REGAINING SRI LANKA:

PART I

Vision For Growth

Part I

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1. Introduction and the Path Ahead

The truth is that Sri Lanka is in the thick of an economic crisis – a crisis born of deep indebtedness. If not arrested soon, it will keep employment and incomes at the worst nadir for generations to come. Therefore, we need to act prudently and with a renewed vision to stop the country from going down the slope of ruin. The need for reforming the economy is compelling as there is no way we can carry on in the current way.

Sri Lanka began to liberalize its economy in 1977. Since then, it has made considerable progress. However, in recent years that progress has slowed, if not come to a virtual halt compared to many other countries. Many have rapidly and successfully moved on with the process of economic reform and integration. For example, many countries affected by the 1997 Southeast Asian financial crisis, stepped up the pace of reform and liberalization in response to their difficulties. They initiated more open economic policies and forged closer economic ties, during this period. In addition, steps towards greater economic integration moved forward at the regional and bilateral level. Tangible examples include APEC among the Pacific Rim countries, the Free Trade Agreement for the Americas (FTAA) in the Western Hemisphere, and the planned expansion of the EU.

Unfortunately, this country has lagged behind. It did not keep pace with or implement the reforms so crucial to build a strong economy. Therefore, the country's economic vulnerability has come to the fore following two devastating events, the attacks on the BIA and the World Trade Centre. As a result, there is mounting pressure on the cost of living. It reflects the precarious position in which the country finds itself. This situation is brought about largely by massive debts incurred by the government during the period 1995 to 2001.

Therefore, we have a single-minded priority – to overcome the debt crisis. Until that is done, little else can be achieved as a country. This means cutting down or pruning in many areas. This means some sacrifices by all. We know that there are the most vulnerable citizens who need special care and attention. The government will do its best to protect them, but the burden will have to be felt by all.

There is only one way ahead. That is achieving substantially higher economic growth. We are not talking of 4 and 5 percent growth levels. We are talking of a much higher growth rate such as 8 to 10 percent. Not just for the short term, but over a number of years – a sustained growth that will free the country from the tentacles of accumulated debt.

We must improve productivity in all areas to achieve rapid economic growth. This is possible only if we aggressively seek investment and market possibilities for our goods and services around the world. For too long, significant parts of our economy have remained inefficient and uncompetitive. The burden of this always fell on the productive sectors. But how did countries such as Singapore, Thailand and China succeed in attaining rapid economic development? They embraced comprehensive reforms aimed at increasing productivity in *all* sectors, including the government and the public sector. There is little hope for Sri Lanka if it continues to produce costly goods and services deploying resources inefficiently.

Improving productivity is a never-ending job. There are many odds stacked against it. But, we can and we must remove these barriers that prevent productive use of our resources. Many of these barriers were created by policies and regulations of past governments. We know of discriminatory attitudes towards a particular sector or industry. We have heard of misguided or poorly implemented measures to protect or encourage a particular sector or industry against another. These actions have inevitably resulted in high costs of production and adverse economic repercussions. The worst part is that consumers are forced to pay for these high costs.

Our core strategy involves accelerating economic growth by removing the barriers to productivity and putting in place review mechanisms to ensure that new barriers do not arise. Improved productivity is also essential to increase incomes and attract increased investment.

There are three key elements in the Government's Program for Sri Lanka to regain control of our economic future. These include:

- Accelerating the process of privatization of commercial activities so that they could be more productively undertaken by the private sector. This is underway.

- Reforming the legal foundation of the economy. The process has begun and the government is introducing new legislation in many key economic areas.

- Increasing substantially the efficiency in the critical government functions. For example efficiency in the areas of tax and custom procedures. Reduced trade and regulatory barriers will enhance competitiveness. To achieve this government is in the process of introducing a world-class Revenue Authority. Soon many other government functions too will fall in line.

A high employment rate is a crucial outcome of higher economic growth. To achieve this, a greater flexibility in the movement of people between jobs is a prerequisite. As such, in the next couple of years it is essential to facilitate the movement of people from low-productivity to high-productivity jobs with higher incomes. However, barriers could impede this movement and undermine economic growth. We want the economy to create two million new jobs in coming years. This would mean providing jobs to those now unemployed, and providing improved job opportunities for those under-employed or seeking higher incomes.

What will regaining control over Sri Lanka's economic future mean for workingmen and women? The keys to improving the economy lie in ensuring that all people have the resources necessary to work in productive jobs. The Government will assist in this process in a number of ways. Just a few examples can be mentioned here:

- **Granting farmers proper title for their land**. This will provide them basis for better access to financial resources so that they can invest in their farms and provide better livelihoods for their families.

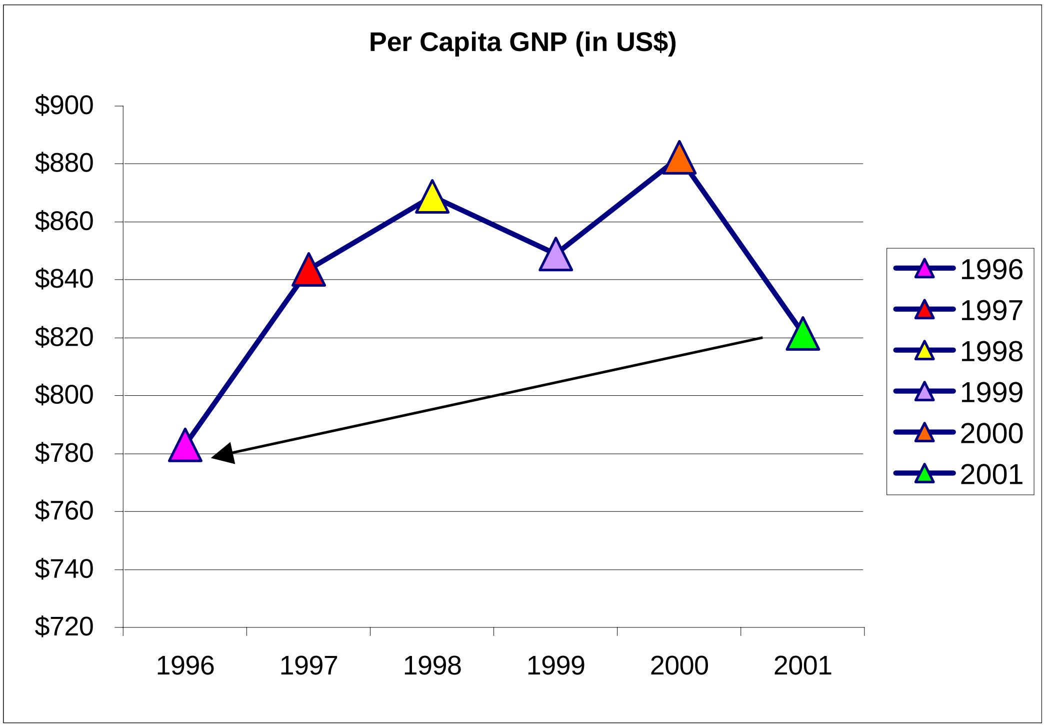
- **Making opportunities for training and education for productive employment will be more available**. This will not be just for young people entering the workforce. It will also provide the opportunity for people now employed to improve their job prospects and their incomes.

- **Reducing the cost of living, the prices that we must pay for everything.** This can only be done if the economy can produce more efficiently the food we eat, the clothes that we wear, and our transportation. Higher growth will not only mean more jobs and higher incomes, but it will also mean lower tax burdens and a lower real cost of living.

Box 1: 2001 The Fall In National Income

In the year 2001, national income (GNP) fell by 1.3 percent. *What did this mean for the people?*

In real terms, this amounted to a decline in per capita national income from US$ 881 to US$ 823, or by nearly 7 percent. For every man, woman and child national income fell by US$ 61 or at today's exchange rate, by Rs. 5,829 – or more than Rs. 100 per person every week.



We have to go back to 1996 to find per capita GNP as low as 2001. In effect, this is like erasing all of the gains in national income per person realized in the last five years!

Data from Central Bank of Sri Lanka, Annual Report 2001.

The Future – Regaining Sri Lanka presents the Government's strategy to meet the economic challenges facing the country and to put the economy on a path where we can reap the benefits of a vibrant economy. A wide range of reform initiatives will be implemented in all areas of the economy. Although everybody wishes to enjoy rapid progress we cannot ignore the constraints created by the public debt crisis, the inherited weaknesses in power and infrastructure and the impact of an uncertain world economy. Therefore, this program relies heavily on the sustained commitment of the whole country. Only if that is ensured, will we succeed.

2. Four Challenges Facing Sri Lanka

The economic crisis facing Sri Lanka has a number of dimensions – *all* of which must be addressed to accelerate economic growth and increase prosperity. To do this, four key challenges must be overcome.

I. Increasing Employment – Creating 2 Million New Jobs

A good job with an adequate income is the desire of all Sri Lankans and has, unfortunately, been beyond the reach of too many for too long. Productive employment available to all is also critical to the success of a Government's economic policies. While the official statistics suggest that there has been progress increasing the number of jobs in recent years, a careful review of the situation makes it clear that the challenge of providing sufficient productive, desirable employment opportunities is greater than might be expected.

To get a better sense of the extent of this challenge, consider the statistics reported in the Central Bank of Sri Lanka *Annual Report 2001*.

- Of a total workforce of 6.7 million, 6.2 million are now "employed", leaving 528,000 people that are officially unemployed. (This *excludes* the North and East, where the number of new jobs that will be required is not known, although it will be substantial.)

- Among the so-called "employed" are people that have worked for as little as one hour per week in paid employment. This definition hides many who are significantly under-employed and who are in need of full time productive jobs. (It has been estimated that the number of "under-employed" amount to as many as 20 percent of the total workforce, or approximately 1.3 million people.)

- Also included as "employed" are approximately 673,000 people that are classified as "unpaid family workers", many of who would no doubt welcome full-time, paid work if it were available.

- There are also approximately one million overseas workers, roughly 75 percent in the Middle East, many of whom are engaged in low paid, menial jobs and would prefer to work at equal or better paying jobs at home.

- Among the "employed" are approximately 1.2 million employees in the public sector, including the government and State Owned Enterprises (SOEs). It is well known that there is much overstaffing in these sectors, thus many of these employees are also seriously under-employed, although ostensibly employed full time. A streamlined, more efficient public sector would release these workers to more productive employment in the private sector, increasing their economic welfare and strengthening the national economy.

- Finally, and most importantly, there will be between 400,000 and 500,000 new entrants to the workforce in the next several years that will need jobs.

A *minimum* of two million new jobs must be created during the next several years if this challenge is to be fully met. This would provide productive jobs for those currently unemployed and the new entrants to the workforce. It would also offer improved alternative employment opportunities for people now under-employed and employed in low productivity jobs.

II. Overcoming The Public Debt Crisis

If the country cannot control its finances, it cannot control its economic future. Government debt has expanded dramatically in recent years, to the point where today the size of the public debt is larger than the country's GDP. As a result, the revenues required to service this debt each year now exceed the total revenues of the government. This has left no choice but to continue to incur large budget deficits if the government is to meet its essential day-to-day responsibilities. This year the deficit target is 8.9 percent of GDP. Based on a mid-year review, the Government remains on track towards meeting this deficit target, although to continue do so will require much effort, discipline and sacrifice.

However, this large budget deficit also means that the total amount of public debt will increase even further. To put this in some perspective, the total public debt translates to Rs. 77,500/- for every man, woman and child in the country. The additional borrowing required to meet this year's deficit will add approximately Rs. 6,000/- to this burden. It should be clear that if these large deficits continue unabated, the public debt would grow faster than the economy. Eventually, we or our children will have to face the prospect of being unable to repay these debts. However, long before that our reputation as a country that can manage its resources and maintain its credit worthiness will be damaged to the point where we will be unable to recover.

Meeting the challenge of bringing the public debt under control requires decisive actions in two areas. The first objective is to create an environment where national income grows faster than the public debt, permitting the country to 'outgrow' the debt burden. And the second objective is to reduce the budget deficit to slow and eventually reverse the increases in public debt. This will entail both reducing public expenditures as well as increasing revenues. These adjustments are unavoidable and will have to be well managed to ensure that the burdens are shared fairly and do not impose an excessive burden on the most vulnerable members of society. It is also essential that these reforms be carried out in ways that do not limit the prospects for increased economic growth.

III. Resources For Reconstruction

Bringing an end to the conflict in the North and East and establishing a lasting peace offers the prospect of reduced military expenditures and focusing resources on improved economic development for the entire country. It also raises new challenges. Nearly two decades of war has left destroyed or badly neglected infrastructure and institutions throughout the country.

It will be necessary to invest in major reconstruction efforts in *all* regions to lay the foundation for substantially higher rates of economic growth. While significant assistance from the international community can be expected in these endeavors, the country will need to generate much of the resources for these efforts itself. Meeting these needs will place large additional demands on the government budget, demands that the current budget has no way to meet. The country can begin to adequately meet these demands only if there is significantly higher growth in employment and incomes, increasing our tax base.

The *Relief, Rehabilitation and Reconciliation (RRR)* process has been initiated to address some of the immediate challenges arising in building a lasting peace. The RRR focuses on meeting the basic needs of the people affected by the conflict; improving economic conditions; and facilitation reconciliation among all ethnic groups. **Our ability to build a peaceful and prosperous future and regain the promise that Sri Lanka offers future generations depends on the outcome of the RRR process, which depends critically upon meeting the country's economic goals.**

IV. Increasing Income Levels – Higher Productivity & Increased Investment

Our goal is not only to substantially increase the numbers of people employed, but also to increase peoples' incomes. However, **incomes can only grow in line with increases in productivity**. Without productivity growth, any attempt to raise incomes will only lead to higher inflation, which robs the workers of any value in salary increases and leaves the country worse off in the end.

Raising productivity is also the key that will allow businesses and farmers to compete more effectively at home and in overseas markets. Increased investment and higher economic growth will be achieved only if the country can produce and sell more and do so with lower costs. **This will require *all* sectors of the economy, including the public sector, to work more productively**.

Meeting the challenges of overcoming the burden of the public debt, creating two million new jobs and generating sufficient resources for reconstruction throughout the country will all depend upon the extent to which widespread productivity improvements and increased investment can be realized. This lies at the heart of our program and will be the standard by which all actions will be measured.

3. Achieving 10% Growth – Feasibility & Implications

To meet the four challenges facing the country, our goal is to achieve a sustainable 10 percent annual growth rate. ***It can be done***. This will no doubt entail a rapid and far-reaching transformation of the economy. To gain an insight as to what would be required, it is worth briefly considering how other countries have achieved and sustained high rates of growth and what their experience suggests for Sri Lanka.

Achieving and sustaining a growth rate of 10 percent is, to say the least, unusual. Table 1 (below) presents average growth rates from the World Bank's *World Development Indicators* for 2001. (These are the countries with the highest averages for the periods indicated and were drawn from data for 115 countries.) A few points worth noting from these figures:

- Only China, with its major market-oriented economic transformation and low initial income and Botswana, with its diamonds and corruption-free good governance maintained growth rates 10 percent or more for extended periods.
- ASEAN countries Thailand, Singapore, Malaysia, Indonesia and Vietnam are all high on this list. They were especially successful in developing trade and as a destination for foreign investment aimed at production for international markets. (The Philippines, a notable exception, had average growth in the 2 to 3 percent range).
- Korea, Chile, Mauritius and Belize, all very export-oriented countries and important locations for FDI are high on this list.
- And most of the countries high on the list have been implementing major economic reforms, including most of the African countries here, and have been on average relatively open to international trade.

It is also important to note that for the most part this list does not include the "developed" countries such as the US and EU countries (other than Ireland). This is a reflection of a fundamental point underlying the economics of growth – when countries have essentially reached maximum efficiency and all resources are fully employed, it is technological change that determines the rate of economic growth. And for much of the post-World War II period, that has been no more than about 3 to 4 percent per year.

Table 1: Average GDP Growth Rates (Percentages)

	1985-1997	1970-99
China	10.09	8.46
Thailand	8.76	6.68
Korea, Rep.	8.41	7.63
Singapore	7.85	8.16
Chile	7.66	4.43
Malaysia	7.57	6.94
Botswana	7.20	10.34
Indonesia	7.18	6.33
Vietnam	6.52	6.46
Mauritius	6.20	5.56
Belize	6.09	5.50
India	5.83	4.77
Luxembourg	5.47	4.11
Lesotho	5.46	5.48
Malta	5.40	6.81
Pakistan	5.39	5.24
Israel	5.25	4.91

Table 1: Average GDP Growth Rates (Percentages) Contd.

Papua New Guinea	5.16	3.23
Ireland	4.83	4.90
Ghana	4.60	2.57
Syrian Arab Republic	4.53	5.93
Sri Lanka	**4.42**	**4.54**
Bangladesh	4.26	3.78

Source: World Bank *World Development Indicators*, 2001

Box 2: Missed Opportunities For Economic Growth

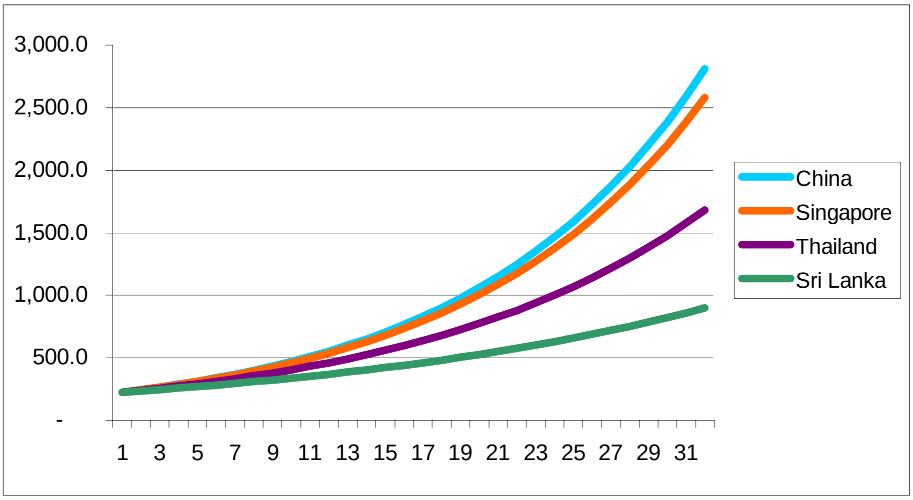
The potential benefits of regaining the economic initiative and achieving significantly higher rates of economic growth can be looked at in light of what might have happened if Sri Lanka had grown at the same rates of some of the more successful countries in the region. In 1970, GDP in Sri Lanka was Rs. 226.7 billion in 1996 prices. It grew at an average of 4.5%, reaching an estimated Rs. 897.8 billion in 2001 or US$ 536 per capita.

	2001 GDP	(% of SL)	Per Person ($)
Sri Lanka	897.8		$ 536.33
If growth same as			
Thailand	1,682.6	87.41%	$ 1,005.17
Singapore	2,579.2	187.28%	$ 1,540.79
China	2,810.4	213.03%	$ 1,678.91

- If more effective policies were pursued from 1970 and Sri Lanka was able to match Thailand's average growth rate of 6.68%, GDP in 2001 would have been 87.4% higher. That would have amounted to Rs. 1,683 billion or $1,005 per person.

- If Sri Lanka had been able to match Singapore's growth rate, GDP would have been Rs.2,579 in 2001,or US$1,541 per person – 187.3% higher.

- Finally, if China's average growth rate for this period was reached, GDP of Rs.2,810.4 billion would have been achieved, more than double the level actually produced by our economy. GNP per capita would have reached US$1,679.



4. A Strategy For Increased Economic Growth

Improving productivity is the key to accelerate economic growth and transform the economy to meet the economic challenges that face the country. This was the basis for China's recent rapid economic development and is why Singapore and other high growth countries have been able to maintain high rates of growth for some time.

How can Sri Lanka improve productivity?

It is important to recognize that productivity is the end result of decisions taken by people responsible for producing goods and services. For the most part, these are business people, manufacturers, farmers, merchants and hoteliers, to name a few. They erect buildings, buy machinery, hire workers, develop marketing campaigns – based on the prices for which they can sell their goods or services and the costs of obtaining the labor and inputs used in production. Anything that interferes with or distorts these decisions – including unwarranted government interference – will reduce productivity and thus reduce economic growth. Consider several recent examples of conditions that have hurt productivity in the Sri Lankan economy:

- **The high electricity prices that are a result of past mismanagement of the power sector increase production costs and thus lower productivity.** This has forced firms to make additional investments in generator capacity to cope with the frequent power outages in recent years. Since electricity is an input into virtually all goods and services, these added costs have far reaching negative impacts on productivity.

- **Regulations restricting the diversification of crops, limitations on land ownership and the length of land leases, and constraints on foreign participation have all tended to reduce productivity in the plantation sector specifically and more generally the agricultural sector.** These restrictions have impeded investments in more productive technologies, such as drip irrigation methods and improved seed varieties, and hindered the emergence of a competitive commercial agricultural sector.

- **Also in the agricultural sector, high import protection of some basic foodstuffs has fostered inefficient production and high prices.** This has come at the expense of production of more profitable alternative crops. To make matters worse, in recent years the government has periodically opened the economy to large imports of basic foodstuffs that have led to large price fluctuations. This hurts farmers' abilities to produce efficiently. And finally, high prices for staple foods put upward pressures on wage rates, which hurt competitiveness throughout the economy.

- **Tax, trade and regulatory policies have reduced investment levels and led to distortions in investment patterns and reduced economic growth.** These differential incentives have also increased costs in various ways and undermined competitiveness.

In each of these examples, attempts to provide incentives to encourage investment and stimulate economic growth has in fact led to lower productivity and undermined prospects for future growth.

It is also useful to compare these experiences with those of other countries facing similar conditions. There is a large body of experience and many studies on which to draw that demonstrate the growth-enhancing impacts of adopting pro-productivity policies. Three recent examples of studies that provide useful insights in the current context:

- A recent study by McKinsey and Company for India estimates that that country could increase GDP growth to 10 percent a year if it were to (i) greatly reduce product market regulations that restrict competition and divert producers from adopting 'best practice' methods; (ii) remove land market distortions and encourage better access to land for commercial activities; and (iii) significantly reduce government ownership and control of companies. (*India: The Growth Imperative,* 2001)

- A major study that analyzed firm performance in Malaysia, Thailand, Indonesia, Philippines, and South Korea confirmed several important points relevant here. Greater openness to international markets leads to higher productivity growth. It was also shown that countries in the process of reducing trade and regulatory barriers could realize major gains from this higher productivity growth in the short term. (*Exports and Manufacturing Productivity in East Asia: A Comparative Analysis With Firm-Level Data*, Hallward-Driemeir, *et al*, National Bureau of Economic Research, 2002)

- In a comparison of the responses of Mexico and Chile to poor economic performance in the 1980s, another recent study found that Chile was able to recover much more rapidly because it had previously introduced fundamental productivity-enhancing reforms in trade policy, fiscal policy, privatization, banking and finance, and bankruptcy laws. In contrast, Mexico was much slower in introducing reforms in these areas and as a result its economy recovered much less quickly. (*Policy-Driven Productivity In Chile And Mexico In The 1980s And 1990s,* Bergoeing, *et al*, National Bureau of Economic Research, 2002)

Immediate Tasks

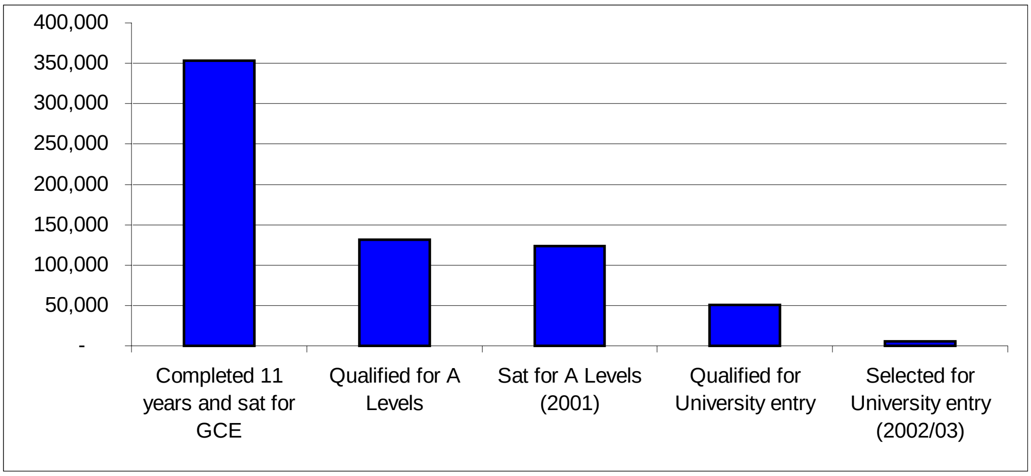
The immediate tasks facing the country are clear. ***A comprehensive and sustained attack must be aimed at the barriers that reduce productivity and, as a result, limit investment and economic growth.*** The Government's economic policies are being reformed to create an environment that encourages all producers of goods and services – including the activities of the Government itself – to become more efficient and to continue to improve efficiency. This will mean a number of important changes.

There must be greater freedom for farmers, manufacturers, tourism businesses, bankers and others businesses to make the necessary decisions to ensure economic efficiency. This will mean a change in the relationship between the government and the private sector. Today the government plays too large a role in making commercial decisions and this leads to inefficiency and uncompetitiveness.

- The Government will undertake an assessment of all regulations that affect business, removing all that are not strictly necessary for public health, safety or maintaining security. Where regulations remain, they will be reformed where necessary to ensure that they impose the least possible burden on economic performance. New regulations will be rigorously reviewed to avoid unnecessarily undermining economic growth.

Box 3: A Failing Educational System

Successfully meeting Sri Lanka's economic challenges will require an educational system that better meets the needs of the country. The present system leaves far too great a share of our human resources under-developed. The chart below shows the sharp fall in the numbers of students that completed 11 years of general education to the very small number entering university.



- In 1998, 353,372 students completed 11 years and sat for the GCE O levels;
- 37% (131,143) of these students qualified for A Levels;
- 35% (123,650) sat as first attempt/fresher applicants in 2001;
- 14% (50,526) of the original group qualified for university entry;
- 2% (5,750) were selected for university.

- **85% or about 100,000 of the students who passed A levels qualified for tertiary education, both university and technical. But only a small fraction of those that qualified and sought vocational training and education got the opportunity!**

Utilization of these under-developed human resources must be significantly improved if Sri Lanka is to achieve the large increases in economic growth on which the future depends.

The country will not reach the goal of 10 percent growth and be able to meet the Four Challenges unless productivity is improved in all areas. In the same way that a private firm cannot be competitive if its marketing department or its accounting department is inefficient, so too must *all* sectors of the economy must become more efficient. A primary responsibility of the Government is to ensure that public resources are used productively and that the public sector can significantly improves its performance.

- ***The Government will accelerate the process of privatization and address the inefficient operations of SOEs.*** The goal is to completely remove the government from all commercial activities that can be more efficiently undertaken by the private sector.

- ***In many areas services now provided by the government can be more efficiently provided through public private partnerships or private contractors.*** Not doing so results in less than fully effective utilization of public resources and often results in providing poor quality services. For example, the provision of agricultural extension services to farmers could be significantly enhanced in a cost effective way through the commercial participation of the private sector. These essential services will be greatly improved through the adoption of a public private partnership approach.

- ***The Government is introducing a new Revenue Authority, which will be at the forefront of improving the efficiency of the public sector.*** The functions of the Inland Revenue, Customs and Excise Departments have important effects on the costs of production throughout the economy. Our goal is to meet or exceed the efficiency with which these functions are carried out in the most successful countries in the region, such as Singapore and Malaysia. When these improvements have been made, similar initiatives will be extended to other government departments.

Reaching the goal of creating two million new jobs will require major improvements in preparing people for employment and increasing the efficiency of the labor markets. A rapidly growing economy requires education and training that meets the needs of the economy and the ability to bring together an effective workforce.

- ***Building on the Government's Draft National Employment Policy, information systems that improve communication between employers and potential job seekers will be put in place***. This network will be island wide and will especially assist graduates in identifying employment opportunities.

- ***The systems providing tertiary education will be significantly expanded and strengthened.*** An important gap in the training of the country's workforce is limitations in providing technical and alternative forms of tertiary education. Additional sources of re-training and ongoing education will be increasingly important in increasing productivity throughout the economy. These are services that the private sector is well suited to supply and greater opportunities for investment in these areas will be provided.

- ***Improvements in the existing regulations will be made, including steps to expedite resolution of employment disputes and guidelines on compensation required when firms must restructure***. The regulations governing employment are frequently identified as major impediments to investment and growth. However, as the economy grows and diversifies, it must be recognized that alternative approaches to regulations and labor relations will be necessary to meet changing needs.

Reaching a 10 percent growth rate will depend critically on increasing exports and expanding access to overseas markets. The Government's responsibilities include maintaining a stable and cost effective trade policy, including efficient customs administration. (Introducing a world-class customs service will be done with the establishment of the new Revenue Authority.)

- ***The Government is committed to actively pursuing greater access to global markets through the ongoing WTO multilateral process.*** It must also be recognized that the pace of that process is likely to be slow and that improving Sri Lanka's economic performance cannot wait. It is essential that a trade policy that supports greatly expanding trade in all areas be implemented. No country has maintained high rates of economic growth without building substantially on the opportunities provided through international trade.

- ***To develop new markets, the Government will seek opportunities through new bilateral and regional trading agreements anywhere in the world.*** Within the region, the Government is broadening the *Indo-Lankan Free Trade Agreement* that will greatly enhance market access to the Indian market. Negotiations to establish a free trade agreement with Pakistan are nearing completion. While these facilities will offer great opportunities for exporters, alone they are insufficient. Discussions on a trade facility with the US are currently underway. Possible trade agreements with a number of other countries are being considered. In principle, the Government is willing to pursue any and all opportunities with any country to expand access to new and existing markets for Sri Lankan goods and services.

These are among the steps that are now being taken.

5. Accelerated Growth and Development – A New Approach

The economic program embodied in **The Future – Regaining Sri Lanka** represents a decisive break from past economic policies. It offers a fundamentally new approach for the Sri Lankan economy – one that includes the elements for success in the world economy today. In order to meet the economic challenges that we face, the entire country must be fully engaged in the process of improving productivity and meeting the competitive demands of world markets. *The reality is that inefficient production of goods and services in any part of the economy represents a burden that must be borne by the entire country.* Excuses for poor performance do not matter when meeting the high expectations of customers, whether these are due to high cost power, slow and inefficient public officials or high cost protected industries.

While the approach is new, the primary goal of this program is not – for Sri Lanka to regain control of its economic destiny, to offer *all* of our people improved health, education and housing, and greater opportunities for productive employment. This can only be done with a lasting peace and a lasting peace can only be maintained with a strong and vibrant economy offering greater opportunities for all.

At the heart of this program is a major change in the relationship between the public and private sectors. We are placing a major share of the responsibility on the private sector for accelerating economic growth, increasing jobs and incomes and providing the resources that will be needed for the reconstruction requirements that peace brings. This cannot be avoided. It is the private sector that makes the decisions that determine productivity and it is on this basis that future growth will depend. However, the Government must provide an environment where they have the freedom to make the decisions necessary to continually improve productivity. The government's direct role in this process should be much reduced. The government's primary responsibility will be to maintain and make clear the rules for ensuring that markets remain competitive and that the policies and regulations that are in place are efficiently implemented in ways that minimize the burdens to the economy.

As we look to the future, we see our country re-joining the ranks of developing countries that are able to offer their people genuine hope for a better life. At one time, Sri Lanka was in the forefront of countries expected to succeed economically. Unfortunately, those prospects were dimmed by misguided policies and economic mismanagement. With this program we intend to regain that lost economic initiative and restore Sri Lanka's place among the countries that will shape the economic future of the world in coming years.

PART I

ANNEXES

Annex 1: A More Detailed Overview of the Elements of The Economic Reform Program

1.1 Introduction

The Action Plan to implement the program currently embodied in **The Future – Regaining Sri Lanka** is the result two processes that have now been integrated.

- The Government's Economic Reform Program (ERP) was developed over six months of intensive review carried out under the *Ministry of Policy Development and Implementation (MPD&I)*, chaired by the Honorable Prime Minister. There were approximately 19 groups working under a *Policy Development Committee* that were responsible for developing plans and recommendations. These were comprised of both government officials and private sector individuals. Not surprisingly, in some areas there was a degree of overlap in the issues covered by the different groups and the recommendations that emerged were not always in agreement. Attempts have been made to reconcile the differences and address any gaps. However, undoubtedly inconsistencies and gaps still remain.

- This Action Plan also now includes the initiatives that were the outcome of a process of review and frequent consultation among stakeholders, officials and experts that spans nearly five years. This began in 1998 with the process that led to the preparation of the *Poverty Reduction Framework* and has continued through to the preparation of *Connecting to Growth: Sri Lanka's Poverty Reduction Strategy*.

By bringing what were two parallel processes together, the country will be much better able to take the steps necessary to significantly reduce poverty and improve the welfare of the entire population. Due to the confluence of the two processes, the sources of growth in sectors such as Tourism, Apparel, Plantations, Financial Services and others have been detailed out in the Action Plan Matrices and given a shorter time frame for implementation.

Several points should be emphasized concerning the present Action Plan:

- **This Action Plan is necessarily an evolving document that will change with time.** New initiatives will be added and some will be removed as implementation is completed.
- **The foundation of the strategy for achieving the Government's economic objectives rests on measures to improve productivity and competitiveness – the only ways to increase economic growth, increase employment and raise incomes.** All of the elements in the Action Plan are intended to contribute to this strategy and all new Government policies and regulations should be assessed in terms of their potential impacts on productivity and competitiveness.
- **In light of the current fiscal constraints, initiatives that have significant budgetary cost are to be implemented starting in 2004 and later years.**

1.1.1 Implementation Plans

The purpose of this Annex is to summarize some of the key elements of the economic reform program, which are detailed out in Part III as well as in Chapter 3 and some other chapters of Part II. Developing far-reaching economic reform programs is relatively easy. The difficult challenges lie in successful implementation. (A key initial step, the passage of a number of key economic laws, is already well underway.)

The *Implementation Program* is being prepared, with a strong focus on managing and monitoring the implementation of this large and complex Action Program. It proposes establishing a number of ***Steering Committees*** that will report to a ***Program Management Committee***, which will report to the ***Economic Policy Committee***. It also proposes the establishment of the ***National Competitiveness Council (NCC)*** that would provide a tri-partite body consisting of business, labor and government representatives. The NCC would focus on the implementation of microeconomic initiatives being implemented by the private sector. It will also serve as a clearinghouse for a range of initiatives intended to provide assistance to the private sector in identifying ways and means of improving their productivity growth.

1.2 Overview of Key Elements in the Action Plan

1.2.1 Macro Policy Framework

The macroeconomic policies of the country provide the essential foundation on which all of the Government's policies must be built. If these policies are not effective, then it is almost certain that it will be impossible to realize the desired high rates of economic growth. And while a sound macroeconomic foundation is necessary, alone it will not be sufficient to attain the Government's goals.

This area of the Action Plan focuses on the design and implementation of macroeconomic policies, including in particular

- Public expenditures;
- Taxation, on both goods and incomes;
- Prices and the exchange rate, through monetary policies; and
- Trade policies, regional and global (including import duties);

International trade policies have both broad economy-wide implications, but also play an important role in constituting the incentives that influence the decisions to invest resources at quite narrow levels within the agricultural and industrial sectors. It is essential that they be designed within a broad economic perspective.

Priority Actions

- The principle immediate objective is to fulfill the Government's commitment to maintain the budget deficit for 2003 at 7.5 percent of GDP. It is also essential to ensure that this is reduced in coming years. This is being addressed through closer monitoring of expenditures and ongoing tracking and analysis of expected revenues.
- Design and implement a stable and efficient low tax regime that will meet the Government's revenue requirements and be conducive with high rates of economic growth. (Investors require confidence that tax regimes will not be constantly changing.)
- Implement a strongly pro-trade package that includes, *inter alia*, moving towards a stable, low uniform tariff rate; take effective actions on comprehensively reducing non-tariff barriers, including addressing inefficiencies in Customs; pursue an aggressive program to explore bilateral trade opportunities while continuing to participate actively in the ongoing WTO *Doha Round;* and develop and implement bilateral and regional free trade agreements that offer improved market access for Sri Lankan exports.
- Take necessary steps to extend and complete the reform of exchange controls, including addressing the remaining capital controls that inhibit investment and the development of financial services.
- Implement the Revenue Authority so that it functions at a world-class level (e.g., as well as countries such as Singapore and Malaysia), so that it (i) minimizes any burdens on the economy; (ii) enables a merging of the BOI and non-BOI regimes; and (iii) demonstrates the benefits of major public sector reform.
- Important laws defining the macro-economic framework are being reviewed, amended and passed through Cabinet and Parliament. These include, *inter alia*,
  - Fiscal Responsibility Law
  - Revenue Authority Law
  - Inland Revenue Law
  - De-Regulation Laws
  - Economic Management Law
  - Intellectual Property Law
  - BOI Law

1.2.2 Employment and Labor

This area in the Action Plan focuses on the steps necessary to ensure maximum productivity from Sri Lanka's labor force. This will entail achieving full employment and improving the education systems to better prepare people for more productive employment. This is politically one of the most sensitive responsibilities of the Government as well as the ultimate test of the success of the Government's economic programs.

A central principle of the program is to take the steps necessary to ensure a flexible, efficient market for labor. This includes not only direct employment, but also improved access to opportunities for self-employment and reducing barriers to establishing small businesses. It is only in this way that the required growth can be achieved. One aspect of this is to address the labor regulations now in place that make it difficult to expand and adapt work forces. Another aspect is the improvement of market information, a key element in the Ministry of Employment and Labor's draft policy.

Priority Actions

- Accommodation on the problems associated with existing labor regulations needs to found, if for no other reason than to clear the air for better labor relations. This has been an area of contention for too long and perceptions of the climate for investment will be influenced positively by a comprehensive settlement.
- A substantial amount of employment will come from self-employed persons and small businesses. The Government's economic reform program's core focus on ensuring efficient markets for employment requires attention to improve access to self-employment and greater ability for SMEs to enter business.
- It is estimated that 1 million Sri Lankans are currently overseas under contract. This has been an important source of employment and efforts to better utilize these opportunities will be taken. These include providing better support for workers overseas as well as identifying more and better employment through skills enhancement.
- A centerpiece of the Ministry of Employment and Labor's proposals is the establishment of a computerized network service that will provide more up-to-date information for people seeking employment.
- Important laws defining the employment, labor and human resources policy framework are being reviewed, amended and introduced through Cabinet and Parliament. These include, *inter alia*,
    - Welfare Benefit Law,
    - EPF and ETF Amalgamation Law,
    - The "4-2-1 Law" to limit the duration of employment disputes, and the
    - Youth Corps Law.

1.2.3 Education, Manpower and Science

Closely related to efforts to increase labor productivity are initiatives to improve educational opportunities for the young as well as for workers changing jobs and upgrading their skills. A number of far-reaching reforms in the education sector have been identified.

- For primary and secondary education, these entail, *inter alia*, bringing the state supported schools closer to the parents and increasing responsiveness to local needs.

- For tertiary education, the Government proposes major structural changes in the supply of education, including admitting the private sector and reforming education finance.

- Important laws defining the employment, labor and human resources policy framework are being reviewed and amended. These include, *inter alia*,
    - Youth Corps Law, and the
    - School Board Law.

1.2.4 Finance and Investment

These reforms would help ensure that all participants see an economic benefit in the system and have access to a choice of instruments with diverse risk-return opportunities. This would then help with the process of transforming Sri Lanka into a financial hub in the region by encouraging foreign financial intermediaries to use the country as their South Asian base.

It is clear that an efficient and effectively functioning financial system will lead to increased competitiveness with economic growth, macroeconomic stability and poverty reduction. The efficiency at which the institutions in the financial system mobilize savings, allocate the funds to finance productive investments, monitor the operations of the entities and transform risk will largely govern the economic performance of a country.

Priority Actions and Objectives

- *Reduce the dominance of the state in the financial system.* At present, it controls 56 percent of the banking business and utilizes over 50 percent of the country's domestic financial resources.
- *Broaden and deepen financial markets*. There is an absence of well functioning financial markets that has led to insufficient risk pooling and risk sharing, limiting the scope for high risk high return projects necessary for greater economic growth.
- *Improve bank efficiency*. Bank intermediation cost is currently around 8 percent, which is one of the highest in the region. Bank-based lending dominates the financial market in the country accounting for 57 percent of assets, (e.g., in India banks account for 35 percent of assets).
- *Reduce high interest rate volatility due to the excessive use of short term borrowing instruments by the state*. This is driving up intermediation costs leading to higher costs for borrowers and lower interest rates to savers (e.g. T-bills yield higher interest rates than bank deposits).
- *Develop a stronger, market based financial sector.* The State's reliance on fixing interest rates by the use of captive sources of funding inhibits a market-determined rate of interest resulting in damaging economic distortions. In addition, the absence of long term yield curve due to non issuance of long term borrowing instruments by the government inhibits corporations from computing their opportunity cost of capital resulting in non optimal capital allocation and driving up the cost of financial products. The lack of long-term capital inhibits investment in infrastructure and public utilities essential for economic growth.
- *Increase access of private sector to long-term savings.* At present, long-term savings in the economy are primarily held in funds managed by the EPF/ETF and the National Savings Bank and these are yielding **real negative rates of return**.
- *Increase the penetration of insurance in Sri Lanka*. Currently, it is extremely low. i.e., only about 5 percent and 7 percent of the working population in the country have access to life and general insurance respectively.
- *Increase long-term financing options available to the insurance industry*. There is now a severe asset liability mismatch (i.e., 25 year liabilities with 3 to 5 year assets) due to the absence of long term investment opportunities and a liquid capital market and therefore unable to offer real returns for life insurance products. The insurance industry suffers from too little regulation in some areas, too many regulations in other areas and no regulation in certain other areas.
- *Improve availability of financial sector data and market information*. Inadequate transparency and disclosure of information is leading to information asymmetries resulting in market inefficiencies as well as the inequitable treatment of small investors.
- *Strengthen the laws and systems for addressing non-performing loans and disputes*. Inefficient legal system hampering speedy disputes resolution and the seeking of redress.
- *Streamline regulatory systems and institutions*. Currently, there are multiple regulatory authorities leading to fragmentation resulting in overlap, excessive bureaucracy, and regulatory voids.
- *Improve the focus and responsibilities of the Central Bank.* Central Bank is now hampered with multiple roles diluting its focus on its primary responsibility of maintaining price stability. As a

result, there is insufficient *de facto* authority and autonomy for the Central Bank to counter financial indiscipline of governments seeking political popularity.

1.2.5 Infrastructure Development

This section of the Action Plan addresses the following sectors - **Telecom and IT Sectors; Power and Energy; Civil Aviation, Shipping and Port Development; Transport, Public Utilities and Housing;** and **Natural Resources Development.** Initiatives in these areas are expected to establish the basis for Sri Lanka becoming a regional economic and transport hub for the South Asian region.

Priority Actions

- **Telecom and IT Sector –** To develop the telecom sector on a competitive basis to facilitate the growth of ICT (Information and Communication Technology Sector) services. This is to follow the principles set out in the ITC road map report – including the strengthening of the regulatory framework. Overall this would help stimulate investment, increase job creation and productivity throughout the economy. A rapid expansion in the IT sector will also help catalyze the accelerated growth of other sectors.
- **Power and Energy –** Move towards achieving a competitive power tariff structure by working towards the restructuring (through progressive unbundling) of the CEB and CPC.
- **Civil Aviation –** To develop both the international and domestic airports. For example, it is expected that the BIA-Katunayake Airport will emerge as regional hub, building on its central location between Singapore and Dubai. Development of the domestic airports as well as the tanks and lagoons that can be utilized to facilitate seaplane transport, which would greatly assist tourism.
- **Shipping and Port Development –** The development in this sector aims at establishing a greater presence in servicing the region and the next generation of deep draft ships, by increasing competitiveness within the subcontinent (south Indian ports) and the gulf region. Major private sector participation is expected in these areas.
- **Transport –** There is an urgent need to invest in improvements in the road network as it is now inadequate to meet the economic and social development needs of the country. The goal is to build a modern road network along with the immediate upgrading of existing roads. National highway development, particularly the Southern Highway and improvements in secondary road systems will improve economic opportunities in rural areas.
- **Housing and Construction –** There are major housing requirements that must be met throughout the country. The needs in the conflict-affected areas are acute, especially in the North and East. Large increases in the supply of affordable housing, including the expansion of housing in Colombo and housing units in cluster townships will also be necessary.
- **Natural resources development –** A sound framework to address the preservation and sustainable development of the country's natural resources is being established. This will be consistent with the broader economic and social objectives of Sri Lanka as well and will be mindful of improving and/or maintaining environmental integrity.

1.2.6 Improving Productivity

This area of the Action Plan includes the reform proposals for the industrial, agricultural and services sectors, including the plantations sector and tourism. These all operate in markets for goods and services and the determinants of the efficiency of these markets are in many (but not all) respects common to all.

Increased economic growth will depend upon the country's ability to compete in the markets for these goods and services. The initiatives addressed in this area focus on the limitations in the markets for goods and services, including for example the costs in acquiring raw materials and regulations governing business. The primary goal in this area is the maintenance of efficient commercial activities throughout the economy. More specific objectives include:

- **Agriculture:** Greatly strengthen the foundation for commercial activity, better development of markets for inputs and outputs;

- **Tea and the plantations sector:** Put operations on a stronger commercial footing through longer leases and reduced restrictions on alternative activities;

- **Industry and Services:** Key issues facing these sectors tend to be addressed under other headings and include, *inter alia*, labor regulations, taxes on goods and services, such as VAT and import duties, high cost of finance, inefficient government services and poor infrastructure.

- **Tourism:** Seeking to transform the industry to increase the services offered and attract a broader clientele.

Priority Actions

- Government policy should get out of the business of manipulating prices to direct resources to favored activities, usually though differential taxes and tariffs. This lowers productivity and hence reduces the capacity of the economy to grow. This would be done through reform of indirect taxes and a program of deregulation.
- Many of the actions defined in the accompanying agriculture action plans constitute relatively limited adjustments in the delivery of government support programs and in the support for supplying inputs (e.g., fertilizer and seeds). Additional work will be necessary to develop more far-reaching proposals that would achieve the goal of establishing a commercial agriculture sector. This will be integrated with the reform program for the plantations.
- The desired transformation of the agricultural sector, into largely commercial production would constitute an important structural change in the economy. It can only be accomplished as the result of a number of reforms in the institutions that define the organization of the sector.
- Restructuring the basis on which the plantation companies are operation to encourage more efficient use of the resources under their control. (See below.)
- Granting of 99 year leases for the plantation companies, and presumably for other commercial agricultural interests and significantly reducing the regulations restricting non-tree crop activities would essentially permit leaseholders to make productivity decisions as owners.
- Strengthen the branding of Ceylon Tea.
- The initiatives for tourism include reorganization of industry bodies and improvements in a number of industry functions, notably the marketing and human resource development activities.
- Establishment of the Tourism Promotional Authority, revise the structure of the Ceylon Tourism Board and set up International Tourism Advisory Council.
- Establishment of a productivity promotional institution that will provide an ongoing force to identify impediments to competitiveness and promote measures to improve productivity.
- Key laws affecting the productive sectors that are being revised include, *inter alia*,
    - Land Ownership Law
    - Tourism Law
    - Rain Forest Law
    - Exploration of Oil and Natural Gas Law
    - Development Projects Acquisition Law
    - Protection of Name of “Ceylon Teas” Law

1.2.7 Public Sector Reform

The prospects for significantly increasing growth rely upon major improvements in efficiency in *all* sectors of the economy. One of the greatest challenges will be making the changes that will be necessary to achieve large increases in public sector productivity. The government absorbs a large share of the countries resources and uses much of this inefficiently. It is widely recognized that virtually all government departments are over-staffed. It is also recognized that the state has too great an involvement in the provision of goods and services that would be more efficiently undertaken by the private sector.

Many of the initiatives described above would lead to a partial reform of the role of the public sector. However, these initiatives alone will not be comprehensive and will not fully address the broader issue of restructuring the government to better meet the needs of the country and use resources more effectively. For example, there are issues about public sector functions that have not been addressed directly, such as how to develop a more facilitative role for line ministries.

The Government's privatization program reflects the approach being taken in this area. However, it was not explicitly designed to contribute to the maximizing economic growth. It should be reviewed to determine if it could be accelerated and/or restructured to better meet the Government's economic objectives.

Priority Actions

- The Government's approach to shifting commercial resources to the private sector, through privatization of viable enterprises and resolution of loss-making enterprises, will be accelerated.
- The establishment of the Revenue Authority will constitute a major initial step towards reforming government activities. The objective is to reach "world-class" levels of efficiency in the Revenue Authority and this will serve as a basis for realizing similar improvements in other government departments.
- Important laws defining the economic framework are being reviewed, amended and enacted. These include, *inter alia*,
    - Revenue Authority Law
    - De-Regulation Laws
    - Human Settlement Planning Law
    - Gramodaya Law
    - National Sports Authority Law