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A FRAMEWORK FOR ECONOMIC RECOVERY

JULY 2021

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Acknowledgments

This report was prepared by a core team led by Dr. Roshan Perera, including Naqiya Shiraz, K.D. Vimanga, Tehani Rassool, and Aneetha Warusavitarana. Additional research support was provided by Hiruni Daberera, Mithara Fonseka, Deveen Harischandra, Ali Jafferjee, Sathya Karunarathne, Sumhiya Sallay and Thiloka Yapa.

We thank Dr. Sarath Rajapatirana, Chair of the Academic Programme of Advocata Institute for his contribution to this study, and his guidance throughout. We would also like to thank Prof. Sirimevan Colombage for his review and feedback. We are also grateful for the support of our Board of Directors, and Dhananath Fernando, COO, for their continued guidance.

Finally, we would like to thank Yasodhara Kariyawasam, Dilumi Hemasinghe and Batya Peter for their help in the design and layout of this report.

Acronyms List

ADR	Alternative Dispute Resolution
BRI	Belt and Road Initiative
CBSL	Central Bank of Sri Lanka
CEB	Ceylon Electricity Board
CPC	Ceylon Petroleum Corporation
ETF	Employees Trust Fund
EDA	Enterprise Development Agency
EFF	Extended Fund Facility
FDI	Foreign Direct Investment
GPN	Global Production Networks
IMF	International Monetary Fund
LFPR	Labour Force Participation Rate
MSME	Micro Small and Medium Enterprises
MOF	Ministry of Finance
NPL	Non-Performing Loans
PAYE	Pay As You Earn
PAC	Public Accounts Committee
PPP	Public-Private-Partnerships
REER	Real Effective Exchange Rate
SLA	Sri Lankan Airlines
SOE	State-Owned Enterprises
SPV	Special Purpose Vehicle
SRR	Statutory Reserve Ratio
TFP	Total Factor Productivity
VAT	Value Added Tax
WHT	Withholding Taxes
WB	World Bank

Introduction

The Sri Lankan economy has been heading towards a precipice for some time now. This has only been exacerbated by the recent pandemic. For much of the period post-independence, Sri Lanka's economy has been characterised by twin deficits, i.e., it has run both a fiscal deficit and a deficit in the external current account. This implies that the country has been spending and consuming more than it earns and produces. Fiscal dominance has been the root cause for macroeconomic instability adversely affecting growth, inflation, interest rates and the exchange rate. Fiscal indiscipline has also significantly narrowed the space for monetary policy. Weak public finance management arising from inadequate revenue collection and uncontrolled expenditure has meant the government has continued to run budget deficits, relying on borrowings to finance the shortfall. This has led to high and unsustainable debt levels.

The extent of the problem is highlighted by the fact that in a period of around 50 years Sri Lanka has been in 16 macroeconomic stabilisation programmes with the International Monetary Fund. The reason for this regular cycle of the balance of payments crises and bailouts has been the reluctance of successive governments to undertake serious macroeconomic and structural reforms.

The country is facing one of the worst macroeconomic crises in its history. This report is an attempt to provide a framework for a macroeconomic adjustment programme/ economic reform programme that contains both immediate and long term measures for macroeconomic stability as well as structural reforms for more sustainable and inclusive growth. The immediate implementation of these proposals would also help restore external confidence and rebuild much needed foreign exchange reserves for the country.

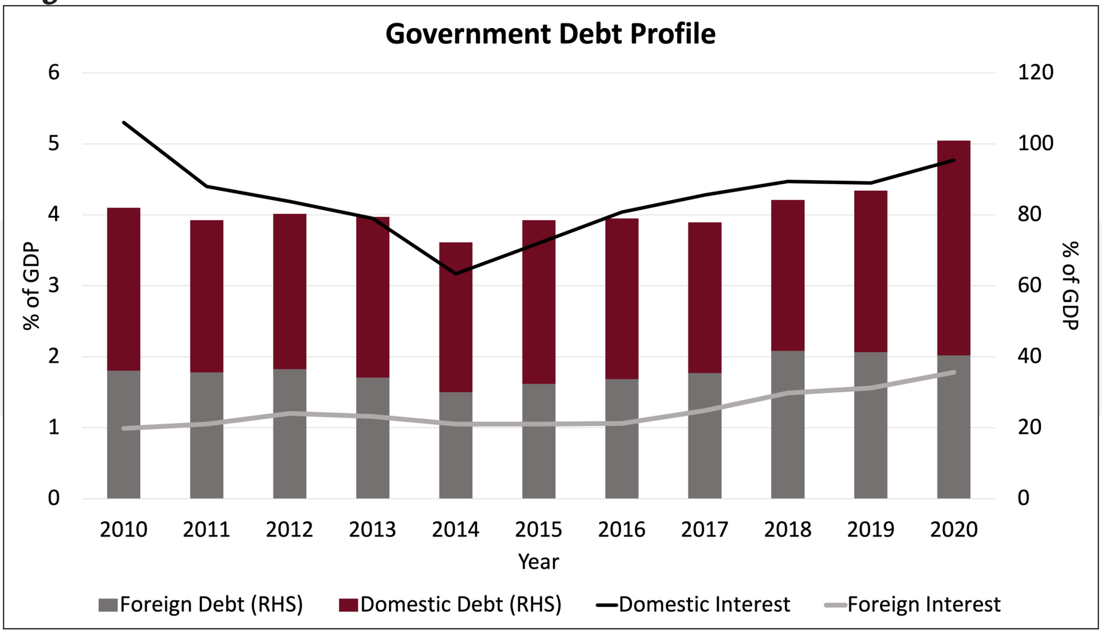
Macroeconomic Stabilisation

The key focus of policy makers should be on addressing macroeconomic imbalances. Priority should be given to correcting the twin deficits, i.e. the fiscal deficit and the external current account deficit, stimulating economic growth and improving competitiveness while building buffers to strengthen the resilience of the economy to shocks. Completing the Extended Fund Facility (EFF) programme entered into with the International Monetary Fund (IMF) in 2016 would be imperative to restoring macroeconomic stability. But even if the current administration is unwilling to enter into an agreement with the IMF, the Central Bank of Sri Lanka (CBSL) and the Ministry of Finance (MOF) needs to come up with their own strategy to ensure macroeconomic stability. The objectives for the EFF were to structurally increase revenues to facilitate fiscal deficit reduction, reverse the decline in foreign exchange reserves, reduce the public debt to GDP ratio and lower Sri Lanka's risk of debt distress, enhance public financial management and improve the operations of State-Owned Enterprises (SOEs), transition to flexible inflation targeting and a flexible exchange rate regime and promote sustainable and inclusive economic growth. These were built on 6 pillars: i) fiscal consolidation; ii) revenue mobilisation; iii) public financial management reform; iv) state enterprise reform; v) enhancing monetary policy effectiveness and maintaining exchange rate flexibility, and vi) supporting trade and investment. These priorities still remain. In the current context, a major component of any macro stabilisation programme would also need to include a debt restructuring plan.

1) Fiscal Consolidation & Debt Restructuring

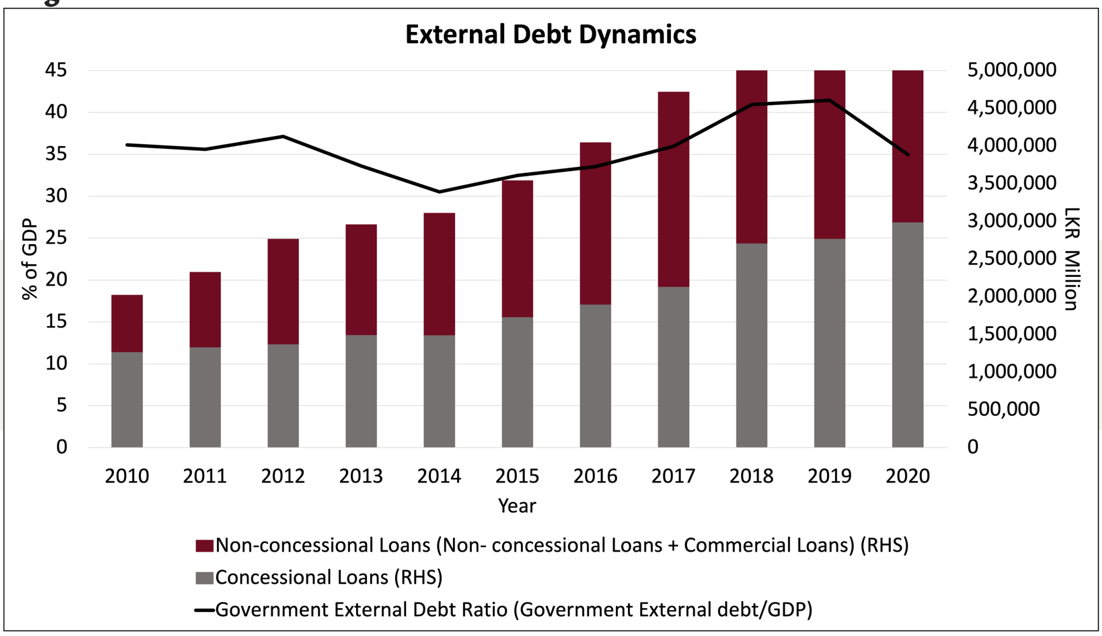
Sri Lanka's debt situation is precarious. By the end of 2020, total outstanding government debt increased sharply to 101% of GDP and public debt (including SOEs) rose to 110% of GDP. Sri Lanka has one of the highest debt service payments in the world. Total debt service payments (both interest and amortization payments) as a ratio of government expenditure was 48.5% in 2020. This as a ratio to government revenue was 141.9%. The ratio of foreign debt service payments (interest and amortization) to exports was 31.9%.

Figure 01



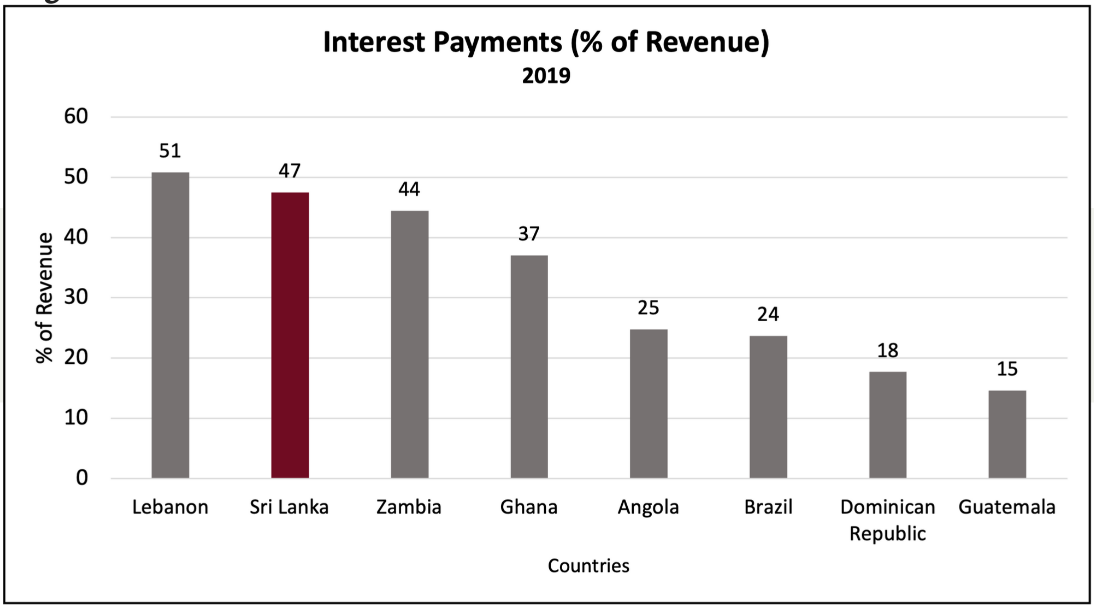
Source: Central Bank of Sri Lanka Annual Reports

Figure 02



Source: Central Bank of Sri Lanka Annual Reports

Figure 03



Source : World Bank

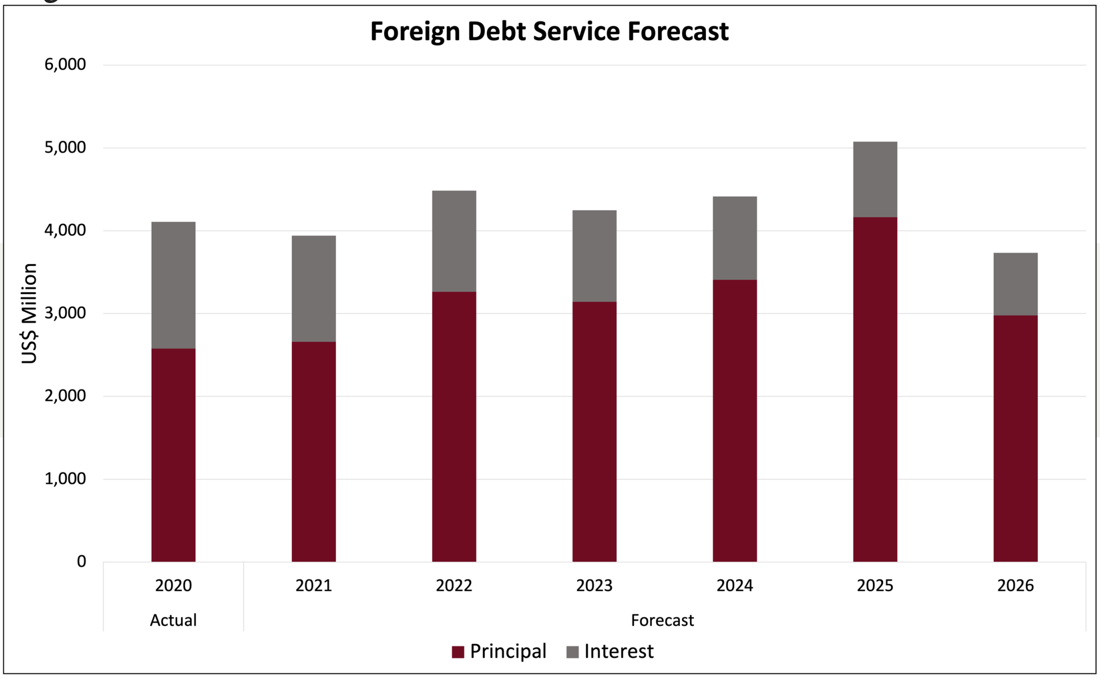
Given the current debt situation, fiscal consolidation is a major priority for Sri Lanka. As part of this process, the government should commit to reducing the fiscal deficit to 5% by 2024 and the next two budgets must indicate the path to reaching this target.[1] Such a fiscal consolidation process would enable the generation of a surplus in the primary balance which would lead to a reduction in the public debt to GDP ratio to a more sustainable level over the medium term.

However, Sri Lanka faces an imminent debt crisis. The compounding effects of debt service requirements are beginning to surface and the long term viability of being able to efficiently finance these payments is being questioned. According to the MOF, the government has around US $25 bn in foreign debt obligations due between now and 2026 (Figure 4).[2] With official foreign exchange reserves estimated at US $ 2.8 bn at the end of July 2021, and foreign inflows affected by the pandemic as well as negative investor sentiment, serious attention needs to be paid to the options available to the country to meet its debt obligations. Based on the experience of other countries that have faced similar debt sustainability issues, there are several options available for Sri Lanka to address its debt issue:

1 This is higher than the deficit reduction envisaged in the IMF's EFF of 3.5% but given the recent shocks to the economy a gradual reduction in the deficit may be warranted.

2 This does not take into account the sovereign debt denominated in foreign currency that is held by domestic entities.

Figure 04



Source: Ministry of Finance Annual Report (2020)

Do Nothing:

One option is to carry on with the current policy of utilising all available foreign funds to meet the upcoming debt service payments. To date, the government has negotiated swaps with China, Bangladesh and India. While these inflows of foreign funds provide a boost to reserves, they are only a temporary solution. Currency swaps are a liquidity management strategy that is being used to address a solvency problem. Overcoming a solvency problem requires addressing the fundamental weaknesses in the economy. This requires restructuring of debt and comprehensive reform of the economy.

With foreign reserves rapidly depleting, and the government running out of options to finance its foreign debt service obligations, the possibility of default is real.

Sovereign Default:

In the event of a default, the long term implications and the repercussions can be severe and all encompassing, especially for a small country like Sri Lanka. The primary lesson from countries that have defaulted in the past such as Argentina and more recently Greece are that economies suffer long term effects as a consequence of default. Domestic costs could be high in terms of severe austerity measures being imposed and growth being set back many years. In the case where domestic banks hold a large share of sovereign debt, it could even lead to a banking crisis. Externally it could lead to market exclusion or higher risk premia on debt and even legal sanctions being imposed.

Debt Monetisation:

Sri Lanka is attempting to use debt monetisation[3] to address the issue, with the CBSL regularly purchasing government securities from the primary auction. However, there are costs involved with this strategy and this can undermine the independence of the Central Bank. Essentially interest-bearing debt is bought by the central bank using non-interest-bearing money.[4] The cost of increasing the monetary base is obviously higher inflation which is a tax on bond holders and can significantly distort the allocation of resources. Such a course of action needs to be handled with care, as there is a high risk of this leading to hyperinflation as seen in countries such as Zimbabwe and Sudan.

Financial Repression:

The government can try to convert its foreign debt to domestic debt. Artificially suppressing domestic interest rates and issuing public debt by capitalising on a captive domestic market is one way the government could address this issue. However, this strategy has welfare implications for savers as the returns they earn are less than the inflation rate. Additionally, by the government channeling private sector funds to finance debt also leads to resource misallocation which could adversely affect investment and future growth. With the CBSL purchasing government securities in the primary market and through moral suasion, interest rates have been suppressed. With inflation gradually rising above the CBSL target (also as a result of debt monetisation) range of 4-6%, real interest rates have turned negative, thus dis-incentivising savings.

The options discussed above need to be carefully evaluated and properly considered. Although such policies may have the desired effect of reducing the level of debt, they entail a cost to the economy and lead to a misallocation of resources.

Debt Conversion:

An alternative strategy that countries have adopted to move towards a more sustainable debt portfolio is to converting its debt. Instead of continuing to make loan payments in foreign (hard) currency, Sri Lanka can find alternative means of settling payments that will be both beneficial to the country and to the creditor. Debt can be converted to equity, debt to nature swaps or debt to development.

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3 This is where the central bank purchases government securities in the primary market with the hope of inflating away the debt.

4 Sohaib Shahid, *"Debt Monetization: The Good, the Bad, and the Ugly,"* TD Economics, May 7, 2020, https://economics.td.com/domains/economics.td.com/documents/reports/ss/Global_Debt_Monetization.pdf (accessed 20 July, 2021).

Debt to equity swaps is the process by which a bank converts the sovereign external debt to an equity stake in a company in the indebted country.[5] In a debt to nature swap,[6] the indebted country agrees to engage in various forms of nature protection in exchange for a reduction in debt commitments.

In 2017, the Sri Lanka government gave a controlling equity stake of the Hambantota Port, to the China Merchants group (state run company) in exchange for a US$ 1.12 bn investment.[7] This lease agreement was for 99 years. Technically this agreement was not a debt-equity swap as there was no change to the loan repayment or the repayment schedule, but this helped finance other loan commitments.

A medium term debt management strategy for the country could include a combination of these options. However, averting a default is paramount as it could disrupt access to future financing, reduce investor confidence, affect credit ratings and have a negative impact on the reputation of the country that can be carried forward well into the future. To minimise these costs, a debt restructuring programme needs to be considered.

Debt Restructuring:

A debt restructuring process would require the debtor country to employ financial and legal advisors who will work preferably together with the IMF (as the lender of last resort) to estimate the total debt relief needed. They will have to prepare proposals that seek to modify the existing terms of the debt contracts, including revising the maturity dates for principal and interest due, requesting a haircut or a reduction in the principal amount, and changing the interest rates. These proposals are called "Indicative Restructuring Scenarios" which should mention both the level of debt relief needed as well as the process by which this could be done.

The complexity of the restructuring plan depends on the debt structure. Securing a deal that is acceptable to most creditors is difficult as there are many stakeholders involved, and conflicts of interest are inevitable.

5 Stephen Wallenstein, "Equity Swaps and Conversion Funds," in Current Legal Issues Affecting Central Banks (Washington D.C.: International Monetary Fund, 1994), https://www.elibrary.imf.org/view/books/071/01505-9781557753069-en/01505-9781557753069-en-book.xml (accessed 22 July, 2021).

6 Mengdi Yue and Christoph Nedopil Wang, "*Debt-For-Nature Swaps: A Triple-Win Solution for Debt Sustainability and Biodiversity Finance in the Belt and Road Initiative (BRI)?*" (Green Belt and Road Initiative Center, February 1, 2021), https://green-bri.org/debt-for-nature-swaps-in-the-belt-and-road-initiative-bri/ (accessed 22 July, 2021).

7 Holvert Hung, "Sri Lanka's Hambantota Port: A Case of China's 'Debt-Trap Diplomacy?" (Division of Public Policy, Institute for Public Policy, and Leadership and Public Policy Executive Education at Hong Kong University of Science and Technology, 2021), https://ppol.ust.hk/public_uploads/2020026D_Sri_Lanka_s_Hambantot.pdf (accessed 28 July, 2021).

However, engaging an internationally accepted institution such as the IMF early on in the negotiation process and ensuring proper coordination with all creditors and making sure the debt relief is as fair as possible to all stakeholders can help mitigate the challenges in the process to some extent.

Restructuring deals are very individualistic and each deal can differ from the next. Argentina for example negotiated the restructure of US $65bn[8] in foreign bonds with its major creditors after defaulting in May of 2020. The deal meant that they would have to pay back their new bonds at 55 cents of every dollar.[9] This deal did not however include the debt to the IMF that Argentina is due to start repaying ($44 bn) in 2021,[10] resulting in a need for further negotiations for additional restructuring. In comparison, Ecuador's restructuring deal was more successful.

According to the FT in 2020,[11] one of the reasons for the success of this deal which allowed Ecuador to restructure $17.4bn were the clauses of the debt itself. They had collective action clauses that as a result led to a reduction in the need for litigation.

It is important to note that for a large country like Argentina, whose indebtedness in monetary terms is much larger than Sri Lanka, renegotiating a restructuring deal is possible as creditors will lose out a lot more if they do not. For a relatively small country like Sri Lanka, a restructuring deal will have to be credible and approached holistically as creditors may not give the country a second chance if the terms of the restructuring are not carefully adhered to.

8 Robin Wigglesworth, Benedict Mander, and Colby Smith, "*Argentina Strikes Debt Agreement after Restructuring Breakthrough*," *Financial Times*, August 4, 2020, https://www.ft.com/content/ecb81529-7853-4403-95a9-577ee1ebc4b8 (accessed 28 July, 2021).

9 Arthur Sullivan, "*Argentina's Debt Restructuring Deal Explained*," Deutsche Welle, August 4, 2020, https://www.dw.com/en/argentinas-debt-restructuring-deal-explained/a-54432373 (accessed 3 August, 2021).

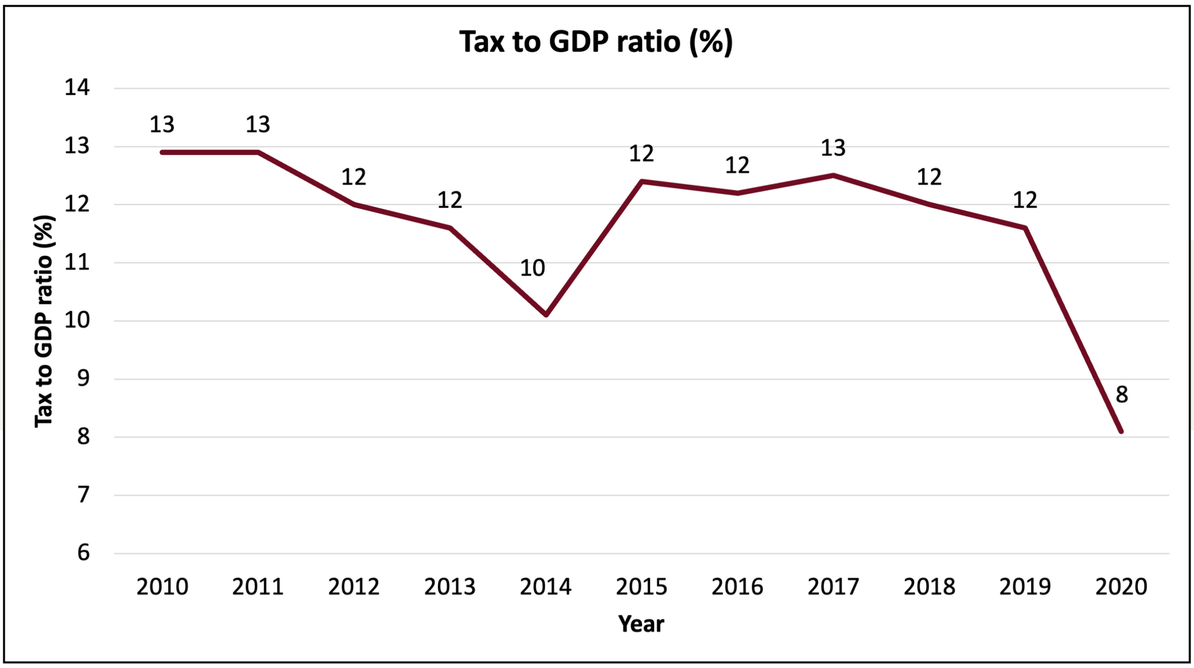
10 Nik Martin, "*Why Argentina Needs More Help with Its Huge Debt*," Deutsche Welle, May 12, 2021, https://www.dw.com/en/why-argentina-needs-more-help-with-its-huge-debt/a-57506421 (accessed 3 August, 2021).

11 Gideon Long, "*Ecuador Basks in Glow of Debt-Restructuring Success*," *Financial Times*, September 6, 2020, https://www.ft.com/content/1dd975c9-e3a1-4fcc-b049-f29dbd59f6fa (accessed 3 August, 2021).

2) Revenue Mobilisation

Tax reform to expand the tax base and improve tax administration is key to reversing the long term downward trend in revenue. Government revenue which was 21% of GDP in 1990 was averaging 15% during the period 2005-2009. This has plummeted even further to around 8% by 2020.

Figure 05



Source: Central Bank of Sri Lanka and Ministry of Finance Annual Reports

A comprehensive review of the tax system is required to ensure the government collects sufficient revenue to meet its expenditure commitments. The last comprehensive review of the tax system was undertaken in 2009 by the Presidential Commission of Taxation under the Chairmanship of Prof. W.D Lakshman (the outgoing governor of CBSL). The two main objectives of the Commission were firstly, to facilitate accelerated growth after the end of the conflict and secondly, to reverse the revenue decline. Unfortunately, the report was never published and its recommendations were not implemented holistically. The serious erosion in government revenue and its implications for macroeconomic stability call for another comprehensive review of the tax system. Some of the issues that need to be addressed are:

1) Reducing the Tax Threshold and Widening the Tax Base:

Currently the income tax threshold in Sri Lanka is more than 4 times its per capita GDP and even higher than the tax threshold in countries with per capita incomes that are several times that of Sri Lanka, such as Singapore and Australia. A high tax threshold removes a significant portion of the working population that can contribute to tax revenue. In addition, Sri Lanka has a low tax base with a large number of workers in the informal sector and a growing public sector that is largely outside the tax net. Measures to bring more workers into the formal sector as well as including public sector employees earning above a certain income level into the tax system are imperative to addressing the government's revenue shortfall.

2) Reintroducing PAYE and WHT:

Due to the challenges faced in tax collection, there were several schemes introduced such as PAYE and WHT to collect taxes at source. These schemes worked quite efficiently and enabled the revenue agencies to reduce the administrative costs of revenue collection. It also made it easier for taxpayers as the tax was paid by the employer in the case of PAYE taxes or the bank or contractor in the case of withholding taxes.

3) Reducing Excessive Reliance on Indirect Taxes:

Around 80% of tax revenue collected in 2020 was from indirect taxes, increasing the regressivity of the tax system, with lower income earners bearing a higher burden of taxation. There is also a significant concentration of taxes collected from a few commodities such as tobacco, liquor, motor vehicles, and food and beverages. This also increases the regressivity of the tax system as some of these are considered essential items and form a higher proportion of the consumption basket of low income earners.

4) Rationalising Tax Incentives:

One of the foundations of the Inland Revenue Act of 2017 was to rationalise tax exemptions and to centralise the granting of exemptions under one authority. The basis for this policy was general acceptance that sweeping tax exemptions to attract investments was not efficient as taxes are not the most important tool to attract investments. Foregoing this tax revenue was not sustainable in the long term.

5) Introducing New Taxes:

In order to broaden the tax base, new taxes such as land taxes should be introduced. In theory, a land tax is relatively straightforward to implement as the ownership of land can be established with a high degree of accuracy. In Sri Lanka, however, the issue of determining ownership and valuing land and properties are not that straightforward. The lack of a centralised land registry makes it difficult to establish ownership of land and property. Further, according to a study by the World Bank (WB) in 2017, less than half of all properties are registered and only around 3% of lands have clear titles. Addressing these issues would be vital to implementing a comprehensive land and property tax. Further, due to a relatively illiquid property market and inadequate valuation infrastructure such as an integrated and comprehensive land registry and cadastral data, it would be hard to determine the value of land.

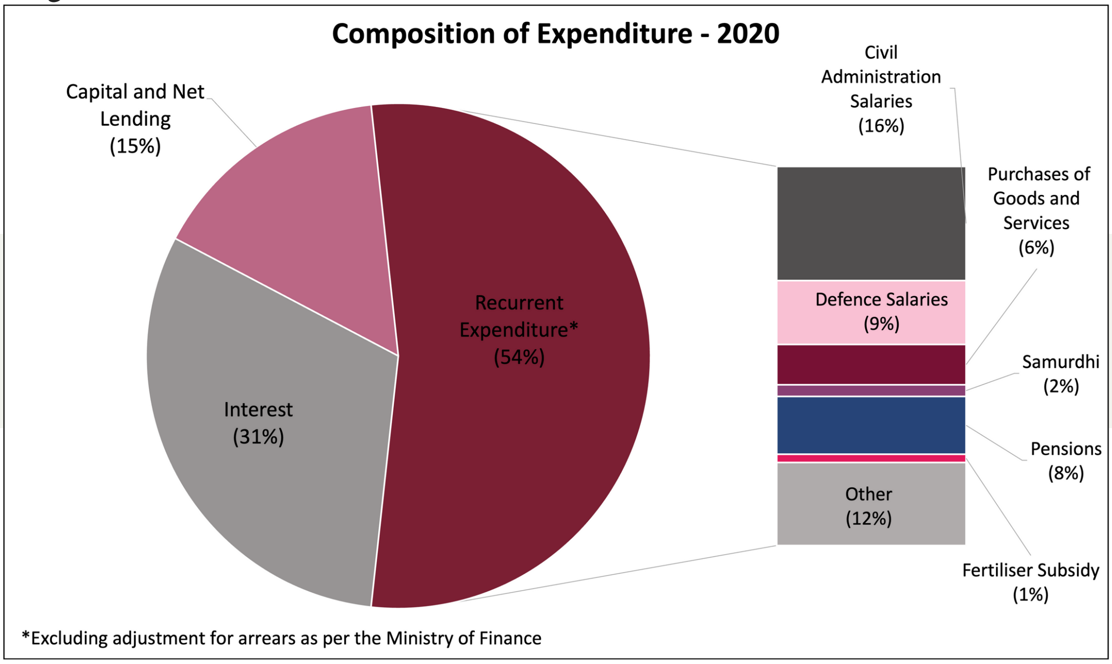
6) Strengthening Tax Administration:

The serious macroeconomic issues facing the country at this current juncture can be an opportunity to call for far reaching tax reforms including changes to tax administration. Despite commissions set up to review the tax system as well as donor funded programmes initiated to address the weaknesses in tax administration there has been very little progress on this front. An effective tax administration needs to facilitate compliance. It also needs to have an effective monitoring system in place. Modern tax administration can be more effective and be made more seamless through the use of technology. However, both political will and support of the public is required to put in place a tax system that is both efficient and equitable.

3) Medium Term Expenditure Framework and Public Sector Reform

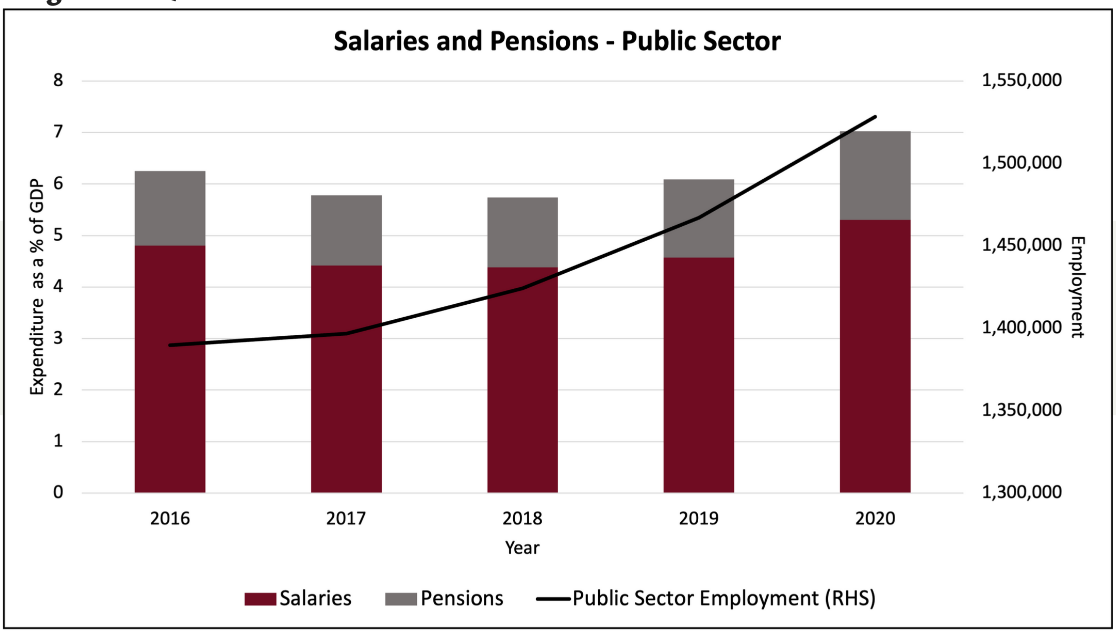
On the expenditure front, contractual obligations such as interest payments, salaries and wages and pensions account for more than two-thirds of total expenditure. An already bloated public sector and continued recruitment will only increase the expenditure on salaries and the pension bill in the future. This leaves less room for spending on education and health.

Figure 06



Source: Central Bank of Sri Lanka Annual Reports

Figure 07



Source: Central Bank of Sri Lanka and Ministry of Finance Annual Reports

Adopting good public finance management practices is paramount for sustainable growth and poverty reduction.[12] This encompasses laws, systems and processes that are put in place to ensure sufficient revenue is mobilised to maintain public services and to ensure that spending is carefully planned and audited for evaluation. This also includes strengthening budgetary oversight by Parliament, having an independent budget office and greater transparency on government spending. Ensuring that the budget complies with fiscal targets and allocating resources to strategic priorities within those targets is vital. Ultimately the key role of the state is to tax fairly and effectively (progressive taxes), and to spend responsibly.

1) Strict Oversight and Control of Government Expenditure:

The increase in recurrent expenditure has come at the cost of capital expenditure as the resource envelope of the government has dwindled. Government expenditure must lead to asset accumulation. The effects of these capital expenditure cuts will be felt in the long term, as building physical infrastructure through sustainable infrastructure projects is key to ensuring continuous and long term economic development and growth. This can only be achieved by better budgetary processes and better management of financial resources that keep the long term objectives of the country in mind.

2) Rationalising the Public Sector:

Recruitment to the public sector has steadily increased in recent years. This has led to higher spending on salaries and pensions. A key pillar of any public sector reform would necessarily include rationalising recruitment to the public sector as well as introducing measures to enhance its productivity.

3) Improving the Targeting of Subsidies and Transfers:

Untargeted expenditure on subsidies has constrained the fiscal space and made it difficult for the government to provide necessary relief to the most vulnerable households and firms affected by the pandemic.

12 Andrew Lawson, "*Public Financial Management PFM: Why Does It Matter and How Best to Improve It?*" (GSDRC, March 2015) http://gsdrc.org/docs/open/reading-packs/pfm_rp.pdf (accessed 20 July, 2021).

4) Strengthening Fiscal Rules to Constrain Discretionary Spending:

This process needs to be supported by a transparent budgetary process and strong oversight. The Fiscal Responsibility Act No.3 of 2003[13] specifies limits on the fiscal deficit and government debt. However, these limits continue to be breached and the goal post keeps being shifted, as in the recent amendment to the Act where the deadline for achieving the fiscal targets was shifted to 2030. Adhering to fiscal rules requires strong political commitment and a well established institutional framework to ensure implementation, as well as adequate sanctions to ensure compliance (IMF WP/10/254).

5) Strengthening Budgetary Institutions:

Committees such as the Committee on Public Finance, Committee on Public Enterprises (COPE) and Committee on Public Accounts (COPA) will be effective only if they operate within an established legal framework with adequate powers. One of the main powers of a Public Accounts Committee (PAC) should be to call the executive and public officials to give evidence before these committees. They should be well financed, have individuals with the necessary expertise, be transparent, independent, and held accountable.

4) State-Owned Enterprise Reform

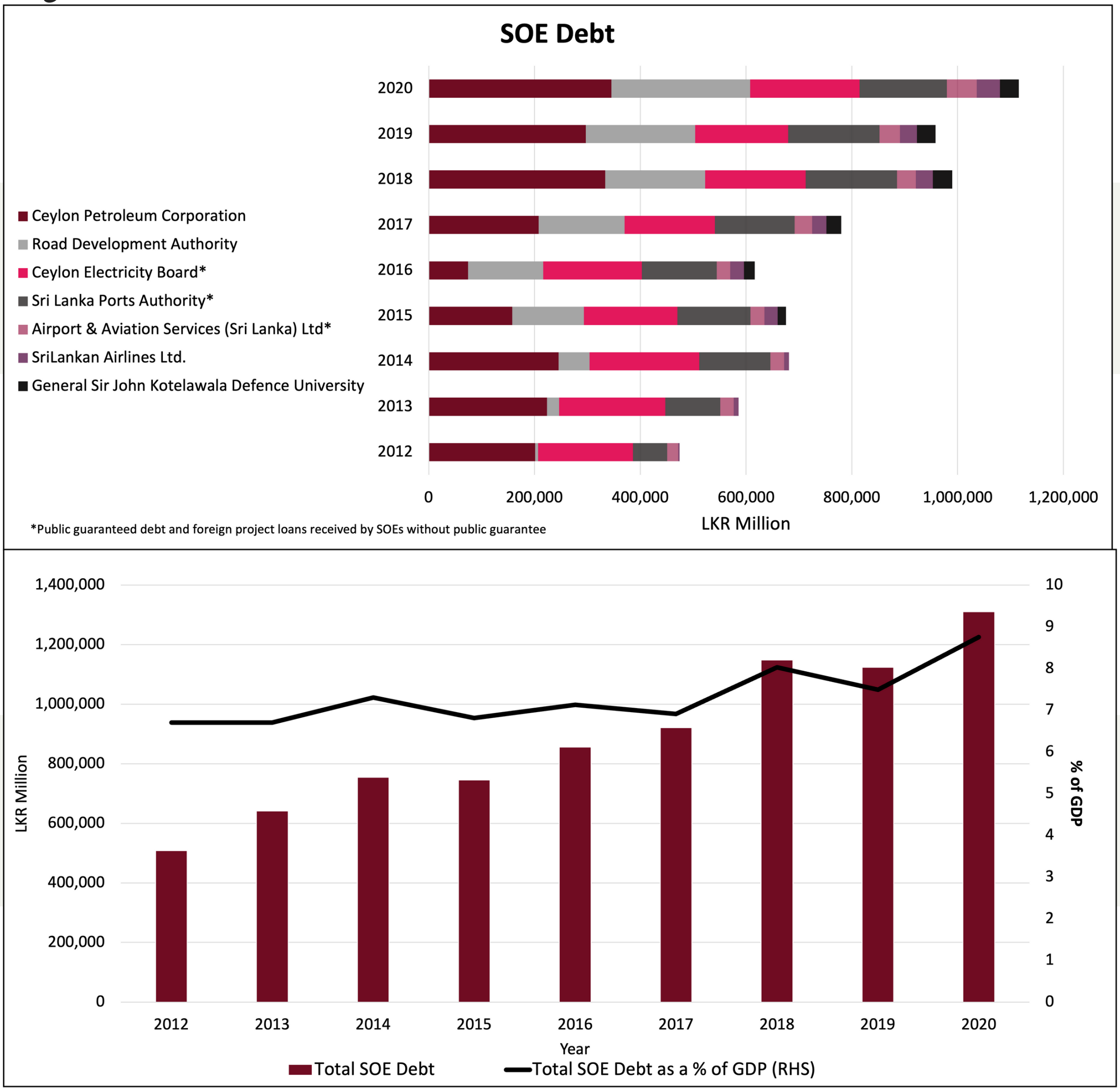
SOEs in Sri Lanka have placed a significant burden on public finances and are a major source of inefficiency in the economy. Although the overall profitability of the 52 key SOEs monitored by the MOF increased in 2020 this was mainly due to the reduction in losses in the energy sector. Borrowings of SOEs from the banking sector continue to balloon.[14]

The figure below displays a steady increase in public guaranteed debt accounted for by SOEs over the past five years, with the Ceylon Petroleum Corporation, the National Water Supply and Drainage Board, and the Road Development Authority accounting for the highest debt value in 2020.

13 *Fiscal Management (Responsibility) Act, No. 3 of 2003*, Parliament of the Democratic Socialist Republic of Sri Lanka, 2003.

14 Ministry of Finance, *Annual Report 2020*, Ministry of Finance, 2021.

Figure 08



Note: Total SOE debt Includes only non financial public corporations

Source: Central Bank of Sri Lanka and Ministry of Finance

Continuing to maintain inefficient SOEs through transfers from the government reduces the funds available for other vital and under-funded sectors such as healthcare and education. In addition, financing losses of SOEs by borrowing from banks against government guarantees is weakening the financial sector and raising the contingent liabilities of the government, both of which have implications for macroeconomic and financial sector stability, hence the urgency for reform. There are several pathways to SOE reform. Below are some options to improve efficiency and productivity of the sector:

1) Strengthening Governance:

Moving to a centralised model for SOEs would improve the accountability and governance of SOEs. This could be achieved with a centralised management model such as a holding company to ensure that enterprises are managed and governed as an investment. This would also improve budgetary and monetary independence and enable lower levels of political interference in SOEs. A holding company could initially be introduced for the ten largest enterprises, and then expanded to the others if successful.

Currently, many SOEs are gazetted under various line ministries, which are also policy makers and regulators, creating an impossible trinity. A case in point is the Ministry of Ports and Shipping which is the policy maker, industry regulator, and also controls the Sri Lanka Ports Authority, which operates several ports around the country.

Additionally, most SOEs suffer from political appointees to their boards, where the selection criteria are not based on professional merit but more on political patronage. This makes accountability weak, and as a result the management does not act in the interest of the principal (the citizens of the country).

Measures to improve corporate governance mechanisms must be implemented, including an ownership policy published by the government that would highlight the nomination and appointment policies for each enterprise's board of directors. Furthermore, key performance indicators must be highlighted in each enterprise's annual report to facilitate performance monitoring by the regulatory authority, with consequences for enterprises that do not meet the set targets.

2) Improving Transparency:

Expecting SOEs to provide services below-cost and to operate in uneconomic markets is unsustainable in the long-run. In such cases, the transparency of subsidies should be improved, and they need to be clearly costed and met through the government's budget.

If the rationale behind providing services below-cost is to protect the poorest and most vulnerable segments of society, the government should instead consider strengthening its social safety net and improving cash transfers to low-income households. As far as possible, SOEs should be made to operate in a competitive market.

Further, there is no clear accounting to delineate between the commercial and noncommercial obligations of SOEs. As such, SOEs must be mandated to quantify the costs of their non-commercial obligations. They must also provide details of the services provided, not simply the cost of running an uneconomic bus route but, specifying the number of passengers and freight carried. The subsidies received for such purposes should be disclosed separately.

Furthermore, data collection on SOE entities should be publicly disclosed by the government - particularly their revenue and losses, as well as identification of all the enterprises and their political linkages. Improved transparency of SOEs also entails the timely disclosure of annual reports to the public. For instance, the annual reports of Ceylon Petroleum Corporation (CPC) have not been updated since 2018.

3) Cost-Reflective Pricing:

Establishing a cost-reflective pricing formula is necessary to improve the commercial viability of SOEs. Cost-reflective pricing would reflect the true cost of supplying a good or service provided by the SOE and reduce reliance on government subsidies. A transparent pricing mechanism would also reduce the uncertainty from sudden price increases.

4) Restructuring and Divestment:

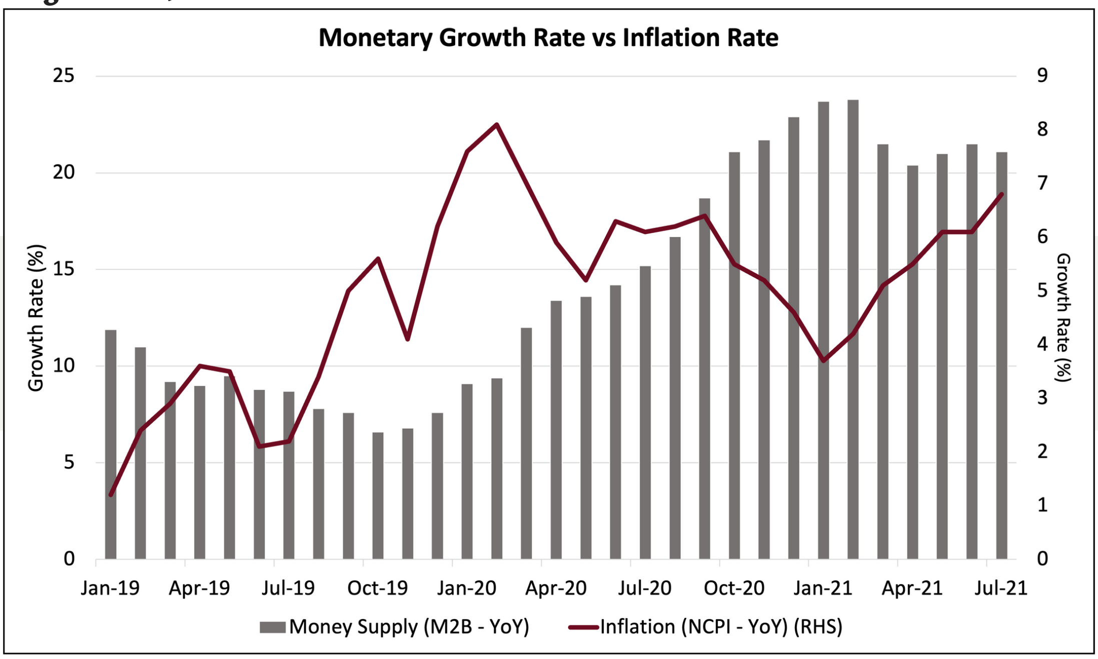
Restructuring and divestiture of inefficient enterprises needs to be considered, as part of a broader reform programme. But it needs to be undertaken within a strong institutional framework and with an overall objective of improving competition. For instance, CPC and Ceylon Electricity Board (CEB) have to be restructured and reorganised to fulfil their assigned functions without being a burden to the government and claiming large resources from the Treasury. These entities would also benefit from a stronger regulatory environment and consistent management. Additionally, the complete privatisation of non-strategic assets and underutilised lands should also be considered, in the interest of ensuring profitability and revenue generation for the government.

The concept of Selendiva Investments, which has been tasked with the ownership and diversification of a collection of state-owned lands and assets, holds promise as long as it is done transparently. However, certain elements of this proposal need clarification to progress. For instance, it is claimed that the formation of the Special Purpose Vehicle (SPV) falls under the Singaporean Temasek Model. However, this is yet to be comparatively explored by studying the mandate of the SPV. This documentation needs to be made available. Further, an identification of the governance standards and feasibility of these projects should be explored.

5) Enhancing Monetary Policy Effectiveness and Maintaining Exchange Rate Flexibility

The CBSL implemented an accommodative monetary policy to mitigate the impact of the COVID-19 pandemic on the economy by stabilising financial markets and cushioning the contraction of real economic activity by providing credit. Although market interest rates fell sharply, private sector credit growth remained subdued, reflecting the depressed economic environment and cautious lending by banks hit by rising Non-Performing Loans (NPLs) and the debt moratorium. The CBSL was also called upon to finance the government due to the widening fiscal deficit and the challenges faced in raising foreign financing due to the sovereign downgrade. Continued high monetary growth is likely to lead to a buildup of inflationary pressures (Figure 9). Rising inflationary pressure underscores the need for the CBSL to be prepared to unwind accommodative monetary policy measures in a timely manner. However, increasing government debt will make it harder to raise interest rates when inflationary pressures start emerging. Further, domestic interest rates have fallen below headline inflation resulting in negative interest rates on rupee deposits. This has adversely affected households dependent on savings, and dampened consumer spending, thus stifling an important channel of growth. Rapid monetary expansion is also exerting pressure on foreign reserves and the exchange rate. However, CBSL has been more inclined to keep the exchange rate stable to cushion the impact on foreign debt service payments. Enhancing monetary policy effectiveness and maintaining exchange rate flexibility must be key policy priorities to ensuring monetary stability in the country.

Figure 09



Source: Central Bank of Sri Lanka Annual Report

1) Inflation Target:

Monetary policy should focus on maintaining inflation within the targeted range of 4 - 6%. The recent uptick in inflation and emerging risks should reinforce the focus of monetary policy to keeping a lid on inflation. Empirical and theoretical evidence have established that the primary concern of a central bank is maintaining price stability which is vital for sustainable economic growth.

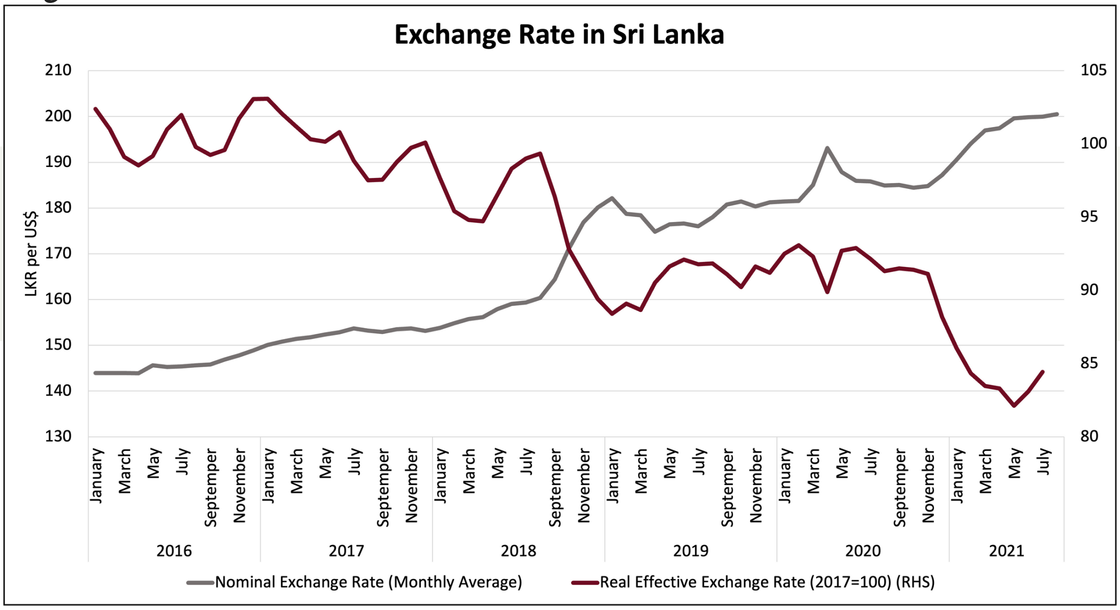
2) Independent Central Bank:

One of the main objectives of the proposed Central Bank of Sri Lanka Act (which was to replace the current Monetary Law Act No. 58 of 1949) was to strengthen the independence of CBSL and to prioritise price stability as the overarching objective of monetary policy. However, independence is only a necessary condition for effective monetary policy. Monetary independence without fiscal discipline is untenable. Hence, the new Act sought to limit monetising the deficit. This was to be achieved by preventing CBSL from purchasing government securities in the primary market as well as limiting CBSL's lending to the government through provisional advances to 10% of the government's estimated revenue of the first four months as opposed to the entire year as in the present Monetary Law Act. This is important to ensure CBSL is able to use its key monetary policy instrument, the interest rate, to manage inflation and not be constrained by other considerations.

3) Flexible Exchange Rate:

CBSL's attempts to "fix" the exchange rate by intervening in the foreign exchange market and through strict exchange control regulations and moral suasion have worsened Sri Lanka's foreign reserves. It has also led to an appreciation of the Real Effective Exchange Rate (REER) undermining the international competitiveness of Sri Lanka's exports. Allowing more flexibility in the exchange rate is imperative to improving Sri Lanka's competitiveness in international markets (Figure 10).

Figure 10



Source: Central Bank of Sri Lanka

4) Financial Sector Stability:

This remains another key vulnerability. Significant attention has to be given to address factors that threaten the stability of the financial sector such as, i) deterioration in credit quality due to exposure to sectors adversely affected by the pandemic and the growth slow down; ii) increasing lending to government and SOEs in the light of the sovereign rating downgrades; iii) decreased foreign inflows due to the pandemic; and iv) tighter global liquidity conditions with the unwinding of stimulus measures adopted by advanced economies. A combination of these factors can lead to a further deterioration in the performance and stability of the banking sector. The impact of these factors on the financial sector is dependent on the nature of the economic recovery with a slower than expected recovery further heightening the risks to the financial sector. The worsening of these conditions can pave the way for a full blown banking sector crisis, with serious consequences for the country. Therefore, a more cohesive financial sector consolidation programme must commence along with the restructuring of SOE debt.

6) Supporting Trade and Investment to Strengthen External Sustainability

In a country like Sri Lanka with a small market (both in size and per capita income) expanding trade can be the only major source of faster growth and employment. Hence, trade has to be a key part of the country's growth strategy. Domestic demand alone will not drive growth sustainably. Empirical evidence shows that countries that are more open tend to have higher levels of employment and better-quality jobs.

1) Global Production Networks:

Over 65% of world trade takes place in Global Production Networks (GPNs). At present, over three-fourths of Sri Lanka's manufacturing exports are exported within GPNs. While this is a positive, a majority of this GPN trade takes place through buyer-driven networks where the lead firm is the international buyer, and producers join the production network with no necessity for FDI. In contrast, in producer-driven networks production sharing happens through intra-firm linkages within the network, and FDI plays an important role in a country's entry and participation in such networks. There is also room for subcontracting within the producer country. Creating a policy environment that attracts FDI for producer driven exports in areas such as electronics, and scientific and medical devices should be a priority.

2) Trade Reform:

Para-tariffs have kept the rates of protection high, creating a bias against exports and have reduced competitiveness. Therefore removing these para-tariffs is essential and would send a signal to the world that Sri Lanka is serious about trade reforms. In order to mitigate this revenue loss incurred from reducing para- tariffs, immediate tax reforms have to be carried out. This has to commence from reducing tax exemptions and widening the tax base by increasing the VAT, income taxes, and introducing new taxes such as land taxes to further compensate for the lost revenue. High protection on imports leads to more domestic resources being diverted to sectors that are not competitive.

3) Trade Facilitation:

Reducing the cost of exporting and importing will be equivalent to trade reform. Improving trade facilitation which reduces the cost of exporting and importing is equivalent to a tax cut without the loss of revenue to the Treasury.

It will also have the immediate benefit of reducing the cost of living, providing a higher return on exports and also bringing greater competition to import substitution industries, making them more competitive. However, this requires a trade adjustment programme that will compensate firms that lose some business due to the trade adjustment program. But this should not be guided by industry lobby groups who raise their profits at the expense of consumers, increase the cost of living, become less competitive, and are incapable of modernising their industries

4) Foreign Direct Investment:

FDI is closely linked to an increase in exports, particularly in countries that are newly industrialising. It not only brings resources but also technology, management know-how and access to external markets. FDI inflows to Sri Lanka have been disappointing. Large inflows were expected after the end of the 30 year civil war, but these investments did not materialise. FDI inflows to Sri Lanka have remained below 2%, significantly lower than our neighbouring countries. Macroeconomic uncertainty, political uncertainty, policy inconsistency, lack of skills, deficiencies in the financial sector to support FDI, weak government institutions, and poor infrastructure have been cited as the reasons for the low FDI inflows. A lack of attractive incentives offered by Sri Lanka is cited as another reason. However, research shows that incentives alone are not effective to attract efficiency seeking FDI. The country needs to embark on a comprehensive reform programme to address the constraints it faces in attracting quality FDI.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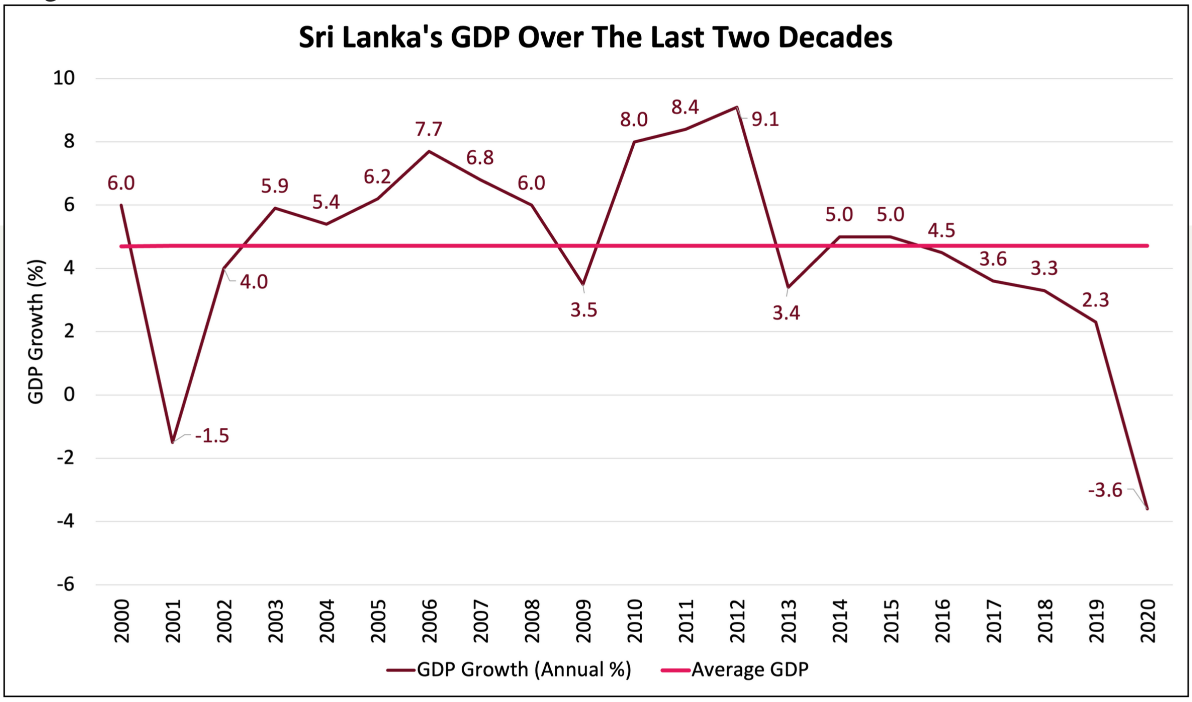
Structural Reforms for Sustainable and Inclusive Growth

Although Sri Lanka experienced periods of significant growth acceleration such as in the period following economic liberalisation and another during the post-war period, these accelerations were short lived. There are two possible explanations for this.

The first covers the political economic argument, that governments prior to an election engage in a spending spree on projects and programmes. Their main purpose is to win votes rather than to raise growth in the medium term. Secondly, productivity growth has been low and sporadic. Various estimates of Total Factor Productivity (TFP), defined as growth that is unrelated to standard factors of production such as labour, capital and land, find that Sri Lanka has relatively low TFP compared to its Asian neighbors.[15] One reason Sri Lanka's growth rates are not sustained is that without TFP growth, the country has to depend on factor augmentation, which means the country has to keep raising its savings rate to increase GDP growth.[16] If one examines high growth countries in Asia and other parts of the world, TFP growth accounts for 56-58% of total GDP growth. This implies that given the low TFP growth rate, Sri Lanka has an upper limit to its GDP growth rate.

Figure 11



Source: Central Bank of Sri Lanka Annual Report

Large infrastructure projects played a major role in the growth spurt experienced immediately after the war.[17] This was however, an unsustainable growth acceleration[18] and hence was short-lived. A debt driven investment and growth strategy was possible in the aftermath of the war due to several factors. Firstly, capital began to flow to emerging and developing markets due to the excess liquidity that was generated from the monetary stimulus programmes adopted by advanced economies in the aftermath of the global financial crisis, and the lack of investment opportunities in those countries due to slow growth and low yields. Secondly, excess liquidity and the search for yield enabled Sri Lanka to borrow relatively easily from international capital markets. Finally, Chinese funding was made available for large scale infrastructure projects. However, many of these public investment projects were not examined from an objective economic evaluation. Areas such as project feasibility and commercial viability were not explored analytically. Consequently, more debt had to be raised to service these loans.

15 Based on estimates by the Federal Reserve Bank of St. Louis in the 1990s; IMF in 2005 (Duma) and 2018 (Eteri Kvinsade et al); the World Bank in 2018; Professor Jayatilleke Bandara and Dr. Thilak S. Liyanaarachchi in 2019.

16 Krugman and Young (1975) showed that East Asian high growth could not be sustained without TFP growth.

17 Sarwat Jahan et al, "*Sri Lanka Selected Issues | IMF Country Report No. 18/176*," Washington D.C.: International Monetary Fund, June 20, 2018, https://www.imf.org/en/Publications/CR/Issues/2018/06/19/Sri-Lanka-Selected-Issues-45998 (accessed 20 July, 2021).

18 Ricardo Hausmann, Lant Pritchett, and Dani Rodrik, "*Growth Accelerations*," Journal of Economic Growth 10, no. 4 (December 2005): 303–29, https://doi.org/10.1007/s10887-005-4712-0 (accessed 19 July, 2021).

The country has thus far experienced sudden spurts of debt fuelled economic growth which have not been inclusive or sustainable. While greater flexibility of interest and exchange rates and allowing market forces to guide the allocation of resources is vital, more focused structural reforms are required to increase productivity and competitiveness to move the economy to a more sustainable growth path. Addressing the structural weaknesses, improving productivity and enhancing competitiveness would be vital for Sri Lanka to achieve stronger, inclusive, and more sustainable economic growth.

One of the barriers to productivity driven economic growth in Sri Lanka is its lack of a competition law framework. The initial basis for competition policy in Sri Lanka were the Fair Trading Commission Act, No. 1 of 1987, The Consumer Protection Act, No. 1 of 1979, and the Control of Prices Act (Chapter 173). These Acts were repealed by the Consumer Affairs Authority Act, No. 9 of 2003.

Drawing from the experience of the Australian Productivity Commission, establishing a productivity commission in Sri Lanka would help address this barrier. The commission would act as a government advisory body on micro economic policy and regulation. The Productivity Commission would be a research and advisory body, which is apolitical. Their mandate would be to conduct inquiries and studies with the aim of improving productivity and social welfare by advising the government on policy making.

While a productivity commission would address policy and regulatory barriers to productivity, specific issues that need to be addressed to improve the productivity and competitiveness of the economy are discussed below.

1) Improving the Doing Business Environment:

Improving Sri Lanka's business environment, by reducing regulatory barriers is crucial to creating sustainable growth in the country. Some of the benefits that have been identified are improved individual investment decisions when property rights are protected; court efficiency aiding economic growth, and better firm entry regulation associated with higher productivity. Improved ease of doing business scores are also associated with higher inflows of FDI into the country. [19]

Currently, Sri Lanka ranks 99th on the Ease of Doing Business Index, an improvement of one point from its ranking in 2019. However, Sri Lanka continues to lag behind regional competitors, with Malaysia, Thailand, and Vietnam ranking 21th, 21st and 70th respectively. Our performance on the indicators for enforcing contracts, registering property, and paying taxes remain low, providing ample room for improvement across all indicators.

In terms of the Global Competitiveness Index, Sri Lanka was ranked 84th in 2019, making it the 'most improved country in the region'. However, in comparison to Malaysia, Thailand and Vietnam which rank 27th, 40th and 50th, respectively, we are underperforming. In particular, Sri Lanka has performed poorly on the indicators for innovation capability, ICT adoption, product market, labour market and institutions.[20]

In relation to contract enforcement, the time cost associated with enforcing contracts in Sri Lanka is prohibitively high, at an estimated 1318 days, in comparison to the 589.6 days in an OECD country. Sri Lanka has recently taken steps to address this, with the introduction of a small claims court for disputes under LKR 1.5 m. The court will also attempt to resolve cases within 18 months or roughly 548 days. This court is expected to be expanded across the county.[21] In addition to this, the introduction of case management systems and automation of court proceedings would improve speed and efficiency in the judicial process. Further, expanding Sri Lanka's Alternative Dispute Resolution (ADR) mechanisms, especially that of commercial arbitration would improve the speed and efficiency of cases, as well as being an incentive for foreign investors.

19 "*Doing Business 2020*" (Washington DC: World Bank, 2020), https://documents1.worldbank.org/curated/en/688761571934946384/pdf/Doing-Business-2020-Comparing-Business-Regulation-in-190-Economies.pdf (accessed 13 July, 2021).

20 Klaus Schwab, "*The Global Competitiveness Report 2019*" (Geneva, Switzerland: World Economy Forum, 2019), http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf (accessed 20 July, 2021).

21 "*Small Claims Court to Hear and Determine Disputes Worth below Rs. 1.5 M*", Daily FT, June 21, 2021, https://www.ft.lk/business/Small-Claims-Court-to-hear-and-determine-disputes-worth-below-Rs-1-5-m/34-719448 (accessed 20 July, 2021).

2) Unlocking Land Supply:

Access to land is a crucial determinant of private investment in the country. At present, Sri Lanka has multiple agencies with varied responsibilities involved in the registration process. A World Bank study identifies sixteen institutions that play a role in different aspects of registrations.[22] These institutions range from the Ministry of Lands, Survey Department, Land Settlement Department to the National Land Commission and the Provincial Land Commissioner. Streamlining the registration process would require that the number of agencies involved in the process are reduced significantly.[23]

Further, Sri Lanka has two systems to register private property: 1) Deed registration through the Registrar General's Department, and 2) Title registration implemented by the Survey and Land Settlement Departments, with the register maintained by the Registrar General's Department.[24] Improving property registration mechanisms in Sri Lanka has been an ongoing effort, with a move to digitise records through the e-Land registry, and to shift from deeds to titles. The title registration process is envisioned to replace deed registration in the country through the Bim Saviya programme, that includes cadastral mapping of land parcels. This would be crucial to identifying land parcels in the country, especially land that is currently idle, and can be prioritised for development. This project should be provided with adequate funding and technical assistance, to fast track title registration across the country. The above reforms would also assist in improving land valuations.

Moreover, a 2020 ILO study on the bottlenecks for private sector investments, identifies the complications associated in determining the rightful ownership of land for investors to acquire land and to set up businesses as demoralising at the very outset for evaluating investment viability.[25] This highlights the pressing need to simplify procedures for land acquisition by private investors.

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22 "*Improving Quality of Land Administration in Sri Lanka*" (World Bank, 2017), https://documents1.worldbank.org/curated/en/750021530107195459/pdf/Improving-the-Quality-of-Land-Administration-in-Sri-Lanka-19-June-2017-final-draft-clean.pdf (accessed 13 July, 2021).

23 Ibid

24 Ibid

25 "*Assessment of the Key Bottlenecks for Private Sector Investments in the Northern Province*" (Geneva, Switzerland: International Labour Organization, 2020), https://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---ilo-colombo/documents/publication/wcms_749508.pdf (accessed 11 July, 2021).

3) Creating Flexible Labour Markets & Raising Female Labour Force Participation

Sri Lanka has a plethora of Acts and ordinances governing labour. While there are many aspects of the law that need to be updated to suit current economic and social realities, there is also a requirement to consolidate these various laws into one comprehensive piece of legislation. While draft legislation has been submitted by the Employers Federation of Ceylon and by the trade unions, there has been limited progress on this front.

A key area for reform is the Termination of Employment of Workmen Act No. 45 of 1971.

This Act imposes a rigid criteria for termination of employees; requiring the consent of the employee or prior written approval of the Labour Commissioner. [26] Additionally, it imposes a high compensation value when terminating employees, with Sri Lankan companies bearing the second-highest redundancy costs in the world.[27] This has resulted in making the termination of employees prohibitively expensive and creates an inflexible labour market. The provisions in the Act have acted as an impediment to the healthy development of the labour market, preventing the private sector from being agile and globally competitive. Further, certain conditionalities in the Act can be a barrier for start-ups or other firms with limited capital to expand their labour force beyond fifteen employees. Such labour market regulation has been a significant factor in the creation of a large informal sector in Sri Lanka, which accounts for almost 70% of the country's labour force. It is recommended that the Act is amended as follows:

- Grant discretion to employers to terminate employment of redundant workers subject to payment of compensation.
- Significantly bring down the redundancy cost paid upon termination and enable such payment only upon non-disciplinary termination.

26 *Termination of Employment of Workmen Act No. 45 of 1971*, Section 2.

27 Schedule, Gazette No. 1384/07, Section 6D, Termination of Employment of Workmen Act No. 45 of 1971 (15 March, 2005).

Figure 12

*Data for Sri Lanka is for Q4 2020

Source: World Bank and Department of Census and Statistics

Sri Lanka's labour market performs poorly in terms of integrating women in the labour force, with labour force statistics showing that male participation in the labour force has always been higher than that of females (Figure 12). The fourth quarter of 2020 reported a Female Labour Force Participation Rate (LFPR) of 31.7%.[28] While there are many contributory factors for this gender disparity in the labour market, gender discriminatory labour laws should be revised to encourage more females to enter into the formal job market. Studies by the ILO indicate that by increasing gender parity countries in South Asia including Sri Lanka could significantly increase economic growth. With an ageing population this is even more urgent for Sri Lanka. Introducing part-time work, flexible work, and removing restrictions on overtime work for women would be crucial to improving female labour force participation.

28 Department of Census and Statistics, *Sri Lanka Labour Force Survey 4th Quarter - 2020*, Ministry of Finance, Economy and Policy Development, 2020, http://www.statistics.gov.lk/LabourForce/StaticalInformation/QuarterlyReports/4thQuarter2020 (accessed 14 July, 2021).

4) Building Human Capital

While immediate measures to address delivery gaps in healthcare and education services were previously discussed in the immediate policies section, they are not sufficient to address these issues at a deeper structural level. Moving forward, the government needs to focus on investing in people and adding to the stock of skills and knowledge in an economy. This requires greater focus on enhancing the quality of health and education, which is critical to improving development outcomes and raising the future growth potential of a country.

Improving the Economic Relevance of Education:

Sri Lanka's education system has proven ill-equipped to prepare students for the changing demands of the workplace - particularly in higher education. This is evinced by the ballooning youth unemployment rate, which stood at 25.7% in the fourth quarter of 2020,[29] the highest among all age groups. In both Technical and Vocational Education and Training (TVET) and higher education, the quality and relevance of current programmes and the employability of graduates are limited. For example, 70% of employers reported that general education does not produce people with up-to-date knowledge of methods, materials, and technology; 70% reported the same about university.[30]

An ILO study in 2015 examined the workforce skills gap across four projected-to-grow industrial sectors, including the ICT sector.[31] An overall shortfall of government expenditure in the education sector only exacerbates the difficulties faced by students, teachers, and administrators. Already, public expenditure on education as a percentage of total government expenditure is lower than the South Asian average.[32]

29 Ibid

30 Halil Dundar et al., "*Sri Lanka Education Sector Assessment Achievements, Challenges, and Policy Options Human Development*" (Washington D.C.: World Bank, 2017), https://openknowledge.worldbank.org/bitstream/handle/10986/27042/9781464810527.pdf?sequence=2&isAllowed=y (accessed 3 July, 2021).

31 Sunil Chandrasiri and Ramani Gunatilaka, "*The Skills Gap in Four Industrial Sectors in Sri Lanka*" (Geneva, Switzerland: International Labour Organization, 2015), https://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---ilo-colombo/documents/publication/wcms_359346.pdf (accessed 12 July, 2021).

32 Carolina Bloch, "*Social Spending in South Asia- an Overview of Government Expenditure on Health, Education and Social Assistance*" (International Policy Centre for Inclusive Growth and UNICEF Regional Office for South Asia, 2020), https://ipcig.org/pub/eng/RR44_Social_spending_in_South_Asia_an_overview_of_government_expenditure.pdf (accessed 19 July, 2021).

- In the medium to long-term, beyond merely improving the capacity of educational institutions - ensuring schools are not understaffed, teachers are not underpaid, and universities have the physical infrastructure to cater to graduates - the core nature of the educational curriculum in schools needs to be restructured and modernised to embrace digitisation and prepare students for the demands of the modern economy and the rapidly expanding IT sector.

- In order to keep pace with the global economy and tap into the potential of the IT sector, particularly as a means of off-setting youth unemployment, the government must invest more resources in the digital training of both teachers and students. Teachers need to be professionally developed in line with the objectives of digital education, which would assist with the quality of distance learning during periods of lockdown as well.

- The pedagogy of higher education institutes also needs to evolve in line with the future of education. The COVID-19 pandemic is an ideal example of how countries with stronger digital education systems were able to make an easier transition to distance learning. The related 'blended learning' efforts over the past 18 months in Sri Lanka has to be considered the inevitable way forward for the sector.

- Investing in digital education and improving digital literacy rates through courses would enable:

    1) Building a more shock-responsive digital education system, able to withstand periods of lockdown in the future.

    2) Allow university students to work part-time to gain a better understanding of the realities and the requirements of the workplace, which could reduce the disillusionment and dissatisfaction of graduates. While naturally, a complete transition to digital education alone is not the solution, gradually increasing the processes of 'blended learning' would be beneficial.

Improving Healthcare Outcomes:

Improving healthcare delivery and health outcomes in the country is critical to improving the productivity and output of the workforce at large. At present, Sri Lanka grapples with a rapidly ageing population - the number of older persons in the country, i.e. those aged 65 or older, is projected to double by 2040 in comparison to 2015.[33] This demographic issue is likely to cause an immense strain on health services moving forward, particularly by increasing the Non-Communicable Disease (NCD) burden and increasing out-of-pocket expenditure on high quality healthcare.

To exacerbate this issue, the country currently also faces the dangerous prospect of a healthcare worker shortage. The expansion of the ageing population has not been met by a parallel increase in healthcare workers - for instance, CBSL measured 1.72 nurses per 1000 people, far below the average of 9 nurses per 1000 population in OECD countries in 2017.[34] The shortage of health workers will only exacerbate the rising incidence of NCDs in the country.

- The first step to addressing these issues and strengthening the country's health services would be to ensure the budget for healthcare is expanded and prioritised, particularly for elder care. Government spending on inefficient areas, such as on the maintenance of loss-making SOEs, needs to be diverted to promoting and improving health services and equipping medical institutions and hospitals with the relevant administration and know-how to improve efficiency.

- The government needs to collaborate with both public sector and private sector medical institutions, such as the Sri Lanka Medical Association (SLMA) and the Association of Private Hospitals and Nursing Homes (APHNH), to gain a proper assessment of the healthcare needs of the country. At present, there appears to be considerable disparity between the country's healthcare needs and the government's allocation of resources. As identified by the Institute of Policy Studies, the 2021 budget proposed spending for pediatric care, but did not allocate funds towards building infrastructure for elder care.[35] As outlined above, this is of utmost importance as the country's NCD burden expands.

33 *"World Population Prospects - Population Division - United Nations,"* (United Nations, 2019), https://population.un.org/wpp/ (accessed 27 July, 2021).

34 OECD (2019), Health at a Glance 2019: OECD Indicators, OECD Publishing, Paris, https://doi.org/10.1787/4dd50c09-en (accessed 8 July, 2021).

35 Ashani Abayasekara, "*Sri Lanka's Health Financing Challenge: Why Smarter Spending Is Key*," Talking Economics, Institute of Policy Studies, April 7, 2021, https://www.ips.lk/talkingeconomics/2021/04/07/sri-lankas-health-financing-challenge-why-smarter-spending-is-key/ (accessed 29 July, 2021).

5) Bridging the Infrastructure Gap

Infrastructure is a key driver of growth and human development. Moreover, infrastructure can enhance the efficiency of other factors of production and thus improve productivity.[36] However the impact of infrastructure projects depends on their quality and cost effectiveness. Bad investments can jeopardise a country's debt sustainability and lead to social and environmental problems.[37] Hence the need to better assess the impact of infrastructure projects and prioritise those with the greatest impact.

Despite investing in several large infrastructure projects over the last decade, significant infrastructure gaps persist in the country. Sri Lanka's urban roads exceed their capacity during peak hours and there is limited integration of the road network with other modes of transport.[38] Due to limited road capacity, average speeds will decrease from 25.75 km/hr in 2011 to 19.13 k/hr in 2031. In the Colombo metropolitan area, speeds will reduce to 14.41 km/hr, and at peak time traffic in Colombo, speeds will decrease to 9.10 km/hr.[39] When considering the alternative of rail, of the 124,000 trains that operated in 2018, 46% did not operate punctually, with delays ranging from 11 minutes to over an hour; creating significant productivity losses. Further, 65% of the current engine fleet is over 30 years old, and purchasing spare parts for maintenance work takes an extended period of time.[40]

Electricity demand has been on the rise in Sri Lanka. In 2010 demand in Sri Lanka was 1,995 MW, and by 2018 demand had increased to 2,616 MW. However, the long term low cost generation plan identifies a generation capacity shortage in the short term, up to year 2023 when looking at forecasted demand.

36 "*Meeting Asia's Infrastructure Needs*" (Mandaluyong City, Philippines: Asian Development Bank, 2017), https://www.adb.org/sites/default/files/publication/227496/special-report-infrastructure.pdf (accessed 29 July, 2021).

37 Gerd Schwartz et al., "*How Strong Infrastructure Governance Can End Waste in Public Investment,*" IMFBlog (blog), September 3, 2020, https://blogs.imf.org/2020/09/03/how-strong-infrastructure-governance-can-end-waste-in-public-investment/ (accessed 9 July, 2021).

38 Department of National Planning, "*2017 - 2020 Public Investment Programme,*" Ministry of National Policies and Economic Affairs, http://www.npd.gov.lk/images/publications/english_pip_book.pdf (accessed 14 July, 2021).

39 Amal S. Kumarage, "*Sri Lanka Transport Sector Policy Note*" (World Bank, 2012), https://kumarage.files.wordpress.com/2015/03/2012-r-01-tp-kumarage-a-s-sri-lanka-transport-sector-policy-note-world-bank-111pp.pdf (accessed 19 July, 2021).

40 Department of Railways, "*Sri Lanka Railways Performance Report - 2018*", https://www.parliament.lk/uploads/documents/paperspresented/performance-report-department-of-srilanka-railway-2018.pdf (accessed 7 July, 2021).

The IMF estimates that countries lose approximately one-third of their resources in the public investment process, and poor infrastructure governance is a key reason for these losses.[41] It is essential for Sri Lanka to develop infrastructure with high social and economic returns and to ensure these projects are financed in a more sustainable manner. Some areas that need to be addressed:

- **Institutional Capacity:** A needs assessment of public investment to be carried out across all sectors and ministries before the commencement of any project, and for projects to be vetted by a development council of senior economists and development professionals.

- **Public Private Partnerships:** Bridge existing infrastructure gaps, especially in areas such as renewable energy, ports, aviation, technology and education where there can be higher rates of returns for private investors through well structured PPP arrangements.

- **Productivity and Skills Enhancement**: To achieve sustainable economic growth, infrastructure growth has to be linked to productivity and skills development. Infrastructure projects should be focused on creating spillover effects to education and skills development by allowing the transfer of new technologies, inflow of new skills, and community participation in project development.

- **Land Trusts for Infrastructure Investments:** Instead of acquiring land outright the government can allow the creation of privately managed land trust funds which will lease out land to infrastructure development. In return the landowners will receive dividends over the lease period instead of outright payments, thus cushioning the immediate impact on the fiscal.

- **Long Term Infrastructure Bonds:** An alternative to high interest non concessional borrowing to finance infrastructure projects. This will also allow domestic investors to invest in infrastructure projects while governments would be held to higher standards of transparency and accountability owing to the commercial status of these bonds.

- **Green Energy Projects**: Community funding can be utilised to build renewable energy infrastructure.

41 Gerd Schwartz et al., "*How Strong Infrastructure Governance Can End Waste in Public Investment,*" IMFBlog (blog), September 3, 2020.

Box Article: Infrastructure-Led Growth

Infrastructure led economic development emerged as a policy priority during the administration of President Mahinda Rajapakse in 2005. Mega infrastructure development projects were implemented, with specific emphasis on highways. Between 2006 to 2010, investment in highways increased from LKR 35 bn to LKR 108 bn. Meanwhile, expressways generated revenue of approximately LKR 8.6 bn in 2019.

Most infrastructure project loans were long term concessionary loans (long grace periods with low rates of interest) while a few were funded through non concessional loans and commercial loans with short grace periods and high rates of interest. However, since 2009 there has been greater reliance on non concessional loans to finance large infrastructure projects with a vast majority financed by Chinese loans.

Area	Name of Project	Date	Investment	Terms of the Loan	Findings on the Project	Impact of the Project
General Infrastructure	**Lotus Tower**	2012- 2019	LKR 19 bn Investment. (LKR 14 bn loan from Exim Bank China and LKR 4 bn investment from TRCSL.)	Unknown	Developed as a multipurpose transmission centre along with space for retail and entertainment	Non Operational. Incurs an interest repayment of LKR 560 m a year.[42]
Road Development	**Southern Expressway**	2003 - 2014	Financed by loans from the JICA, ADB and Export and Import Bank of China. The total costs for the project was $906.5 m.	**JICA Loan** Interest Rate - 2.2 Grace Period- 10 years Loan Period including Grace Period - 40 years	According to ADB post project assessments, the GDP of the Southern Province has grown at 11.96% and the national GDP growth rate in 2012-2013 was 6.40%.[43] There has been a significant increase in productivity due to reduced travel times.	
	Colombo Katunayake Expressway	2009-2013	Total cost US $ 292 m. Founded by a loan of US $248.2 m by Exim Bank of China and the government of Sri Lanka US $45 m.	**4 separate loans for each stage of the project.** Each loan Interest Rate - 6.3 % Grace Period - 4 years Loan Period including Grace Period- 16 years	28.5 km highway connecting the capital city to the national airport in Katunayake. Made a significant contribution to reducing travel times and increased productivity for businesses using the free trade zone, airport and the port.[44]	
	Outercircular Expressway	2009-2021	$ 12.8 m loan from the EXIM Bank of China.[45]	Interest Rate - 2% Grace Period- 5 Loan Period including Grace Period- 20	Unknown. The outer circular expressway has the highest cost per km of US$ 57m per km3.[46]	
Ports and Aviation	**Mattala Rajapaksa International Airport**	2009-2013	US$209m o/w US $190 m from the Exim Bank of China.	Interest Rate -2% Grace Period - 6 years Loan Period including Grace Period - 20 years	Once it was called the "world's emptiest airport" by Forbes. However due to the pandemic the airport is being used for repatriation and seafarer flights. Prior to development it was recommended by the then strategic management agency, that the development of the BIA and improving the landing strip in Puttalam would achieve better national outcomes and of a lesser economic cost to the nation.	

42 *"Lotus Tower Generates Zero Revenue Since Opening,"* Ceylon Today, January 21, 2021, https://ceylontoday.lk/news/lotus-tower-generates-zero-revenue-since-opening (accessed 2 July, 2021).

43 *"Sri Lanka: Southern Transport Development Project | Completion Report"* (Asian Development Bank, August 2014), https://www.adb.org/sites/default/files/project-document/81845/26522-023-pcr.pdf (accessed 5 July, 2021).

44 University of Sri Jayawardenepura, *"Colombo Katunayake Expressway - Environmental Impact Assessment Report"* (Battaramulla, Sri Lanka: Road Development Authority, October 1996), https://www.eia.nl/docs/mer/diversen/pos_046_eia_report__highway.pdf (accessed 5 July, 2021).

45 Ministry of Finance, Annual Report 2015, Ministry of Finance, 2016, http://oldportal.treasury.gov.lk/documents/10181/12870/2015/07e97126-41af-4d72-98ef-a0a813e83731 (accessed 2 July, 2021).

46 *"Outer Circular Highway,"* (Road Development Authority, October 29, 2013), https://web.archive.org/web/20131029202437/http://www.rda.gov.lk/supported/expressways/och.htm (accessed 5 July, 2021).

	Magampura Mahinda Rajapaksa Port	2010	US$361 m loan from the EXIM Bank of China. With the SLPA investing 15%.	I5 separate loans. With interest rates of 6%, LIBOR 6+4 and 3 loans at 2%.	The port was unable to make an operating profit and therefore was leased on a 99 year arrangement to the China Merchant Port Holdings Company under a Private Public Partnership of US $1.12 bn.
Electricity	**Norocholai Lakvijaya Power Plant**	2006-2011	US$ 455 was spent for the construction of a 300 megawatt coal power station using loans from the EXIM Bank of China.	Loan 1 (in the form of a preferential buyer's facility of US$300 m) Interest Rate - 2% Grace Period - 7 years Loan Period including Grace Period - 21 Loan 2- in the form of a credit facility of US$ 155 m. Interest Rate - LIBOR 6+1 Grace Period - 9 years Loan Period -18 years	

Although Sri Lanka's investment infrastructure rate has been on par or better than its peers, the question is whether this infrastructure has led to an improvement in productivity. While the large post war public investment programme helped boost growth in the short term, it was not sustainable and came at a high cost. Much of this investment was made using non-concessional financing which raised the share of non-concessionary financing in the government's external debt portfolio from around 7% in 2006 to 50% by 2012.[47] This has created serious issues for debt sustainability and the country's ability to continue financing its infrastructure needs in the future.

These investments have also come at a significant opportunity cost. Investing in alternative projects such as telecommunication infrastructure or expanding public transport infrastructure may have achieved higher economic outcomes/ productivity gains. Further, expenditure on large infrastructure projects have come at the cost of reduced financing to other sectors such as healthcare, education and rural road networks.

This highlights the critical importance of improving the efficiency of infrastructure investment in Sri Lanka by putting in place clear processes for project appraisal and selection, better management of risks which lead to cost overruns and project delays and reducing corruption.[48]

47 Dushni Weerakoon, Utsav Kumar, and Roselle Dime, *"Sri Lanka's Macroeconomic Challenges: A Tale of Two Deficits"* (Asian Development Bank, 2019), https://www.adb.org/publications/sri-lanka-macroeconomic-challenges-two-deficits.

48 Gerd Schwartz et al., "*How Strong Infrastructure Governance Can End Waste in Public Investment*," IMFBlog (blog), September 3, 2020, https://blogs.imf.org/2020/09/03/how-strong-infrastructure-governance-can-end-waste-in-public-investment/.

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