflation has been rising faster than general inflation (Figure 12.9 a-b). This might indicate a positive impact on farmer income at the cost of consumer welfare, especially for low income households. However, retail prices seem to have increased relatively faster than the producer prices (Figures 12.10 a-d). This implies the widening price gap in Sri Lanka between the price that farmers receive for their agricultural products and the price that consumers pay for these products at the retail level. Various factors can influence this gap and can have significant implications for the agricultural sector and the overall economy of the country. The cost of agricultural inputs such as fertilisers and fuel has risen significantly, further squeezing farmers' margins from the final consumer price. This perennial issue of marketing in agriculture, heightened during the crises, needs a sustainable solution.

Figure 12.9a
Nominal Producer Prices

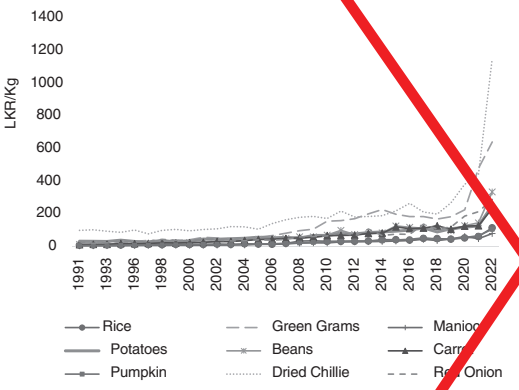
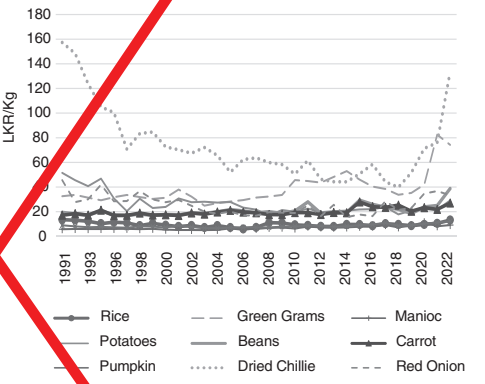


Figure 12.9b
Real Producer Prices



Source: Central Bank of Sri Lanka (CBSL) (Various Years), Economic and Social Statistics of Sri Lanka.

Figure 12.10a
Rice Producer-Retail Price Gap

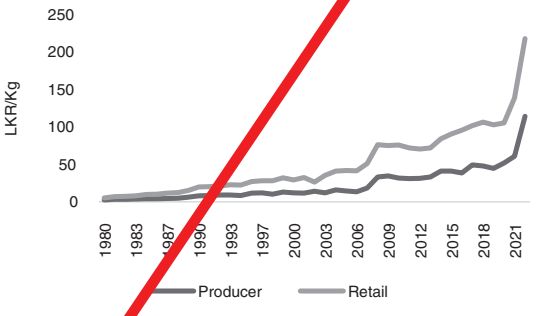


Figure 12.10b
Beans Producer-Retail Price Gap

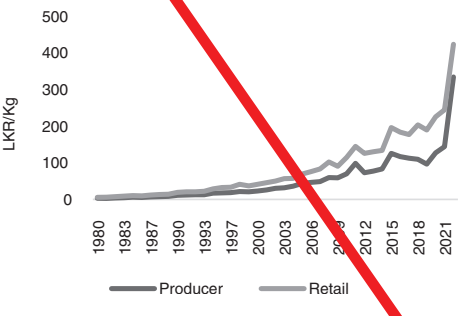


Figure 12.10c
Red Onion Producer-Retail Price Gap

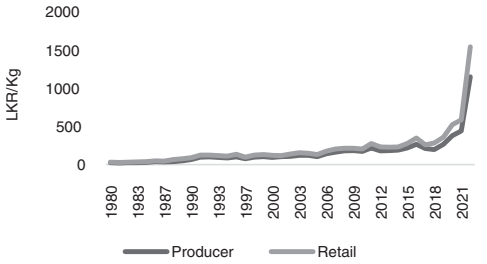
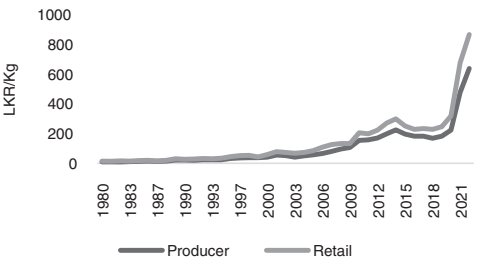


Figure 12.10d
Green Grams Producer-Retail Price Gap



Source: CBSL (Various years), Economic and Social Statistics of Sri Lanka.

12.6 Conclusion and Policy Implications

The compounding economic challenges faced by Sri Lanka due to COVID-19, coupled with the impact of the fertiliser import ban and the Russia-Ukraine conflict, have resulted in significant hardships for the agriculture sector and food security. Due to shortages and rising costs, farmers faced hardships in accessing quality seeds, other inputs, fuel and necessary equipment which led to a decline in crop production and yields. Smallholder farmers constituting a sizeable portion of the agricultural sector, were disproportionately affected by significantly reduced productivity, income losses, and declining purchasing power. Many farmers, already burdened by existing debts, found it challenging to secure new credit, leading to financial distress and, in some cases, the inability to sustain their farming activities. The contraction in domestic agricultural production coupled with disrupted marketing channels contributed to soaring food prices, making it difficult for many households to afford basic staples, exacerbating food insecurity and malnutrition in the country.

There are also some key lessons from the experience of short-term crises. Sri Lanka's agriculture sector inherently exhibits long-term structural weaknesses that render it particularly susceptible to short-term shocks. These weaknesses can stem from various factors, including economic, environmental, technological, social and institutional dimensions. These dimensions cover a gamut of structural issues such as low productivity, lack of diversification, market inefficiencies, climate change vulnerability, natural resources degradation, poor adoption of modern technologies, inadequate research and extension, smallholder dominance, youth abandoning agriculture, poor infrastructure and weak governance. For example, low productivity combined with small farm sizes does not provide adequate income for farmers in Sri Lanka to meet their farm investments and consumption needs during short-term crises. Similarly, farmers faced severe challenges in terms of marketability, i.e. selling their products at a fair price during crises due to challenges in traditional marketing.

Sri Lanka's agriculture sector inherently exhibits long-term structural weaknesses that render it particularly susceptible to short-term shocks.

The short-term crises also hindered the structural transformation process, delaying agricultural development. For example, financial distress during the short-term crises further limited the capacity

to invest in productivity improvements. The short-term crises have also demonstrated that some past interventions to address the long-term structural issues by governments, such as subsidies for fertiliser, seeds, irrigation, and extension and government procurement systems including guaranteed price schemes, have contributed to worsening the budgetary pressures amplifying the economic crisis. Therefore, the current situation could be taken as an opportunity to carefully evaluate and revise these programmes for optimal outcomes.

Against this context, the short-term priority should be to support farmers in recovering from the economic turmoil within the budgetary constraints of the government. Therefore, repurposing the current available budgets, focusing on farm productivity and income is essential. These measures can encompass revisiting irrigation expenditures to transfer some capital spending towards increasing the efficiency of irrigation water use including site-specific water use through micro-irrigation techniques, water-saving technologies, etc. The fertiliser subsidy should be provided purely in the short-term, and targeted using newly collected farmer data through databases such as 'Geo Goviya'. Savings from the fertiliser subsidy expenditures could be used to improve fertiliser use efficiency through precision/site-specific application techniques, third-generation fertiliser use, etc. The efficiency of using the available research and development (R&D) budgets should be maximised by introducing key performance indicators (KPIs) for the R&D institutions under the National Agriculture Research System (NARS). An online network system can be devised using the 'Geo Goviya' database to link the farmers and other stakeholders to prevent shortcomings in the information markets, prevent wasteful gluts and deficits, reduce post-harvest losses, promote technology adaptation, etc.

The short-term crises also hindered the structural transformation process, delaying agricultural development.

In the longer-term, a broader structural transformation is needed to convert traditional subsistence agriculture to one that maximises productivity while giving priority to improving processing, marketing, and downstream activities to increase value addition to agricultural products. Public investment in agriculture should gradually be withdrawn from less productive avenues (e.g. price and input subsidies and market interventions) and reallocated to more economically and socially beneficial activities such as agricultural R&D, technology, climate adaptation and sustainable agriculture and information management. High priority should be placed on achieving a broad-based shift from traditional low-value to modern high-value agriculture through the promotion of cutting-edge technology and mechanisation including micro-irrigation, site-specific input application and polytunnel technology. Training and capacity building of youth on scientific modern farming methods along with promoting agricultural entrepreneurship would enhance youth participation in agriculture.

Against this context, the short-term priority should be to support farmers in recovering from the economic turmoil within the budgetary constraints of the government.

Private sector participation and public-private-producer partnerships should be promoted where feasible (e.g. trader-farmer contracts, contract grower systems, etc.) to integrate smallholders with

dynamic value chains and facilitate the linkages between producers and the modern value chain actors. By focusing on land consolidation and land use efficiency, current land policy should be reformed to rationalise land ownership for efficient use of land resources by revising the dated regulations on ownership and removing restrictions on transactions of such lands. Strict enforcement measures of regulations on land use such as limiting agricultural land use only to suitable land classes, amending regulations on soil conservation to prevent improper land uses, and identifying activities leading to degradation of land are vital. Scientifically reforming the institutional structure in agriculture is needed to enhance the coordination between institutions, avoid duplication of responsibilities, minimise transaction costs, and increase the efficiency and effectiveness of service delivery for the benefit of the farming community.

13. Export Diversification of Minor Export Crops

13.1 Introduction

Sri Lanka exports diverse agricultural products such as tea, rubber, coconut, spices, vegetables, minor agricultural crops, unmanufactured tobacco, etc., with agriculture export earnings varying between 20-24% in terms of total export earnings over the last five years. The agricultural export composition has undergone a notable transformation within the past decades, with a decline in the export shares of conventional large-scale plantation crops such as tea and rubber. In contrast, a noticeable increase is seen in the contributions of small-scale non-traditional minor export crops, represented by a variety of spices, vegetables, minor agriculture products, unmanufactured tobacco, etc.

More than half of such non-traditional minor export crops are made up of spices. Sri Lanka's spice sector contributed 14% to agricultural export earnings and accounted for 3% of total export earnings in 2023. According to industry experts, nearly 1.3 million (Mn) small and medium-scale farmers are directly and indirectly involved in the sector. The main spices produced include cinnamon, pepper, cardamom, cloves and nutmeg. Sri Lanka has been ranked as the 15th most important exporter of spices in the world in 2023,[1] and was the world's largest producer and exporter (90% of the world market) of true cinnamon, while ranked 8th for pepper and 10th in the world for cloves, nutmeg and coffee in 2022.[2]

With a growing recognition globally for their unique quality and taste profile, Sri Lankan minor export crops can make further inroads and tap into world demand. The global spices and seasonings market is predicted to grow from United States Dollars (USD) 18.5 billion (Bn) in 2022 to USD 25.4 Bn by 2029, at a compound annual growth rate of 4.7% during the projected period,[3] in part driven by the increasing demand for authentic cuisines globally. Indeed, such agricultural crops are valued for their use in the production of spices, essential oils, extracts, seasonings, sauces, food products, fragrances, cosmetics, and medicines, among others. Therefore, there is substantial potential for Sri Lanka's minor export crop sector to benefit from these evolving trends if industry limitations – in production, processing, and marketing – can be overcome. Furthermore, opportunities lie in the minor export crops sector for improving livelihoods, particularly of smallholder farmers and rural communities in Sri Lanka. Against this background, this chapter aims to identify the untapped

Strategies and recommendations to tap into export potential and expand the global market share for selected minor export crops ultimately provide benefits to the stakeholders involved in the value chain.

1 Export Development Board. (n.d.). *Why Source Spices from Sri Lanka*, https://www.srilankabusiness.com/spices/source-spices-from-sri-lanka.html

2 United Nations Industrial Developemnt Organization. (2023). *Value Chain Analysis on Pepper, Clove, and Nutmeg in Sri Lanka*, https://downloads.unido.org

3 *Ibid.*

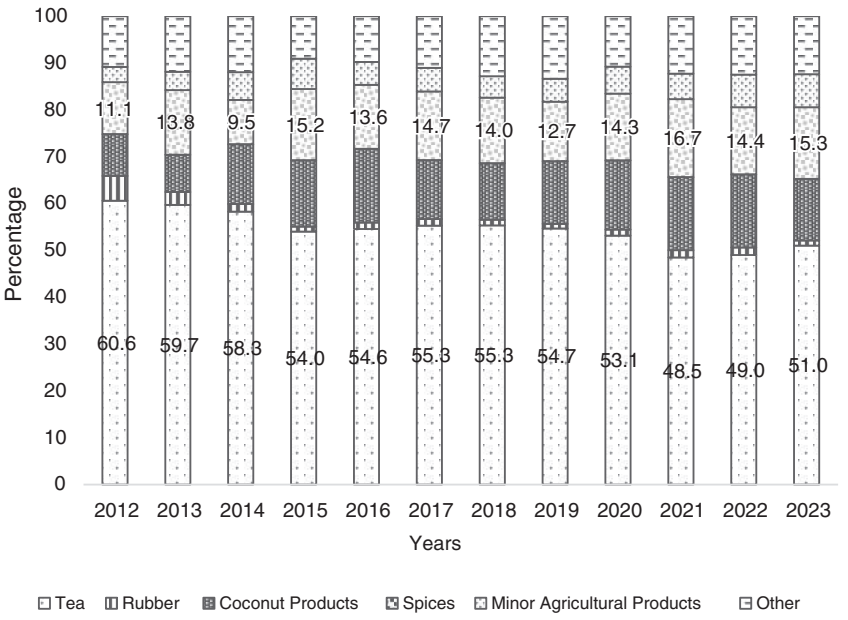
export potential in minor export crops in Sri Lanka, primarily focusing on cinnamon, pepper, cloves, cardamom and nutmeg. Further, it suggests strategies and recommendations to tap into this export potential and expand the global market share for the selected crops to benefit stakeholders involved in the value chain of these selected minor export crops.

13.2 Export Trends in Minor Export Crops

Sri Lanka's export agricultural crops include a wide range of products that make a significant contribution to the country's overall export earnings. On average, over the last decade, agriculture exports as a percentage of total export earnings were around 22% in 2023. While large-scale plantation crops such as tea, rubber, and coconut were dominant in the past, there has been a noticeable shift in the composition of agricultural exports.

The emphasis on diversifying agricultural exports has seen the growth of non-traditional export crops such as spices (e.g., cinnamon, pepper, clove, nutmeg, etc.), and other agricultural products (fruits, vegetables, beverages. etc.). As a result, the share of export earnings from tea and rubber has declined over the years while that of other minor agricultural export crops has grown (Figure 13.1). The main crops which contributed to the growth in minor agriculture products are cinnamon, pepper, clove, cardamom, and nutmeg which are categorised as spices.

Figure 13.1
Share of Agriculture Exports, 2012-2023



Source: Central Bank of Sri Lanka (2023). Annual Economic Review 2023. Colombo: Central Bank of Sri Lanka.

Since 2014, the production of selected minor export crops shows an increasing trend, albeit with some fluctuations in certain years (Table 13.1). Most of these crops are seasonal, which have one or two rounds of plucking in a year. Furthermore, climate change has had significant impacts on the production fluctuations of these minor export crops – changes in rainfall patterns and temperature predominantly affect plant metabolism, flowering, and fruiting processes. Aside from impacts during the production stage, impacts also occur during harvesting and storage periods.

Table 13.1
Production of Selected Minor Export Crops (MT), 2014-2023

Minor Export Crop	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Cinnamon	17,600	17,707	18,945	22,341	20,398	20,352	20,866	22,872	24,094	24,475
Pepper	18,660	28,177	18,476	29,546	22,551	22,156	23,970	25,047	24,029	24,618
Cloves	3,225	5,253	1,823	6,413	3,360	4,786	3,512	3,837	4,088	4,179
Cardamom	87	91	120	113	86	69	86	104	140	141
Nutmeg and Mace	2,960	2,750	2,723	3,545	4,180	5,119	2,751	2,818	2,878	2,902

Note MT denotes metric tonnes.
Source: Central Bank of Sri Lanka (2023). Annual Economic Review 2023. Colombo: Central Bank of Sri Lanka.

The cultivation of the aforementioned crops predominantly occurs on smallholding lands, typically occupying areas of less than 1 hectare (ha). Notably, pepper and cloves are also cultivated within home gardens. In contrast, a considerable proportion of cardamom cultivation is observed in larger estates. The bulk of the produced yield, approximately 90%, is directed towards export markets, with less than 10% allocated for domestic consumption. Moreover, national productivity levels for all the selected minor crops surpass 0.5 (MT/ha),[4] with the exception of cardamom, according to the latest available data from the Department of Export Agriculture (DEA) in 2021. However, this figure is fairly low against the productivity of the Indian spice sector, which was 2.36 MT/ha in 2022.[5]

The bulk of the produced cardamom yield, approximately 90%, is directed towards export markets, with less than 10% allocated for domestic consumption.

13.2.1 Export Markets and Trends

Cinnamon: Cinnamon is the most pivotal minor export agriculture crop in Sri Lanka which contributed more than 50% of the total sector export earnings. Remarkably, over 90% of 'true cinnamon' (Cinamomum Zylanicum/Ceylon cinnamon) production and exports in the world is dominated by

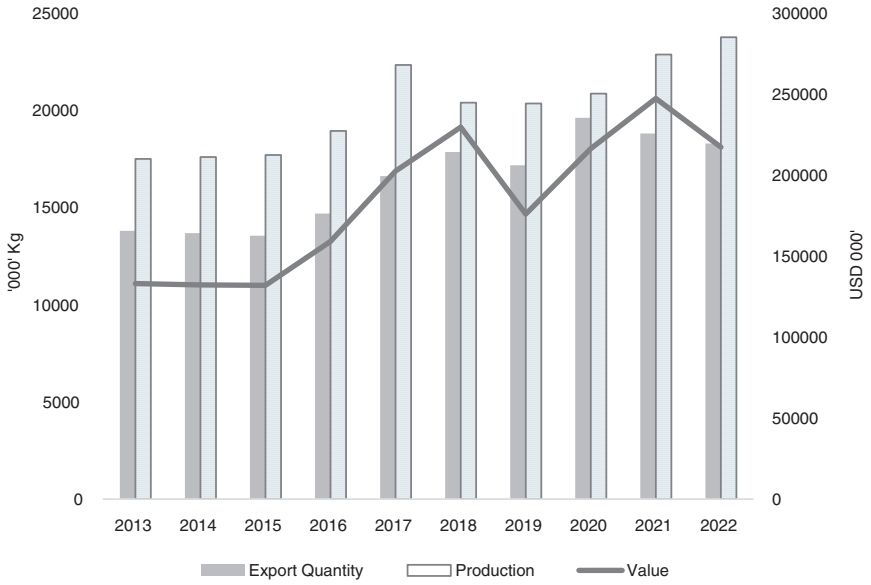
4 MT/ha denotes metric tonne per hectare.

5 Spices Board, India. (2023). Major Spice State-wise Area Production, https://indianspices.com

Sri Lanka. Ceylon cinnamon is renowned for its superior high-quality, and is scarcer and generally more expensive than cassia cinnamon which is found in Indonesia, China, Vietnam, and India. The scarcity of 'true cinnamon' contributes to its value in the spice market.[6]

Over 90% of 'true cinnamon' production and exports in the world is dominated by Sri Lanka.

Figure 13.2
Production and Export Trends of True Cinnamon



Source: Author's calculations using the International Trade Centre (ITC) database.

Ceylon cinnamon production has been on an increasing trend though with some fluctuations reported in certain years (Figure 13.2). The production fluctuations are mainly due to dry weather and the unusual shift in rainfall patterns in the main growing areas, an increase in the production cost, and price fluctuations in export markets.[7] Cinnamon exports exhibit an upward path, notably marked by a remarkable surge post-2015, largely attributed to several factors, including new markets for cinnamon.[8] Implementing strategic policies or initiatives aimed at enhancing the production, processing, and marketing of cinnamon include investments in modernising production methods, improving quality control measures, and expanding market access through trade agreements and brand promotional campaigns.[9]

6 Export Development Board. (n.d.). *Why Source Spices from Sri Lanka?,* https://www.srilankabusiness.com/spices/source-spices-from-sri-lanka.html

7 Industry Capability Report, Export Development Board. (2020). *Spices & Allied Products Sector - Industry Capability Report* (srilankabusiness.com).

8 Hirimuthugodage, D., Thibotuwawa, M., & Wijayasiri, J. (2017). *Analysis of Cinnamon Pepper and Cardamom Value Chains in Sri Lanka*. Colombo: JICA and Institute of Policy Studies of Sri Lanka.

9 Industry Capability Report, Export Development Board. (2020). *Spices & Allied Products Sector - Industry Capability Report* (srilankabusiness.com).

In the global market for both cinnamon (Cinamomum Zylanicum/Ceylon cinnamon) and cassia (Cinnamomum cassia J. Presl /Chinese cinnamon),[10] Sri Lanka has supplied nearly 22% of the world's cinnamon demand in value terms since 2018. However, before 2018, Sri Lanka's export share in terms of USD value to the world market was nearly 30%. China, Vietnam, and Indonesia are other major exporters of cinnamon, which primarily produce cassia. In recent years, cassia exports from China have spiked, shrinking Sri Lanka's share in the global market. However, the quality of the cinnamon exported from China, Vietnam, and other countries has been identified as different or rather inferior compared to the exceptional characteristics of Ceylon cinnamon, which contains low levels of the toxic chemical compound coumarin. In contrast, cassia cinnamon from other countries has a comparatively high concentration of coumarin.[11]

Pepper contributed approximately 12.5% of Sri Lanka's minor export earnings in recent years.

The US, Mexico, and Peru are the main export markets for Ceylon cinnamon. Colombia, Ecuador, Spain, Guatemala, Chile, and Bolivia are among the countries with a high demand for Ceylon cinnamon. The market penetration ratio, which measures the relative strength of an exporter compared to its competitors in a given market was calculated using International Trade Centre (ITC) data for the main cinnamon export destinations for Sri Lanka. In the US market, the market penetration for Ceylon cinnamon was 23% in 2014 with a drop to 17% in 2023. In the Mexico market, a slight drop is seen from 96% market penetration in 2014 to 93% in 2023. However, in the Peru market, Sri Lanka has retained market penetration at a high level of 96% over the same period. These figures highlight a mixed outcome suggesting that Ceylon cinnamon has been sufficiently strong in capturing and maintaining markets in some countries but is losing in others owing to growing competition, changing consumer preferences, or the declining overall demand for Ceylon cinnamon.

Pepper: Pepper contributed approximately 12.5% of Sri Lanka's minor export earnings in recent years. Sri Lankan pepper is renowned for its unique flavour profile, characterised by a robust and bold taste. Various factors, including the land (environmental conditions such as soil, climate, and altitude), pepper varieties, and the traditional cultivation methods passed down through generations contribute to this.[12] Sri Lankan pepper has higher piperine content, estimated to be 2-6 times higher than in other countries,[13] which gives it a superior quality and pungency. Figure 13.3 provides data on the production and export quantity and value of pepper.

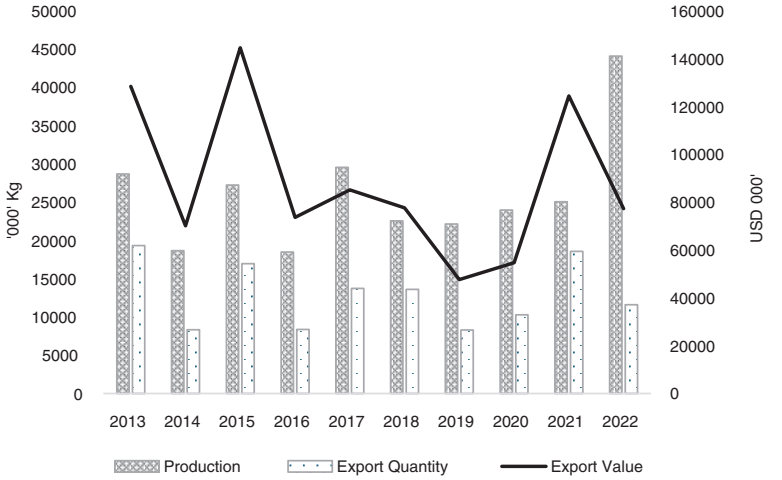
10 Suriyagoda, L., Mohotti, M., Vidanarachchi, J.K., Kodithuwakku, S.P., Chathurika, M., Bandaranayake P.C.G., Hetherington, A.M., & C. Beneragama. (2021). Ceylon Cinnamon: Much More Than Just A Spice. *Plants People Planet* (3), 319–336.

11 *Ibid*.

12 Export Development Board. (n.d.). *Why Source Spices from Sri Lanka*, https://www.srilankabusiness.com/spices/source-spices-from-sri-lanka.html

13 *Ibid*.

Figure 13.3
Production and Export Trends of Pepper



Source: Author's calculations using World Integrated Trade Solutions (WITS) data.

While pepper production has fluctuated over the last decade, in 2022, a sharp increase in production has been evident. This increase in yield was attributed to the introduction of new technology, the provision of subsidies, and prolonged rainy weather following the previous year's dry conditions.[14] As shown in Figure 13.3, a high percentage of production was exported in most years.

In 2014, the world market share for Ceylon pepper in USD terms was nearly 6% and shows a slight decline to 5.6% by 2022. India, as the main export destination for Sri Lankan pepper imported a total of 10,129 MT, contributing to 86% of Sri Lanka's total pepper exports in 2022. Other major destinations for Sri Lankan pepper include Germany, the US, Spain, and the United Arab Emirates (UAE).

The market penetration ratio in the Indian market for Ceylon pepper is increasing. In 2014, it was nearly 27% and increased to nearly 46% in 2023. Throughout this period, on average, the market penetration was nearly 40%. Particularly in 2017 and 2018, the penetration rate was high primarily due to a large volume of pepper re-exports from Sri Lanka. Further, in recent years, domestic wholesale pepper prices in India have been high due to a shortage in production, creating opportunities for increased exports of Sri Lankan pepper to India. This underscores the strong establishment of Ceylon pepper in the Indian market. In the other main exporting countries such as Germany, Spain, and the UAE, the market penetration ratio has been very low at close to 1% in recent years.

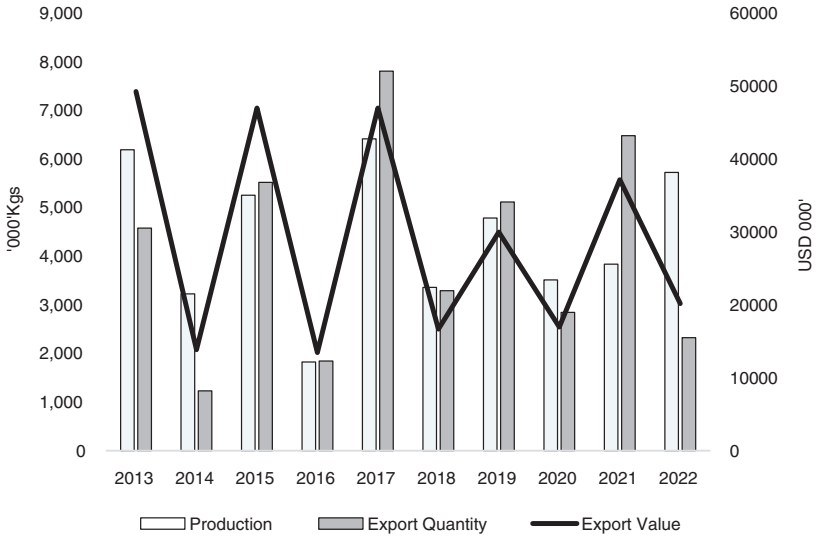
Clove: Sri Lanka is among the top 10 clove-exporting countries in the world, holding 8-10% of the world market share on average. Figure 13.4 illustrates the production and exports in terms of quantity and value. Production fluctuated significantly over the last decade, with changes in rainfall patterns and temperature seen as factors that predominantly affected plant metabolism, flowering, and fruiting

14 News.lk, Government Official News Portal. (2024, June 3). *Pepper Harvest Up by Over 7,000 MT from Previous Year*, https://news.lk/news/political-current-affairs/item/36451-pepper-harvest-up-by-over-7-000-mt-from-previous-year

processes. These climatic variations adversely impact clove production not only during the production stage but also during the harvesting and storage periods. In certain years, the export quantity of cloves exceeded the quantity of production, indicating that imported cloves were re-exported. The highest share of clove imports were from Turkey and India.

Sri Lanka is among the top 10 clove-exporting countries in the world, holding 8-10% of the world market share on average.

Figure 13.4
Production and Export Trends of Clove



Source: Author's calculations using ITC database (UN Comtrade database).

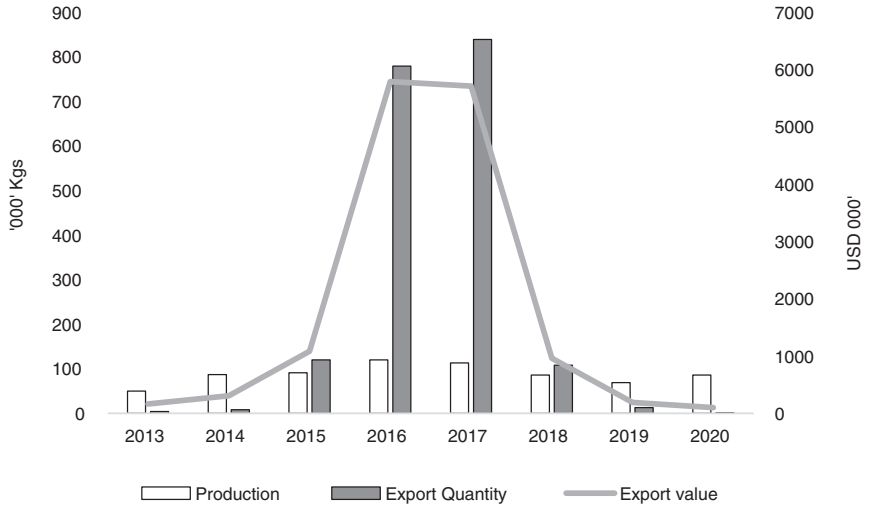
The main export destinations for Ceylon cloves are India, the UAE, the US, and Germany. The market penetration ratio in these main export markets varies. In the Indian market, the penetration was 8% in 2014, averaging around 11% over the next few years and increasing to nearly 18% in 2022. In the UAE market, market penetration halved from 10% in 2013 to 5% in 2023. Clove imports from Comoros and Tanzania in the UAE market provide competition for Ceylon cloves which may have affected the drop in market penetration. In the US market, the average market penetration was 15% over the same period. Notably, in the German market, the penetration of Ceylon cloves more than doubled from 15% in 2014 to 32% in 2017, but by 2023, it dipped to 22.5%.

Cardamom: Cardamom is the third most expensive spice in the world spice market, second only to saffron and vanilla. Sri Lanka serves nearly 0.3% of the global demand for cardamom in value terms. Sri Lanka exports mainly two grades; namely Lanka Green Cardamom (LG) and Lanka Light Green Cardamom (LLG). Sri Lanka's export volume has grown but it is largely driven by the impact of increasing re-exports due to a surge in cardamom imports rather than a local production drive.[15]

15 Hirimuthugodage, D., Thibotuwawa, M., & Wijayasiri, J. (2017). *Analysis of Cinnamon Pepper and Cardamom Value Chains in Sri Lanka*. Colombo: JICA and Institute of Policy Studies of Sri Lanka.

Cardamom is primarily consumed in Middle Eastern countries, India, Pakistan, European countries, the US, and Japan. It is used in various forms – as a primary product (whole cardamom), as a secondary processed product (ground cardamom), or as a value-added product (oil and oleoresin extractions). Middle Eastern countries such as Saudi Arabia and the UAE, along with South Asian countries such as India, account for over 60% of global consumption. In the case of Sri Lanka, the main buyers of Ceylon cardamom are India, Australia, and Canada. However, it was only in 2017 that significant exports of cardamom were made to Saudi Arabia and Iraq.

Figure 13.5
Production and Export Trends of Cardamom Since 2013



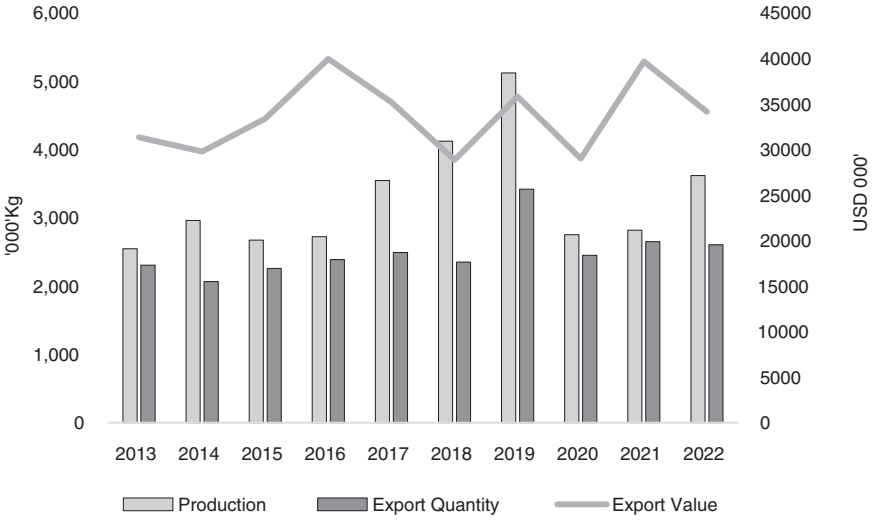
Note: WITS and ITC only provide data for the sub-categories of cardamom exports.
Source: Author's calculations using Annual Reports (Various years), Central Bank of Sri Lanka (CBSL).

Despite cardamom production in Sri Lanka being around 100,000 kilogrammes (Kg), a surge in export quantity was seen in 2016 and 2017 (Figure 13.5). This was mainly because of re-exports, with cardamom imports being sourced mainly from Myanmar, Indonesia, and India. Sri Lanka's market penetration in the main markets such as India, Singapore, Japan, and the UAE is rather low. In India, for instance, the market penetration was around 4% in 2015, increasing to 8% by 2017 before gradually decreasing to less than 1% at present.

Nutmeg and mace: Nutmeg yields two distinct spices – nutmeg, sourced from the seed, and mace, extracted from the seed covering. It is widely utilised in culinary, food, and beverage applications, as well as in medicinal products. Sri Lanka contributed approximately 5% of the global nutmeg supply in value terms in 2020, with major exports directed towards India, the US, Germany, and the United Kingdom (UK).[16]

16 United Nations Industrial Development Organization. (2023, August). *Value Chain Analysis on Pepper, Clove, and Nutmeg in Sri Lanka*, https://downloads.unido.org

Figure 13.6
Production and Export Trends of Nutmeg and Mace



Source: Author's calculations using CBSL, Annual Reports (Various years)L.

As shown in Figure 13.6, nutmeg and mace production in Sri Lanka gradually increased over time, with a slight decrease in 2022. The latter can be attributed mainly to unpredictable changes in rainfall and labour shortages during the coronavirus (COVID-19) pandemic. Nutmeg production and harvesting are highly labour-intensive activities, and the lockdowns and travel restrictions imposed along with mounting health concerns during this period likely resulted in a shrinkage in production.

Sri Lanka maintained a very high market penetration in its main export destination, India. On average, the market penetration ratio over the last decade was more than 50%, and in some years, it reached up to a record-breaking 72%. The market share in the US decreased from 7% to 2% over the same period. Similarly, in the UAE too, a substantial drop in market share is seen from 26% to 18%. In contrast, in the European market, particularly in Germany and the UK, the market share grew from 1% in 2014 to 10% in 2023. China has emerged as a new market for nutmeg, recording a market penetration of 5% in recent years.

As highlighted in the export market trends analysis explained above, the selected five minor export crops have shown a steady market share in most of the main export destinations, except for some destinations that experienced a decreasing share. Overall, the European Union (EU) region has shown an increasing market share for most selected minor export crops, as well as a few emerging markets.

An analysis of Revealed Comparative Advantage (RCA), which provides valuable insights into the relative strengths and competitiveness of a country's export sectors was calculated for the above-mentioned five minor export crops in 2023.



The RCA of 374 for Ceylon cinnamon indicates that Sri Lanka has an exceptionally strong comparative advantage in the production and export of this product. It further signifies a very high level of specialisation in Ceylon cinnamon production in the world market (see infographic). This suggests that Sri Lanka can produce and export Ceylon cinnamon more efficiently than other countries, making it a dominant player in the global market for this product. Additionally, it reflects the country's strong competitive advantage, economic reliance on this sector, and the potential for further growth and investment in the Ceylon cinnamon industry.

An RCA of 27 for Ceylon pepper indicates that Sri Lanka has a competitive edge in producing and exporting Ceylon pepper compared to other countries. It signifies that Sri Lanka holds a significant comparative advantage in the global market, highlighting its economic importance, strategic opportunities for growth, and the necessity for continuous improvements to maintain competitiveness. While beneficial, having a comparative advantage with an RCA of 27 also implies that Sri Lanka faces competition from other pepper-producing countries. Therefore, diversification strategies and continuous improvements in productivity and quality are crucial to sustain and expand market share.

An RCA of 59 for clove signifies that Sri Lanka has a strong comparative advantage in the global market, indicating economic significance, strategic opportunities for growth, and the necessity for ongoing efforts to enhance competitiveness amidst global competition. Sri Lanka is relatively more efficient in producing cloves compared to other countries, enabling it to capture a larger share of the global cloves market. This specialisation suggests that Sri Lanka can produce cloves at lower costs or with higher quality than many other producers. Because of its high RCA, policymakers and industry stakeholders can prioritise the clove sector for further development and support. This could involve investments in improving cultivation practices, enhancing processing capabilities, and expanding market access.

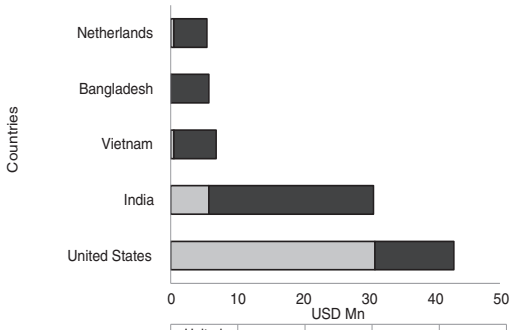
Cardamom exports from Sri Lanka with an RCA of 28 demonstrates Sri Lanka's prominent position in the world market for Ceylon cardamom. This resembles a stable presence in international markets and the potential opportunities for expanding market share through strategic initiatives. However, sustaining and enhancing Sri Lanka's competitive position in the global cardamom industry requires constant improvements in productivity, quality, and market diversification tactics.

An RCA of 92 for nutmeg indicates that Sri Lanka possesses a robust comparative advantage in the production and export of nutmeg relative to other countries. Moreover, Sri Lanka demonstrates high efficiency in nutmeg production, facilitating effective competition in the global market. This efficiency may be attributed to factors such as favourable climate conditions, skilled labour, and established agricultural practices. The high RCA underscores how important nutmeg production is to the nation's economy. Sri Lanka is strategically positioned to advance its nutmeg sector, presenting opportunities for expanding production capacity, enhancing quality standards, and broadening market access.

13.3 Untapped Export Potential and Challenges for Minor Export Crops

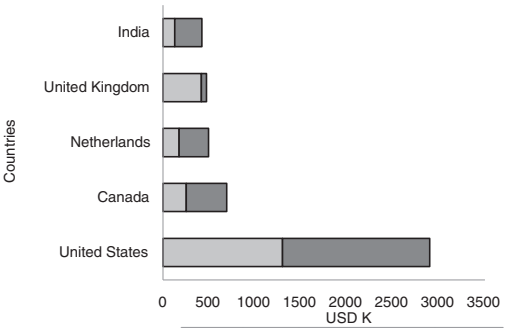
This section describes the untapped export markets and quantifies the volume of the five specified minor export crops. The preceding section clarified the significance of these crops in generating export revenues. Notably, Ceylon spices are becoming more and more in demand on the international market because of their unique flavour and quality. Consequently, it becomes imperative to recognise potential markets and formulate strategies aimed at augmenting the volume of minor export crops while exploring novel market avenues.

Figure 13.7a
Untapped Potential for Cinnamon "Cinnamomum Zeylanicum Blume" Fresh



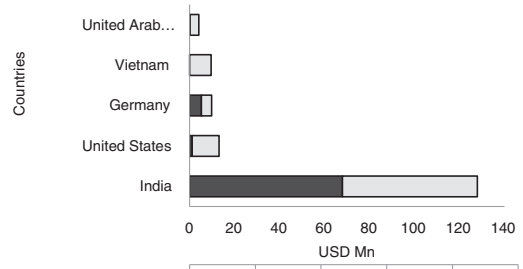
	United States	India	Vietnam	Bangladesh	Netherlands
Actual Export (USD Mn)	31	5.8	0.5	0.000143	0.5
Untapped Export Potential (USD Mn)	12	25	6.4	5.8	5

Figure 13.7b
Untapped Potential for Cinnamon Crushed/Ground



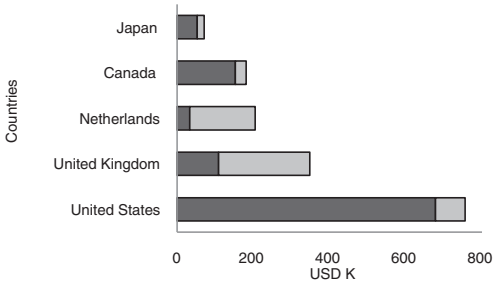
	United States	Canada	Netherlands	United Kingdom	India
Actual Export (USD K)	1300	254	176	416	127
Untapped Export Potential (USD K)	1600	439	320	57	297

Figure 13.7c
Untapped Potential for Pepper "Piper", Not Crushed/Ground



	India	United States	Germany	Vietnam	United Arab Emirates
Actual Export (USD Mn)	68	1.1	5.2	0	0.278
Untapped Export Potential (USD Mn)	60	12	4.6	9.6	3.8

Figure 13.7d
Untapped Potential for Pepper "Piper", Crushed/Ground



	United States	United Kingdom	Netherlands	Canada	Japan
Actual Export (USD K)	678	109	33	153	53
Untapped Export Potential (USD K)	78	239	172	28	18

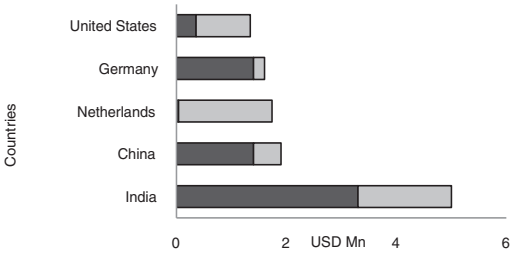
Source: Author's calculations using Export Potential Map, ITC data.

Figures 13.7a and 13.7b delineate the market potential for the principal varieties of cinnamon products – cinnamon fresh products, available in quill form, and cinnamon crushed or ground products. Among these, an unidentified market worth USD 25 Mn exists in India, with additional markets identified in the US (USD 12 Mn), Vietnam, Bangladesh, and the Netherlands. A substantial market of nearly USD 54 Mn awaits exploration for fresh Ceylon cinnamon. Regarding crushed or ground cinnamon, the US presents the highest potential at USD 1.8 Mn, while India, Canada, and the UK collectively demonstrate a potential of approximately USD 200,000. The combined market potential for both Ceylon cinnamon products suggests a wealth of opportunities in untapped markets. When considering the present export market destinations, except the US and Ecuador, all the other main market potentials have already been achieved (Mexico, Peru, Colombia, Spain, etc).

However, realising these opportunities poses challenges as Ceylon cinnamon contends with competition in major importing countries from Vietnamese, Chinese, and Indonesian Cassia cinnamon, which dominate the market due to its relatively high affordability with price competition. The elevated price of Ceylon cinnamon stems from constraints in production volume and the inefficiencies prevailing in the cost structure within Sri Lanka's cinnamon-producing industry, meaning that higher production costs push up the prices. Farmers face high labour costs attributable to an insufficient number of skilled peelers, compounded by the relatively high portion of expenses on fertilisers and planting materials. In essence, the root cause of these high prices lies in the absence of adequate production infrastructure and technology.[17]

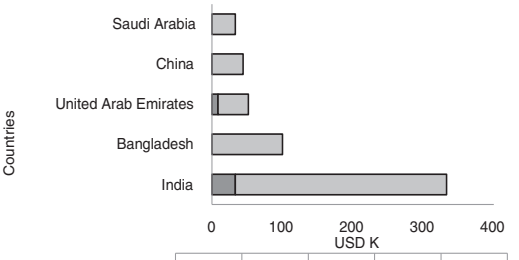
The markets with the greatest potential for Sri Lanka's exports of pepper 'piper', not crushed/ground are India, the US and Germany. India shows the largest absolute difference between potential and actual exports in value terms, leaving room to realise additional exports worth USD 60 Mn. In total, considering all the main five countries, USD 90 Mn worth of untapped global market awaits to be exploited for Sri Lankan pepper (Figures 13.7c and 13.7d).

Figure 13.8a
Untapped Potential for Nutmeg



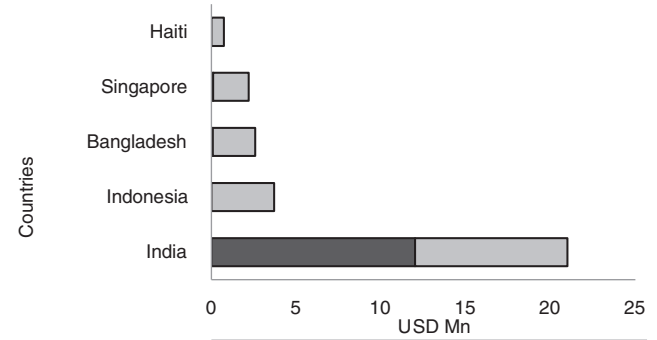
	India	China	Netherlands	Germany	United States
Actual Export (USD Mn)	3.3	1.4	0.039	1.4	0.356
Untapped Export Potential (USD Mn)	1.7	0.5	1.7	0.2	0.985

Figure 13.8b
Untapped Potential for Cardamoms



	India	Bangladesh	United Arab Emirates	China	Saudi Arabia
Actual Export (USD K)	33	0	8.6	0.2	0
Untapped Export Potential(USD K)	300	100	43	44	33

Figure 13.8c
Untapped Potential for Cloves



	India	Indonesia	Bangladesh	Singapore	Haiti
Actual Export (USD Mn)	12	0	0.074	0.1	0
Untapped Export Potential (USD Mn)	9	3.7	2.5	2.1	0.739

Source: Author's calculations using Export Potential Map, ITC data.

Sri Lanka has not yet captured new emerging markets for exporting cardamom. Figure 13.8b shows that Sri Lanka has an untapped export potential for cardamom in the Indian market (USD 0.3 Mn) and is currently exporting minimal volumes against this potential. Additionally, an untapped potential of USD 100,000 lies in Bangladesh, where Sri Lanka has not exported cardamom yet. In total, a substantial unexploited potential of USD 0.6 Mn is projected for Sri Lanka in the cardamom sector. However, in the existing markets (Canada and Australia), the market potential has already been achieved.

Regarding clove exports, except for India, the other four international markets identified are new. Overall, there is an opportunity for approximately USD 18 Mn to be exploited for clove exports (Figure 13.8c). However, in the existing markets (UAE, US, and Germany), the market potential has already been achieved. The untapped potential for nutmeg is mainly in India (USD 1.7 Mn) and the Netherlands (USD 1.7 Mn), accounting for a total of USD 5.1 Mn (Figure 13.9a).

As previously mentioned, upon examining the five selected minor export crops, it becomes evident that the Indian market offers the highest export opportunities for all products. India (96.3 Mn) exhibits significant potential across all selected crops, particularly for pepper and cinnamon. Additionally, noteworthy export opportunities are also present in the US (26 Mn), Vietnam (16 Mn), Bangladesh (8.4 Mn), and the Netherlands (7.1 Mn).



13.4 Unveiling Hidden Opportunities: Strategic Approach to Unlock Untapped Potential

As described in the preceding sections, there exists a noticeable upward trajectory in exporting minor agricultural crops, notably the five crops selected, compared against a declining trend in the share of export earnings from primary agricultural commodities, such as tea and rubber. This phenomenon is attributed to the growing global demand for distinctive, high-quality minor export crops originating from Sri Lanka. With its high quality, the export resilience of minor export crops is praiseworthy, as it has managed to sustain demand even during economic downturns. Furthermore, all the selected minor export crops exhibit a relatively high RCA in the export markets, and these crops demonstrate stability in most current exporting markets, as indicated by market penetration ratios. Additionally, there exists a great potential for growth in both existing and new markets. Subsequently, this section aims to propose strategic approaches aimed at unlocking the untapped market potential for these minor export crops.

All the selected minor export crops exhibit a relatively high RCA in the export markets, and these crops demonstrate stability in most current exporting markets, as indicated by market penetration ratios.

Since the selected five minor export crops are encountering similar challenges in improving production and enhancing quality to exploit untapped potential in the international market, the recommendations will be presented with a focus on the minor export crop sector as a whole rather than on the individual selected five crops.

13.4.1 Increase Production and Ensure Constant Supply

As described before, the production of the selected minor export crops fluctuated during the past years. One main reason for these fluctuations is adverse weather changes. Climatic changes such as rain and drought mainly affect the planting, flowering, and harvesting stages of these crops.[18] Usually, the selected minor crops typically require minimal use of chemical fertilisers, pesticides, and herbicides during the production process. Thus, even though the recent fertiliser ban (which was lifted later) severely affected other major export crops like tea and rubber, the selected minor export crops were minimally affected.

As explained before, most producers are smallholders, with an average per capita land use of approximately 0.25-3.0 acres, except for cardamom. Importantly, most smallholders cultivate these minor crops as a supplementary income and use mixed cropping methods – i.e., cultivating with other crops. The overall productivity of these selected crops was nearly 0.5 MT/ha in 2021. In comparison, the productivity of Indian spices was 2.36 MT/ha in 2022. For black pepper, productivity in India was 0.46 MT/ha in 2022, while in Sri Lanka it was 0.58 MT/ha in 2020.

To increase production, it is apt to implement new planting and re-planting techniques for these crops with the assistance of extension officers from the DEA. This will also ensure smooth production. Introducing new varieties that are tolerant of climate change is crucial. Although the DEA has already developed some varieties suitable for different climatic conditions, these should be popularised and made available with the support of extension officers. Also, introducing cultivation subsidies can incentivise those cultivating the developed varieties resistant to adverse climatic changes. Promoting recommended agrochemical practices for selected minor export crops is also vital.

Furthermore, it is crucial to introduce modern technology, impart knowledge, and provide technical training, and information on market behaviour to all stakeholders in the minor export crop value chain, including producers, collectors, processors, and exporters. For cinnamon, the Cinnamon Academy (CTA) was recently established to address these issues and provide timely training for value chain stakeholders. Additionally, plans are on the way to introduce common processing centres in the country's major cinnamon-producing areas such as Galle, Matara, and Ratnapura to minimise the adverse involvement of middlemen. Similar common collecting and processing centres would also be beneficial for other minor export crops such as pepper, clove, nutmeg, and cardamom.

Considering the common challenges faced by stakeholders in the minor export crop sector, the asymmetry of information – such as market information, climatic data, and details about peelers and collectors – stands out as a significant issue. To achieve smooth production, a systematic flow of information is crucial. A study conducted in the Matara District on cinnamon stakeholders' usage of mobile applications for information revealed that nearly 91% of them use mobile phones and

18 Department of Export Agriculture. (n.d.). Make Souvering with the King of Spices, https://dea.gov.lk

are keen on receiving updates/notifications through a developed mobile-based information system.[19] Expanding mobile application systems to other minor export crops could facilitate an effective and rapid flow of information to enhance production and ensure constant supply.

Imports of selected minor export crops have occasionally been used to blend with Sri Lankan-origin products to cater to distinct consumer taste profiles and to support maintaining a constant supply of exports. The government has periodically issued Gazette notifications to regulate the import and re-export of spices, primarily based on production levels. For example, in December 2019, a Gazette was issued prohibiting the re-export of key spices, including pepper, cinnamon, clove, ginger, turmeric, cardamom, and others. However, in June 2020, this prohibition was revoked, allowing imports for re-export, provided that these imports included 35% or more local value addition, such as processing, blending, and packaging. Again, in March 2024, a new Gazette was issued allowing the import of spices, including pepper, cardamom, ginger, nutmeg, turmeric, cumin, and others, for re-export purposes. This was subject to the approval of the Controller General of Import and Export and a requirement of 35% local value addition. According to a key policymaker, these imports are necessary to address two main prevailing issues: compensating for low production and catering to distinctive consumer taste profiles, for instance in the case of Ceylon pepper which needs to be blended with other peppers to adjust the piperine content.[20]

However, re-exports must comply with existing regulations, maintain product quality, and optimise the process. Importantly, these must adhere to product standards and ensure the quality of Ceylon products. Additionally, comprehensive and effective monitoring and inspection must be in place, including laboratory testing facilities. Furthermore, maintaining a proper traceability and surveillance system can ensure a constant supply of quality exports.

13.4.2 Ensure Product Quality Through a Geographical Indication (GI) Certification System

As explained earlier, Sri Lankan minor export crops command a premium price in international markets due to their unique taste and quality. There is also high demand for Ceylon minor export crops from blenders and re-exporters, as a significant percentage of these crops are exported as primary products. However, in some cases, re-exporters and blenders misuse the name ‘Ceylon’ by marketing low-quality blends and products, thereby undermining the reputation of genuine Ceylon products.

To protect Ceylon products from forging and misusing the name, the Intellectual Property Rights (IPR), No. 36 of Act of 2003 provides two types of protections: a trademark, and a GI registry system, which is practised as a business mode. Pure Ceylon Cinnamon (PCC) and the Lion Logo of Ceylon Tea are registered certification marks under Sri Lanka’s trademark law in a few selected countries. The PCC is owned by the Export Development Board (EDB) and can be used only on value-added cinnamon packs containing 100% PCC manufactured in Sri Lanka. Those who wish to use the PCC certification logo on their products must obtain a license from the EDB.

19 Mohamed, A., & Walisadeera, A. E. (2019). Minimising Issues and Information Gaps in Value Chain of Cinnamon Industry in Sri Lanka through ICT based Intervention: A Case Study, 7(2), 63-75.

20 This section draws from author’s interviews with a key policymaker in the spice sector.

However, even with trademark protection, several instances of misuse occur, as a trademark only serves to distinguish the goods or services of diverse enterprises. In contrast, a Geographical Indication (GI) certification system indicates and informs consumers and traders that the product originates from a specific country or geographical location and possesses special qualities, characteristics, or reputation. GI certification provides the highest level of branding and visibility for promoting a product based on its origin.

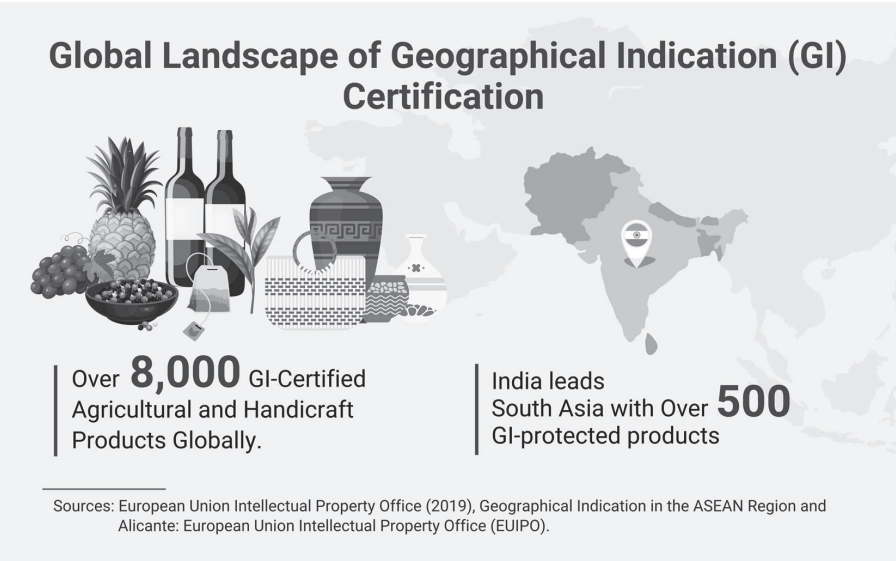
Furthermore, GI registration assures consumers of the unique quality of the products through a proper control mechanism that includes monitoring, supervision, and a traceability system throughout the entire value chain. Only stakeholders who comply with the specifications outlined in the document called the 'Book of Specification' are permitted to obtain the GI certificate, not just anyone in the value chain. Box 13.1 explains Sri Lanka's first GI-certified product, Ceylon cinnamon.

Box 13.1
Ceylon Cinnamon GI

Ceylon cinnamon obtained GI in 2022 as the first-ever GI-certified product from Sri Lanka in the EU. The purpose of GI registration is to differentiate Ceylon cinnamon in the EU market from its substitutes of lower quality. GI will act as a source of a competitive advantage, which will help to increase market differentiation, product turnover and allow for a premium price from the consumer. An enhanced competitive position of Ceylon cinnamon in the EU market will have a positive impact in terms of an increase in exports for Sri Lanka, higher income, and employment generation across the cinnamon value chain, benefiting about 30,000 stakeholders involved in cinnamon production and processing. The quality of uniqueness of cinnamon growing in Sri Lanka is linked to the territory through the variety (wild cinnamon tree endogenous to Sri Lanka) soil, climate (the production zone is mainly located in the Southern region of the country), local know-how (unique knowledge for peeling and preparing), and reputation (the story of Ceylon cinnamon started when the spice trade began) (Barjolle, 2013).

As part of obtaining the GI status, the Ceylon Cinnamon Geographical Indication Association (CCGIA) was established representing all the stakeholders in the cinnamon industry in the country. The responsibility of the CCGIA is to implement an internal control mechanism to monitor their members meeting the specifications stated in the GI specification document. The participants within the cinnamon supply chain need to be registered/obtain membership of the CCGIA to export Ceylon cinnamon to the EU region under the "Ceylon cinnamon" name. Recently, the EDB has recognised the first batch of GI-certified growers in the country. Since the certification was obtained very recently, sufficient data is unavailable to prove the benefits of Ceylon cinnamon GI.

Sources: Barjolle, D. (2013). *Ceylon Cinnamon: A Roadmap Towards its Protection as Geographical Indication.*



Currently, more than 8,000 agricultural and handicraft products worldwide are protected by GI certification. India leads South Asia with over 500 protected products. Sri Lanka can also protect its unique minor export products, such as pepper and other selected crops. The process to obtain GI certification for Ceylon pepper began a few years ago. Box 13.2 illustrates the benefits gained by stakeholders involved with the two world-famous types of pepper.

Box 13.2
Popular Pepper GI Systems in the World
Kampot Pepper: Cambodia

Kampot pepper is well known for its superior quality due to the well-structured agro-environment which is influenced by the appropriate combination of weather, coastal climate, and soil conditions. In addition to that, local know-how and production techniques play a greater role by applying natural fertiliser and irrigation systems to improve the quality and the uniqueness of the crop (Food and Agriculture Organization (FAO), 2023).

However, such a unique product was unable to reach a wider market due to limited international brand recognition and inconsistency of the quality which resulted in access to a low-volume niche market. To address the issue, the Kampot Pepper Promotion Association established in 2009, requested to register the product as a GI. The effort succeeded in 2010 as Kampot Pepper was awarded a GI registration by the Ministry of Commerce. After several attempts, the product was also registered as a GI product in the EU, Vietnam, and Thailand in 2016 and 2017, respectively. Since 2020, the country has been a member of the Geneva Act of the Lisbon Agreement on Appellations of Origin and GIs, which has extended GI protection effectively across the world in more than 50 countries (FAO 2023).

After the recognition of the product as GI, several positive benefits were offered to the value chain actors in terms of volume produced, income, and promotion.

1. Extension of land registration:

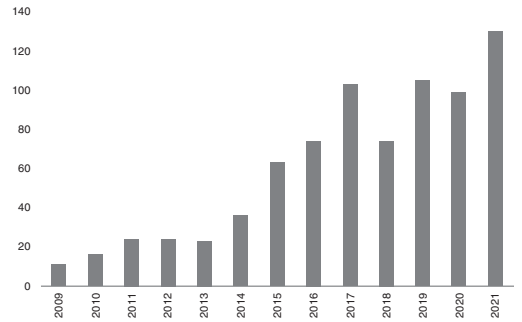
The lands dedicated to the cultivation of the product have increased from just 1 ha in 2010 to 264 ha, in the provinces in the production zone (FAO, 2023).

2. Increasing production of Kampot pepper:

Membership of the Association has expanded from 118 producers to 410 during the counting period from 2010 to 2021. The fact that needs to be highlighted mostly is the majority in the association represent smallholders, who claim fewer than 1,000 pepper poles (FAO, 2023). The Annual production has gradually increased with fluctuations in some periods, as shown in Figure a.

Figure a

Annual Production of Kampot Pepper Produced by Members of the Kampot Pepper Promotion Association (in Tn)



Source: FAO of the United States, 2023.

After obtaining foreign GI, the volume of production has almost doubled by 2017 compared to the period prior to the international recognition as of 2015 (FAO, 2023; Sok, 2021).

Apart from this, the EU registration led the country to increase export volume by more than 250% in 2017, compared to the period 2013-2016 (Sok, 2021; FAO, 2023).

3. Expansion of the market:

The domestic niche market has been expanded to Germany, the US, France, Taiwan and Vietnam (FAO, 2023).

4. Increase in prices:

The prices of Kampot pepper have also risen to a significant level as evident from the price before and after GI.

The recorded price changes are as follows:

- The price of black Kampot peppercorns has increased by more than three times (from USD 4.5/Kg to USD 14.5/ Kg) in 2020 compared to 2010.
- The price of red Kampot peppercorns increased by almost one and a half times (USD 10/ kg to USD 25/Kg) during the same period.

The price premium exceeds more than two-thirds of the price for other peppers which do not have GI status (Sok, 2021).

Moreover, approximately 30% of the Kampot pepper production depends on the varieties of red and white which are claiming higher prices all the time (FAO, 2023).

5. Other economic benefits:

Apart from the above-mentioned values, an increase in agrotourism and investment in the production process can smoothen the value chain activities (FAO, 2023).

Muntok White Pepper: Indonesia

Muntok White Pepper which originated in Indonesia is popular for its quality due to its fragmented aroma and spice flavour. The unique characteristics of Muntok White Pepper are associated with high rainfall, consisting of 90% low land, unique soil nutrition, and the intensity of solar radiation. The know-how of the people highly influenced the exclusivity of the product as the history of Muntok White Pepper has been written since the 19th Century (European Union Intellectual Property Office (EUIPO), 2019; Darwance et al., 2023,). The Muntok White Pepper was registered as a GI-certified product in 2010.

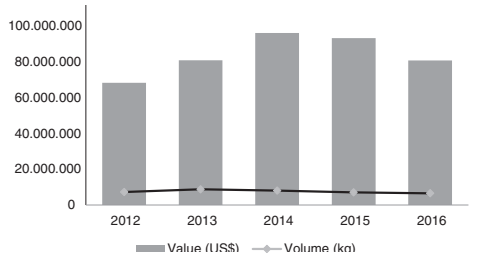
Table a
Composition of Production, Export and Price Per Selected Years

Variable	2007 (Before GI Certificate)	2014 (After GI)
Production	3,000 (Tn)	10,000 (Tn)
Export	2,700 (Tn)	8,000 (Tn)
Price	<IDR 40,000/Kg	IDR 172,000/Kg (2015)

Note: IDR denotes Indonesian rupiah; Tn denotes tonnes.
Source: Geographical Indication in the ASEAN region, 2019.

After obtaining GI, the local price of Muntok White Pepper showed a 475% growth rate in price by 2015 (EUIPO, 2019).

Figure b
Muntok White Pepper Export in Bangka Belitung Province, 2012-2016



The volume of export has shown remarkable growth as the quantity increased threefold by 2014 compared to that of 2007. Most importantly, the hidden message of this is, Muntok White Pepper could capture the global market after obtaining GI.

Source: Muntok White Pepper Price Transmission in Bangka Belitung Island Province, 2020.

Sources: European Union Intellectual Property Office. (2019). *Geographical Indication in the ASEAN Region.* Alicante: European Union Intellectual Property Office; Sok, P. (2021). An Analysis of Pepper (Piper Nigrum) Value Chains in Cambodia. *North American Academic Research Journal,* 4(1): 107–127; Kampot Pepper Promotion Association (KPPA). (2022). KPPA Overview in Numbers. In: Kampot Pepper Promotion Association, https://www. kampotpepper-kppa.com/in numbers/ ; Darwance, Haryadi, D., Sari, R., Anwar, M., & Satrio, N. (2023). Tin Mining in Bangka Belitung Islands and Its Impact on the Reputation of Geographical Indication: A Policymakers Perspective. *IOP Conf. Series: Earth and Environmental Science (pp. 1-7).* Bristol: IOP Publishing; Food and Agriculture Organization of the United Nations. (2023). *Cambodia: Geographical Indication Registration of Kampot Pepper Builds Brand Recognition, Raising Producers'income and Spurring Local Development.* Bangkok, Thailand: FAO Regional Office for Asia and the Pacific.

In Sri Lanka, the 2022 amendment to the IPR Act of 2003 introduced a register-based GI system. However, the National Intellectual Property Office (NIPO) has yet to introduce the regulations necessary for conducting a local GI registration system. This is particularly important because, except for the EU, other regions and countries require local registration prior to international GI registration. Therefore, NIPO must expedite the process of presenting these regulations to the Parliament of Sri Lanka.

13.4.3 Strengthening the Value Chain Actors

As explained above, several value chain actors are involved in the spice sector. The value chain structure of the selected five crops is quite similar, involving producers (mainly smallholders), village-level collectors, central-level collectors, processors, and exporters. The behaviour of value chain agents is also crucial for maintaining product quality as well as seeing the wider picture of its importance in the global market. Therefore, it is essential to improve the attitudes of these agents to adopt the common goal of maintaining good agricultural and manufacturing practices to enhance productivity and ensure product quality.

In addition, a proper system of traceability, monitoring, and control must be developed at each layer of the value chain to ensure product quality. As mentioned earlier, a GI system requires a well-established traceability system from farm to consumer, along with control and monitoring mechanisms. Thus, providing proper education and training through extension service officers is crucial. Implementing a certification or tagging system, monitored by extension officers or leaders in district associations/ societies, can help minimise the room for unethical or illegal handling of products at various stages of the value chain. Additionally, it is essential to emphasise and implement the three steps in the control mechanism: self-control, internal control (through extension officers), and external control (main government institutions).

Moreover, several governments and non-governmental organisations (NGOs), associations, and societies are involved in these value chains. Creating strong linkages between these institutions and the value chain actors to ensure smooth functioning is a must. Enhancing the efficiency of extension services by increasing/optimising the allocation of resources at the relevant government institution, particularly the DEA, is also important. Adopting a cluster-based approach with producers, as currently implemented by the Tea Small Holdings Development Authority (TSHDA), could be an effective solution for disseminating extension knowledge more efficiently. These steps will strengthen the backward and forward linkages in the selected minor export crop value chains.

13.4.4 Promote 'Ceylon' Brand

The promotion of the 'Ceylon' brand internationally through an improved market intelligence system is crucial for creating new market links, particularly with the countries identified in the previous section for their untapped potential. The Sri Lanka Tea Board (SLTB) has demonstrated the importance of the 'Tea Promotion Unit' in selected countries, which can also be leveraged to promote minor export crops. One or two minor export crops can be promoted through a single unit established in foreign countries, a task that could be jointly undertaken by the EDB, the DEA, and Sri Lankan foreign missions. When selecting countries for establishing promotion units, priority should be given to those with high untapped potential for minor export crops. Promotion of the 'Ceylon' brand in the domestic market is also important. Additionally, strategising on regional branding, such as 'Kolonna Pepper' can be promoted similarly to the seven regional tea brands (Ruhunu, Dimbula, Nuwara Eliya, etc.).

Furthermore, the EDB could create an online portal named 'Ceylon Spices' to support online trade initiatives similar to the 'Made in Sri Lanka' portal. As previously mentioned, a GI registry system will enhance the international promotion of the 'Ceylon' brand. As previously explained, Ceylon spices have significant potential in the EU market. EU consumers recognise GI-certified products and are willing to pay a premium for GI products. Therefore, with the GI certification system, Sri Lanka could expand its potential in the EU market.[21] Moreover, adopting and keeping pace with the latest digital technologies such as blockchain to ensure the traceability of products and further promote the 'Ceylon' brand is crucial for Sri Lanka.

India and Bangladesh, as two major South Asian countries, represent largely unexplored markets, particularly for pepper and cinnamon. Existing trade agreements, such as those under the South Asian Association for Regional Cooperation (SAARC) or the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), could be instrumental in exploring this untapped potential. These agreements offer significant benefits, including tariff reductions, addressing non-tariff barriers, and fostering investment and technical cooperation to enhance trade between the countries. According to the present tariff measures, pepper, nutmeg, mace, and clove imported from Sri Lanka to India are subject to a 70% tariff rate under the Most Favoured Nation (MFN) principle of the World Trade Organization (WTO). However, a special lower tariff rate applies for those products under bilateral agreements and regional trade agreements. The applied tariff rate is 8% for pepper in India. However, exports of nutmeg and mace, cardamom, and clove are not included in the bilateral trade agreements between Sri Lanka and India which face a high MFN tariff of 70%. As indicated above, Bangladesh is another potential yet untapped market for cloves which also has a higher applied tariff rate of 25%.

As an initial step, the Department of Commerce could suggest negotiating or removing/relaxing the pepper 70% quota under the India-Sri Lanka Free Trade Agreement (ISLFTA). Furthermore, the EDB could make available the necessary arrangements and provide facilities to encourage exporters and other relevant brand ambassadors to participate in trade events and exhibitions, such as Biofach in Germany and Gulfood in Dubai, to promote the 'Ceylon' brand.

21 EU International IP Cooperation. (2020). *Geographical Indication in the Asian Region*, https://internationalipcooperation.eu/

13.5 Conclusion

In light of the aforementioned facts, the minor export crop sector in Sri Lanka holds great potential in the international market for exploration in the future, given its relatively high RCA and market penetration ratios. It is imperative to emphasise the existing reputation for 'Ceylon' minor export crops and ensure their unique and unmatched quality. However, to meet the current demand, Sri Lanka must ensure a sustainable supply of products through improved production practices. Further, the minor export sector is a lifeline for nearly 1.3 Mn small farmers in Sri Lanka, offering economic, social, and environmental benefits essential for their sustainability and growth. Therefore, all stakeholders in the value chain bear the responsibility to uphold the high quality of 'Ceylon' minor exports to be on par with what the world expects.

To provide this guarantee, the GI certification system is the best method to hold all value chain stakeholders accountable for quality while offering assurance to consumers. Given that Sri Lanka faces stiff competition for these minor export products at the global level, it is required to consistently highlight its superior quality and upkeep market presence, even during re-exportation with proper monitoring and surveillance systems in place. Moreover, the GI certificate will provide benefits to all the stakeholders involved in the value chain, from smallholders to exporters. Also, it is recommended to prioritise addressing the individual challenges that the selected crops face to boost production and maintain a constant supply.

Finally, to realise the unutilised trade potential in Sri Lanka's minor export crops, several measures can be implemented, as explained above. In summary, it is crucial to introduce the GI certification system for minor export crops to ensure product quality. Countries with high potential such as India, the EU, Vietnam, and the US value the recognition of products with GI certificates.

Simultaneously, conducting regular market research is essential to identify emerging trends, consumer preferences, and competitive landscapes in target export markets. Effective marketing and promotional campaigns should be launched to raise awareness of Sri Lankan quality minor export products and brands internationally. Furthermore, establishing a comprehensive market surveillance system supported by digital and e-commerce platforms will enhance this process.

By implementing these measures comprehensively and strategically through targeted interventions, Sri Lanka can unlock its unutilised trade potential in minor export crops, expand its export base, and support efforts toward sustainable economic growth. This approach will simultaneously support the enhancement of livelihoods for small farmers and local communities involved in the minor export crop sector.

14. Climate Policies, Energy Prices and Export Competitiveness

14.1 Introduction

Amidst Sri Lanka's current economic turmoil, recent industry policies have identified export promotion and diversification as crucial strategies to boost the economic recovery and sustain it in the long-term. The proposed plans for a more manufacturing-oriented export economy also embrace a shift towards a greener growth path. However, among many factors, growth in industrial exports requires more resources such as land, water, and electricity.

Energy is a key utility with implications for the cost of production and competitiveness of industrial exports from Sri Lanka. Owing to the high import dependence of the energy sector for electricity generation and transport, Sri Lanka faced significant challenges as the foreign exchange crisis advanced. The situation was further aggravated by the surge in world market fuel prices and supply chain disruptions with the Russian invasion of Ukraine in 2022. The combined result was that Sri Lanka could not afford to maintain an uninterrupted electricity supply and transport services owing to energy shortages. At the peak of the crisis, fuel queues and power outages exceeding 10 hours per day were the norm, severely impacting the economy, including the industry sector's performance and denting investor confidence. As part of the agreed set of policy measures to be implemented under Sri Lanka's International Monetary Fund (IMF) Extended Fund Facility (EFF) programme, the government had to cut down on consumer subsidies on fossil fuels (FFS) and electricity to implement a cost-reflective pricing mechanism to address the fiscal burden. Besides such adjustments, Sri Lanka's electricity generation cost remains comparatively high mainly due to high general and administrative expenses, inefficient power plants, and lack of transparency.

As the country seeks to address these challenges, it will be well served to align policy to developments taking place in the global setting. The Paris Agreement adopted at the United Nations (UN) Climate Change Conference (COP21) has implications for sectoral (agriculture, electricity, transport, industry, waste, and forestry) greenhouse gas (GHG) emission reductions to be achieved by 2030 which opens opportunities to adopt low-cost clean energy technologies. Sri Lanka's industry sector committed to reducing GHG emissions by 4% unconditionally and 3% conditionally.[1] Similarly, the electricity sector's GHG emission reduction plan is 5% unconditionally and 20% conditionally (altogether 25%), with restrictions for expanding coal power generation. The latter is considered the cheapest, but the worst GHG-emitting fossil fuel by far, which still supplies around 26% of the world's energy demand.[2] The long-term policy target is to achieve net zero emissions by 2050 as set out by the International Energy Agency (IEA) and Sri Lanka, too, has committed to this goal.[3] Complementing these policy

1 Ministry of Environment. (2021). *Updated Nationally Determined Contributions under the Paris Agreement on Climate Change Sri Lanka.* Battaramulla: Ministry of Environment.

2 Hannah, Ritchie., & Pablo, Rosado. (2020) - "Energy Mix" Published online at OurWorldInData.org, https://ourworldindata.org/energy-mix' [Online Resource].

3 Ministry of Environment. (2023). *Carbon Net Zero 2050 Roadmap and Strategic Plan Sri Lanka*. Battaramulla: Ministry of Environment.

shifts, rising consumer awareness and environmental concerns have increased the demand for sustainably sourced and eco-friendly goods and services globally. Thus, the possession of a cheap, reliable, climate-resilient, and sustainable energy supply is a competitive advantage for an industrial export economy. Against this background, this chapter attempts to identify the impacts of climate change-combating policies such as reforms on FFS and electricity tariffs on energy-intensive export industries that compete in the international market. Identifying the potential opportunities and industry responses to mitigate the impacts is crucial for supportive public policy recommendations.

14.2 Competitiveness and Energy Policy Impacts

To limit global warming to 1.5^0 C,[4] global GHG emissions must be cut down by 45% by 2030. To achieve such a decarbonisation target, climate mitigation policies that need consideration include carbon pricing, FFS reforms, feebates (for highly emitting vehicles), renewable subsidies, emission rate regulations, and public investments worldwide.[5] These policies directly and indirectly influence the energy prices of economies. Energy prices driven by climate change policies have varying impacts on a sector such as manufacturing, depending on the energy intensity of the industry mix. Further, the impacts can vary between developed and developing economies.

A study conducted in the European Union (EU) region has shown that the impact of environmental policies is not harmful to export competitiveness while the energy tax policies and resulting innovations positively influence exports.[6] A comparative analysis of Germany, Switzerland, and Austria at the firm level has shown similar outcomes concluding that international competitiveness is not affected by the energy policies. Moreover, the likely negative impacts can be compensated by efficient technologies.[7] A review paper by the Organisation for Economic Co-operation and Development (OECD) on empirical studies in the EU region finds that in most ex-post analyses the impact of carbon pricing on the competitiveness of electricity and industry sectors is not statistically significant. It was evident over a multitude of dimensions in terms of competitiveness, such as foreign direct investments (FDI), net imports, turnover, employment, value-added, productivity, profits, and innovation. Also, the review states that although the impacts are statistically significant in few studies, either positive or negative, the magnitude is small.[8]

However, deviations can exist in impacts across regions and countries. For instance, a study conducted to analyse the short-term competitiveness impact of a uniform global carbon price claims heterogeneous impacts across regions and sectors. A uniform carbon price was used to avoid carbon linkages, and the impacts were monitored through the carbon content of the final output. The study

4 C denotes Celsius.

5 Black, M. S., Parry, I. W., Mylonas, M. V., Vernon, N., & Zhunussova, K. (2023). *The IMF-World Bank Climate Policy Assessment Tool (CPAT): A Model to Help Countries Mitigate Climate Change*. Washington, D.C.: International Monetary Fund.

6 Costantini, V., & Mazzanti, M. (2012). On the Green and Innovative Side of Trade Competitiveness? The Impact of Environmental Policies and Innovation on EU Exports. *Research Policy*, 41(1), 132-153.

7 Rammer, C., Gottschalk, S., Peneder, M., Wörter, M., Stucki, T., & Arvanitis, S. (2017). Does Energy Policy Hurt International Competitiveness of Firms? A Comparative Study for Germany, Switzerland and Austria. *Energy Policy*, 109, 154-180.

8 Venmans, F., Ellis, J., & Nachtigall, D. (2020). Carbon Pricing and Competitiveness: Are They at Odds?. *Climate Policy*, 20(9), 1070-1091.

further revealed that the competitiveness of the United States (US), Japan, Brazil, and the advanced economies of the EU tend to improve while the labour markets and industries in newly industrialising Asian and Eastern European countries tend to deteriorate.[9]

Policy reforms might differently impact the industries. For instance, a study of the climate policy impact on energy-intensive manufacturing industries in the US has shown that the international competitiveness of industries will be severely affected in the absence of new low-carbon technologies. The study evaluated the cap-and-trade system for steel, aluminium, chemicals, and paper industries. According to this, the impacts will be diverse depending on the energy intensity of the manufacturing industry, energy mix, how the energy is used (such as thermal or power generation), speed of adaptability of new technologies, import dependence, and the ability to pass on the impact to the customers while facing international competitiveness.[10]

In contrast to the above, studies analysing the export competitiveness and climate policies in the South Asian context are limited. A study based in India using a gravity model approach highlights that an energy price increase of 10% reduces exports by 1%, which varies across industries depending on energy intensity.[11] Elsewhere in Asia, a firm-level data analysis (micro, small, and medium-level firms) in Indonesia has shown that higher energy prices tend to incur a slight adverse impact on the long-term competitiveness of firms. As a response to higher energy prices, the firms have adopted coping mechanisms such as fuel substitution, energy efficiency, and passing on costs to consumers.

14.3 Methods to Assess Impacts of Policy Reforms

Three approaches are used in identifying the impact of consumer subsidy policy reforms on key stakeholders such as household consumers and industry consumers. A simple analysis based on income and expenditure surveys and input-output (I-O) data can be used to assess poverty and social impacts. It involves identifying the household consumption profiles, estimating price changes in fuels to goods and services consumed, and using those price changes to estimate the fuel price-driven expenditure changes.[12] Similarly, identifying the industry profiles based on energy consumption levels can be used to identify the impact of policy reforms on the cost shares of respective industries. Other methods include partial equilibrium models which accommodate the direct impacts, and computable general equilibrium (CGE) models. The latter accommodates economy-wide impacts, including both direct and indirect welfare changes, and finally, energy sector models.

The most immediate impact of an FFS reform is financial. The expenditure on energy will rise for the consumers and the government can recover the sizeable amount of money spent on subsidies in return. The beneficiaries of the subsidies such as domestic consumers, private energy producers,

9 Ward, H., Steckel, J. C., & Jakob, M. (2019). How Global Climate Policy Could Affect Competitiveness. *Energy Economics*, 84, 104549.

10 Bassi, A. M., Yudken, J. S., & Ruth, M. (2009). Climate Policy Impacts on the Competitiveness of Energy-Intensive Manufacturing Sectors. *Energy Policy*, 37(8), 3052-3060.

11 Kumar, S., & Prabhakar, P. (2020). Industrial Energy Prices and Export Competitiveness: Evidence from India. *Environmental Economics and Policy Studies*, 22, 1-20.

12 Beaton, C., Gerasimchuk, I., Laan, T., Lang, K., Vis-Dunbar, D., & Wooders, P. (2013). *A Guidebook to Fossil-Fuel Subsidy Reform for Policy-Makers in Southeast* Asia (based on iisd.org).

and businesses will adopt coping measures to minimise or eliminate the inefficiencies in the short- and medium-terms. At the macroeconomic level, the impacts are complex. In the short-term, energy price shocks affect the gross domestic product (GDP) and increase inflation. In such a setting, energy-intensive businesses may endure a decrease in international competitiveness. At the household level, the impacts will vary based on the income level. Effective incomes will deteriorate due to the short-term inflation effect and access to energy will also be reduced due to high energy bills. As a result, poverty levels can be on the rise.

The price volatilities in the international market directly affect domestic prices and the economy. Over time, the price volatility is expected to promote a more rational consumption behaviour of energy. Thus, in the medium-term, more accurate pricing and efficient resource allocation are expected to be observed, ultimately leading to higher GDP growth and a decrease in inflation. Indeed, if the reforms can create a level playing field in the energy supply sector, a better-quality energy supply service can be expected. The end outcome is also expected to see improved environmental effects if consumers move into less polluting fuels, renewable energy, and increased energy efficiency. If they switch fuel type to biomass, forest resources may be subject to potential pressures.

In Sri Lanka, electricity is subsidised and nearly 30-40% is generated by fossil fuels. Hence, electricity consumers benefit from two types of subsidies: FFS and electricity subsidies. Therefore, the expected impact of FFS and electricity price reform is a considerable shock to consumers. As already noted, these reforms are mainly aimed at easing Sri Lanka's fiscal burden considering the economic crisis and IMF guidelines in addition to the country's emission reduction targets.

A policy that intends to set a price on carbon emissions has its embedded objectives to promote energy efficiency improvements, job creation, and investments in low-carbon technologies in industry decarbonisation. This transition to a low-carbon economy incurs substantial costs. Therefore, it requires appropriate supporting public policies, transparent investment strategies, and commitments by industries.

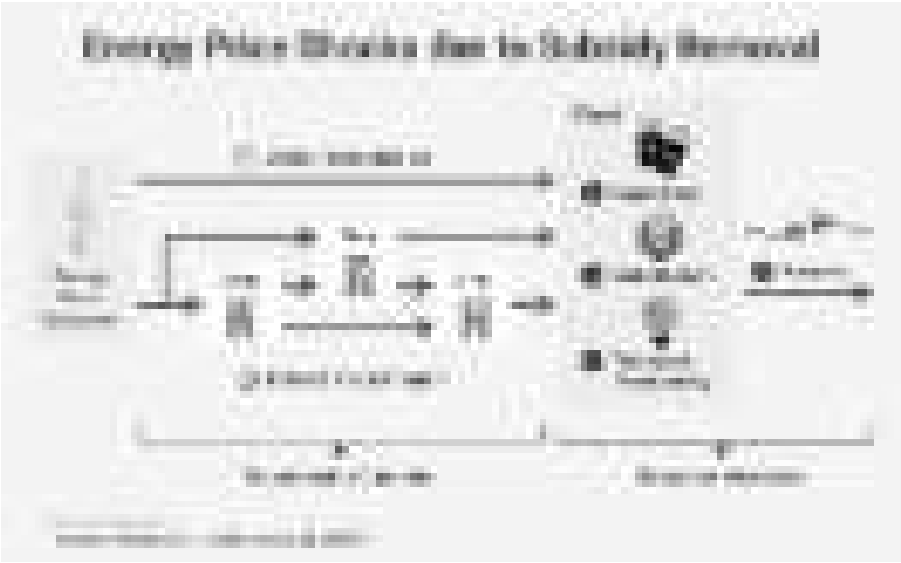
The cost impacts of climate change policy-driven energy price hikes can be observed in terms of production costs and profitability of firms. When energy-price-driven costs increase, a firm's ability to pass on costs to consumers can be limited in the face of international competitiveness. It may have negative impacts on the profitability and market share of export manufacturing industries. How these industries respond to energy price hikes and threats to competitiveness depends on the choice of investment options and opportunities.

Firms face both direct and indirect impacts. Direct impacts can be measured through the change in energy cost due to a change in the energy price. In other terms, it depends on the energy price elasticity of the cost of each firm. Alternatively, changes in energy cost share can be compared. The indirect impact involves the rise in the cost of other inputs used in the manufacturing process such as intermediary inputs. The manufacturing cost of intermediary inputs also rises with the energy price increase and will pass on to the final manufacturer. Firms using high-energy-intensity inputs will have to face higher costs. The geographical location of inputs also matters. For example, when the inputs are imported, the cost of inputs is not influenced by local policy reforms other than transport costs.

Moreover, these price shocks will slowly pass through the supply chains to the final producer, totally or partially. Capturing these indirect impacts needs economy-wide approaches such as CGE modelling.

Response mechanisms of firms are typically four-fold: absorption, substitution, resource efficiency, and pass-on.[13] These strategies are interrelated. The infographic below illustrates how price shocks are transmitted and the response mechanisms. The first three mechanisms (absorption, substitution, and resource efficiency) show the internal strategies adopted by each firm to mitigate the impacts. The absorption capacity of firms varies with the magnitude of the profit margin. If the margins are positive and sufficient, firms may go with lesser profit margins without any adjustments to the sales price, technology, or production. If the firms cannot absorb the profit change, switching the energy type to low-cost options can be observed. In other words, the same level of energy consumption is maintained while the energy mix is modified. The capacity to energy shift depends on many factors including the compatibility of technologies, availability of other energy sources, reliability, knowledge, skills, and finance. These come under medium- to long-term strategies.

Improving resource efficiency or productivity is the third response mechanism. From the energy side, the firms tend to improve the energy efficiency of the production process to minimise the energy cost. In most cases, material costs surpass energy costs. Hence, efficiency improvements in other resource utilisation can also be observed. Similar to fuel switching, efficiency improvement responses are not short-term. For example, through an energy audit, a firm can identify some simple low-cost measures to improve energy efficiency. However, replacing machinery with more efficient technologies may require additional financing and the availability of alternative technologies. Efficiency improvements can be captured through the marginal product of energy and the marginal product of other inputs.



13 Rentschler, J., & Kornejew, M. (2017). Energy Subsidy Reforms and the Impacts on Firms: Transmission Channels and Response Measures. In *Oxford Energy Forum* (No. 108, pp. 16-19).

The fourth response mechanism is 'price pass-on' which describes the ability of a firm to increase the sales price to accommodate increased energy costs without adjusting sales volumes. It can be measured by a change in sales price due to a change in energy price. However, the ability to pass on depends on the price elasticity of demand of the product's end users and the time dimension. The empirical evidence based on an *ex-post* evaluation study of the EU Emission Trading System, for instance, has suggested that the pass-on rate of manufacturing industries varies from no cost to 100%, depending on the sector-specific conditions.[14]

Potential competitiveness losses often constrain the introduction of unilateral carbon pricing policies. However, most studies have confirmed a considerable decrease in energy intensity and less impact on competitiveness indicators such as output and employment, while some impacts cannot be directly attributed to carbon pricing. Some studies have interpreted the measures taken by firms to safeguard competitiveness as innovations taken by firms because of carbon pricing. Porter's hypothesis explains this relationship with examples from diverse manufacturing industries worldwide, stating that well-designed environmental regulations lead to firms' innovation and enhance competitiveness. The schematic representation of Porter's hypothesis is explained in the infographic, accommodating the ambiguity of business performance and mixed results.[15] This might be attributed to 'bad policies' as explained by Porter.



14 Arlinghaus, J. (2015). Impacts of Carbon Prices on Indicators of Competitiveness: A Review of Empirical Findings. *OECD Environment Working Papers*, No. 87, https://doi.org/10.1787/5js37p21grzq-en.

15 Ambec, S., Cohen, M. A., Elgie, S., & Lanoie, P. (2013). The Porter Hypothesis at 20: Can Environmental Regulation Enhance Innovation and Competitiveness?. *Review of Environmental Economics and Policy.*

14.4 Energy Pricing and Sri Lanka's Industrial Export Competitiveness

Competitiveness is a broad term, and the definitions vary depending on the context in which it is applied. It may be at the firm level, sector level, product level, value chain level, national or global level. Isolating competitiveness that spurs from carbon pricing is a tedious task. However, its direct impact on firms, mostly the short-term impacts, can be observed through cost shares/profit shares. Cost shares and profit shares of inputs indicate the relative importance of each factor of production in the final output. Hence, the cost shares of electricity and fuel consumption are used in this chapter to identify the impact of price shocks related to FFS reforms, electricity price reforms, and climate policies. The medium-term adaptation measures (innovations) can be captured through their responses.

When export-oriented firms are considered, competitiveness indicators in export markets indicate how competitive the products are in the international markets. Some indicators of measuring competitiveness in the export market are export shares, growth rates, export potential, Revealed Comparative Advantage (RCA), Relative Import Advantage (RMA), Relative Trade Advantage (RTA), Revealed Competitiveness (RC), Extensive and Intensive Margins (EM, IM), etc.

For this analysis, the RCA is used to obtain insights into the international competitiveness of Sri Lanka's main electricity-consuming industrial export goods. The RCA is the widely used index to measure the competitiveness of the tradable part of the goods.[16] It is the relative share, whereby the export value of a particular good of a country, relative to the country's total export value, is the numerator. The denominator is the export value of the product in the world market, divided by the value of all the export products in the world export market.

Algebraically, RCA is expressed as follows:

$$RCA_{ij} = \frac{\left(X_{ij}/X_{ik}\right)}{\left(X_{nj}/X_{nk}\right)}$$

where X is the value of exports, 'i' is a country, 'j' is a product, 'k' is all the products other than product 'j', and 'n' is all the countries other than country 'i' where X_{ij} is the export value of product j from country i, X_{ik} is the export value of other products by country i, X_{nj} is the export value of product j by all the other countries, and X_{nk} is the export value of other products by all the other countries. To avoid double-counting, the above index was further improved.[17] Therefore, the total export value of country 'i' (X_{ik}) excludes product 'j'; the world export value of product 'j' (X_{nj}) excludes country 'i'; and the total value of world exports (X_{nk}) excludes product 'j'. This improved index is called the Relative Export Advantage (RXA).[18]

$$RCA_{ij} = RXA_{ij}$$

16 The method was initially developed by Balassa, 1965 and known as Balassa Index. See Balassa, B. (1965). Trade Liberalisation and "Revealed" Comparative Advantage 1. *The Manchester School*, 33(2), 99-123.

17 Latruffe, L. (2010). Competitiveness, *Productivity and Efficiency in the Agricultural and Agri-Food Sectors*. OECD Food, Agriculture and Fisheries Working Papers, http://dx.doi.org/10.1787/5km91nkdt6d6-en.

18 Vollrath, T. L. (1991). A Theoretical Evaluation of Alternative Trade Intensity Measures of Revealed Comparative Advantage. *Weltwirtschaftliches Archiv*, 127(2), 265-280.

Value 1 is considered as the breakeven and may take any value up to infinity. If the RCA is greater than 1, the respective product is said to be competitive or has a RCA. If it is less than 1, the product is said to be non-competitive. This analysis adopted the improved equation.

14.4.1 Industry Sector in the Economy

Industrialisation is influential in achieving economic development as evident through different eras – starting from Great Britain, the United States of America (USA), Japan, and China, etc. As Sri Lanka emerges from its current economic crisis, attention is being paid to develop the industry sector, mainly through export development, as a part of the broader efforts to revive the economy. The industry sector's contribution to the economy is around 25-30% of GDP over the last decade. In 2023, data indicate that it is around 25% of GDP showing a slight declining trend over the crisis period (Figure 14.1a). Similarly, the overall Index of Industrial Production (IIP) for 24 industry divisions using the International Standard of Industrial Classification (ISIC) at two-digit shows a declining trend over the period (Figure 14.1b). The industry sector employs nearly 28% of the labour force. By contrast, the services sector is the key economic player contributing to nearly 60% of GDP in 2023, showing a slight increase in contribution during the crisis period in comparison to the industry sector.

Figure 14.1a
Contribution of Main Economic Production Sectors to GDP (2019-2023)

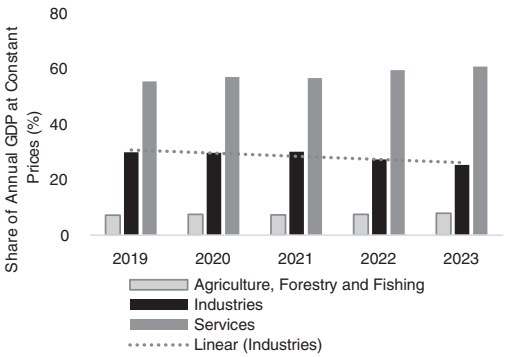
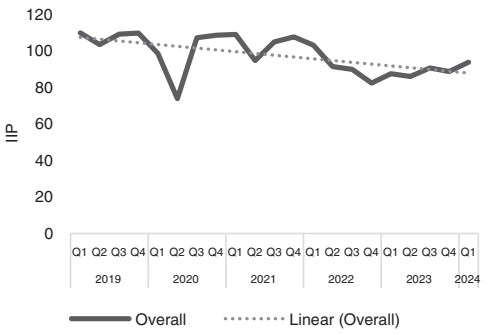


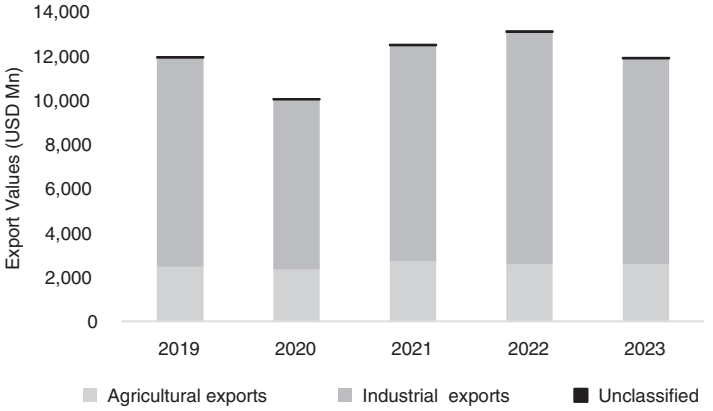
Figure 14.1b
Index of Industrial Production (2019-2023)



Source: Central Bank of Sri Lanka (CBSL). (2022, 2023). Annual Reports. Department of Census and Statistics (DCS), 2024. Index of Industrial Production (IIP), http://www.statistics.gov.lk/Industry/StaticalInformation/IndexIndustrialProduction.

Exports from the industry sector: The value of Sri Lanka's goods and services exports in 2023 (United States Dollars (USD) 14.9 billion (Bn) was nearly 20.4% of GDP while manufacturing exports contributed to 14% of GDP. The value of merchandise exports was around USD 11.9 Bn, a slight drop against the previous two years and nearly equivalent to the pre-pandemic and pre-crisis value in 2019. Sri Lanka's merchandise exports constitute mainly industrial goods, agricultural commodities, and mineral exports. Nearly 77% of the export income comes from industrial goods while around 22% comes from agricultural exports followed by mineral and other exports over the last decade. Figure 14.2 shows the export value of Sri Lanka's key export sectors during the crisis period.

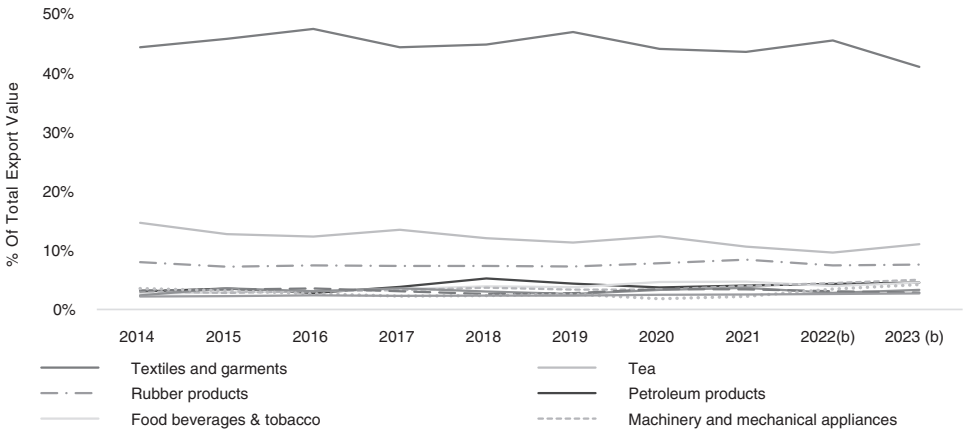
Figure 14.2
Export Earnings from the Main Sectors, 2019-2023



Source: CBSL, (2022, 2023). Annual Reports.

The apparel sector generates around 58% of the export income of Sri Lanka's industry sector. Rubber products add another 10% while food, beverages and tobacco; machinery, mechanical appliances and petroleum products add 5% each, followed by gem and jewellery. Around 53% of the agricultural export income comes from tea exports, followed by coconut, spices, and rubber products. The rest constitutes minor agricultural products, seafood, vegetables, and rubber. Figure 14.3 shows the main export income-earning commodities regardless of the sector. Over the last decade, these 10 commodities contributed to nearly 87% of export income for Sri Lanka. The apparel sector's contribution is roughly 45% followed by 12% and 7%, respectively, from the tea sector and rubber products. It shows a limited diversification of the export commodity mix indicating a high dependence of the export economy on the apparel sector and traditional plantation crops such as tea and rubber. These export sectors primarily depend on relatively inexpensive labour and unique product quality attributes such as flavour.

Figure 14.3
Main Export Income Earning Commodities, 2014-2023



Source: CBSL, (2022,2023). Annual Report.

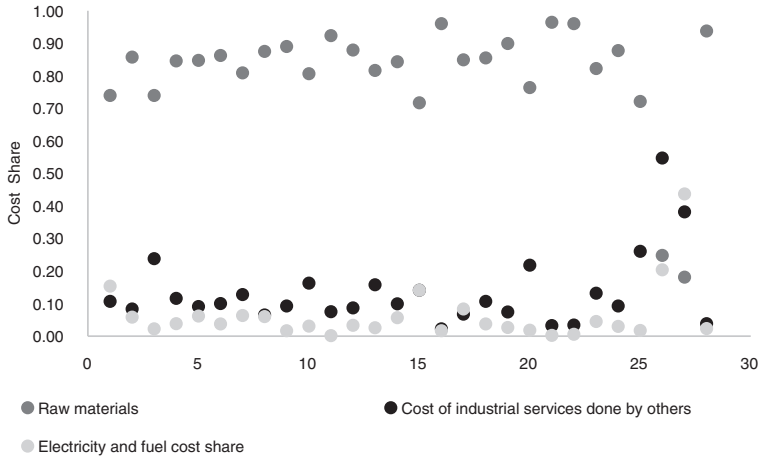
Intermediate consumption cost shares: According to the Survey of Industries data of 2019, almost 0.81 of the intermediate consumption cost is spent on raw materials while 0.13 is spent on industrial services carried out by other parties and the rest 0.06 is spent on electricity and fuel costs. It shows that energy costs are not that high in comparison to material costs. However, these costs matter when the profit margins are narrow, and firms face high competition. Previous studies in Indonesia have shown that the energy cost share is comparatively small which varies with the energy intensity and still the impact is statistically significant in firm-level profits.[19]

It shows that energy costs are not that high in comparison to material costs. However, these costs matter when the profit margins are narrow, and firms face high competition.

Figure 14.4 shows these cost shares among the main industry divisions (28 types). This varies slightly across industry types and a similar pattern follows for large establishments (with greater than 25 persons) and small-scale establishments (with less than five persons). Among the industries, other than water treatment and supply and electricity (0.44), the energy cost share was above the average for other quarrying activities (0.15) such as cement, and manufacture of non-metallic mineral products (0.14) such as glass and fabricated metallic products (0.08). The cost share for the manufacture of textiles is 0.06 while for the wearing apparel sector, it is 0.04. The energy intensity of textile factories is comparatively high relative to that of garment (wearing apparel) industries due to thermal energy usage in the mills whereas the electricity is mainly used for air-conditioning and sewing machines in the wearing apparel sector.

19 Rentschler, J., & Kornejew, M. (2017). Energy Pricing and Competitiveness: Firm Level Evidence from Indonesia. *Energy Economics*. Vol. 67, pp 242-254.

Figure 14.4
Cost Shares of Intermediate Consumption Among Main Industry Divisions in 2019



Source: DCS, (2020). Annual Survey of Industries.

14.5 Industry Sector Electricity Consumption

Implementing energy sector policies for industries requires a better understanding of the energy intensity of industries, scale and adaptive capacities, and cost shares of energy. This is generally practiced in the household consumer category with political interest. For example, when a cost-reflective pricing mechanism is introduced, the resulting high tariff rate increases the poverty intensity of low-income households which can be supported through targeted cash transfers at a lesser cost to the government than applying an overall subsidy.[20]

During the last two years, Sri Lanka has lowered consumer subsidies for transport and electricity with supplementary social protection policies to provide cash transfers to low-income households in compliance with the IMF agreement (see infographic on consumer subsidies for FF and electricity in Sri Lanka). As evident, the amount spent on subsidies increased considerably during the crisis period. The subsidy paid on the electricity bill was in percentage terms. For example, the first low consumer category got 75% off the bill, the second 50% and the third 25% off. In August 2022, a subsidy reduction scheme was implemented after nine years of pending revisions. This can be further attributed to the price increase of electricity and petroleum. Since the implementation of the cost-reflective pricing mechanism, price volatilities in the international market are absorbed through frequent revisions (quarterly). For example, the March 2024 revision reduced the rate by 18% for the industry sector with a further 9% reduction in the July 2024 revision, based on international market prices.

20 Organisation for Economic Co-operation and Development. (2024). *Development Co-operation Report 2024, Tackling Poverty and Inequalities Through the Green Transition*, https://doi.org/10.1787/357b63f7-en.

Electricity pricing policies should consider the diversity of industries, possible impacts, and adaptive capacities to better target and implement subsequent assistance schemes for firms in general and also for firms in need. Energy intensity determines the extent of the direct impact of price shocks. The possible negative impacts on businesses are short-term international competitiveness reductions for energy-intensive industries, agriculture and fisheries, and transport services.[21] The positive impacts include a stable energy supply in the medium-term with more incentives for energy sector investments and energy efficiency, a level playing field for energy supply, and enhanced finances in energy companies. It encourages adopting low-cost energy alternatives available, particularly for renewable energy sources such as solar photovoltaics (PV).



Sri Lanka's industry sector energy mix consists primarily of biomass (72%), followed by electricity (15%), petroleum, and coal. Electricity is the cleanest form of energy, which is mainly consumed by the domestic sector (40%) followed by industry (33%) and commercial (26%) sectors. The energy mix of electricity constitutes hydro, thermal (fossil fuels), and non-conventional renewable energy (NCRE) resources. Figure 14.5a shows the electricity use by the industry sector over the last decade where the three scales represent the electricity consumption category of the industry. Figure 14.5b shows the number of industrial consumer accounts under each consumer category. There are 74,053 registered industry accounts under the Ceylon Electricity Board (CEB) and Lanka Electricity Company (Private) Limited (LECO) as of 2023. Nearly 90.8% of the accounts are small-scale industries while medium and large-scale industries are 8% and 0.5% (365 accounts) of the total accounts, respectively. However, the small-scale industries consume only 8% of the industry sector's electricity demand. Medium- and large-scale industries consume 50% and 42% of the industry sector's electricity supply, respectively. A gradual increase is seen in the number of consumer accounts over the years, while consumption has fluctuated during the economic crisis where power outages were severe during 2022.

21 Beaton, C., Gerasimchuk, I., Laan, T., Lang, K., Vis-Dunbar, D., & Wooders, P. (2013). *A Guidebook to Fossil-Fuel Subsidy Reform for Policy-Makers in Southeast Asia* (based on iisd.org).

Figure 14.5a
Electricity Consumption by Industry

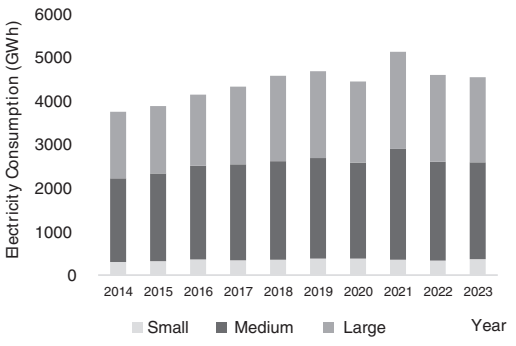
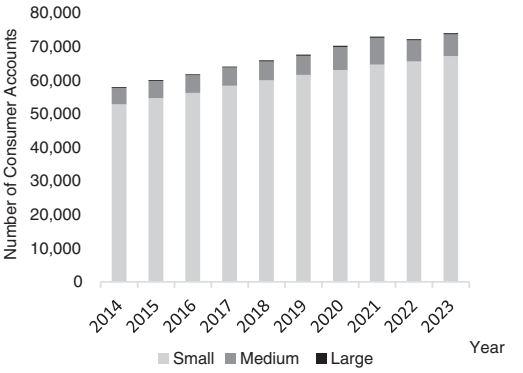


Figure 14.5b
Number of Industry Consumer Accounts



Note: GWh denotes gigawatt hours.
Source: Ceylon Electricity Board. (2023). *Statistical Digest Report*, https://ceb.lk/publication-media/statistical-reports/en.

A consumer account analysis based on the ISIC categories conducted by the United Nations Industrial Development Organization (UNIDO) in collaboration with the Sustainable Energy Authority (SEA) and the CEB has revealed that the main electricity-consuming industries are food and beverage, garment and textile, and rubber and plastic. Figure 14.6a shows the electricity consumption by the highest electricity-consuming industries (top 10) over three years (2020, 2021 and 2022) amidst the economic and power crises. Figure 14.6b shows the product subsectors under the food and beverage industries. Tea processing consumes nearly 30%, while rice and meat processing each consumes 14%.

Figure 14.6a
Industry Sectors

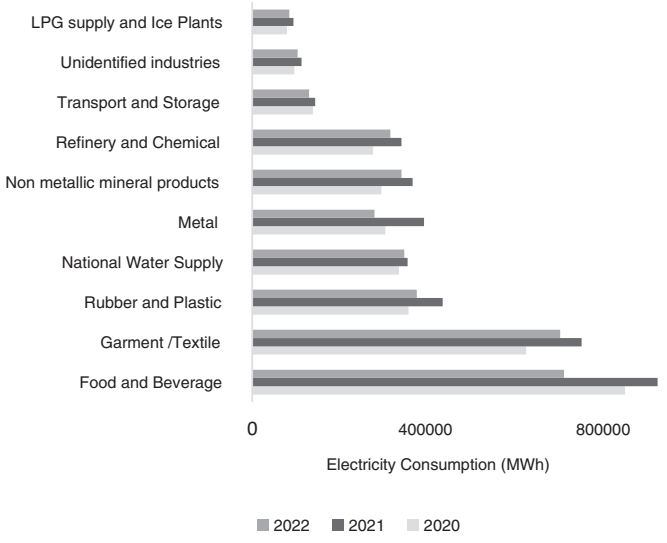
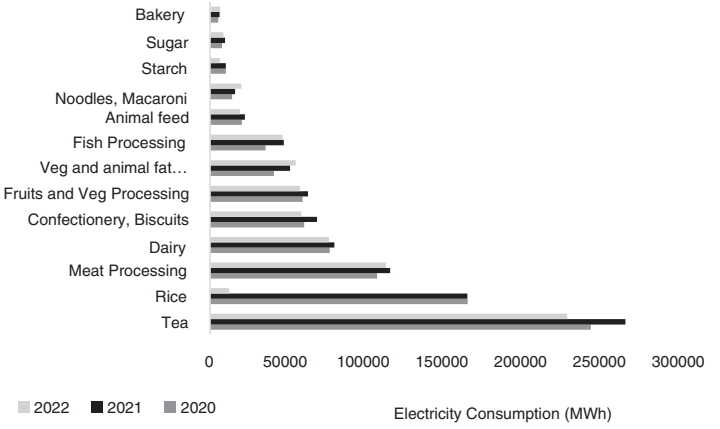


Figure 14.6b
Food and Beverage Industries



Note: MWh denotes megawatt-hours.
Source: UNIDO, SEA and CEB.

According to the above illustrations, the main export-earning industries such as apparel, tea, and rubber products are the key electricity-consuming industries. Therefore, it is important to identify the impact on these industries and industry response mechanisms such as the capacity to adopt substitute energy sources (like NCRE), energy efficiency measures, the ability to pass on the cost to consumers, and the need for financial and technical assistance.

The main export-earning industries such as apparel, tea, and rubber products are the key electricity-consuming industries.

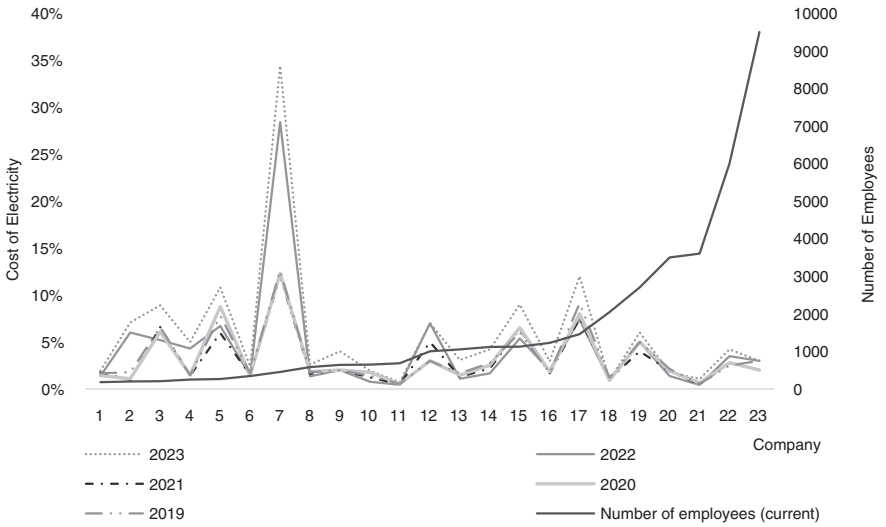
14.5.1 Apparel Sector Electricity Cost Share

Electricity and fuel consumption data in recent years are not available with the DCS. Therefore, a short online survey was conducted among apparel and tea factories to identify how significant the electricity bills are on production costs during the crisis period. Figure 14.7 shows the share of electricity as a percentage of the manufacturing cost of the apparel sector. In the apparel sector, textile cost share is the largest followed by utility cost. The average cost share of electricity has increased from 3.38% in 2019 to 5.58% in 2023, making a 2.2% rise in costs and shrinking profit margins. The share varies from around 1%-34% – while 15 out of 24 companies reported the cost as less than 5%, five companies reported it to be between 5-10%, and the rest at around 11-12% (while one company had a higher rate of 34%). A gradual increase in the cost share of electricity observed during the period can be largely attributed to tariff revisions. The electricity cost share diminishes towards the large-scale companies.

In the apparel sector, textile cost share is the largest followed by utility cost. The average cost share of electricity has increased from 3.38% in 2019 to 5.58% in 2023, making a 2.2% rise in costs and shrinking profit margins.

When response mechanisms are considered, 11 companies have adopted solar energy while one company is using both solar and biomass. A few companies adopted renewable energy during 2017-2019 while the rest adopted it after 2021. This movement can be attributed to low energy costs and the buyer requirements (brand demand) for climate change mitigation and carbon footprint according to a key informant interview (KII). The apparel sector is moving towards installing renewable energy, particularly solar energy, while the grid dependence of some factories is very low. For example, solar energy has reduced the cost of electricity by 12-25% in a leading apparel company. The wearing apparel sector has adequate roof space for solar panel installation and the energy intensity is comparatively low. However, the textile sector (fabric knitting) has capacity limitations in installing rooftop solar and the energy intensity is comparatively high. The textile sector comes under the industry consumer category 3 (IP-3) and is charged the highest electricity rates. The textile sector electricity cost is nearly 8.4%-12% of the manufacturing cost. It displays the adaptive capacity of the firms for substitutes and new opportunities in the markets. However, the cost share still varies between groups, possibly depending on the scale of adoption.

Figure 14.7
Cost of Electricity as a Percentage of Manufacturing Cost in the Apparel Sector



Source: Short Survey of Apparel Sector by the authors.

The areas where policy support was required according to the firms include subsidising renewable energy adoption, reducing electricity tariffs for the apparel sector or reducing the cost of electricity provided, using a transparent formula for annual or biannual tariff revisions, monitoring off-peak cost rates, power wheeling, regional electricity pricing, and maintaining low utility charges to compete with low-cost manufacturing destinations (India, Bangladesh, and Vietnam). Figure 14.8a shows the word cloud analysis of what respondents requested as policy support for electricity. Figure 14.8b shows the electricity prices in the SAARC region.[22] It shows that Sri Lanka's position is less competitive in terms of electricity prices whilst it is competing with these countries to attract investments and orders.

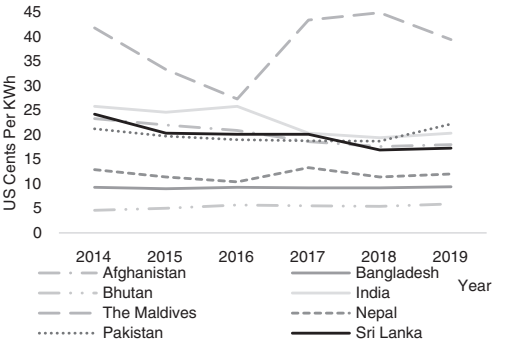
Sri Lanka's position is less competitive in terms of electricity prices whilst it is competing with these countries to attract investments and orders.

Figure 14.8a
Policy Support for Electricity - Word Cloud Analysis



Source: Short Survey of Apparel Sector by the authors.

Figure 14.8b
Electricity Prices in the SAARC Region



Source: The World Bank, Price of electricity (2014-2019).

14.5.2 Tea Sector Electricity Cost Share

Tea is the second largest electricity-consuming export industry and the second largest export income-earning commodity for Sri Lanka. An online survey conducted among tea manufacturers received responses from 25 factories. Figure 14.9a shows the electricity cost share among 13 factories while Figure 14.9b shows the electricity cost per kilogramme (Kg) of tea from 2019 to 2023. The share of electricity increased from 10% to 13% during the period while the electricity cost per Kg has increased from Sri Lankan Rupees (LKR) 17 to LKR 29 which is exceptionally high. The average represents a nearly 3% cost increase which shrinks the profit margins and competitiveness in the international market. The cost-reflective tariff revision and cost of thermal power sources are the contributing factors. The adoption of solar power is reported by six factories and biomass by three factories for boilers. These companies started solar power adoption after 2020, and this shift is probably related to

22 SAARC denotes the South Asian Association for Regional Cooperation, which includes seven member countries.

the electricity price hike. Geographical location and climatic conditions can constrain the installation of rooftop solar panels. Similar to the apparel sector, the electricity cost is not comparatively high in tea manufacturing. The highest cost shares in the tea sector are for labour followed by fertiliser.

Figure 14.9a
Electricity Cost Share

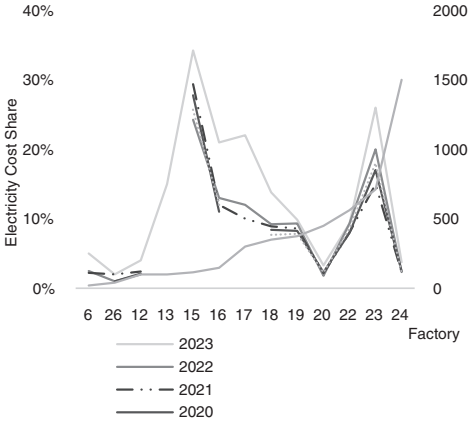
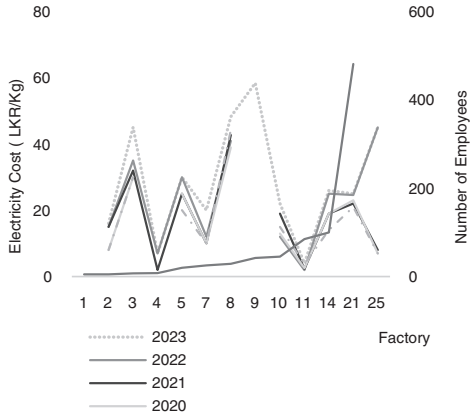


Figure 14.9b
Electricity Cost Per One Kg



Source: Online survey of tea manufacturers by the authors.

Most factories expect to install solar power and request subsidy programmes such as concessionary loan schemes, financial grants, and connecting to investors. A few respondents highlighted the importance of using renewable energy for tea manufacturing to receive a price premium in the international market for sustainable energy use. A newly established tea company uses biomass and directly exports to the world market and their product is in high demand due to sustainable energy use. Two companies highlighted the importance of the government's involvement in enhancing awareness and encouraging tea factories to use sustainable energy. Some respondents requested energy audits of tea processing facilities to identify areas for improvement and implement targeted energy efficiency programmes since some factories are old. The need for technical support and financial incentives for adopting energy-saving measures identified through energy audits are also highlighted. The respondents proposed these policy measures to mitigate the impact of electricity cost increases on tea production, promote sustainability and enhance the competitiveness of the tea industry. A reduced tariff rate similar to domestic consumers is requested for tea considering that it is an export industry. High rates during peak hours are considered a burden by a few factories. Figure 14.10 visualises the word cloud analysis for policy support responses.

Figure 14.10
Policy Support Requested- Word Cloud Analysis



Source: Short Survey of Tea Sector by the authors.

The average cost of a unit of electricity in Sri Lanka depends on the hydrological conditions and the global fuel price owing to its energy mix. The unit cost of electricity varies among different energy sources (Figure 14.11). The lowest cost is reported for hydroelectricity followed by coal for which Sri Lanka has reached its potential limits. Moreover, thermal fuel electricity reports the highest cost, the very aspect for which Sri Lanka needs the least cost options. Nearly, 16%-34% of the electricity was generated from fuel oil during the 2017-2021 period. Therefore, adopting NCRE in compliance with the Paris Agreement has positive implications for the industries and the electricity sector. The government has considered this an opportunity to attract more climate finance which supports the economy. For example, a climate prosperity plan is prepared based on attracting more investments for the NCRE investments. Globally, measures are being taken to lower fossil fuel consumption. The Clean Energy Transition Partnership (CETP), also known as the Glasgow Statement, is a commitment by 40 countries to stop financing fossil fuel projects abroad.

Figure 14.11a
Unit Cost

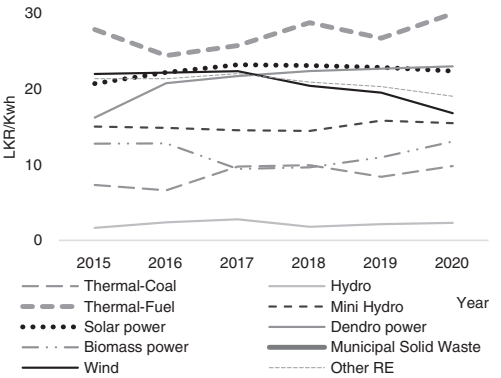
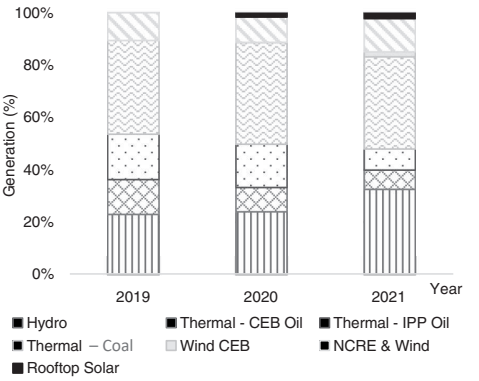


Figure 14.11b
Generation Source



Source: CEB Sales and Generation Data Books (2015-2021).

The above sections focused on cost shares and response mechanisms of firms faced with high electricity prices. This section examines the behaviour of competitiveness of the products in the export market. Table 14.1 shows the export share of the apparel and textile sector during the crisis period. According to this, the export share remains around 0.43, which is slightly lower than the pre-crisis shares. However, the world market share of Sri Lanka and the world export share for apparel products remained constant during the crisis period. The export share of tea, too, has remained unchanged during the period as did its world market shares.

Table 14.1
Export Shares and International Market Shares of Apparel and Tea Exports

Tea exports[a]	**2019**	**2020**	**2021**	**2022**	**2023**
Export share of tea (Out of total exports from Sri Lanka)	0.11	0.12	0.10	0.10	0.11
World market share for Sri Lanka	0.16	0.16	0.16	0.15	0.18
World export share of tea (Out of total world exports)	0.0004	0.0005	0.0004	0.0003	0.0003
Apparel & textile exports[b]					
Export share of apparel& textile (Out of total exports from Sri Lanka)	0.48	0.45	0.46	0.48	0.43
World market share for Sri Lanka	0.01	0.01	0.01	0.01	0.01
World export share of apparel & textile (Out of total world exports)	0.04	0.04	0.04	0.04	0.04

Notes: HS codes denote harmonised system codes.
a. Tea (HS 0902, whether or not flavoured); b. Apparel (HS 61- Articles of apparel and clothing accessories, knitted or crocheted and 62- Articles of apparel and clothing accessories, not knitted or crocheted), and textile (HS 50 to 60 and 63).
Nearly 87% of the export earnings of the apparel and textile sector comes from apparel exports (HS codes 61 and 62 categories) while the rest 13% comes from textiles. Around 61% of the apparel export earnings come from the HS code 61 category.
Source: Authors' compilation based on Trademap data.

Figures 14.12a and 14.12b show the RCA for the tea and apparel sectors. The RCA values are well above 1 over time indicating that Sri Lanka has a comparative advantage for tea and apparel sector exports.

Figure 14.12a
RCA Index for Selected Commodities

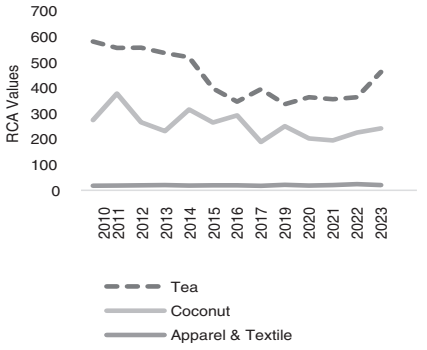
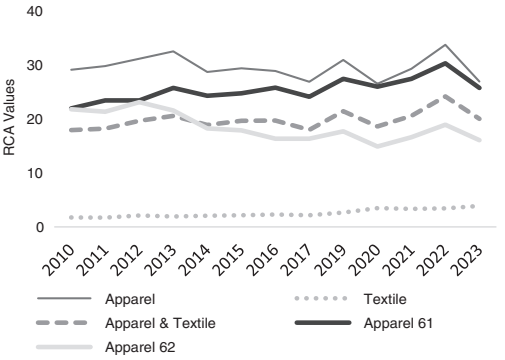


Figure 14.12b
RCA Index for Selected HS Codes of Apparel and Textile



Source: Authors' calculation based on Trademap database.

14.6 Conclusion

A FFS reform is expected to have a checklist of aspects to be considered to mitigate the impact on business and economic sectors.[23] A gradual phase-out has to be supported by removing price controls in other sectors (food and transport sector price shocks), and short-term compensation for key sectors (such as fuel subsidies, reduced taxes, import tariffs, and export awards, etc.), and extending access to credit by providing concessionary loans for energy efficiency, and micro-credit schemes for small and medium-sized enterprises (SMEs). These measures will benefit the industries by allowing them time to adapt to new prices (energy efficiency improvements or substitution) and reduce the impact on profits when the price cannot be transferred to the consumers while avoiding long-term support measures. The adaptation and substitution measures must align with the climate change policy commitments. For example, the companies look for improving energy efficiency to reduce energy intensity and costs and look for solar and other NCRE sources to cut down the prices while claiming a competitive advantage in producing green products.

The evidence presented above shows that the main export industries in Sri Lanka are not energy-intensive since their cost share is comparatively low and probably labour-intensive. However, the price shocks it generates affect short-term profits to a certain level.

The evidence presented above shows that the main export industries in Sri Lanka are not energy-intensive since their cost share is comparatively low and probably labour-intensive. However, the price shocks it generates affect short-term profits to a certain level. Hence, the industry stakeholders demand subsidies, reduction of electricity costs, and support for energy efficiency and NCRE adoption.[24] Since the competitiveness of products in the international market is on the decline, the ability to

23 Beaton, C., Gerasimchuk, I., Laan, T., Lang, K., Vis-Dunbar, D., & Wooders, P. (2013). *A Guidebook to Fossil-Fuel Subsidy Reform for Policy-Makers in Southeast Asia*, (based on iisd.org).

24 The Island. (2024, July 18). *JAAF Lauds PUCSL Reduction in Electricity Tariffs and Calls for Continued Energy Policy Reforms,* https://island.lk/jaaf-lauds-pucsl-reduction-in-electricity-tariffs-calls-for-continued-energy-policy-reforms/

pass on the shock to consumers can be limited. Shifting to NCRE also needs time and other resources. Therefore, energy-related policies should be complemented with assistance schemes for the relevant industries to adapt to the new policy environment. Moreover, a slow phase-out provides space to adjust the new prices, while having a transition plan for consumers and employees by the state-owned enterprises (SOEs) eases the shock.

Energy-related policies should be complemented with assistance schemes for the relevant industries to adapt to the new policy environment.

14.7 Policy Recommendations

The literature on cross-country ex-post analyses of FFS reforms has extensively highlighted that it requires tackling the related political economy issues for successful implementation.[25] These studies have shown that the countries have attempted to do the reforms over time using various approaches while improving their scope and direction. Most studies have initially focused on the impact on households while the impacts on other sectors have been gradually incorporated and the beneficiaries were streamlined. However, some succeeded while most failed in the middle when fossil fuel prices skyrocketed in the world market. In general, these studies have identified that FFS reforms should consist of a sound technical analysis of the subsidy programme, an effective communication plan to emphasise the need for such reforms to the public, compensation and social protection strategies, a redistribution plan of the saved expenditure on subsidies, smart timing (e.g. price fall in the world market), complementary policies and a long-term vision for reforms. However, it still is challenging to withstand the impacts in the presence of major external shocks such as coronavirus (COVID-19) and the Russian-Ukraine war which enhanced the fuel subsidies worldwide.

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'Thinking and working politically' (TWP), is proposed for the successful implementation of reforms. A politically feasible, locally driven, flexible, and adaptive approach is suggested to be effective. The TWP considers whether the pathway to reform is in line with the existing political objectives or whether an alternative pathway is available to change it. Moreover, identifying the best way to encourage the supporters and discourage the opposing groups is considered in TWP.

Countries tend to go for reforms when the subsidy cost explodes and becomes a burden on the budget. For example, a fiscal deficit, a current account deficit and a reserve deficit forced Jordan to FFS reforms in 2012. Similarly, 2015 reforms in Indonesia, the Dominican Republic and Ghana were driven by fiscal burdens due to oil price hikes. Mostly, as a proposal from IMF assistance, these countries implemented reforms which are quite similar to those adopted in many developing countries

25 Inchauste, G., & Victor, D. G. (Eds.). (2017). *The Political Economy of Energy Subsidy Reform*. Washington, D.C.: World Bank; Hoy, C., Kim, Y. S., Nguyen, M., Sosa, M., & Tiwari, S. (2023). *Building Public Support for Reducing Fossil Fuel Subsidies: Evidence across 12 Middle-Income Countries*. Washington, D.C.: World Bank.

including Sri Lanka. Some reforms are driven through the burdens imposed on power groups such as energy importers or distributors for payment settlements for subsidies and the poor who are backed by non-governmental organisations (NGOs), civil society organisations (CSOs) and development partners. For example, reforms in Ghana were forced by the bulk distributing private companies for which its government incurred arrears payments for selling at subsidised prices. Some similarities occurred in Sri Lanka when electricity and petroleum were sold at subsidised prices causing losses to the SOEs. Thirdly, reforms are driven by inefficient benefit delivery to the poor. For instance, general consumption subsidies benefit the well-off since they consume more energy. Those are replaced by cash transfers to the poorest categories identified through existing social protection schemes, new surveys, consumption thresholds, or targeted fossil fuels such as kerosine. Sri Lanka has a tariff system for electricity for different consumer and industrial categories. Additionally, the reforms are driven by climate change policies that discourage fossil fuel consumption and encourage renewable energy use.

Globally, FFS reforms started with price reforms alone at the beginning. Then institutional reforms were added to deregulate pricing and make subsidy allocations efficient. For example, after establishing Ghana's new National Petroleum Authority with representatives for the Governing Board from State officials, firms, trade unions, NGOs and experts, it monitors whether the domestic price is in line with the international price. Sri Lanka, too, has Committees representing government officials and experts. It would be beneficial to include representatives from various industries and other key stakeholder groups in the relevant Committees.

Brazil has used a step-by-step approach to subsidy removal according to the political power order of stakeholders starting from the lowest. 'Information reforms' make available the information to facilitate more informed decisions. For example, Ghana's reforms were facilitated by sharing information on price calculation to the public which made the process transparent. Moreover, communicating the alternative benefits of the reforms to the citizens (about what they receive in return) helped convince them of the need for reforms. In the Sri Lankan setting, information reforms are lacking.

Complementary reforms are vital for social legitimacy and the political sustainability of the reforms. For example, after a 26% hike in diesel prices in Gabon, a cash transfer programme for the poor was initiated while an improved census for low-income groups was conducted. Moreover, free threshold levels were introduced for low consumers of electricity and water, free textbooks and fee waivers were granted for school children, while introducing micro-credit schemes in rural areas, providing improved rural infrastructure such as health facilities, drinking water facilities, electricity, and public transport facilities were also expedited. Sri Lanka has initiated cash transfer programmes (Aswesuma), school meal programmes and electricity tariff revisions in favour of low consumption groups. However, these were not well communicated. Industry sector electricity tariff rates are developed based on the electricity consumption level. However, to compensate short-term losses for the firms, so far there have been no specific complementary policy reforms in Sri Lanka. Those complementary policies could be technically and financially supporting renewable energy installation, small grants programmes or temporary tax relief for the industry sector covering small-scale industries, energy-intensive industries and export industries to retain international competitiveness.

Box 14.1
Delivery of Reforms in Different Contexts

Cross-country facts based on the above literature detail the delivery of reforms in different contexts.

Ghana: Ghana had failed to implement a price formula due to political influence during elections. Later, with the increased burden of subsidies and debts, Ghana had to seek an IMF facility and agreed to completely deregulate fuel prices in 2015. This move was facilitated with the extensive involvement of stakeholders, including unions and businesses and a communication campaign to educate the public regarding the need for reforms. In the meantime, cash compensation was provided through the country's main social protection programme to compensate for the impacts. Moreover, SOEs were used to prevent the formation of cartels by private fuel supplying companies. The government also assisted the politically powerful fishing communities through a fuel subsidy for a low octane premix. The oil price collapse in the world market just after the subsidy implementation positively influenced the subsidy removal in Ghana. However, FFS reforms in Ghana have shown that with the price increase of liquefied petroleum gas (LPG), household consumers increased biomass and charcoal consumption, making more emissions.[a]

India: India successfully implemented FFS reforms during 2013-2014. The reforms were streamlined for different fuel types to target different income groups. Diesel is mainly consumed by the rich households in India. Hence, the subsidy on diesel was gradually removed with a monthly price increase of USD 0.01 until the subsidy was fully eliminated. Meanwhile, prices of LPG and kerosene were not increased, whereas the LPG subsidy for households was increased. The country could save on the government budget, and the rapid increase in diesel consumption stopped. Politically, the main opposition parties opposed the price increase. However, when the opposition came into power, the same reform continued seeing its success.

Indonesia: Indonesia abolished subsidies in 2014 while gaining approval from the society to swap the subsidy money for better quality healthcare and education where people can access quality education and free healthcare. This was an election promise made during the election campaigns that led to winning the elections. However, after some time, the price formula was abandoned, and the price revisions were ad-hoc. As a result, when the prices were quite high, the government was reluctant to increase the price and provided fuel at a subsidised price under a state-owned oil company.

Iran: Iran's reforms also failed due to the weak administration and controls in paying cash compensations for its people. The estimated targets were exceeded due to the overuse of funds where people could get benefits by manipulation, providing false information.

El Salvador: El Salvador reforms were a successful story for LPG when implemented in 2011. The poorest groups in the country do not consume or consume less LPG as opposed to the well-off. Hence the subsidy was provided to low-electricity consumers (<200 kilowatt-hours (Kwh) per month) as a direct transfer of USD 8.5 per month, equivalent to the price difference of a 25 pounds (lb) canister of LPG before and after the reform. Households with no access to electricity also received the cash transfer. The programme was successful according to the surveys conducted at three stages of implementation (before, during, and after the implementation). However, regardless of the success of the programme, one-third of the population opposed the reforms based on their political ideology. Hence, the new government revised the reforms, assuming the existing policy reform was unsuccessful.

Europe: The EU and Ireland subsidise fossil fuels in terms of tax breaks. For example, the member countries apply low VAT rates for fossil fuels compared to other consumer goods.

Source: a. Beaton, C., Gerasimchuk, I., Laan, T., Lang, K., Vis-Dunbar, D., & Wooders, P. (2013). A Guidebook to Fossil-Fuel Subsidy Reform for Policy-Makers in Southeast Asia (based on iisd.org); Greve, H., & Lay, J. (2023). "Stepping Down the Ladder": The Impacts of Fossil Fuel Subsidy Removal in a Developing Country. Journal of the Association of Environmental and Resource Economists, 10(1), 121-158; Hoy, C., Kim, Y. S., Nguyen, M., Sosa, M., & Tiwari, S. (2023). Building Public Support for Reducing Fossil Fuel Subsidies: Evidence across 12 Middle-Income Countries. Washington, D.C.: World Bank.

Box 14.1 highlights the pros and cons of implementing FFS reforms in diverse contexts. As proposed by the TWP approach, the outcomes show the importance of understanding the system first. For example, it is necessary to identify the consumers of various types of fuels, beneficiaries of the subsidy, who pays for the subsidy, the monetary value of the subsidy, and how the subsidy works practically. Understanding the political economy of the subsidy scheme is equally important. For instance, the views and possible reactions of key political actors and groups, and identifying potential hidden beneficiaries of the subsidy scheme such as political elites are important before implementing a reform.

Next, the need for reforms should be effectively communicated through campaigns to convince the public. Cash transfers were found to be an effective tool to target the compensation for low-income households during a reform. The literature suggests that providing cash transfers before implementing the reforms would minimise the initial resistance of people since they are suspicious about the selection criteria and actual implementation. Considering that most FFS reforms can result in significant savings of money for the government, even after the cash transfers to the poor, there should be a mechanism for the majority of citizens to be benefitted. For example, improving the quality of education and healthcare, improving nutrition and school feeding programmes, investing in renewable energy, growth, and employment creation are some of the strategies governments might consider depending on the context. Sometimes people demand an end to corruption and more accountability to accept reforms as evident in Nigeria during 2012-2016. The ability of politicians to deliver a politically attractive subsidy scheme focusing on providing solutions for burning issues of the public is identified as important.

Timing and smoothing are other techniques to be considered in FFS reforms. For example, FFS reforms in Nigeria in 2012 were reversed due to incorrect timing. A sudden implementation of reforms when international prices hiked resulted in sharp shocks for consumers in the absence of compensation and prior communication. The literature suggests that a gradual approach tends to be much more successful since it prevents sharp shocks and chances for mobilising protests by opposition parties in the political arena. Smoothing and ratcheting are the other successful techniques used to eliminate subsidies gradually using price formulas. Smoothing uses regular price revisions according to a formula on a daily, weekly, or monthly basis comparing the gap between international and local prices. In ratcheting, price volatility in the international market is absorbed, maintaining a higher share for price hikes and a lower share for price reductions to ensure reaching the international price gradually. However, using formulas is not politically attractive when a price increase is demanded. The literature suggests that if governments can maintain a reputation for adhering to a formula, these methods would be feasible. For instance, South Africa uses a smoothing formula with monthly price revisions to match international prices.

However, it is shown that even after successfully removing the subsidies, they keep recurring in many countries due to other factors such as inflation differences, currency depreciation, and energy price fixing. Therefore, regular price adjustments to accommodate changes in exchange rates and international fuel prices are suggested. Liberalising oil imports and supply is effective in enhancing competitiveness and local refineries. However, the possibility of forming a cartel is high in small and poor economies. Moreover, when the political elites are connected with the cartels it is challenging to implement anti-competition laws.

The new global political move on building back better with the green transition is important to meet the climate goals through renewable energy investments and energy efficiency.[26] The price drop in fossil fuels paved the way to reduce and redirect FFS for clean energy transition. Some countries have committed to FFS reforms in their Intended Nationally Determined Contributions (INDCs). However, with hikes in fossil fuel prices, the Russian-Ukraine war in 2022 diverted the situation in the opposite direction. As a result, many more countries enhanced consumer subsidies to contain the price shock to the consumers.

According to the literature, FFS reforms mainly focused on household consumers while studying the impacts on firms' competitiveness is less prominent. Therefore, it is important to understand the impacts on firms through enterprise surveys to design effective reforms.[27] A specifically designed gradual and predictable approach is acceptable for firms and households while the implementation challenge heavily depends on political factors including political leadership.

26 United Nations Development Programme. (2021). *Fossil Fuel Subsidy Reforms: Lessons and Opportunities* (based on undp.org).

27 Rentschler, J., Kornejew, M., & Bazilian, M. (2017). Fossil Fuel Subsidy Reforms and their Impacts on Firms. *Energy Policy*, 108, 617-623.

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Sri Lanka: State of the Economy 2024
Economic Scars of Multiple Crises: From Data to Policy

There has been positive news on Sri Lanka's economic front in 2024. Signs of slow but steady improvements to economic growth are occurring on the back of improved macroeconomic fundamentals with low inflation and a stable exchange rate. The improvements, however, have come at a cost as incomes have shrunk and households have adjusted their spending, especially on crucial areas like food and health. The disruption to the labour market is seeing more students staying on in education, a disinclination to search for jobs and high outmigration. These developments can also reshape the context within which an economic strategy is built to compete globally and drive rising living standards. Amidst these, electoral policy agendas threaten to reverse fiscal gains and the still fragile economic recovery. This year's report examines these issues in detail to better understand the scale of challenges ahead, and help build consensus on an economic strategy that will take Sri Lanka from stabilisation to growth and prosperity.

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ISBN 978-955-7397-33-7

Designed & Printed by, Horizon Printing (Pvt) Ltd.