REGAINING SRI LANKA:

PART II

Connecting to Growth:
Sri Lanka’s Poverty Reduction Strategy

Part II

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EXECUTIVE SUMMARY

I. Introduction

This is a critical year in Sri Lanka's history. A major opportunity is within reach to restore peace and bring an end to the 19-year conflict that has held back the social and economic advancement of this country. A ceasefire has stopped the killing and careful steps are now being taken towards advancing peace talks. However, it is clear that this process will be neither rapid nor simple and its eventual success will depend a great deal upon the efforts of all sections of society and the support and goodwill of the international community.

One of the central objectives of the Government is to restore economic growth and thereby effectively eliminate poverty in Sri Lanka. With the attainment of a lasting peace there will be much better prospects to significantly improve the economic and social welfare of the people of this country than has been the case for a generation. It should be recognized, however, that the challenges that must be overcome to achieve major improvements in social and economic conditions will be substantial. An average of 4 to 5 percent GDP growth since Independence has not been sufficient to provide full employment at acceptable incomes for all Sri Lankans. Much higher rates of economic growth will be needed to bring about the required improvements in opportunity and living standards. The Government has set a long-term target growth rate of 10 percent. This will be necessary not only to substantially reduce poverty, but also to carry out the necessary reconstruction and rehabilitation to ensure a permanent end to the conflict in the North and East.

***A Poverty Profile*. Between 25 and 39 percent of the population can be classified as poor, depending on whether or not poverty is measured with a low or twenty percent higher poverty line.** Poverty is *predominately a rural phenomenon* with nearly 90 percent of the poor residing in rural areas. Farmers cultivating small plots of land, with few off-farm sources of family income, and casual workers account for a large share of the poor. Two decades of civil conflict have left large numbers of families displaced, disabled and desperate. Poverty conditions in the North and the East are far more severe than in other parts of the nation, compounded by massive destruction of economic and social infrastructure.

High, persistent poverty is simply unacceptable to Sri Lanka. There is an urgent need to *redefine strategies* for reducing poverty in all its many dimensions. The *Poverty Reduction Strategy* (PRS), prepared by the Government in consultation with a wide range of stakeholders, including donors, NGOs, the private sector, and civil society, is based on an assessment of the extent, causes and consequences of poverty in Sri Lanka. In addition to defining the main pathways for a broad-based poverty reduction effort, it also provides a detailed set of policy and programmatic interventions designed to connect the poor to economic growth.

The development and implementation of the PRS has been an ongoing process, building upon extensive consultation with stakeholders and interested groups, including multilateral and bilateral donors. It reflects the integration of two closely related activities - the Government's development of its economic reform program (ERP) during its first year in office, as outlined in The Future - Regaining Sri Lanka (Part I), and the PRS (Part II) that has been developed during the last four years, with the former serving as a detailed guide to action for the latter.

Six major pillars constitute the strategic foundation for future poverty reduction efforts:

- Building a supportive macroeconomic environment
- Reducing conflict-related poverty
- Creating opportunities for the poor to participate in economic growth
- Investing in people
- Empowering the poor and strengthening governance
- Implementing an effective monitoring and evaluation system

II. Building a Supportive Macroeconomic Environment

A set of *stable, consistent and predictable macro-economic policies* underpin private sector led growth and development. If the private sector has full confidence in the nation's macro-economic management and if the high costs of doing business can be reduced, they will make the investments necessary to boost productivity and expand output. Tremendous build-up of public debt endangers macroeconomic stability and makes Sri Lanka highly vulnerable to international market volatility. The fiscal deficit has been far too high for far too many years, crowding-out private initiative and saddling the Government with an unsustainable debt. Living within the nation's fiscal means is absolutely essential if macro-economic stability is to be restored.

The 2002/03 Budget began the process of *fiscal consolidation*, as a prerequisite for rapid and sustainable growth. On the revenue side, a broad-based VAT has been introduced to replace and consolidate GST, NSL and other turnover taxes. The temporary Custom's surcharge is to be phased-out, uniform import duties will be applied to the majority of agricultural commodities, and the stamp duty will be eliminated. Top marginal rates of household and business income will be reduced, and the direct tax system simplified and its base broadened.

Government will rationalize the *existing tax incentive system* and reduce its scope. All tax incentives, including those now presently granted by the Board of Investment (BOI), will be included under the revised Inland Revenue Act. With the aim of reducing avoidance and improving collections, the 2002/03 Budget signals the restructuring and amalgamation of three Departments: Inland Revenue, Excise and Customs. These three agencies will be transformed into a modern, efficient Revenue Authority.

On the *expenditure side*, priorities have been sharpened and steps taken to reduce public enterprise losses. Defense and welfare spending have been reduced, and a number of subsidies have been phased-out. The Budget also contains a multi-year plan to trim the public service. Every Government agency will be required to rationalize its cadre over the next three years. Departments and agencies will also be required to submit proposals for consolidation of functions within and between relevant agencies.

A Fiscal Responsibility Act has been introduced to set a multi-year deficit target to which Government shall be held strictly accountable. Public accounting procedures have been revised to ensure that public spending is accounted for in a timely manner. More effective financial management and better public procurement practices and procedures can help ensure that existing resources are used effectively. In addition to accelerating foreign aid disbursement, Government will undertake institutional reforms aimed at introducing program budgeting, developing a medium-term budget framework, automating public accounts and audit practices, and introducing a public expenditure management system to track implementation and cadre.

The Government is fully committed to a set of market-oriented trade, sectoral and structural policies to support private sector led economic growth and poverty reduction. *Structural policy reforms* have been designed in full consultation with stakeholders to promote ownership and social cohesion.

Trade and Investment Policy Reform. The Government is committed to reducing trade protection and establishing a two-band tariff system. Tariff surcharges, established in response to the 2001 petroleum shock, will be phased-out. Import monopolies on petroleum products will be eliminated and greater stability and predictability restored to the trade regime for foodstuffs.

A bilateral Free Trade Agreement (FTA) has been reached with India and one is being negotiated with Pakistan. At the same time, Sri Lanka will continue to pursue free trade accords with other countries, especially South Asian nations, and to honor its commitments to free and fair trade under the WTO.

Commercial Legal Reform. Government will modernize the regulatory environment to facilitate both the entry and exit of businesses. Towards this end, Government will introduce appropriate bankruptcy legislation that will protect creditor interests and facilitate and orderly exit of failed firms. It will also amend the Companies Act to facilitate the creation and registration of new businesses. A Land Ownership Act will be prepared to clarify property rights in land and the operation of the land market. A Consumer Affairs Authority Bill will be promulgated to enhance consumer protection and ensure that Sri Lanka's products are of a quality standard acceptable in global trade.

Labor Market Reform. One of the main challenges in the process of labor market reform is to balance the urgent need for increased flexibility with the need for protection of the workforce. The new Employment and Industrial Relations Act enhances the flexibility of the labor market, promote the upward mobility of labor, and increases labor productivity. Amendments to the Termination of Employment Act will set specific time limits for the processing of labor dispute settlements and the arbitration and termination of involuntary labor. Social dialogue between government, workers and employers organizations will continue to be undertaken to ensure harmonious implementation of labor market reforms and to seek further improvements in labor relations, laws and regulations. New, automated systems for employment registration and job search will be developed, involving public-private partnerships to connect employers and potential employees.

Financial Sector Reform. In spite of some improvement, the soundness of the banking system remains a cause for concern because of the weakness of the two state commercial banks. But further reform of the banking system is warranted. To establish a sound and efficient private banking system, the state banks will be restructured. The non-performing assets of the People's Bank will be assessed and audited.

To foster competitive capital market development, opportunities for foreign investment and ownership in the insurance and brokerage sectors will be enhanced. Government will pass a Financial Services Act (FSA) to develop a system for regulating the securities market, insurance and private provident funds; improving accounting and auditing standards; and preventing money laundering. A pension reform program will be mounted, which liberalizes investments that can be held by private pensions and the provident funds. Improved management of the state-operated pension schemes (EPF & ETF) will be encouraged through mergers, private fund management, some foreign portfolio investments, improved collection and management reforms to reduce evasion. To ensure that the cost of public pensions is manageable a contributory pension scheme will be established in 2003 for all future public officers recruited.

Power Sector Reform. The main objective of the Government's energy sector reforms is to restructure the industry into a number of commercially managed entities that are well governed and managed and mandated to focus on the delivery of higher standards of service to customers at least cost. A coordinated effort has been launched to overcome the power crisis. This includes the establishment of an Energy Supply Committee as well as a legal framework for overseeing the Electricity Act, the CPC Act and other acts that concern power, with a view to ensuring a stable and reliable power supply in the future. More private sector participation in the power sector, a rational tariff structure and greater competition are needed to put an end to power crises once and for all.

A new Electricity Act is to be promulgated in 2002, which will unbundled the power sector in the areas of generation, transmission and distribution, allow for the creation of an independent regulator, and provide a transparent solution to power purchasing and selling problems. Under the new power sector structure, CEB and LECO's generation, transmission and distribution functions will be unbundled into a series of commercial, generation companies. Government will maintain a lifeline tariff policy to ensure that a basic allotment of electricity is available to the poor. Over and above the lifeline level, the regulator will set and supervise a market-oriented energy pricing policy.

In the petroleum sector, the monopoly of the Ceylon Petroleum Corporation will be eliminated. At least two new companies will be provided import licenses, and petroleum tariffs will be set on a monthly basis, in line with movements in world market prices.

In light of the growing involvement of the private sector in the provision of utility services, a professional and autonomous form of utility regulator will be required. Towards this end, an independent regulatory authority will be established to oversee the energy utilities, including issues related to tariff setting, quality control, licensing, and dispute resolution. The Regulatory Commission is to be operational by 2003.

III. Reducing Conflict-related Poverty

Sri Lanka's protracted conflict has caused a humanitarian problem of significant proportions. Since the inception of the conflict at least 60,000 people have lost their lives, around 600,000 have been internally displaced, and an estimated 172,000 persons are living in welfare centers with minimum access to basic services. Among the more severely affected groups are the displaced, who have lost productive assets and land, as well as social capital. The impact of the war goes beyond the war-torn areas to affect the rural poor in particular. Poor rural youth on both sides of the conflict are faced with fewer opportunities to better their lives; they make up a substantial share of the soldiers fighting the war.

Peace is the key to reducing conflict-related poverty. A three-pronged strategy is being followed to solve the conflict. This includes negotiation of a political settlement, advancement of a political and constitutional framework that fulfils the aspirations of all, and expediting development in war-torn areas.

Government initiated a wide-ranging process of stakeholder and community consultation to identify strategies for improving the effectiveness of relief, rehabilitation and reconciliation efforts, in 1999. Government has maintained and will continue to maintain the RRR dialogue process in the search for more effective partnerships for peace. The recommendations generated by this process will be implemented with the support of the donor community and civil society.

Government is according priority to the return of internally displaced persons, de-mining and the restoration of essential social services. Government, with the assistance of the donor community, is supporting an urgent effort to accelerate de-mining, assist in relocation of internally-displaced families, and provide seed capital for these families to restore farming and other micro-enterprise operations. Rehabilitation efforts are also proceeding to restore water supplies, basic education and primary health care facilities. In 2003, Government will convene a donor conference aimed at mobilizing medium-term resources for the reconstruction of the North and the East.

IV. Creating Opportunities for Pro-poor Growth

International experience suggests that economic growth can be a powerful engine for poverty reduction if the poor are provided opportunities to participate in the growth process. One of the Government's main challenges is to *effectively connect poor regions* to rapidly growing domestic and international markets. This will be accomplished by a spatial and information integration strategy that focuses on six main pro-poor transport and communication initiatives:

- Upgrading the Port Network
- Building a National Highway System and Integrated Road Network
- Enhancing Performance of the Bus System
- Modernizing the Railways
- Improving Access to Telecommunications Facilities
- Bringing Internet into the Countryside

Future public investments will be aimed at a selection of *strategic infrastructure* initiatives coupled with, wherever possible, private sector participation. In the past, infrastructure development has been financed almost entirely by public investment. By introducing public-private partnerships, the scope for investment can be expanded and a wider range of services provided to the public, in such areas as energy, ports, water supply, and transportation.

Competitiveness will also be improved as private sector management experience is brought into the public domain. An e-Sri Lanka initiative will be launched to apply the benefits of modern technology to the workings of Government and the private sector.

Policies that integrate the nation in a transport and information sense will be complemented by measures that actively foster inter-regional competition. Business promotion measures will be designed and funded locally, in partnership with business associations, universities, financial institutions and government officials. The private sector will be encouraged to invest, not only in the Western Province, but also throughout the nation. Government has created 5 Economic Zones out of 22 Districts and set up five Economic Commissions, each to attract local and foreign investment. A new BOI law will be passed which will include the establishment of BOI investment promotion offices in these five regions of the nation.

New Tourism Development Zones are being established in selected tourist areas, where currency and other restrictions will not operate in respect of companies registered with the Tourist Board. A new Tourism Act will provide a framework for sub-sector development efforts.

Structural change, or the gradual shift from an economy based on low-productivity subsistence-orientated agriculture to higher-productivity services and industrialization, is the primary means by which economic development contributes to poverty reduction. To *revitalize rural development* and raise investment and returns in agriculture, Government will establish a more stable and market-based trade and price policy; introduce more private land ownership through divestiture of surplus state-owned lands and acceleration of freehold titling procedures; provide support to industry groups for improved plantation operations; and foster off-farm employment and rural electrification. In the future, the private sector will play a far greater role in technology transfer. Imports of seed and planting material will be deregulated, and the private sector will be encouraged to provide improved seeds. Management of crop and livestock extension will also be progressively contracted out to the private sector. New wholesale/retail agricultural markets will be developed through private-public partnerships. In the five economic zones, the BOI will attach a high priority to fostering commercial agribusiness investment.

Small and medium-scale enterprises (SMEs) are an important source of employment for low-income rural and urban households. Government is supporting the development of a vibrant market for SME business services. It will augment financing available for SME investment and undertake an ambitious deregulation and tax reform program aimed at widening investment space for the SMEs.

With structural change will come increased migration to existing and new urban settlements. Urbanization can be a powerful engine for poverty reduction if it is based on thriving industrial and service sector activity. The PRS defines strategies for pro-poor *urbanization* based on:

- Promoting industrialization in areas of clear competitive advantage
- Fostering new inroads in service sector industries, coupled with tourism
- Improving urban amenities, strengthening property rights, and providing more land for low-income urban housing development
- Promoting greater private participation in urban water supply schemes to broaden access
- Fostering community-based development of water distribution and sanitation services in poor urban as well as rural areas, and
- Expanding local government capacity and finance to manage urban infrastructure and service delivery

In the future, a number of *community-led development initiatives* must be mounted if the poor are to be empowered to re-enter the economic mainstream. Government will support such initiatives, in cooperation with non-governmental and community-based organizations, to assist specific target groups of very-poor communities. To ensure that public support is effective and sustainable, community based interventions should have full participation of target beneficiary households in all phases of project design and execution. This includes, *inter alia*:

- cost-sharing for all phases of the project;
- a suitable business plan for any investments that are to be made; and
- community-based organizations vested with the responsibility, authority and capacity to operate and maintain assets created through community-specific investment support.

V. Investing in People

Government invests in people to build the human resource base for a just and prosperous society. Ensuring that basic needs are met, and that each citizen is provided opportunities to realize their fullest potential, is central to Government's efforts to address poverty.

Improved access to *quality education* is needed to raise productivity and enhance living standards. A larger role for the private sector and the local community in the provision of education services is envisioned, enabling the Government to focus its resources on improving access and service quality in poor communities. An effort will be made to redress regional inequities in the provision of basic education facilities and instructors. At the secondary school level, new curricula will be introduced and more emphasis will be given to English, Mathematics, Science and Computer Science. To mobilize resources for quality improvement, education outlays will need to be rationalized. School-based management systems will be introduced to enhance efficiency and promote stakeholder participation. Vocational training will be shifted to competency-based education and private sector involvement will be significantly boosted. Access to higher education will also be increased, and higher education institutes will boost management, enjoy a greater degree of managerial and financial autonomy, and introduce rigorous quality certification to promote human resource development and foster social harmony.

Improving the quality of the general education system will be an expensive, but essential, process. With limited resources, Government recognizes that it will need to concentrate spending on rural schools and other education institutions utilized by the poor. Private education will need to play a growing role in catering to the demands of those who are relatively well off. Towards this end, Government will continue its liberal licensing policy for private schools, while ensuring that education quality standards are rigorously adhered to.

Government aims to foster a healthy nation through the provision of *comprehensive health* services that are of high quality for the entire nation. The main goals are to improve the nutrition levels for infants, children and pregnant women, to ensure that the incidence of non-communicable diseases is kept very low, to free the nation of malaria and other communicable diseases, to combat lifestyle related diseases, such as AIDS and alcoholism, to ensure that patients receive medical care of an international standard, and to provide maximum care for disadvantaged groups.

In the health care sector, priority will be accorded to preventive programs. Better disease prevention amongst the poor can reduce the health-financing burden and contribute to more rewarding and productive lifestyles. In the future, Government support in the health care sector will need to be concentrated more on the poor, with the public sector reducing its role in providing subsidized health services that cater to all segments of society. A selective number of district-level hospitals will be upgraded and efforts will be made to overcome chronic nutritional deficiencies. To meet the challenges posted by the demographic transition and the changing morbidity profile, Government will continue to encourage the private sector to develop secondary and tertiary care private hospitals. Government will expand preventive and other public health care programs, with greater emphasis on public health awareness and education. Hospital-based management will be introduced, and the network of public clinics and hospital facilities, rationalized. Training facilities will be expanded in the area of mental health and geriatric medicine to meet emerging health care requirements.

The provision of *safe drinking water and adequate sewage and sanitation* systems is frequently cited as the single, highest social-service priority by poor households. Government's objective is to ensure safe water to the entire population by 2010 and to at least 79 percent of the population by 2005 from the present 70 per cent. In the rural areas, community based organizations will provide safe drinking water systems in response to local demand. The costs of maintaining and operating these systems will be borne by the community. In the towns and urban areas, the private sector will be encouraged to invest and operate clean drinking water systems. A suitable regulatory framework and tariff setting mechanisms will be established to facilitate private sector involvement in delivery of clean urban drinking water.

Solid waste management has reached crisis proportions in many of the urban areas. The future strategy is based on a combination of capacity building in local authorities and public-private partnerships to expand sanitary waste disposal facilities.

Sri Lanka has a long tradition of *social protection*, with specific social programs designed for the most vulnerable groups, and cash transfers provided to those with low incomes. New initiatives will be launched to significantly improve the quality of community-based care for the disabled, conflict victims and the elderly. Increased public support will be provided for these social service initiatives.

Special attention needs to be paid to the *Samurdhi program*. While around 1.5 million households benefit from this program, recent research finds that the program does not assist some 40 percent of the poorest income quintile. A new Social Welfare Benefit Law provides the legislative base on which social assistance can be targeted to eligible persons without politicization. Clear eligibility and exit criteria will be established to limit the program to the truly needy. In the medium-term, all welfare schemes will be brought under the Welfare Benefit Law, effectively ensuring that social assistance is well targeted to the needy

A range of private and non-governmental organizations also provide *social insurance* for workers in the informal sector. Government's strategy is to encourage the development of social insurance, both by Samurdhi and by a range of non-governmental organizations, on a commercial and competitive basis.

VI. Empowering the Poor and Strengthening Governance

The role of Government in Sri Lanka is changing from being a leading provider of goods and services to being a facilitator of private sector economic activity. This is a difficult transition, vastly complicated by an overhang of institutions resistant to change.

Government is committed to *transforming the public service* to achieve high standards of good governance. Improved accountability, transparency, predictability and popular participation in public affairs will guide efforts to improve governance. New approaches to developing human capital in government will guide the business-change process in the major ministries and departments. All government bodies will be encouraged to prepare business plans, hold stakeholder consultations and regularly report to the public on progress made. More open recruitment procedures will be used to attract better-qualified personnel, from within government and from the private sector, to serve in Government.

Political patronage and interference in the affairs of civil administration are major obstacles to more effective governance. Government is cognizant of the seriousness of this situation and has established new Constitutional safeguards to advance the independence and neutrality of the public service.

The *press* will play a vital role as a neutral watchdog, reporting on way in which Sri Lanka’s scarce public funds are utilized. There are several laws in place that hinder the freedom of the media. Government will rescind most of these laws this year including the Criminal Defamation Law. The right to information, will be secured by law through an Act of Parliament. Government policy is to ensure that the state media acts impartially and enlightens the public about how government finances are used.

Shifting the focus of authority from central to *local government* offers a promising route for empowering the poor. Incomplete decentralization, however, has resulted in high levels of complexity and fragmentation of the system. The Government has tried to redress deficiencies in fiscal decentralization. Capital spending has gradually been increased since 1999 and a greater share of resources previously channeled through line ministries are now disbursed directly to the Provinces. Government will help strengthen the management capacities of local government to ensure that they can play an increasingly effective role in meeting locally defined initiatives and in discharging the devolved responsibilities.

Empowering local communities and civil society to play a greater role in the management of their day-to-day affairs is central to the battle against poverty. Nowhere is the need for community-driven development more important than in the management of Sri Lanka's fragile natural resource base. Deforestation, coastal erosion and encroachment in wildlife reserves are some of the more serious environmental problems affecting the poor. Community-based resource management approaches, involving poor communities directly, are being promoted to reverse environmental degradation and to improve sustainability.

The Government is committed to *mainstreaming gender considerations* in all anti-poverty efforts, and special programs will be mounted to make society free of violence against women and children. Mainstreaming gender considerations in public policy will require continued efforts to train staff in gender analysis and gender monitoring and evaluation, as well as a conscious effort to incorporate gender considerations in program and project design. To ensure that women’s concerns are better reflected in the political system, Government will enact regulations reserving a minimum of 50 percent of all nominations in local and national government elections for women.

Sri Lanka has an extensive array of *micro-credit institutions*, many of which have received considerable support from the Government. Future support for micro-credit institutions will aim at twinning these bodies with larger, financial market institutions and encouraging a shift from micro-finance schemes *per se* to the development of financially sound and sustainable micro-finance organizations, with focus on women. The National Development Trust Fund will be restructured to become an apex organization for the development of micro-finance. A body will be established with responsibility for developing policy and exercising regulatory functions for the many micro-finance organizations. Complementary to this will be the development of a legal framework that clarifies the role and responsibilities of the different organizations involved in micro-finance. Government will prepare a Micro-Finance Institutions Act to provide that clarity.

VII. Monitoring and Evaluation

Poverty reduction goals and monitoring indicators have been carefully defined in conjunction with the implementing agencies and other stakeholders. Halving the number of poor by 2015, in line with the targets set under the Millennium Development Goals, guides the long-term strategy for poverty reduction.

The PRS will be regularly monitored and evaluated, both by Government bodies and by independent agencies. An effective monitoring and evaluation (M&E) system is critical for tracking the implementation of the PRS. The Monitoring Team, to be coordinated by the National Operations Room (NOR), will meet regularly to assess progress in implementing the PRS and report regularly to the Secretary of Policy Development. A poverty reduction progress report (PRPR) will be prepared on an annual basis. This report will be critical for determining whether the poverty reduction effort is on track and what action needs to be taken to address implementation problems/drawbacks. The monitoring system will be further refined to suit the requirements of the agencies responsible for tracking the performance indicators and outcomes.

An annual stakeholder consultation process will be mounted to take stock of progress made in the PRS and to recommend areas in which mid-course corrections may be warranted. It is anticipated that the next PRS will be prepared in 2006.

VIII. From Framework to Action

Major strategic choices have been made in the PRS. The actual resource envelope available for poverty reduction efforts will depend on a number of variables that are difficult to predict, such as the realization of a lasting peace, the willingness of the private sector to support infrastructure investment, and the international economic environment. The PRS gives high priority to policy and institutional reform and to investment in critical physical and social infrastructure.

Priority actions, including structural reforms, which are to be undertaken over the medium term, are shown in Part III. Priority poverty reduction initiatives in the form of projects, which have major implications on the budget, are given in Annex 6. The priority actions relating to relief, rehabilitation and reconciliation are given separately in Annex 5. These initiatives, including rehabilitation projects, are to be funded mainly by donors.

Major policy emphasis in such areas as revenue reform, public expenditure reform, trade and investment policy reform, financial sector reform, power sector reform, and labor and land market reform, are detailed in Chapter 3 and some other chapters, as well as in Annex 1 of Part 1. Some of the program loans targeted for the donors are mainly to support this reform process. The capital expenditures shown in Annexes 6a and 6b include roughly US$ 200 million per year---from 2003 to 2006---of program loans, which will reduce the requirements of domestic borrowings.

The capital expenditures by sector have been adjusted for counterpart fund contributions to implement the projects as well for funds provided for smaller domestic capital and donor-funded projects. Smaller capital expenditures can be accommodated within the normal budgetary ceiling and are hence not detailed out. Total projected capital expenditure is summarized in Annex 6c.

The program and project loans lay heavy emphasis on donor funding because of sluggish export growth (caused by adverse international economic conditions), urgent rehabilitation needs, and the necessity for fiscal consolidation over the medium term.

In the past many sound initiatives failed at the implementation stage. For its part, Government has established the *Ministry of Policy Development and Implementation*, under the leadership of the Honorable Prime Minister, as the focal point to ensure that its responsibilities in this process are met. Responsible groups have also been established to monitor implementation of the necessary policies and programs in all of the relevant Ministries.

Support from Sri Lanka's development partners will be required to help finance and assist in the implementation of the measures outlined in the PRS. Depending on policy concerns and comparative advantage of perspective donors, assistance for specific slices of the PRS will be secured. *Concerted and cooperative action* by a wide range of stakeholders, including donors, the private sector, NGOs and CBOs, will be needed to implement the measures outlined in the PRS. While Government will exercise leadership in poverty reduction measures, its support will be limited by fiscal constraints. Government will also actively encourage the involvement of the private sector, NGOs and community groups to achieve the objectives outlined in the PRS.

1. Introduction

I. Restoring Peace and Economic Growth

This is a critical year in Sri Lanka's history. A major opportunity is within reach to restore peace and bring an end to the 19-year conflict that has held back the social and economic advancement of this country. A ceasefire has stopped the killing and peace talks have been initiated. However, it is clear that this process will be neither rapid nor simple and its eventual success will depend a great deal upon the efforts of all sections of society and the support and goodwill of the international community.

This is also a critical year for Sri Lanka in another respect. Last year was the first year since Independence that the country faced significant negative economic growth. This was the result of a number of factors, including the accumulated burden of the costs of the conflict and the deterioration in recent years of the management of the economy. The devastating terrorist attack at the airport last July and the global ramifications of September 11th pushed the economy deeper into recession.

One of the central objectives of the Government is to restore economic growth and thereby effectively eliminate poverty in Sri Lanka. With the attainment of a lasting peace there will be much better prospects to significantly improve the economic and social welfare of the people of this country than has been the case for a generation. It should be recognized, however, that the challenges that must be overcome to achieve major improvements in social and economic conditions will be substantial. An average of 4 to 5 percent GDP growth since Independence has not been sufficient to provide full employment at acceptable incomes for our people. It is clear that much higher rates of economic growth will be needed to bring about the required improvements in opportunity and living standards. This Government has set a target growth rate of 10 percent. This will be necessary not only to substantially reduce poverty, but also to carry out the necessary reconstruction and rehabilitation to ensure a permanent end to the conflict in the North and East.

These efforts will build upon the achievements that have been realized in social and human development, outcomes that are on a par with many developed countries and that have already surpassed almost all of the *Millenium Development Goals*. For example, life expectancy at birth is 73 years, the adult literacy rate is 93 percent, the infant mortality rate is 17 per thousand, and the maternal mortality rate is 23 per hundred thousand. Moreover, around 90 percent of the poor have completed at least primary education and 81 percent of children under five receive full immunization coverage. These successes in improving non-income dimensions of poverty have been due to the sustained efforts of successive governments to provide universal education and health care to the population. Some 4 to 5 percent of GDP have been devoted to public health and education for several decades. However, increased growth in the economy will be essential if the progress in these areas is to be maintained and the benefits extended throughout the country.

Success in achieving a lasting peace and significantly reducing poverty are not unrelated, independent national objectives. They are closely linked. Progress in both areas will depend critically on improving economic performance in ways that will effectively reach all areas of the country. For example, large regional variations in poverty remain. Important areas of economic development, such as in manufacturing, have largely taken place in Colombo and the Western Province. This has led to a widening gap in living standards between that Province and other regions.

II. The Poverty Reduction and Economic Development Strategies: Broad Outlines

The Sri Lankan economy has demonstrated great underlying strength in the past, reflecting the rich natural and human resources of this country. Real economic growth rates of 4 to 6 percent have been realized *despite* the heavy burdens of the conflict in the North and East, the large drain of resources by large, inefficient state owned enterprises in key sectors, and excessive intervention and regulation by an overly large public sector. The goal of achieving increased economic growth – a target of 10 percent – can be seen to be more attainable when viewed in this light. Peace and comprehensive economic reforms will permit the reallocation of resources to more productive uses that will help generate the real growth necessary to increase employment and raise incomes.

The process of economic reform has been underway in many areas since 1977 and much of what needs to be done amounts to completing and consolidating initiatives begun earlier. Experience in Sri Lanka and in many other developing countries has shown that the full benefits of economic reform are not usually realized until the process is largely completed and locked-in place. One of the cornerstones of the *Poverty Reduction Strategy (PRS)* and of the Government's economic development strategy is to ensure that the necessary steps are effectively implemented.

It should be emphasized that the development and implementation of the PRS is an ongoing process, building upon extensive consultation with stakeholders and interested groups, including multilateral and bilateral donors. At this time, it reflects the integration of two closely related activities – the Government's development of its economic reform program (ERP) during the first year in office, as outlined in The Future – Regaining Sri Lanka (Part I), and the PRS (Part II) that has been developed during the last four years. The core reforms are common to both. While the PRS defines an array of core strategies to reduce poverty and nurture inclusive growth, the ERP concentrates on the detailed actions necessary to boost productivity and implement strategic change.

The central focus of the ERP/PRS is to encourage and facilitate the more productive use of all resources, necessary in an internationally competitive economy. Very briefly, some of the key areas include:

- **Employment, education and human resource development:** It will not be possible to significantly reduce poverty without increasing access to productive employment throughout the country. It is widely recognized that many of the restrictive labor regulations that were designed to protect employees actually inhibit the creation of new jobs. At the same time, the need to protect workers as they move from one job to another is essential if efficient, flexible labor markets are to be developed.

  In a rapidly developing economy it is essential that the education system provide suitable training and skills to meet changing needs. This is increasingly important in the integrated global economy in which Sri Lanka must compete. Primary, secondary and tertiary education must be made more responsive if the requirements of students and the private sector are to be met. New opportunities for training must also be developed to address needs in other areas. For example, demobilization in the military and restructuring of state owner enterprises will require people to acquire new skills if they are to find productive employment.

- **Investment, new business development and public-private partnerships:** Sustaining higher rates of economic growth will depend upon increased levels of domestic and foreign investment. It will be equally important to ensure that new investment is productive and is drawn to activities where Sri Lanka can be internationally competitive. This will require a policy and regulatory environment that establishes incentives that reflect economic realities. Too often in the past, public policies have intervened in ways that have fostered investment in inefficient activities that have been a burden on consumers - burdens that usually are borne by the poor.

  Economic development in Sri Lanka has benefited greatly from the promotion of investment in export industries based in the export zones. This has laid the foundation of much of the export-oriented manufacturing sector, most notably the apparel industry. This was done by targeting operational reforms and reducing the burdens of regulation for these businesses. The success and growth of these activities has demonstrated the good sense of ensuring that *all* productive activities have access to a similar commercial environment. This will be done through reforming the approach of the Board of Investment (BOI) and strengthening dialogue and understanding among stakeholders, such as through the establishment of a *National Competitiveness Council* to include pubic sector, labor and the private sector.

There are many critical areas where the public sector will continue to play an important role, including the provision of some infrastructure services. Experience in other countries has shown that in some cases this can best be done through establishing public-private partnerships. This is especially true with respect to the provision of some types of services directed at the rural poor.

- **Land, natural resource use and agricultural development:** A large share of the poor live and work in the rural areas and depends directly or indirectly on agricultural activities. Improving productivity and increasing growth in this sector will have a direct impact on alleviating poverty. This will be encouraged by reducing wherever possible the regulatory impediments and market restrictions inhibiting the growth and development of commercial agricultural activities. There are, for example, steps that will be taken to enhance the productivity of the plantation sector, a major part of Sri Lanka's agricultural economy.

  The tourism industry plays a major role in the economy, providing considerable employment opportunities outside of the major urban areas, particularly for the young and inexperienced entrants into the labor force. In addition, the great potential of the tourism sector amply demonstrates the economic importance of carefully conserving the country's rich natural resources.

- **Trade, strengthening regional and international economic relationships:** No country has ever been able to significantly increase the economic well being of its people without succeeding in international trade. An open, efficient system for trade establishes important linkages between domestic and international markets and provides the competitive pressures that spur productive economic growth. The plantation sector and apparel industry illustrate the need to expand and strengthen access to overseas markets. And there are increasing opportunities for small and medium scale enterprises to broaden their markets through international trade. While the process of trade liberalization has been underway for many years, further reforms need to address remaining barriers to trade and to ensure that these do not limit economic growth.

  Sri Lanka is well placed to significantly increase its presence in regional trade in both goods and services. This will begin by building upon the existing trade agreement with India and the soon to be completed free trade agreement with Pakistan. It is also important to pursue other markets outside of the region. An initial step has already been taken to develop improved trade with major traditional trading partners, such as the EU and US, and plans are being developed to approach other developed and developing countries for improved market access.

- **The financial sector:** A healthy, efficient financial sector is essential in ensuring that the country's resources are employed in their most productive uses, so that all segments of society will realize the economic benefits of growth. To this end, reforms in the financial sector are being developed that will enable the Sri Lankan economy to compete more effectively globally and to permit Sri Lanka to emerge as a financial hub in the South Asian region.

In summary, the development of the Government's ERP defines in greater detail many of the actions that will be required to put the *Poverty Reduction Strategy* in place. It reflects the changing circumstances facing the country and the intention to implement a wide range of market-friendly measures to substantially increase economic growth. These efforts are continuing to be refined and remain very much works in progress. Core principles that have guided this process include, *inter alia*:

- The protracted civil conflict has caused serious humanitarian problems and weakened the country's social fabric. Peace, relief, rehabilitation and reconciliation are the highest priorities for Sri Lanka today and these will depend very much on alleviating poverty.

- The rate of economic growth must be significantly increased in order to generate new employment opportunities, diversify the economic base, foster structural change and improve living standards. Private sector initiative will be needed to lead the growth process. Government can provide an environment conducive to private sector initiative by maintaining a stable and sustainable macroeconomic setting and by reforming public policies to foster efficient private initiative.

- The poor must benefit from the economic growth process. Bringing poor communities into the mainstream of a dynamic market economy is central to the poverty reduction challenge.

- A combination of globalization, urbanization, demographic change and the increasingly demanding requirements of the private-sector led workforce imply that new approaches are needed to deliver social services in a way that ensures steady achievement in human resource development. Concentrating public resources on delivering social services more effectively to the poor, while forging closer partnerships with the private sector in improving social capital, are important challenges.

- Economic reform and poverty reduction is a task for all segments of the society, most especially the poor. Governance deficiencies and the limited empowerment of the poor hinder efforts to reduce poverty. Making institutions more responsive to the needs of the poor, by reforming governance and by empowering the poor to be better able to help themselves, will create a foundation for a durable reduction in poverty levels.

III. The Evolution of the Poverty Reduction Strategy

A Framework for Poverty Reduction

Poverty in Sri Lanka is complex and multi-dimensional. By its very nature, an integrated and well-coordinated approach is needed. Stakeholders engaged in these efforts must base poverty reduction efforts on a good technical understanding of the causes and consequences of poverty. A comprehensive assessment of what has contributed effectively to poverty reduction in the past and to those factors that constrain future progress is needed to achieve progress in these efforts in the future.

The Government and the stakeholders, including the multilateral and bilateral donor agencies, have made considerable progress. The *Framework for Poverty Reduction* (PRF) was the result of a three-year analytical and consultative process involving a large number of government agencies, donors, research institutes and NGOs. The *Framework* embodies a fundamental shift in the role of government with regard to poverty reduction. This new role for Government requires it to work towards creating an enabling environment for poverty reduction, not to attempt to solve poverty directly through public spending or restrictions on private economic activity. This shift in approach is continuing with this Government’s economic reform program. More specifically, the PRF recognizes that a strategic approach to poverty reduction implies different areas of focus, such as:

(i) Move from developing a fixed plan, ideas and solutions, to much more iterative and consultative processes.
(ii) Move from a view that it is the state alone which responsible for poverty reduction towards making the society responsible as a whole.
(iii) Move from centralized and controlled decision-making towards shared results and opportunities, transparent negotiation, co-operation and concerted action and development partnership among the stakeholders.
(iv) Move from a focus on inputs and outputs towards a focus on outcomes and results.
(v) Move from the traditional sectoral planning approach towards a more integrated planning approach, which involves linking strategic frameworks to sectors or crosscutting themes and policy making.

(vi) Move from dependence on public sector deficit financing to finance poverty reduction to a situation in which public resources are targeted more effectively and public policies inspire greater private initiative in achieving social development objectives.

The Ongoing Consultative Processes

The manner in which a poverty reduction strategy is formulated is a critical part of the process of implementing an effective strategy. Critical analysis and reflection, openness to varying ideas and perspectives, and a conscious effort to listen and learn from all stakeholders, especially from the poor themselves, have been an integral part of the PRS preparation process. Starting in 1998, the Government mounted an intensive consultative process to lead the preparation of the *Poverty Reduction Framework* and the follow-up *Poverty Reduction Strategy* exercise. Inputs were solicited from the Government, technical experts, the donor community, non-governmental and community organizations, private sector organizations, and other public opinion leaders. A steering committee, consultative committee and technical committee were charged to prepare technical reports and to engage sub-sector experts and other stakeholders in a wide-ranging, consultative search for solutions to Sri Lanka's poverty problem.

Workshops were held in May 1998, February 1999, October 1999 and May 2000 in which the results of technical assessments were presented and discussions held on anti-poverty strategies, policies and programs. Several versions of the PRF were produced and each was extensively discussed, debated and commented-upon by all the stakeholders involved in the process. Extensive written comments and guidance provided by leaders from Government, the private sector, the NGO community and the main external donors are reflected in the Framework that the Government has adopted. The *Framework for Poverty Reduction* was presented to the Development Forum in December 2000.

The focus of the *Poverty Reduction Strategy* is very much on how to put into operation the visions, strategies and reforms identified in the Framework. In so doing, the PRS builds on this seminal document, while also incorporating key lessons and recommendations generated from recent poverty assessments prepared by the several of the nation's major development partners, the United Nations, World Bank and Asian Development Bank[1]. The PRS also builds on the results of a three-year, island wide, consultative process aimed at improving relief and rehabilitation and ethnic reconciliation in conflict-affected areas.

Government has recently established a number of Steering Committees and Task Forces to jointly monitor implementation of the ERP/PRS priority actions, as elaborated upon in Chapter 9. These entities will maintain close contact with the line agencies and local government representatives to ensure that the macro-economic framework and public policies, programs and projects give priority to and are consistent with the strategies defined for poverty reduction. A PRS monitoring team on poverty reduction goals and indicators has defined the monitoring and evaluation process.

Frequent consultations with stakeholders have enriched the preparation of the PRS. In October 2001, the UNDP hosted a workshop of more than 150 representatives of non-governmental organizations to provide inputs and advice to the PRS preparation team (see Box 1). This was followed by an offsite PRS workshop (November 2001), in which a wide range of stakeholders participated, including Government agencies, donors, NGOs and private sector umbrella organizations. Stakeholder meetings were also held in January, February and March 2002 with specific groups of Government officials, donors, private sector business associations and NGO groups to solicit inputs, comments and feedback on various drafts of the PRS. The revised draft of the PRS was posted on the ERD web site and comments were solicited from the public at large. A second, offsite PRS workshop for stakeholders was held in April 2002, followed by a workshop organized exclusively for the NGO community (May 2002) with focus also on the PRS. In these two workshops, the revised draft of the PRS, especially the technical annexes,

[1] This includes the United Nations, 2001, *Sri Lanka: Common Country Assessment*; World Bank, 2001, *Sri Lanka Poverty Assessment*; and Asian Development Bank, 2001, *Poverty Reduction in Sri Lanka: Maximizing the Asian Development Bank's Contribution.*

underwent in-depth review, discussion and debate. The PRS was also reviewed in detail at the Development Forum, held in Colombo in June 2002. The participants comprised senior representatives from the Government, the donor community, the private sector and civil society, as well as independent observers. The draft PRS underwent further review and debate at a trade union seminar, sponsored by the ILO, in November 2002.

The results from these consultations were used to revise and restructure the PRS. Drawing on the inputs provided by stakeholders, greater attention was accorded to measures aimed at enhancing the business environment, reducing wasteful public spending, and refining policy measures to address constraints of socially excluded groups.

Consultations held in the context of developing the Government's Economic Reform Program have also been used to guide the revision of the PRS. For the preparation of the Economic Reform Program, policy development steering committees, and consultative processes, were launched in the areas of macroeconomics and trade, employment and labor, human resources development, finance and investment, infrastructure development, natural resources development, IT/telecommunications development, productivity improvement, agriculture and public sector reform. A large number of stakeholders, from government, academia, NGOs and the private sector were involved in detailed consultations leading up to the preparation of the Economic Reform Program. While poverty reduction was not the main focus of these consultations, detailed actions that would contribute to poverty reduction was an integral part of the consultation process.

Government's priorities for external assistance are clearly defined in the PRS, and it is expected that the broad sectoral focus of the main external donors, and the comparative advantage of the different donors, will be used to create synergy between multilateral and bilateral finance[2]. In the future, the Government will endeavor to secure a program budget from the donors to accelerate implementation of the PRS.

Moving Beyond The PRS to Implementation

The requirements for substantially reducing poverty are now generally well understood and accepted. The interrelated importance of achieving a lasting peace, increasing economic growth and reducing poverty is now also better appreciated than was the case in the past.

A major challenge remains in the implementation of the policies and programs that are necessary to achieve Sri Lanka's social and economic objectives. In the past many sound initiatives failed at the implementation stage. For its part, Government has established the *Ministry of Policy Development and Implementation*, under the leadership of the Honorable Prime Minister, as the focal point to ensure that its responsibilities in this process are met. Responsible groups have also been established to oversee and implement the necessary policies and programs in all of the relevant Ministries. (See Chapter 9.)

Full and effective implementation of the discussed in this PRS will require the combined efforts not only of Government, but also individuals and organizations drawn from civil society, the NGO community and the multilateral and bilateral donor partners. This process will depend a great deal on continuing what has been a productive consultation process among the various stakeholders.

[2] Priority actions for Sri Lanka's external assistance agencies are defined in Part III.

Box 1: Civil Society and the PRS: the October 2001 Consultations

UNDP hosted a two day conference on the 22nd and 23rd of October 2001 in Colombo in order to obtain the views of civil society as inputs into the PRS. The objective of the conference was to listen to the voices of the poor, and to stakeholders involved in poverty reduction. More than three hundred participants, representing over one hundred NGOs and private and public sector organizations, participated. Key issues raised included:

Plantation Sector: Alcoholism, rising indebtedness, inadequate access to education, and isolation of the plantation community from the mainstream of local government administration were revealed as the main issues related to poverty in the plantation areas. The main recommendations were to (i) create formal and informal education facilities in these areas; (ii) make plantation work more attractive to the younger people; (iii) curtail the liquor licenses in order to prevent people from becoming addicted to drugs and alcohol; (iv) establish better banking, culture, sports and welfare facilities; and (v) integrate estate communities with other communities based on a concept of hamlets, which will come under the administration of local authorities.

Pro-poor Services: Credit alone will not reduce poverty, but credit bundled with other services, such as market information, business skills and new technology, may be more effective. Public-private collaboration at the grass roots level is not working effectively. Production of more low-cost nutritious foods (including local milk) may be needed to improve child nutrition.

Local Government Sector: Local government is frustrated by a lack of clarity of roles and responsibilities. Decision-making remains centralized and much government spending goes to waste. There is a need for a proper coordinating body at the local level (rural or divisional secretary level) and government activities should become more market-oriented, and less welfare (or handout) inclined.

Organization of the poor: Empowerment of civil society should be accepted by all and poverty reduction must become a collective responsibility. Policies should focus on empowering women who are seriously affected by poverty. To foster empowerment, Government should minimize cash transfers and subsidies provided to the poor and instead, prepare programs for poor people to be economically empowered.

Conflict Affected Areas: Security considerations cannot be over-emphasized as they are adversely affecting the welfare of the population, especially the displaced persons. There is a need for a regular dialogue to better balance security and welfare concerns. Donors, NGOs and the Government should monitor relief and rehabilitation activities, which are operating at the grass root level.

2. A Profile of the Poor

Efforts to reduce poverty must begin with an informed understanding of the nature and magnitude of poverty in Sri Lanka. But for this, definitional issues matter. Poverty is experienced in a number of dimensions. Those who are unable to afford basic necessities will certainly be regarded as poor. Individuals who lack access to essential collective goods and services will also normally be regarded as poor. And poverty has dimensions that extend well beyond economic considerations and into the realm of political and human rights. Individuals, households and even communities do not necessarily suffer equally from all dimensions of poverty at the same time. To understand poverty implies a need to examine impoverishment from a variety of perspectives.

Poverty yardsticks are inevitably subjective, for perceptions of poverty are undoubtedly linked to changing social perceptions. In Sri Lanka, the combination of economic progress, urbanization, globalization and liberalization has altered expectations and raised the threshold for what the general population would regard as "poor". Public policy must respond to poverty in its many dimensions, taking into consideration both a technical assessment of poverty and the perceptions of the population at large.

Absolute poverty is most commonly measured with respect to the ability of a household to afford a minimum set of consumption requirements. In this approach, a food poverty line is first derived using the cost of a food bundle that satisfies a food energy requirement, at given tastes and preferences. To this is added an amount equal to the average non-food consumption of those who can just afford to meet their food energy requirements. Twenty percent is added to the low poverty line to take into consideration the arbitrariness that necessarily exists when a poverty line is defined.

The official government agency responsible for collecting and disseminating primary data on poverty is the Department of Census and Statistics (DCS). Two household consumption surveys covering the entire nation, except the North and East (i.e., the conflict areas), were undertaken by the DCS during the first half of the 1990s. Both defined the poverty line in terms of the estimated cost (per capita) of a minimum food and non-food consumption bundle.

A comparison of the two surveys suggests that absolute poverty increased significantly between 1990/91 and 1995/96, i.e., from 33 to 39 percent according to the higher poverty line, and from 20 to 25 percent, according to the lower poverty line. Although numerous qualitative studies have been undertaken in the conflict-affected areas, there is no official estimate of the extent of poverty in the North-Eastern Province as it has been excluded from national consumption surveys during the past two decades. Nonetheless, there is ample evidence from small-scale surveys and local government studies undertaken in recent years to suggest that poverty affects nearly half of the population of the North and East. On the basis of available data, we could conclude that chronic poverty affects around 25 percent of the population and that chronic and transitory poverty combined affects around 40 percent of the population.

The DCS is currently conducting the Household Income and Expenditure Survey of 2002 in 12 monthly rounds. A preliminary report, based on the first 3 months' survey data covering about 4000 households, indicates that around 28 percent of the population is experiencing consumption poverty. This finding, even though it is tentative, suggests that there has been no significant change in the poverty level in the latter half of the 1990s.

The incidence of consumption poverty (head count index) varies significantly across provincial boundaries, with Uva, North Western and North-Central provinces having a significantly higher poverty level than the other provinces. The highest incidence (using the higher poverty line) is in Uva province (55 percent) and the lowest, in Western province (23 percent). Those regions disadvantaged in terms of economic and social infrastructure tend to exhibit a high incidence of consumption poverty.

The levels of human poverty, as measured by the human poverty index, also show substantial regional variation, with the Uva Province recording the highest incidence (27 percent) and the Western Province recording the lowest incidence (14 percent).

A major cause of poverty is slow economic growth. GDP growth averaged 5.1 percent while per capita GDP growth averaged 3.9 percent during the 1990s. During the same period, the Gini coefficient[3], which is an indicator of income distribution, declined marginally for income receivers (from 0.52 to 0.50) as well as for spending units (from 0.46 to 0.45). A high economic growth rate (of 8-10 percent per annum) without significant income redistribution could sometimes have the same impact on poverty as a lower growth rate with substantial income redistribution. But neither of these two scenarios appear to fit the Sri Lankan case in the 1990s, where a modest growth rate has been accompanied by little or no income redistribution. It is clear therefore that neither the GDP growth rate nor its distributive effects were sufficient to bring about a marked reduction in the poverty level in this country. In other words, the benefits of economic growth have not automatically trickled down to the poor.

The civil conflict has caused immense human suffering and deprivation in Sri Lanka. The conflict has resulted in at least 60,000 deaths and many more people have been killed, injured, incapacitated, or internally displaced. The human and economic costs of the war are felt most directly by populations in the North and East. According to Government estimates, the size of the overall economy of the Northern Province shrank from US$ 350 to US$ 250 million between 1990 and 1995, corresponding to a negative annual average GDP growth of 6.2 percent per annum. The Central Bank reports that the conflict is likely to have reduced Sri Lanka's GDP growth by about 2-3 percentage points a year.

The indirect costs of the war are at least as high. These costs represent the income lost as a result of foregone domestic investment, reduced tourism, the decline in foreign direct investment, and the human capital loss associated with death, injury and displacement. The conflict has prompted the out-migration of large numbers of skilled and semi-skilled persons, depriving the economy of trained professionals, entrepreneurs and highly skilled civil servants that the nation so badly needs.

The socio-cultural consequences of protracted conflict weaken the nation’s institutional capacity to address poverty. Political violence, violence against women, amongst youth, within families and suicide are all manifestations of the armed conflict setting. A tacit acceptance of violence adds a further dimension of physical insecurity to the lives of the poor.

The evidence also shows a strong link between poverty and isolation. People living in remote areas are subject to economic isolation due to lack of access to markets, information and basic infrastructure facilities, such as good roads, rail and port systems, well-functioning bus networks, telecommunications and information technology. Isolation adds to vulnerability, since remote communities are both more susceptible to and likely to be impoverished by shocks, such as drought, floods and famine. Isolation also contributes to social marginalization. Communication links are largely confined to the villages in which the poor reside. A characteristic feature of isolated communities is the absence of spatial, occupational and social mobility.

Limited access to quality education is also linked to poverty. While basic education facilities are widely available, the quality of the education available to the poor is vastly inferior to that available to the better-off, urban households.

The poor also have limited access to basic social services. The evidence shows that only a small share of government health expenditure reaches the poorest 20 percent of the population. It also shows that in many areas, the poor do not have adequate access to safe drinking water and basic sewage and sanitation infrastructure.

[3] The Gini coefficient indicates the extent to which the Lorenz curve bends away from the straight line of complete equality, with respect to income. The higher the coefficient, the more unequal the distribution of income.

Low labor productivity in agriculture is a major contributor to persistent rural poverty. Crop yields have either stagnated or declined during the 1990s. The single most important impediment to agricultural prosperity is an overly restrictive policy regime. State ownership of some 80 percent of the lands, restrictions on technology imports and land use, pervasive input and credit subsidies, and frequent changes in agricultural trade policies combine to promote inefficient use of resources and restrict access to improved technologies.

One of the factors inhibiting rural income growth is the lack of clear private property rights in land. Most poor farmers operate land parcels for which they do not have clear title. As a result of this insecurity and of government restrictions on land use, the poor are not empowered to make choices in land use and land allocation, and hence cannot use their lands to their most productive potential. Furthermore, under the Land Development Ordinance, women are not ensured the right to land settlement areas.

Environmental degradation is an increasingly serious concern. In the rural areas, key problems include deforestation and soil erosion, encroachment of agriculture into protected areas with adverse effects on bio-diversity, water pollution, coastal erosion, the mining of riverbeds and the use of wood as the main cooking fuel. The nexus of poverty and natural resources has immense macro-level impacts. Non-sustainable resource use creates unaccounted costs that are estimated to be 2.5% of GDP. Insecure land use and usufruct rights and uncontrolled access to natural resources are two of the major causes of resource degradation. Socially disadvantaged groups tend to move to areas where they can access land or marine resources, adding pressure to a fragile resource base.

Several other impediments to poverty reduction also merit serious consideration: (a) high fiscal deficits are crowding the private sector out of the banking system, while debt service is pre-empting public spending on a vast array of services aimed at the poor; (b) rigid labor laws, public land ownership and other factor market distortions tend to discourage urbanization and private employment generation; (c) incomplete decentralization has resulted in complex and frequently conflicting parallel systems of administration in the provinces; and (d) over-staffing, weak incentives, political interference and an administrative orientation in public sector management lowers returns to public initiatives.

Due to these impediments, efforts to empower the poor and draw them into the mainstream of economic development have met with limited success. Reforming governance and promoting genuine and sustained pro-poor growth are challenges for both Government and civil society.

A detailed poverty assessment is provided in Annex 2.

3. A Supportive Macro-Economic Environment

I. Trends in Macroeconomic Performance

Sri Lanka began to liberalize its economy in 1977. Since then, it has made considerable progress. Despite the escalating war and several shocks to the international economy over the last decade, Sri Lanka has averaged 5 percent GDP growth during the period 1990-2000 (Table 3.1). The main factor underpinning this expansion has been the robust growth in primary commodity and manufactured exports. Unemployment has declined to 7.7 percent in 2000 from rates in excess of 14 percent in the early 1990s. Inflation has been maintained in the single digits during most of the years, and investment rates have been maintained at about 25 percent of GDP.

However, in recent years that progress has slowed, if not come to a virtual halt compared to many other countries. Many other countries have rapidly and successfully advanced the process of economic reform and global market 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.

Unfortunately, Sri Lanka has lagged behind. It did not keep pace with or implement the reforms so crucial to build a strong economy. Instead, expansionary public spending was used to expand employment, defray the cost of the conflict and spur economic activity. After a decade of profligate spending, 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 and amortize the public 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.

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 into Rs 77,500/- for every person in the country. The additional borrowing required to meet 2002's target deficit will add approximately Rs 6,000/- per person to this burden. If large deficits continue unabated, the public debt would grow far faster than the economy. At a certain point, the burden of debt could become unsustainable.

Due to the fiscal deficit, Sri Lanka tended to import more goods and services than could be financed through export and service earnings. As a result, the currency has steadily depreciated and the *balance of payments* record has come under considerable pressure during the last decade. While the current account deficit declined significantly in line with the strong growth of exports and remittances, the capital account weakened considerably as short-term capital flows turned negative starting in 1995 and amortization payments increased significantly. Privatization receipts of more than US$450 million during 1995–99 were insufficient to counter the underlying weaknesses. As a result, gross official reserves declined gradually over the decade to 3 months of imports by the end of 1999.

Table 3.1: Selected Economic Indicators, 1990 to 2000

Indicators	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Annual GDP Growth (at 1982 prices) (%)	6.4	4.6	4.4	6.9	5.6	5.5	3.8	6.4	4.7	4.3	6.0
Atlas GNP Per Capita US $	470	490	540	600	640	700	750	800	810	820	860
Investment/GDP Ratio (%)	22.2	22.9	24.3	25.6	27.0	25.7	23.9	24.4	25.1	27.3	28.0
Domestic Savings / GDP Ratio (%)	14.3	12.7	15.0	16.0	15.2	15.3	15.3	17.3	19.1	19.5	17.3
C/A Balance (before grants) as % of GDP	-5.4	-7.7	-6.4	-5.3	-7.8	-6.5	-4.9	-2.6	-1.4	-3.5	-6.4
Change in International Reserves (US$ Mn.)	-119	-290	-190	-661	-241	-52	68	-163	-37	263	516
Gross Offic. Reserves (months of GNFS imports)	1.7	2.4	2.8	4.5	4.5	4.1	3.8	3.5	3.3	2.2	1.5
External Debt Service Ratio (%)	17.8	21.2	19.5	12.9	13.7	16.5	15.3	13.3	13.3	15.2	14.2
Government Revenue (% of GDP)	21.1	20.4	20.2	19.7	19.0	20.4	19.0	18.5	17.2	17.6	16.8
Govt. Current Expenditure (% of GDP)	22.3	22.5	21.1	20.8	22.6	23.1	22.8	20.9	19.6	18.7	20.3
Govt. Capital Expend & Net Lend (% of GDP)	8.7	9.6	6.4	7.6	6.8	7.4	5.7	5.7	6.7	6.5	6.5
Budget Deficit (% of GDP)	-9.9	-11.7	-7.3	-8.7	-10.5	-10.1	-9.4	-7.9	-9.2	-7.5	-9.9
Nominal average exchange Rate (Rs/US$)	40.1	41.4	43.8	48.3	49.4	51.3	55.3	59.0	64.6	70.4	77.0
Annual Change in Consumer Price Index (%)	21.5	12.2	11.4	11.7	8.4	7.7	15.9	9.6	9.4	4.7	6.2

Source: Government of Sri Lanka, Ministry of Finance and Central Bank, 2002.

Total *external debt* increased gradually over the years due primarily to appreciation of key currencies and the large disbursements in the early 1990s. It peaked at 64 percent of GDP in 2000, reflecting borrowings for defense imports and loans to the national airline. *External debt service* has remained manageable because of the concessionary terms of external assistance.

The *external position suffered a further setback in 2000* when the escalating costs of the conflict and the rise in the world oil price increased the import bill by US$600 million. The current account deficit almost doubled to 6.4 percent of GDP despite record earnings from garments exports and remittances. Increased commercial borrowing by the Government helped mitigate this shock, and the balance of payments ended 2000 with a deficit of US$522 million. Gross official reserves fell to 1.5 months of imports. The exchange rate depreciated by about 15 percent over the year, which helped sustain good export performance. However, because of delays in raising domestic prices for petroleum products and utilities, several public corporations incurred large financial deficits – estimated at 2 percent of GDP. In 2001, the current account deficit narrowed sharply to about 2.4 percent of GDP due to a large decline in imports driven by lower GDP growth, and capital inflows that were supported by trade credits and the imposition of a 40 percent surcharge on the import of non-essential goods in February 2001.

The real economy was racked by a series of *severe shocks* in 2001. A drought adversely effected agricultural output and reduced hydroelectric generating capacity. Precautionary power cuts, arising from the hydropower shortfall, hindered production in the manufacturing sector. The June terrorist attacks on the airport, combined with the September 11th tragedy in the USA, weakened consumer confidence and contributed to a decline in inward investment and tourism arrivals. Rising utility prices and high interest rates contributed to weak domestic demand. Earlier defense of an unsustainable exchange rate policy led the CBSL to raise interest rates well above historical norms/equilibrium rates.

International recessionary conditions triggered a decline in export earnings while sagging domestic demand resulted in a sharp fall in merchandise imports. As a result of deficit spending pressures and the flow-through effects from devaluation, domestic inflation rose to nearly 15 percent on an end-year basis.

Due to the rapid deterioration of the macroeconomic environment, the economy registered negative GDP growth in 2001 for the first time in Sri Lanka's post-colonial history. The combined effects of recession and inflation produced the condition known as stagflation, which dampened investment, stifled economic growth, and inflicted considerable hardship on the poor and vulnerable segments of society. Negative GDP growth in 2001 is partly a reflection of the severe shocks that the economy was subject to, but also to the lack of an adequate policy response to a decade of external and internal shocks only served to hasten the decline

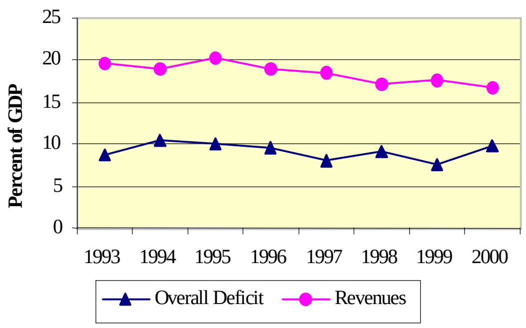
Budgetary management was poor throughout the 1990s, as reflected in widening deficits and a weakening revenue performance (Figure 1). The rising costs of the civil conflict, the rising domestic debt burden and a decline in domestic revenues were the three main factors contributing to the widening fiscal gap. Hence the government was compelled to borrow heavily from domestic bank and non-bank sources, not only to bridge the widening budget deficit but also to finance rising amortization and interest payments. This drove up interest rates and crowded out investment. In addition to the budget deficit, very little was done to stem quasi-fiscal losses, which raised the debt stock of public corporations to Rs. 41 billion in 2001.

The customary practice of using *ad hoc* fiscal measures to garner popular support during election years has tended to aggravate fiscal instability. For instance, wages and pensions were increased and several indirect tax instruments were either reduced or abolished in late 2001. These measures were taken in view of the General Elections, without regard for their budgetary implications.

A serious problem that emerged in the second half of the 1990s was that the Government failed to fully honor its commitments in respect of a wide range of structural reforms, which were necessary for restoring macroeconomic stability and investor confidence, as well as creating an enabling business environment for the functioning of an efficient and competitive private sector. For instance, an expansionary fiscal policy was pursued (due to lower revenues, high defense expenditure and the non-realization of expected privatization proceeds) in violation of the commitment to exercise fiscal prudence; interest rates were not adjusted in time to offset the dampening effects of the recession; administrative price reforms were not implemented, the external and internal shocks not-withstanding; the restructuring of loss-making public enterprises was not undertaken; the gradual phasing out of distortionary multiple taxes was not attempted; the public service was expanded, when the need was to downsize; the capital markets were not reformed; deregulation of key sub-sectors, such as finance, IT and services, was not pursued; land and labor market reforms were avoided, and so on.

The expansionary fiscal path on which previous governments have steered the economy is simply unsustainable as it has taken the debt burden to a prohibitively high level. The domestic debt grew by a phenomenal 18 percent per annum between 1996 and 2001. As a result, Sri Lanka is saddled with a domestic debt of Rs 800 billion by end of 2001and a total outstanding government debt that is larger than GDP.

Figure 1: Fiscal Deficit and Revenues



Note: Provisional data for 2000.
Source: Central Bank of Sri Lanka; IMF

Domestic financial policies were tightened in response to the 2000 and 2001 shocks. The most important policy measures introduced include the floating of the rupee, adjustments in administered prices and interest rates, postponement of non-priority expenditures, an increase in excise taxes, introduction of an import surcharge, and a tight budget for 2001. The IMF has provided support to the stabilization program through a 14-month Standby Arrangement approved on April 20, 2001.

The Government has announced a series of new policy measures aimed at restoring a more sustainable fiscal balance, as per the 2002 and 2003 Budgets, which need to be viewed in tandem, due to their close inter-connectedness. These two Budgets place considerable emphasis on economic stabilization, to be achieved through fundamental reforms for building a sustainable revenue base, as well as creating an enabling environment for rapid, pro-poor growth. On the revenue side, a broad-based VAT has been introduced to replace and consolidate GST, NSL and other turnover taxes. The retail sector will be brought under VAT during 2003, once the required legal steps have been completed.

The temporary Custom's surcharge is to be phased-out commencing end 2003 and uniform import duties applied to the majority of agricultural commodities. The stamp duty and capital gains tax have been eliminated and duties on tobacco and spirits rationalized to improve collections. Top marginal rates of household and business income have been reduced and the direct tax system simplified. A low, uniform withholding tax has been introduced for interest earnings and dividends while new fees, such as the debit tax, have been introduced to augment revenues.

The 2002/2003 Budgets signal the Government's intention to rationalize the existing tax incentive system and reduce its scope. All tax incentives, including those now presently granted by the BOI, will be included under the new Inland Revenue Act. The implementation of these measures will be undertaken either by the BOI or the Department of Inland Revenue. A simplified fiscal incentives system has been designed to promote non-traditional agricultural, industrial and IT exports as well as pioneering investments in designated areas, such as power generation, transmission and distribution and the development of highways, sea-ports and airports, railways and water services. The former group will be taxed at a gradually increasing rate after three years and be fully incorporated into the existing corporate tax system by the sixth year, whereas the latter group will enjoy a tax holiday period of 5-10 years, depending on the size of the investment.

These tax reforms are designed to eliminate the excessive use of ad hoc tax incentives and distortionary multiple tax instruments, broaden the tax base, and streamline the tax administration system. The reforms will increase revenues significantly in 2003/04 and enable the Government to develop a sustainable resource envelope in the medium term. With the aim of reducing avoidance and improving collections, the 2002/2003 Budgets signal the restructuring and amalgamation of three Departments: Inland Revenue, Customs and Excise. These three agencies will be transformed into a modern, efficient Revenue Authority. To prepare for this, a Revenue Advisory Council has been appointed with full authority to develop the legal framework for a Revenue Authority and to undertake the management reforms necessary to prepare the two services to function in an efficient, effective and fully integrated manner. The Budget also envisions the strengthening of the Large Payers Tax Unit through automation and logistical support to enhance collections.

On the expenditure side, priorities have been sharpened and steps taken to reduce public enterprise losses. A Defense Committee has been established to regularize and control defense expenditure. The fertilizer subsidy scheme has been streamlined so as to release funds for a targeted, voucher-based farm inputs support scheme for small producers. A new Welfare Benefit Law has been enacted in order to establish the legislative base for restructuring the ongoing Samurdhi Program and for targeting social assistance to eligible persons without politicization.

The 2002/2003 Budgets also contain a multi-year plan to trim the public service. A hiring freeze will remain in place for all Government departments and agencies except for recruitment of technical staff and certain professional categories. Recruitment of other categories will be decided on a case-by-case basis.

Further initiatives for strengthening macroeconomic fundamentals while stimulating broad- based social and economic development include:

- Reducing the interest cost of the public debt by replacing short-term facilities with the banking sector by long-term bonds issued at lower interest rates
- Enactment of a Special Provisions Law for harnessing undeclared monies for tax into development and broaden the tax base
- Enactment of a Fiscal Management Responsibility Law in 2002 for ensuring effective implementation of fiscal policy
- Achieving public sector expenditure consolidation through administrative reform
- Achieving cost savings through streamlining of tender procedures and disposal of idle government assets, other than land and buildings
- Stimulating private sector development through further simplification of the tax system, including reduction of the corporate tax from 35 percent to 30 percent
- Enactment of a new Exchange Management Law to ease exchange restrictions
- Establishment of a Human Resource Endowment Fund, to be jointly managed through a public-private partnership
- Establishment of a wide range of mechanisms, including budgetary support and innovative institutional arrangements, for the development of the rural economy, the tourism sector, the plantation sector, the agro-industrial sector, the garment industry, and the gem and jewelry industry
- Provision of affordable housing finance for low and middle-income households
- Establishment of road fund to be used for road repairs and maintenance

The combination of peace talks, a resolution of the power crisis and the introduction of measures aimed at fostering growth and fiscal sustainability in the 2002 Budget have begun to show signs of success. Economic growth was positive, but low (at 1.3%) in the first half of the year; inflation decelerated; external reserves increased; financial market stability further strengthened; fiscal consolidation got underway and investor confidence improved. Economic growth is likely to accelerate in the second half of the year, resulting in growth of 3.0% for the year as a whole. Investment is slowly increasing, and is expected to be in the range of 24% of GDP. Headline inflation is recording a declining trend and is expected to be in the range of 8-9 percent by the end of the year. Achievement of the fiscal deficit target, set at 8.9% for 2002, will hinge on buoyant growth and revenue collections in the second half of the year, including substantial privatization revenues. The external position shows signs of slow improvement in midyear, with modest growth in exports, imports and a small balance-of-payments surplus forecast for 2002.

II. The Macroeconomic Framework and Determinants of Pro-Poor Growth

A set of stable, consistent and predictable macro-economic policies underpin private sector led growth and development. If the private sector has full confidence in the nation's macro-economic management, and if the high-cost of doing business can be credibly reduced, they will make the investments necessary to boost productivity and expand output. Government will create space and incentives for private sector development by putting in place the institutional underpinnings of a globally, competitive market economy. Not only will new investment be attracted to Sri Lanka, but existing land, labor and capital resources will be utilized far more productively. Businesses will have greater incentives to invent and innovate, contributing to an increase in employment and productivity.

The medium-term macro-economic framework calls for the economy to break away from the negative growth of 2001 and move towards a higher trajectory (6-7% growth) by the year 2006 (Table 3.2).[4] This will result in a corresponding increase in the per capita income from US$ 838 in 2001 to about US$ 1141 by 2006. This is expected to pave the way for a sustainable high economic growth path of 8-10 percent per annum in the long run with per capita income rising to nearly US$ 2000 by 2010.

Increase in the productivity of domestic resources and a high level of domestic and foreign private investment (rising from 22% to 29% of GDP by 2006) will be needed to sustain an increase in the aggregate growth rate. The former will be inspired by improvements in public policy and regulation. High rates of private investment should be financed, as much as possible, by raising the domestic savings rate. The Government forecasts call for national savings to rise from 20 percent of GDP in 2002 to 25 percent of GDP in 2006 as public sector dis-savings are transformed into a modest level of public savings. Private savings, representing about a fifth of national income, will continue to finance the vast majority of investment.

With a recovery in economic growth, unemployment is forecast to fall from 8.0 per cent in 2001 to just over 5 per cent in 2006. Growth in broad money will be on the order of some 13 percent per annum, well in line with an increase in domestic demand. Private sector credit will grow at approximately 12-14 per cent per annum to meet the upsurge in private investment. Underlying inflation is forecast to fall steadily from 12 per cent in 2001 to just about 5 per cent by 2006, which requires fiscal prudence and consistent monetary management. Due to an increase in public savings, the current account deficit will average some $800 million per annum during the 2002-2006 period, causing the absolute balance to shift into a surplus position, thereby enabling the country to gradually build official foreign exchange reserves to provide for about four months of import cover.

[4] See Annexes 3a-3c and Annexes 4a-4f for a breakdown of summary projections provided in Table 3.2.

Table 3.2: Macroeconomic Framework - 2003-2006 (As percent of GDP unless otherwise stated)

Item	2001 Provisional	2002	2003 Projections	2004	2005	2006
Population (mn)	18.7	18.9	19.0	19.2	19.4	19.6
Per Capita Income (US$)	838	867	921	994	1066	1141
Unemployment (% of labor force)	7.7	8.0	6.0	5.7	5.4	5.1
Economic Growth and Inflation						
GDP Growth	-1.4	3.0	5.5	6.5	6.8	7.0
Underlying Inflation (annual average)	12.0	9.3	7.5	7.0	6.0	5.0
External Assets						
Gross Official Reserves/Goods Imports (Months)	2.5	3.1	3.5	3.8	4.1	4.2
Gross Official Reserves/Import of goods and services (Months)	2.1	2.7	3.1	3.3	3.5	3.7
Total Reserves /Imports (Months)	4.3	5.2	5.7	5.8	5.9	6.0
Investment/GDP	22.0	22.5	24.0	26.5	27.6	28.7
Public investment	5.9	4.1	5.3	6.3	7.0	7.3
Private investment (rest of the economy)	16.0	17.9	18.8	20.3	20.7	21.5
Savings/GDP	22.0	22.5	24.0	26.5	27.6	28.7
Gross Domestic Savings	15.9	15.8	16.2	18.2	19.3	21.0
Public	-4.9	-4.3	-2.3	-0.1	1.8	2.9
Private	20.9	20.1	18.4	18.3	17.5	18.1
National Savings	20.1	20.2	20.5	22.3	23.2	24.8
Fiscal/GDP						
Revenue	16.5	16.8	17.1	17.9	18.7	19.1
Expenditure	27.4	25.7	24.6	24.2	23.7	23.4
Budget deficit before grants	-10.9	-8.9	-7.5	-6.3	-5.1	-4.3
Total Central Government Debt/GDP	103.5	103.4	101.4	93.9	87.0	80.9
External Sector Indicators						
Trade deficit/GDP	-7.4	-7.6	-8.7	-8.8	-8.8	-8.0
Current A/C with grants (Official Current Transfers)/GDP	-1.7	-2.1	-3.4	-4.1	-4.3	-3.8
Overall BOP/GDP	1.4	1.5	0.3	0.5	0.4	0.4
Total External Debt and Liabilities/GDP	61.9	61.3	60.8	57.5	54.8	52.0
Government External Debt/GDP	45.2	46.1	46.6	44.3	42.5	40.2
Debt Service/Exports of Goods and Services	13.1	13.4	12.1	12.1	10.5	9.5
Export of Goods and Services Value (% change)	-4.5	-5.3	4.3	24.3	27.9	26.7
Import of Goods and Services Value (% change)	-13.4	-2.5	9.7	27.4	27.5	23.4
Monetary Aggregates - Annual Growth						
Broad Money (M2b)	13.6	15.0	13.5	14.0	13.2	12.3

Source: Ministry of Finance and Central Bank of Sri Lanka, December 2002

Double-digit growth in the services and the manufacturing sectors are expected to lead the growth process. Tourism is expected to record double-digit growth as the cease-fire inspires an upsurge in visitors and higher utilization of existing capacity. An upsurge in tourism is expected to have positive knock-on effects in the wholesale and retail trade. Manufacturing will continue to expand, diversify, be export-oriented and take on more of a skill-intensive character as Sri Lanka's economy becomes increasingly integrated with regional and global markets. Peace, deregulation, structural reform and macro-economic stability will inspire higher rates of private investment in manufacturing, infrastructure, utilities and the services sector. Higher rates of productivity growth will result from the application of modern technology and the long-term effects of sustained, quality-oriented investment in education and social services.

With consolidation of the cease-fire, the level of inward investment will increase, reconstruction programs will be launched and capacity utilization in the tourism and other service industries will rise. Structural change, involving a shift in the rural labor force from low-productivity subsistence based agriculture into commercial agriculture and non-farm activities will contribute to higher labor productivity and output, especially in the rural areas.

Growth by Widening Opportunities for Private Sector Initiative

Peace is vital to Sri Lanka's economic recovery. Without it, confidence will not return. But peace will not be sufficient to attract the capital, technology and market links so vital to economic recovery. There are many peaceful but stagnant parts of the globe. Sri Lanka must compete for private investment, and to do so, Government plans to widen the scope for private sector initiative. Government has pledged to rejuvenate the economy, improve governance and encourage private sector led growth. Against this background, the economic program for 2002 focuses on stabilization policies---in particular reserves accumulation and fiscal consolidation---while initiating a radical program of reform measures to tackle structural weaknesses.

More opportunities for private sector investment will be created by eliminating the heavy burden of over-regulation. Regulations on the use of the sea, airspace and coastal resources are to be relaxed. The private sector will be encouraged to exploit these resources to their fullest while managing them in a sustainable manner. New Sri Lanka tourism development zones will be established in selected coastal areas. The tourism development zones will be free of trade, currency, and other investment restrictions. Specific legislative provisions will be introduced in consultation with line agencies to remove restrictions.

State lands will be released in Greater Colombo, Moratuwa and Kotte Municipal areas for property and other development purposes to private enterprises. The private sector will be encouraged to invest, not only in the Western Province, but also throughout the country. Government will create 5 Economic Zones out of the 25 Administrative Districts and set up an Economic Commission for each. Within these Commissions, Government will establish business promotion authorities to encourage the private sector to develop industries, tourism and agriculture in a planned manner. A new BOI Law will be passed, which will include the establishment of BOI Investment Promotion Offices in these five regions. Opportunities will also be provided to the private sector to develop requisite infrastructure facilities and to establish new tourist resorts under the guidance of the Sri Lanka Tourist Board.

Bureaucratic delays and excessive administrative controls continue to hold back economic progress. To overcome this, the BOI will establish a special “time-bound” individual investor facilitation service to obtain inter-ministerial regulatory approval, on a project-by-project basis, for new initiatives consistent with the Government's deregulation policy.

The benefits of enterprise deregulation shall be extended throughout the economy. Special attention will be devoted to relieving the regulatory burden on small and medium-sized enterprises. The Deregulation Committee will assess policy barriers to enterprise development. Government will regularly review and implement the recommendations of the Committee.

V. Fostering Private-Public Partnerships

Government plans to work more closely with the private sector to put in place the economic infrastructure and quality social services that the nation so badly requires. Output-based contracting and multi-sector regulation will be used to encourage greater private sector participation in the provision, operation and management of infrastructure and other services. Performance-based contracts will be entered into which link payment to provision of infrastructure services that meet acceptable quality levels. Qualified private sector firms will be encouraged to bid for the provision of such infrastructure contracts in the areas of water supply, toll roads, railway management, and port services.

The private sector will be encouraged to work more closely with the state enterprises to improve the management and utilization of existing Government assets. A tremendous amount of land and other assets used by railway stations, major bus terminals and postal centers, which are close to markets, are idling due to lack of proper management and finance. In selected areas, joint ventures will be formed to release these idle assets to the private sector to improve public services. Significant benefits will accrue to the railways and the postal services through improved efficiency.

Private Sector Participation. As market conditions permit, Government will continue to pursue the closure of non-viable state enterprises and the sale of the more commercially oriented enterprises. Government is committed to reducing its involvement and ownership of commercial ventures, and anticipates significant revenues from attracting greater private participation in the next three years. The actual pace at which ownership is transferred to the private sector will also hinge on market conditions and private investor sentiment.

Government will exit from loss-making commercial businesses to create scope for private initiative. PERC will continue divesting the remaining Government stake in several public enterprises including two plantations, one sugar mill, Government rest houses and hotels, SLIC, the National Lottery, CPC and the remaining stake in SLT. Divestiture will be conducted in a professional and transparent manner. Fostering competition will be critical to the success of the divestiture process. Government will ensure that the industries undergoing divestiture are subject to competition in the market.

For many years, Government has competed with and even crowded-out private sector involvement in the provision of economic infrastructure and utilities. These services have been priced below a level at which they could be made to operate at a reasonable profit. Quality has suffered and Government's losses have mounted. A multi-sector utility regulator will be established to encourage the private sector to invest in the public utilities. This authority will initially license operators in the areas of power, water and ports and regulate tariffs. Government will also enact separate laws (covering electricity, water and ports) to promote competitive markets and allow private sector entry into these sectors.

Restoring Fiscal Stability

Government's fiscal position has deteriorated considerably during the past few years. The private sector will have to play a growing role, not only in the traditional commercial activities but also in areas hitherto reserved for the public sector. The fiscal deficit will be reduced from 11% in 2001 to 8.9% of GDP in 2002 and further reduced to 5% of GDP by 2005 by consolidating spending and augmenting revenues. Public sector debt, as a share of GDP, is expected to decline from 103 percent in 2002 to 81 percent by 2006, thanks to higher growth, lower interest rates and steady progress in fiscal consolidation. Expenditure restraint will include reductions in defense spending, subsidies and public sector employment. In the medium-term, consolidation of government departments and agencies, a reduction in public sector over-staffing, and the commercialization and divestiture of selected public enterprises will reduce strains on the budget. To depoliticize wage and pension setting, it is proposed that under the Constitutional Council, the Salary Commission will recommend wage and pension adjustments in consultation with the Treasury and the Central Bank.

Government is resolute in its determination to reduce macroeconomic instability by adopting a disciplined monetary and fiscal policy stance. Fiscal sustainability will be restored by increasing the rate of economic growth and by a combination of revenue-augmenting, debt-reduction and expenditure compression measures.

Revenue Reform. Revenue reforms are expected to add nearly 3 percent of GDP to the domestic resource mobilization effort between 2002 and 2006. On the revenue side, the Government will continue to expand the tax base to improve buoyancy and increase the fairness of the tax system. The tax system will be simplified and Government will reduce the onerous burden that high tax rates place on enterprises and households. The medium term objective is, as it broadens the tax base and consolidate expenditures, to converge to a top-rate of 20 percent applied to all firms. A flat, low rate withholding tax on interest earnings, dividends and rents is to be established. The newly created Revenue Advisory Council is expected to submit further measures to improve tax administration and tax compliance, as well as simplify the tax system.

Revenue losses from various BOI tax concessions are estimated at 2-3 percent of GDP annually. The economic distortions arising from unequal tax treatment are greater still[5]. Government is committed to maintaining a foreign trade and tax regime that is competitive and non-discriminatory across sectors. Rationalizing tax concessions is an important part of the Government's strategy to have a more buoyant, broader and neutral tax base. The medium-term objective is to transform the BOI into more of an investment-promotion and investment-facilitating organization, rather than one that dispenses tax relief. Consolidating all tax concessions within the Inland Revenue Act in 2002/03 is viewed as the first step towards replacing tax concessions with a globally competitive enterprise tax system.

Public Accountability and Expenditure Reform. The Government will introduce a Fiscal Responsibility Act to underscore the importance accorded to restoring a sustainable level of public debt. The Fiscal Responsibility Act will include a three year fiscal forecast, with a set of targets that must be achieved. By 2006, the Fiscal Responsibility Act will require Government to operate at a deficit that is no greater than 5 percent of target GDP. Under that Act, a medium-term fiscal framework will be presented, and the Government will be obliged to report on the expenditure performance and budget execution every six months. The Act includes provisions aimed at insulating public spending from populist, pre-election spending impulses. Prior to elections, Government will be obliged to report on the fiscal consequences of all new policies that are introduced.

In addition to setting clear medium-term targets, Government will take special measures to ensure that spending is kept within bounds on a year-to-year basis. At present, some government bodies fail to account for their spending for many years after it has taken place. Absent this information, it is difficult to assess whether or not spending has been undertaken in accordance with government procedures and is in line with budget priorities. In 2002, a new circular on public accountability was issued by the Ministry of Finance. In the future, all public organizations will have to account for their spending no later than six months into the fiscal year, otherwise the flow of funds to those organizations will be curtailed.

More effective financial management and better public procurement practices and procedures can help to ensure that existing resources are used effectively and that waste is reduced. Steps will be taken to streamline and rationalize the defense procurement system. Government will bring defense procurements squarely within the realm of good budgetary practice by establishing an Arms Procurement Advisory Committee as well as the office of a Controller General in the Defense Ministry. The Controller General, who will be responsible for regulating defense expenditure, will function in consultation with the Ministry of Defense, the Ministry of Finance, and the above Committee.

The Government has a backlog of nearly $3 billion worth of foreign assistance projects that can’t move because of antiquated procurement procedures and processes. Increased private sector participation will be encouraged with a view to facilitating implementation of key donor-funded projects. External aid disbursement rates will be increased through greater ownership of project implementation efforts, through systematic monitoring at the department and national level, through adoption of simplified procurement and project management procedures, and through the establishment of separate foreign aid impress accounts. External project aid disbursements could rise from about $400 million in 2001 to over $700 million in 2004 if these measures are put into effect, providing a much-needed boost to short-term growth. In addition to accelerating foreign aid disbursement, the Ministry of Finance will undertake institutional reforms aimed at introducing program budgeting, developing a medium-term budget

[5] IMF, 2001, *Sri Lanka Recent Economic Developments*, Washington DC.

framework, automating public accounts and audit practices, and introducing a public expenditure management system to track implementation and cadre.

The public debt burden is a serious threat to fiscal sustainability. A public debt management office will be established to recommend ways to reduce financing costs and to improve the active and passive management of the public debt. A reduction of the interest cost of the public debt on a gradual basis is one of the strategies to be adopted to reduce debt service costs. High interest bearing debt, which were issued in the recent past, can be retired and exchanged for debt carrying a much lower interest rate. The interest paid by Government on overdrafts and import bills can also be substantially reduced, since Government holds a large amount of funds in demand deposits in the same institutions that charge interest for overdrafts. Securitization of government import bills and overdrafts may be another way of reducing debt service costs. A combination of a reduced fiscal deficit and more professional public debt management techniques could reduce public debt service outlays by a quarter of what they now are in three to four years time.

Pension costs are rising rapidly and are crowding-out other essential expenditure requirements. The value of public pensions has been eroded by inflation. At present, there is an unfunded pension liability of Rs. 550 billion. The new contributory pension system to be set up in 2003 will help to cure this. It will also discourage un-curtailed growth of civil service, since under the new system only those who contribute to public pensions will receive this benefit.

Medium-Term Fiscal Outlook. In the medium-term, public expenditures are expected to decline by approximately 2.3 percent of GDP between 2002 and 2006. Expenditure compression is expected to have a positive effect on poverty reduction because (i) public spending on services most important to the poor will be protected from cuts and indeed better focused on the needs of the poor; (ii) the lower deficit will reduce government's debt service obligations, creating greater budgetary space for pro-poor public investment; and (iii) a reduction in government borrowing will reduce the crowding out of the private sector from the domestic financial markets, leading to more private investment and employment creation.

If Government is successful in establishing a lasting solution to the civil conflict, it will initiate a much more ambitious public expenditure program, principally financed by donors and focusing on urgent rehabilitation of the North and East, and on health, education and other infrastructure. Private sector participation will be the key to this drive to generate employment and reduce poverty across the entire nation.

In addition to systemic efforts aimed at tightening fiscal controls and reducing waste and duplication in public spending, Government will undertake a number of measures aimed at consolidating public spending:

- With a lasting peace, defense expenditures will be reduced to 2-3 percent of GDP and defense outlays (including external borrowing for defense purposes) will be fully financed through the budget.
- Better targeting of Samurdhi outlays will enable a more effective social protection system with a reduction of nearly one percent of GDP in welfare transfers.
- The high costs of servicing domestic debt will be reduced as the deficit declines and as improved public debt-management procedures are adopted.
- The number of departments, agencies and public entities will be reduced; those providing commercial services will be released to the private sector; and over-staffing in government will be gradually reduced.

Stemming Quasi-fiscal Losses. Losses from the major public enterprises have become very large in recent years. While these losses are initially financed through the banking system, ultimately Government is obliged to bear the burden of unsustainable public enterprise debts. Despite considerable progress in public enterprise privatization, there are still more than 150 statutory boards and fully owned government companies. In addition, there are at least 40 commercial companies in which government has a significant stake. Infrastructure services have not been priced on a cost–recovery basis, placing a heavy burden on public finances directly or through quasi-fiscal deficits accumulating in state commercial banks on account of non-performing SOE loans. In 1999, 2000 and 2001, the financial burden of loss-making state-owned enterprises increased considerably. Several of these suffered from rising world input prices, especially oil, and an inability to pass on higher costs to consumers in a timely manner. Overall, SOEs made losses equivalent to 2 percent of GDP in 2000. Quasi-fiscal losses raised the debt stock of public corporations to 41 billion rupees at the end of 2001 - a colossal waste of money by any standards. The debt stock of the three main loss-making enterprises – the Ceylon Petroleum Corporation (CPC), the Ceylon Electricity Board (CEB) and the Cooperative Wholesale Establishment (CWE)---stood at Rs. 19 billion, Rs. 10 billion, and Rs. 8 billion, respectively. Between 2000 and 2001, public borrowings, including those by the loss-making state owned enterprises, rose from Rs.186 billion to Rs. 242 billion, thereby pre-empting much needed private investment.

For many years, the Government has guaranteed the loans of the state-owned enterprises to the state banks. When those enterprises were unable to honor their debts, their bad loans were assumed by the Government. Starting in 2002, the Government has begun impose a hard budget constraint on the state enterprises. This will inspire the state banks to be vigilant in providing loans and collecting outstanding obligations from them.

Increases in administrative prices of goods and services produced by public employees will help reduce losses. A switch to a pricing formula linked to world market prices for imported petroleum products will similarly reduce losses in the CPC. Tariff adjustments in other sectors will be made more automatic to prevent the accumulation of quasi-fiscal arrears.

For the largest state enterprises, including CPC, CEB, CWE, Sri Lanka Railways and Sri Lanka Posts, urgent measures are needed to stem escalating losses and halt the drain on the budget. An Energy Supply Committee has been established to oversee the restoration of financial stability to SOEs in the power and energy sector, while closer supervision will be extended to oversee SOEs in the other sectors.

The broad elements of the financial loss reduction package are: (a) improving revenue performance by raising tariffs where necessary, improving collections and reducing revenue leakages; (b) reducing recurrent costs by downsizing excess labor forces, contracting services out and selling non-core lines of business; (c) improving corporate governance by appointing independent and professional boards, hiring competent managers and making the process of their appointment and removal free of political interference; (d) limiting new borrowing to financing working capital and where necessary, financing operating deficits via budget transfers rather than new bank loans; and (e) defining an enterprise restructuring and reform strategy, consisting of corporate restructuring, the introduction of competition and, where necessary, improvements in regulatory frameworks, and possibly divestiture and contracting out of services. This ambitious undertaking is essential to safeguard public finance and will be undertaken over a period of three to five years.

Public Enterprise Reform. Government will continue to reform corporate governance of the public enterprises to ensure that they operate as competitively as possible. All SOEs will be provided with independent boards having private sector representation, open and competitive processes will be used to provide professional management, and unviable SOEs will be liquidated. In the near term, to encourage more private sector participation in areas now largely in the domain of SOEs, Government will mount a corporatization program for the Colombo Port and restructure the Airport and Aviation Services. Government will also streamline processes and approval procedures for private sector participation in BOO, BOT and similar arrangements for infrastructure and public utility investments. The management of state run rest houses will be privatized as a prelude to divestment. Private management will also be introduced to enhance the efficiency of the Hotels Corporation and the airport. Commercial activities undertaken within the airport will be privatized, with the private sector also being responsible for marketing airport services to international carriers. PERC is expected to develop a medium-term plan of SOEs to be divested and to undertake such divestitures as market conditions permit.

Monetary policy will be aimed at maintaining price stability and encouraging the development of a robust and secure financial market. Monetary policy will complement fiscal policy in achieving the desired macro-economic objectives. Government will continue to allow the exchange rate to be determined in a competitive, market-determined manner, and will intervene only to smooth out severe volatility. Indirect monetary management, primarily through open-market operations, will be used to ensure expansion of the monetary base consistent with price stability. External sector policies will aim at maintaining a sustainable reserve position. The envisaged low inflation rate and the resulting stability in the exchange market would help to correct high inflationary expectations prevailing at present.

The capital account will be liberalized gradually, cautiously and in an appropriately sequenced manner over the next decade. As part of the 2002 Budget, some of the restrictions on FDI flows have been removed, and new measures have been introduced in 2003 to liberalize offshore investment accounts. External reserves would be built up to a comfortable level by 2005. With the expected foreign capital flows, gross official reserves are expected to rise to a level sufficient to cover about 4 months of imports, while total reserves are expected to reach a level adequate to cover nearly 6 months of imports. The build up of reserves to a comfortable level would provide a protective buffer for the exchange rate in the medium term in facing external shocks. Public debt and external debt would be gradually brought down to a sustainable level in the long run. The high growth in exports and services and income receipts would reduce the external debt service ratio to 10 per cent by 2005 from the 13 per cent registered in 2001.

The Central Bank remains committed to using a suitable mix of monetary policy and financial market instruments to foster price stability and ensure prudential soundness in the financial markets. The restructuring of the Central Bank will enhance the effectiveness with which this mission is carried out. This will involve fundamental changes in organization and human resources, implementation of a Voluntary Retirement Scheme, and automation of the payments system through introduction of a real time gross settlement system. Government will expand open market operations, improve securities market regulations, and introduce scriptless and electronic trading systems, and other support for e-business. Monetary policy making will be made more accountable and transparent by increasing the membership of the Monetary Policy Board and Monetary Policy Committee; by including private sector representatives in the Committee; by announcing monetary policy decisions within one day of the Committee meetings; and by publishing minutes of those meetings.

The following legal reforms are also expected to have a far-reaching impact on the monetary system:

- Replacing the outmoded laws with modern architecture for the growing financial sector, which will include a new CBSL Law and a new Banking Law.
- Integrating the Sri Lankan economy with the global economy through enactment of a new Monetary Exchange Management Law (to replace the existing Exchange Control Act) and through preparation/implementation of a strategy to move towards an open Capital Account.

III. Structural Policy Reform

Public policies will need to become ever more conducive to socially-progressive private sector initiatives in order to increase the economic growth rate, reduce vulnerability by diversifying economic activity and foster higher rates of productivity growth. The Government is fully committed to a set of trade, sectoral and structural policies to support economic growth and poverty reduction. Public policies have been designed in full consultation with stakeholders to promote ownership and social cohesion.

Trade and Investment Policy Reform. Sri Lanka's economy is highly open, with total trade equivalent to more than 70 percent of GDP. The economy is bound to become even more exposed to international markets as regional and multilateral trade accords broaden Sri Lanka's market access. The Government is committed to reducing trade protection and establishing a two-band tariff system. Tariff surcharges, established in response to the 2001 petroleum shock, will be phased-out. Import monopolies on petroleum products will be eliminated and greater stability and predictability will be restored to the trade regime for foodstuffs.

A bilateral Free Trade Agreement (FTA) has been reached with India. By 2006, when this is fully implemented, some three-quarters of all goods will be subject to free trade with India. Since India is expected to be a low-cost trading nation, this essentially implies that a considerable share of Sri Lanka's external trade will be on a near duty-free basis. The number of import items facing zero-tariff will be increased over time to facilitate implementation of this accord. A bilateral Free Trade Agreement (FTA) is in the advanced stages of negotiation with Pakistan. At the same time, Sri Lanka will continue to pursue free trade accords with other South Asian nations and honor its commitments to free and fair trade under the WTO.

Government involvement in domestic marketing and price administration for consumer goods impedes the development of the domestic services sector. Rather than protect consumer interests through public marketing, price and trade restrictions, Government will develop new Consumer Protection legislation and establish a Consumer Protection Authority to enhance competition and safeguard consumer protection. Once established, this Authority will replace the Fair Trading Commission and the Department of Internal Trade.

Commercial Legal Reform. Government will modernize the regulatory environment to facilitate both the entry and exit of businesses. Towards this end, Government will introduce appropriate bankruptcy legislation that will protect creditor interests and facilitate and orderly exit of failed firms; and amend the Companies Act to facilitate the creation and registration of new businesses. A Land Ownership Act will be prepared to clarify property rights in land and the operation of the land market. A Consumer Affairs Authority Bill will be promulgated to enhance consumer protection and ensure that Sri Lanka’s products are of a quality standard acceptable in global trade.

Labor Market Reform. Sri Lanka’s labor market is highly distorted due to outdated laws and regulations, which are impeding investment growth, job creation and business expansion. One of the main challenges in the process of labor market reform is to balance the urgent need for increased flexibility with the need for protection of the workforce. Labor market reforms are a complex exercise and has a major link with poverty, as job losses could potentially bring displaced workers back into the margins of poverty. Genuine and constructive social dialogue has taken place to identify ways of making the labor market more flexible while protecting workers rights. Towards this end, Section 68 of the Factories Ordinance Act of 1942 was amended in 2002. This Act, which restricted the number of overtime hours for female employees to 100 hours per year, was amended to relax the overtime limit to 60 hours per month. The Industrial Dispute Act of 1950 will be amended. This amendment will make it mandatory for labor tribunal cases to be completed in 120 days, arbitration cases to be completed in 60 days and termination applications coming before the Labor Commissional General to be processed in 30 days. In addition, Government will pass an Employment and Industrial Relations Act with a view to enhancing the flexibility of the labor market, promoting the upward mobility of labor, and increasing labor productivity. Amendments to the Termination of Employment Act (TEWA) No. 45 of 1971 will set specific time limits for the processing of labor dispute settlements and the arbitration and termination of involuntary labor. These efforts to reduce delays will be limited to the establishment of binding formulas for the compensation of involuntarily terminated labor. The Industrial Disputes Act will be revised to promote less contentious collective bargaining. The Factory Ordinance will be revised to permit more overtime employment. Wage Boards will be restructured and uniformity in holidays and leave between the public and private sectors will be secured. Social dialogue between government, workers and employers organizations will continue to ensure harmonious implementation of labor market reforms and to seek further improvements in labor relations, laws and regulations.

Financial Sector Reform. In spite of some improvement, the soundness of the banking system remains a cause for concern because of the weakness of the two state commercial banks. Wide spreads between borrowing and lending costs, a high share of non-performing loans, under-provisioning and a large number of directed credit programs characterize the operations of the state commercial banks. Government is restructuring the state-owned banks by introducing professional management and independent boards; resolving non-performing loans, increasing compliance with prudential regulations and encouraging management to enhance operational performance. Efficiency will be improved through branch downsizing, financial and operational restructuring, setting of key targets for cash collection, reduced levels of non-performing loans, and improved financial ratios. The relationship among the two state banks, the Government and the public corporations will be revisited, revamped and made more transparent. Currently, about two-thirds of the transactions of the two state banks relate to the transactions between Government and public corporations. Special measures will be taken in the case of the People's Bank. It will be converted to a public company and its assets and liabilities will be valued. If it possible to divest it as a single unit, that will be done. If not, the Bank will be split into a commercial bank, a savings bank and an asset management unit which will workout the bank's non-performing assets. Thereafter, the commercial bank portion will be divested as expeditiously as possible.

To foster competitive financial sector development, opportunities for foreign investment and ownership in the insurance and brokerage sectors will be enhanced. Full foreign ownership of securities brokerage firms will be allowed, and foreign investors will be allowed to invest in domestic mutual funds. A regulatory authority for the insurance industry has been established and restrictions on the operations of private insurance companies are being eased. The jurisdiction of the Securities and Exchange Commission will be extended and its authorities increased to cover intermediaries such as securities underwriters, margin providers, credit rating agencies, investment managers and clearing houses. Stockbrokers will be allowed to be listed on the exchange and restrictions on brokers that limit their ability to expand operations and diversify their services will be eased. The CSE will formulate and enforce obligatory standards of performance and service provision from its member, particularly with regards to capital requirements, human resource availability and the quality of services provided. In addition to the commercial banks, other non-bank financial institutions will be licensed to provide off-shore banking services and new products will be introduced to increase the maturity structure of off-shore dollar deposits in the banking system. A pension reform program will be mounted, which liberalizes investments that can be held by private pensions and the provident funds. A Superannuation Benefit Funds Regulatory Act will be enacted, as well as a Financial Services Act (FSA) to develop a system for regulating the securities market, insurance and private provident funds; improving accounting and auditing standards; and preventing money laundering. Improved management of the state-operated pension schemes (EPF & ETF) will be encouraged through mergers, private fund management, some foreign portfolio investments, improved collection and management reforms to reduce evasion.

Power Sector Reform. The urgency of the power situation demands that special attention be devoted to this sector. The events of 2001 and 2002 demonstrate that hydropower cannot be relied on to provide a large share of generating capacity, particularly in periods of uncertain rainfall. In the near-term, the Government has accelerated the completion of on-going investments to expand generating capacity. Government has also increased the amount of energy purchased from non-traditional, private providers to add approximately 100 MW of grid capacity.

The CEB has prepared a long-term power generation plan[6]. If this plan is diligently implemented, power shortages will no longer hamper national development. In line with this plan, the Government has completed the commissioning of the 165 MW Combined Cycle Power plant at Kelanitissa in August of 2002. Government will expedite the implementation, by the private sector, of a 165 MW Combined Cycle Power plant at Kelanitissa by mid-2003. Government will also accelerate the construction works of the Kukule hydropower project in order to commission the plant by the end of 2003. The Government's strategy for the development of the power sector in the medium term (2002-05) also includes the establishment of a 2x150 megawatt combined cycle power plant at Kerawalapitiya. This combination of measures will ensure that power shortages do not reoccur over the next four to five years. Thereafter, Government is initiating a 150 MW Upper Kotmale hydropower project, and is assessing the feasibility of a 300 MW Coal fired thermal power plant to optimize alternative fuel sources.

A coordinated effort has been launched to overcome the power crisis. An Energy Supply Committee was created with a two-year mandate to overcome immediate power shortages and to make improvements to the legal framework for overriding the Electricity Act, the CPC Act and other acts which concern power,

[6] Ceylon Electricity Board, 2001, *Long-Term Generation Expansion Plan*, 2002-2016.

with a view to ensuring a stable and reliable power supply in the future. More private sector participation in the power sector, a rational tariff structure and greater competition are needed to put an end to power crises once and for all.

The power sector is dominated by the Ceylon Electricity Board (CEB), which together with its subsidiary, the Lanka Electricity Company (LECO), and three independent power producers, comprise the industry in Sri Lanka. CEBs tariffs have not keep pace with rising costs and high growth in demand. CEB recorded large losses of Rs. 4.3 billion in 2000 and Rs. 10 billion in 2001. CEBs cash position continues to worsen as demand grows, rainfall in the catchments remains below average, fuel prices remain high, and emergency measures are taken to maintain supply. The growing demand for power is barely being met as a result of delays in building efficient new generating capacity. Unless corrective action is taken, power shortages will increase in frequency. Between 2001-2007, some $250 million per annum will be needed to increase and upgrade system capacities, much of which must come from the private sector. Government will contribute about $50 million per annum to finance the transmission and distribution of power to poor, rural areas, equal to roughly one-quarter of the above amount.

The main objective of the Government's energy sector reforms is to restructure the industry into a number of commercially managed entities that are well governed and managed and mandated to focus on the delivery of higher standards of service to customers at least cost. An Energy Supply Committee will guide the reform of the power sectors. The goals of these reforms are to ensure that energy demands are met in a competitive manner; that the financial health of the energy sector is restored; that transmission losses are reduced; and that reliable power services would continue to be provided. A new Electricity Act has been promulgated in 2002, which will unbundled the power sector in the areas of generation, transmission and distribution, allow for the creation of an independent regulator, and provide a transparent solution to power purchasing and selling problems. A multi-sector regulatory bill provide the legal basis for a Regulatory Commission, that will issue licenses and introduce procedures for "automatic" adjustment of tariffs in response to pass-through items (taxes and fuel costs). The Regulatory Commission is to be operational by 2003.

Under the new power sector structure, CEB and LECO's generation functions will be unbundled into a series of commercial, generation companies. The transmission functions will likewise be unbundled into a transmission company, with separate subsidiaries for the transmission company and the purchase/sale of bulk power. Distribution functions will also be unbundled into three or four distribution companies. CEB and LECO will be financially restructured, with the cooperation of their lenders and they shall continue to improve their business practices during the period of reorganization. A financial restructuring plan for the power sector will be prepared and will include measures aimed specifically at addressing CEB's cumulative cash deficit through 2003. Thereafter, CEB is expected to operate on a sound financial footing, and Government will ensure that its accounts payable for electricity do not adversely affect the financial position of CEB. Government will maintain a lifeline tariff policy to ensure that a basic allotment of electricity is available to the poor. Over and above the lifeline level, the Regulator will set and supervise a market-oriented energy pricing policy.

In the petroleum sector, the monopoly of the Ceylon Petroleum Corporation will be eliminated. At least two new companies will be provided import licenses, and petroleum tariffs will be set on a monthly basis, in line with movements in world market prices.

4. Reducing Conflict-related Poverty

Sri Lanka is firmly emerging from a two decade long civil conflict. The Government of Sri Lanka and the LTTE signed a Memorandum of Understanding (MoU) on February 23, 2002 which established a formal cease fire. The internationally monitored ceasefire has fostered an environment conducive to fostering a peace settlement. The military has vacated public buildings in the Northeast while the Government has lifted the economic embargo on LTTE-controlled territory. Paramilitary groups have been largely disarmed and agreement has been reached that the civilian population will not be harmed.

Peace negotiations commenced in Thailand on September 16,2002. The government and the LTTE discussed reconstruction efforts in the North East Province and the return of internally displaced persons to their original homes. The Government and LTTE agree to set up a six member joint task force to oversee humanitarian and reconstruction activities in the North East. The immediate priorities of the task force are to accelerate humanitarian mine action and accelerate the return of internally displaced persons.

Two decades of conflict have taken a heavy toll on all segments of Sri Lankan society. The war-affected areas and nearby villages in the North and East are the most disadvantaged in terms of households' ability to obtain a secure livelihood because of loss of life, assets, or displacement, or as a result of the deterioration of infrastructure, irrigation systems, and roads. Among the more severely affected groups are the displaced, who have lost productive assets and land, as well as social capital. The impact of the war goes beyond the war-torn areas to affect the rural poor in particular. Poor rural youth on both sides of the conflict are faced with fewer opportunities to better their lives; they make up a substantial share of the soldiers fighting the war. Ethnic minorities face discrimination, both real and perceived, making conflict resolution and ethnic reconciliation central to poverty reduction in the decade to come.

I. Peace is the Key

Peace is the key to reducing conflict-related poverty. Restoring peace is the single most important challenge facing Sri Lanka at the start of the new millennium. A three pronged strategy is being followed to solve the conflict. This includes negotiation of a political settlement, advancement of a political and constitutional framework that fulfils the aspirations of all, and expediting development in war-torn areas.

The transition from conflict to a durable peace has already begun. The cease-fire has been in place since February 2002. The main road to Jaffna was opened after a gap of twelve years. Travel to Jaffna and Trincomalee is proceeding unimpeded, resulting in a manifold expansion of commerce and civilian contact. Agriculture and fisheries output in the North has begun to recover, boosting incomes and adding to the supply of goods in local markets. In August 2002, the first Jaffna Trade Fair in nearly two decades was conducted, attracting businessman and overflowing crowds from throughout the nation. Reconstruction activity is accelerating, aimed initially at restoring essential social services and resettling internally displaced households. But the peace process is far from complete. In addition to a mutual cease fire and a process of political negotiation, ultimately this will require military demobilization, resettlement and relocation of displaced persons, de-mining and other efforts to make the war-torn areas habitable, and the implementation of a major rehabilitation, reconstruction and reconciliation program.

Although the timing of a negotiated peace remains uncertain, Government has initiated a post-conflict planning exercise to ensure that the transition from the conflict to a lasting peace is as rapid and effective as possible. Towards this end, Government will develop strategies and mechanisms to assist in the reintegration of demobilized soldiers, ex-policeman and former combatants, to prepare for the transition to peace. Government has already initiated a de-mining program in the affected areas. Parallel activities include creating an efficient mine action capacity, developing mine awareness programs and training mine clearance personnel.

The eventual reconstruction of war-ravaged areas in the Northeast will be a major undertaking. Government's strategy is to be continuously prepared to face this tremendous challenge so that, once political and security conditions permit, sufficient external financing can be quickly mobilized and reconstruction activity can take place in an expeditious manner. Preliminary plans have been prepared for the reconstruction of economic and social infrastructure in the war-torn areas, in cooperation with local authorities and communities. The development partners have been requested to more clearly review these plans and assess needs so as to lay the groundwork for post-conflict planning in the affected areas.

Government initiated a wide-ranging process of stakeholder and community consultation to identify strategies for improving the effectiveness of relief, rehabilitation and reconciliation efforts. Extensive stakeholder consultations, involving government agencies, donor representatives, community groups and, most importantly, those directly affected by the conflict in the North and border village areas, were held starting in 1998 (see Box 4.1). Government will continue to maintain the RRR dialogue process in the search for more effective partnerships for peace. A National Coordinating Committee for Relief, Rehabilitation and Reconciliation has been created, which reports directly to the Prime Minister. That Ministry has continued the consultation process, and strives to ensure that reconstruction efforts are undertaken in a pace and manner that contributes to forging a lasting peace. The RRR findings were presented by the Government to the donor community in a Development Forum in June 2002[7]. The key recommendations generated by the RRR process are shown in Annex 5. It is important to view the PRS in conjunction with the RRR Framework document in order to get acquainted with the full range of actions being taken by the Government to reduce conflict-related poverty.

II. More Effective Relief for the Victims of the Ethnic Conflict

Unlike conflict situations in many other countries, the Government has from the start recognized its obligations to the affected population and is committed to providing humanitarian relief and essential services to those living in the war-torn areas controlled by opposition groups and to families that have sought refuge in secure areas. It is committed to reconstructing damaged and destroyed assets and to promoting reconciliation among the communities. Public services in education and health continue to be provided through district administrations. Banking and postal operations are maintained and there is limited and controlled movement of persons and goods between cleared and un-cleared areas.

The Government's commitment to relieving the immediate burden on those most immediately affected by the conflict is demonstrated by expenditure totaling over Rs.50 billion for life-saving support and programs to alleviate hardship among the affected populations in the 1990s; many billions of rupees have been paid as compensation to persons for bodily injuries and to families who have lost family members and their properties. The international community has responded by providing generous assistance to reinforce Government's determination to lessen hardship among people exposed to the conflict, to support the rehabilitation of persons and communities, and to create an environment conducive to reconciliation.

[7] The findings were presented in Government of Sri Lanka, 2002, National Framework for Relief, Rehabilitation and Reconciliation, Colombo.

Box 4.1: Developing a Framework for Relief, Rehabilitation and Reconciliation (RRR)

A consultative process to develop a Framework for Relief, Rehabilitation and Reconciliation (RRR) was initiated by the External Resources Department in July 1999. A wide-ranging consultative process was organized to bring together government, civil society, individuals, and communities—including the donor community—to identify ways to work together to improve relief, rehabilitation and reconciliation efforts.

The objectives of the RRR Framework are to help strengthen Sri Lanka's capacity 1) to ensure that the basic needs of people affected by conflict are met; 2) to rebuild productive livelihoods where feasible; and 3) to facilitate reconciliation across ethnic lines. All donors, international agencies and NGOs represented in Sri Lanka contributed in different ways. To respond to the needs of all stakeholders, an inclusive consensus-building approach was used during the process. Although it focused on the Northeast, the Framework extended to the entire country.

Several mechanisms were put in place to advance the process, including (i) conducting consultative workshops organized by the Consortium of Humanitarian Agencies in 11 districts, including the Northeast; (ii) conducting sectoral workshops, concentrating on pre-identified populations affected by the war (ex-combatants, children, the education sector); and (iii) preparing workshop reports on how the war has affected people's lives and offering the people's views on how war-related issues and the conflict might be addressed. This information, along with background papers by experts, were the foundation for the RRR Framework and for many of the reform measures planned by Government to reduce conflict-related poverty.

A steering committee provided leadership for the Framework process and ensured that critical linkages are maintained between key decision-makers in government, civil society, and the donor community. The working groups were convened and hosted by officials of the Government. They brought together government officials, donors, NGO representatives, and academics who have had frank discussions of the rich information collected during the process. Prior to the Development Forum in Paris in December 2000, the four working groups formulated interim recommendations that ultimately became part of the Framework. These recommendations are now being further refined and developed into operational programs and institutional reforms.

The RRR Framework and the draft PRS were published simultaneously and the former is being updated to take into account the implications of the cessation of hostilities in the North and East for post-conflict management.

Despite these constraints, Government has undertaken a number of measures to enhance the effectiveness of relief and rehabilitation efforts. In 1996, the Resettlement and Rehabilitation Authority of the North (RRAN) was created to focus program interventions in the north. A Commissioner General of Essential Services (CGES) was appointed to ensure that supplies reached the North and East.

Movement restrictions and restrictions on certain economic activities have sometimes been necessary to ensure national security, but they may inadvertently inhibit economic activity and impede the effective delivery of relief supplies. To ensure that adequate relief supplies can reach those in need, the Prime Ministers office, on January 15, 2002, lifted the embargo on goods in the North, except for seven banned items and four restricted items. The Ministry of Rehabilitation, Resettlement and Refugees (MRRR) has appointed committees to coordinate and monitor the lifting of movement restrictions, with the aim of ensuring the free flow of essential goods. To accommodate increased overland traffic, the Road Development Department of the Northeast and the Road Development Authority has begun to effect repairs on the road between Vavuniya and Mannar. Air travel between Colombo and Jaffna is too expensive and the number of flights, insufficient to accommodate demand. Government will increase the frequency and capacity of transport services to and from Jaffna to accelerate return to normal conditions. With the signing of the MOU with the LTTE on February 23, 2002, Government has agreed that:

- Restrictions on economic activities will be systematically withdrawn
- The A9 route to be rehabilitated on an urgent basis
- Restrictions on flights by private companies will be withdrawn
- Restriction of free movement (i.e. issue of passes) withdrawn

By mid-2002, these agreements have been substantially completed, boosting economic activity and substantially easing the process of providing relief to conflict victims.

The interface between civilian development and national security policy is a difficult one to manage, particularly with shifting battle lines. But clear, forthright and focused communication, especially between humanitarian agencies and the security forces in essential to ensure that relief and rehabilitation services can be provided as effectively and efficiently as possible. To facilitate effective dialogue, the National Coordinating Committee on Relief, Rehabilitation and Reconciliation will provide a forum for resolving constraints in the delivery of essential goods and services and for ensuring wider participation in addressing the concerns of the civilian administration in respect of security issues.

In 1998, a Unified Assistance Scheme was introduced to provide cash grants, loans and materials to families or persons who have endured injury or loss of life or property damage due to ethnic violence, insurgency and civil unrest. Government will review and revise relief and assistance packages, with the aim of better linking food assistance to nutritional norms and the prevailing level of food costs. Government will also review and revise the Unified Assistance Scheme with the objective of adjusting entitlements to reflect present reconstruction cost conditions. First steps have been taken towards this objective with the payment of compensation under the Unified Assistance Scheme to families in the uncleared areas. Other shortcomings of the Unified Assistance Scheme will also be addressed.

Some 600,000 persons were displaced internally by the conflict, and it is estimated that 186,000 have returned home between February and October of 2002. The sooner that poor, internally displaced persons (IDPs) can be resettled or relocated from the centers, the sooner they can begin to rebuild their lives. The tendency for residents of camps and welfare centers to become passive recipients of handouts from relief agencies should be counteracted by every means. Towards this end, Government will implement an urgent program aimed at accelerating the return of IDPs from the welfare centers. This will involve three major initiatives: (i) de-mining activities will be accelerated to ensure that areas are habitable for human settlement; (ii) welfare center inhabitants will be provided funding under the Unified Assistance scheme to finance initial resettlement costs, mainly related to reconstructing low-cost shelter; and (iii) a post-conflict trust fund will be provided to finance the cost of restoring agriculture and micro-enterprise activity so that families can begin to earn the income required to meet their basic needs. Government is seeking donor financing, on an urgent basis, to meet the extraordinary budget requirements arising from the historical opportunity to safely reunite IDPs to their homelands.

III. Fostering Rehabilitation

The indefinite cease-fire and removal of movement restrictions, which have been in operation since the signing of the MOU, have set the stage for rehabilitation efforts. However, even with the achievement of peace, there will not be an instantaneous economic revival in the North and East. A major effort will be required to make the environment safe (from land mines, in particular) for economic activity and free movement of the population.

Efforts to lessen hardship among conflict victims face numerous constraints: railway and trunk road connections through the Northern Province are broken; the power supply from the national grid is cut off and telephone links are non-existent; and markets and trade between conflict and adjacent areas have been reduced to a small fraction of normal economic exchange. A short-term program for the rehabilitation of Jaffna includes the following priority sectors: power supply, transportation (roads, railway tracks, KKS harbor), telecommunications, health and education. The people of the North East also face the burden of taxation, which can be alleviated once a proper interim administration is established and LTTE is brought into the economic mainstream.

Rehabilitation of the North and East must be conducted in a manner that reflects the concerns and capacities of all stakeholders. Careful attention must be paid to ensure that the manner in which rehabilitation is carried out does not inadvertently aggravate ethnic tensions. The National Coordinating Committee on Relief, Rehabilitation and Reconciliation is charged to ensure that that uniform strategies, programs and procedures are adhered to by all stakeholders, that adequate financial resources are made available, and that the overall humanitarian situation is regularly assessed. Government will also establish in all districts affected by the conflict, District, Division and Village Coordinating Committees with the objective of enhancing rehabilitation opportunities and ensuring that such policies are clearly defined and effectively implemented.

Many government agencies are involved in restoring essential economic and social services, and fostering small-scale income generation activities. The Ministry of Rehabilitation, Resettlement and Refugees (MRRR), the Ministry of Eastern Development and Muslim Religious Affairs (MEDMRA), Samurdhi, and the Northeastern Provincial Council are all undertaking a range of small-scale rehabilitation activities. MRRR is issuing seeds and raw materials for micro-industries, providing training, tools and machinery for self-employment projects, issuing livestock, fishing nets and boats for fisherman, providing power for lift irrigation and supporting a revolving loan scheme for self-employment. MRRR is also implementing a major recruitment program for pre-school teachers and primary healthcare volunteers. MEDMRA is developing a range of economic infrastructure, fostering agricultural development, augmenting social services and rebuilding conflict-damaged infrastructure in the East. The Provincial Council is concentrating its efforts on rehabilitating small-scale irrigation facilities, reconstructing provincial roads, rehabilitating government schools and repairing hospitals and other health facilities. A major effort is also being made to increase recruitment and enhance recurrent cost spending for basic social services in the North and East.

Government agencies, the LTTE, ADB, WHO, JBIC, GTZ and World Bank have conducted three joint donor rapid needs assessments for education, health and water supply. In the education sector, the Provincial Department estimates that approximately 15,300 classrooms need repair and there are some 4,100 teachers who are unevenly deployed. In rebuilding the education sector, priority is to be accorded to the poorest districts and to the areas where the largest number of beneficiaries are located. In the health sector, there is an estimated shortage of some 3,300 health care personnel and insufficient supply of essential drugs. Established health surveillance systems have broken down; malaria and cholera are resurgent while psychological trauma and conflict-related physical disability are pervasive. Initial reconstruction efforts will focus on restoration of the primary health care system at the district level and the multi-disease surveillance system in the North East. Donor assistance is also being mobilized for the urgent reconstruction of hospitals. With respect to drinking water, the pre-conflict system of rainwater harvesting, lagoon barrages and solid waste management in the Jaffna peninsula has been largely destroyed. This has led to declining levels of the water table, salinaton of ground water aquifers and aquifer contamination. Water supply access will be provided as part of various community water supply programs and emergency repairs will be conducted in Jaffna as well as, initially, in Kilinochchi, Batticaloa, Vavuniya and Amparai districts.

Government is mobilizing international support for a wide-range of rehabilitation efforts. With the support of the World Bank, communities in the North are receiving assistance to rehabilitate small-scale irrigation systems and village roads and being provided with key agriculture inputs to raise food production levels. The World Bank has also provided an emergency reconstruction credit to provide livelihood assistance for returning IPDs and to restore access to essential health, education and water supply facilities. With the assistance of the European Union, Government plans to rehabilitate a number

[8] See North East Provincial Council, 2001, *Poverty Reduction Strategies and Investment Program 2002-2005*, Trincomalee. MRRAN, 2001, *Rehabilitation and Development for the North*, 2002-2005, Colombo and Ministry of Development, Rehabilitation, Reconstruction of the East and Rural Housing Development, 2001, *Update of Six Year Development Program for the Preparation of the Poverty Reduction Strategy Paper*, 2002-2005, Colombo.

of fish harbors and cooling plants to enable a resumption of artisanal fisheries activity. With the support of the German government, the water supplies for Jaffna have been restored and a number of schools rehabilitated. With Asian Development Bank support, essential water supplies and health facilities will be repaired in a number of both cleared and uncleared villages. A combination of community participation and careful consultation with all civilian and combatant stakeholders will be central to each of these rehabilitation efforts.

Government is fully supportive of all efforts to restore essential services and enhance opportunities for productive employment in the Northeast. In October 2002, a Master Plan for the rehabilitation of the war torn Northern Province was released by the Ministry of Rehabilitation, Resettlement and Refugees. This called for an estimated US$500 million in assistance to finance resettlement, infrastructure repair, provision of drinking water and the establishment of health services.

It will be difficult for Government to finance urgently required reconstruction efforts in the North and the East from its own budgetary resources. External financing will be required if the humanitarian needs of the North and the East are to be met. The donor community has indicated a willingness to assist in the reconstruction of the North and the East. A reconstruction needs assessment is due to be completed by the end of 2002. A special donor's group meeting will be held in 2003 to mobilize support for this effort.

Government and its donors alike appreciate that the public debt overhang precludes a major expansion of external borrowing at this point in time. By the same token, a failure to act quickly and forcefully to reconstruct the North and the East could undermine the positive momentum peace negotiations have afforded. Accordingly, Government will endeavor to mobilize grant resources or soft-loans on extraordinarily concessional terms to finance reconstruction efforts. Moreover, the financing requirements for reconstructing conflict-damaged zones shall be treated separately in the budget, to ensure that the extraordinary mobilization of grant assistance for reconstruction purposes does not violate Government's statutory requirement to contain the fiscal deficit.

IV. Investing in Social Harmony

The civil conflict, which has spanned nearly two decades, has fractured Sri Lankan society along ethnic lines and made the rebuilding of social harmony a daunting task. The Government is cognizant of the harm done by discriminatory policies and has taken measures to correct these biases[9]. Still, perceptions of bias remain, and Government has to take cognizance of the fact that communities that lived in friendship for centuries are now divided and face the unfortunate agony of war and mistrust. Peace-building efforts in the interim period can help address some of these grievances.

In any political or social conflict, reconciliation is a challenging and difficult process, as the bases for trust and collective activity have been eroded and remain fragile. Reconciliation initiatives tend to be disparate and disjointed, and NGOs, CBOs and the private sector have an especially important role to play in this process. "Sri Lanka First" is a slogan that is already being promoted by the private sector. Government is firmly committed to combating discrimination in all its forms and to fostering a process of ethnic reconciliation.

One immediate measure that can help foster ethnic reconciliation is to ensure that all citizens have ready access to identity cards. Delays in issuing identity cards for large numbers of internally displaced persons, as well as other members of the minority community, have hindered movement and access to public services. Government will mount a special effort aimed at expediting the provision of identity cards, particularly to conflict-displaced persons and Estate workers. Over the next few years, Government will introduce a computerized system to issue trilingual identity cards for ensuring equivalent identification procedures for all citizens.

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[9] The 1987 amendment to the Constitution made both Sinhala and Tamil official languages, and the 1977 university quota system is now weighted more equitably.

Better protection will be offered to all citizens against human rights abuse. The Ministry of Justice, in consultation with the Human Right's Commission, will establish district ombudsmen in the conflict-affected areas to register and act upon reported infringements of human rights.

Changes will also be made to the existing formal education structures to inculcate values consistent with mutual trust and understanding. In areas where more than one ethnic group is located, Government will promote multi-ethnic (multi-language) schools where more than one ethnic group is located. If new schools are established in mixed urban and rural areas, including estates, such schools will be multi-ethnic and instruction provided in both Tamil and Sinhala. Certain textbooks contain material that may be considered biased in terms of their treatment of ethnicity, religion and other identities. The Ministry of School Education and the National Institute of Education (NIE) will expand the Textbook Review Committee to include multi-ethnic and multi-denominational scholars with experience in social harmony development to review and revise these texts.

Even if good schools and textbooks exist, they are unlikely to play a positive role if teachers are not properly trained to take into account the nation’s multi-ethnic and multi-religious reality. Future teacher training initiatives will include skill and pedagogic development appropriate for serving in a multi-ethnic and multi-religious environment. No new ethnically segregated teacher education institutes will be established in the future. Moreover, those that exist in mixed areas will be reorganized in line with the policy of integration. University curricula will also be expanded to include training in ethnic reconciliation.

The Constitution provides for equality in the use of Sinhala and Tamil, but these provisions need to be more rigorously enforced. Government will continue to maintain an incentive scheme aimed at rewarding officials proficient in several languages. A program for the use of English in the secondary school system as a link-language for diverse ethnic groups is being implemented.

Translation from one language to another is recognized as having a significant social and political function. Government will expand and upgrade the Translator Services and transfer this function to the Ministry of Justice, Law Reform and National Integration. The need for translation is particularly important for the administration of justice. The dearth of trained and competent court interpreters causes significant delays in court proceedings. The Official Languages Department, in consultation with the above Ministry, will increase the number of trained court interpreters to address this problem.

Frequent inter-action and exchange amongst communities of differing ethnic and religious character is essential for promoting a broader appreciation of the tremendous value inherent in all cultures and religions. The removal of travel restrictions in 2002 has done much to improve mutual understanding. Interaction between people of various regions has served to demonstrate the enormity of the reconstruction challenge - a challenge that will require both tolerance and understanding. Inter-cultural social, business and cultural events serve to foster a sense of mutual understanding and national identity. Government will encourage non-governmental and community organizations to hold such events, particularly in areas of mixed ethnicity.

5. Creating Opportunities for Pro-poor Growth

Economic growth is necessary for poverty reduction, but it is no guarantee that poverty will be reduced. While Sri Lanka's economy grew by some five percent per annum in the 1990s, much less progress was registered in poverty reduction. International experience suggests that economic growth can be a powerful engine for poverty reduction if the poor are provided opportunities to participate in the growth process. Government will pursue a number of strategies aimed at widening opportunities for the poor to participate in the growth process. As noted in chapter 3, one of the main ways in which pro-poor growth will be promoted is by ensuring a stable macro-economic environment and a structural policy environment that promotes private-sector led development and Sri Lanka's integration into the global markets. Over and above this, the Government will help widen opportunities for the poor to participate in the growth process by:

- Enhancing connectivity, to close the transport and information divide, between poor communities and dynamic markets;
- Revitalizing rural development;
- Promoting development of small and medium-scale enterprises;
- Increasing employment and mainstreaming poverty reduction objectives in sectoral development strategies; and
- Incorporating participation and empowerment in approaches aimed at assisting poor regions directly;

I. Connecting Poor Regions to Dynamic Markets

a) Connectivity: The Infrastructure Agenda

One of the main reasons for the great disparity in regional poverty levels is that the poorer regions are isolated from rapidly growing domestic and international markets. Overall improvement in transport can contribute to economic growth that leads to poverty reduction; individual transport improvements also improve poor people’s access to economic opportunities and services, and reduce the cost they bear for using transport services.

Even areas in which heavy investment has been made to enhance agricultural productivity (i.e. Mahaweli), the links between production centers and major urban and international markets are very weak. Substantial investment has been made in roads over the past four decades, but most of it has been concentrated on small, rural access roads rather than roadways that provide rapid access to major urban markets.

One of the Government’s main challenges is to effectively link poor regions to rapidly growing domestic and international markets. During the 1990s, infrastructure investment was less than 2 to 3 percent of GDP per annum, with actual investment barely sufficient to keep pace with the normal wear-and-tear on already existing structures[10]. To increase infrastructure investment, Government strengthened its public procurement management system and introduced several programs aimed at encouraging private sector participation through BOO and BOOT type projects. In the coming years, a significant increase in both public and privately financed infrastructure investment will be needed to meet the demand-backlog and to forge a well-integrated, competitive national marketplace. Linking poor regions to dynamic national markets will be accomplished by a spatial integration strategy that focuses on six main pro-poor transport and communication initiatives:

- upgrading the port network
- building a national highway and integrated road network
- enhancing the performance of the bus system

[10] The World Bank, *Sri Lanka: Country Assistance Note, November 1998* notes that “Infrastructure development was and, with the exception of telecommunications, remains grossly inadequate.”

- modernizing the railways
- improving access to telecommunications facilities
- Bringing internet to the countryside

Ports. An efficient well managed port reduces costs that eventually benefit the poor in terms of improved product prices and access to global markets. Government aims to expand total container handling capacity from 1.75 million TEU to 2.89 million TEU by the year 2005, and to 4 million TEU by 2007 while doubling general cargo handling productivity. The long-term objective is to develop the Port of Colombo as the leading shipping center and hub port in South Asia, supported by a number of regional ports. Since 1998, growth in transshipment handling has been sluggish due to the delay in providing additional capacity. The opening of new ports in neighboring countries and the global economic slowdown have also adversely affected throughputs. Port productivity, measured in terms of TEUs per employee, has dropped significantly in recent years due to a significant increase in the workforce of the Sri Lanka Ports Authority. Enhancing port capacity and productivity can have a significant effect on poverty reduction by expanding employment opportunities in construction and export- and import-related enterprises, by lowering the costs of traded goods, and by inspiring higher levels of capital investment and private economic activity. A recent poverty impact assessment of the Colombo South Harbor Development Project finds that this project alone–by lowering costs and expanding economic opportunities - could reduce poverty by as much as five percent during the decade to come[11].

Major investments have already been made to deepen the harbor basin and to expand the container capacity of the Colombo Port by improving the North Pier – Unity Container Terminal. With private sector participation, a program aimed at upgrading port capacity by widening the Queen Elizabeth Quay has been launched. A feasibility study is examining the viability of developing a second, southern breakwater and with it a southern harbor, a particularly major public sector investment. The Galle port is to be developed for break bulk cargo and to relieve pressure on the Colombo Port. This will involve construction of a breakwater, terminal facilities and dredging of the harbor basin and entry canal. To strengthen the regional ports, over the longer-term, Hambantota is to be developed as a major port and, when peace is secure, the Trincomalee port will be upgraded. Major on-going port development programs include: (i) the Elizabeth Quay Development Project which, with private sector investment, will provide three new berths and expand throughput capacity of this facility up to one million TEU per year; (ii) the North Pier Development Project which will expand capacity by 230,000 TEU per year; and (iii) the South Harbor Development Project, which will include breakwater construction, dredging the harbor and preparing the quay walls for deep draft berths in container terminals. This last project will be undertaken with both private and public sector support.

Management of port operations will be dramatically improved. Participation of the private sector in port upgrading and management will be actively encouraged to inspire high standards of management and efficiency in port operations. A regulator of ports activity will be introduced as private sector involvement increases, to foster competition and to encourage fair treatment of different entities involved in operating port infrastructure.

Building a Modern Road Network. Large numbers of rural households are trapped in poverty because the high transport costs and delays posed by the road transport system make it uneconomic for them to market their produce in the more affluent urban markets. Although Sri Lanka has a very high secondary roadway density, a large part of it remains sub-standard, badly congested and unable to meet the rising demand for competitive overland transport. Most roads were built more than 50 years ago. Road maintenance, rehabilitation and new construction have not kept abreast of the rapid growth in demand for transport. Traffic levels now exceed the design capacity of many roads. Due to neglect of road maintenance, road conditions are often poor. Uncontrolled roadside development has also reduced the quality of the network, with negative consequences for road user costs, road safety and the quality and frequency of transport services. Major investment expenditures in the road sector have been on

[11] Asian Development Bank. (2000), *Poverty Reduction Impact: Colombo Port South Harbour Development Project*, prepared by Maunsell MeIntryre Pty Ltd.

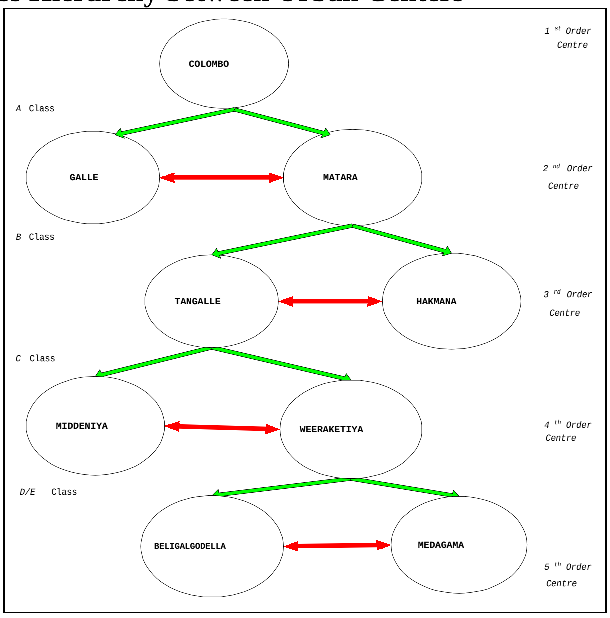
maintenance, rehabilitation and reconstruction of existing roads and not on the construction of new truck roads. Government's main objectives in the road sector are to begin the process of developing a proper, national highway system; better management of the existing road network and enhanced road safety.

Over the next decade, Government, in partnership with the private sector, will develop some 600 kms of new expressways on six different roads. The objective is to provide an integrated system of high-speed transport points connecting the major urban centers of the country. This will provide an overland transport grid linking farmers, small businesses, industries, hotels and all other businesses (see diagram 5.1). Government fully appreciates that the financial, administrative and technical costs associated with the construction of a national expressway system are very high. For that reason, careful studies have been made of the technical, economic and social feasibility of each portion of the road network.

But government also recognizes that the costs of inaction are very high indeed. Poor communities in the South rank the Southern Highway as their single most important priority. They feel that it will provide producers of perishable crops with better access to major, urban markets; that it will create new opportunities in cash-crop agriculture for unemployed youth; that better transport will enhance women’s employment opportunities in urban areas as an alternative to overseas migration; and that it will allow the South to attract good teachers and develop a quality education system. The ADB finds that modern roadway systems can generate important benefits for the poor when such networks result in reduced consumer and higher output prices and stimulated employment. They also find that the poor tend to benefit from social improvements associated with better transport and by being employed in road construction and subsequently in road maintenance[12].

Without good road systems, farmers are bound to continue producing low-value grain crops that can be consumed locally, thereby remaining locked in a vicious circle of low-incomes, low returns and low risk. Diversification into higher value crops and agricultural activities is only a real option once farmers are confident that their produce can competitively reach urban and export markets.

Diagram 5.1: Road Access Hierarchy between Urban Centers



Source: Kumarage, A, 1998, *Formulation of Policy Framework for Poverty Alleviation: Transport*, Technical Report prepared for a Policy Framework for Poverty Reduction in Sri Lanka.

With the support of the Government of Japan and the ADB, a Southern Highway from Colombo to Matara will be constructed in the first stage of developing a modern inter-regional highway network. This is to be complemented by the construction of a semi-circular pass road in Colombo (Outer Circular Road)

[12] ADB, 2001. *Paving the Way to Poverty Reduction Through Better Roads*, Manila.

linking major artery roads and the proposed expressways to divert North-South bound traffic. This will ease congestion in the capital and facilitate access to the port. Implementation of this project has been delayed for nearly two years, largely due to concerns arising from a modest amount of involuntary resettlement. This experience has demonstrated the importance of carefully assessing social impact and planning resettlement as an integral part of the highway planning office. For future projects, a social impact assessment division within RDA will be created to improve the land acquisition and resettlement functions. In the near-term, the Government will construct an expressway between Colombo and Katunayaka to ease access between the Capital and the international airport. Feasibility studies are also being conducted for an expressway from Colombo to Kandy as an alternative to the present two-lane trunk road. The construction of a Northern expressway that will bisect the Colombo-Kandy road through the Northwestern Province to reach Anuradhapura will commence, once peace is secured. Government recognizes that the financing and operating costs of a new highway network will be very high indeed. Opportunities for public-private partnership in developing highways, including the use of toll roads, will be pursued.

Progress on the Southern Highway has been delayed due to the need to reform certain aspects of resettlement policy. Progress is now being made on this project, which is due to be completed in 2006. Corridor development is being promoted, with full private sector participation, to ensure that urban and industrial development efforts take advantage of the new transport routes.

A large portion of the network of class C, D & E roads belong to provincial councils and local authorities. These are the roads that connect settlements to market places and service centers. Many of these roads require long overdue repairs and regular maintenance. Local governments do not yet have either the financial or the institutional capacity for adequate road maintenance. Government will continue to invest in the improvement of provincial and primary roads. New investments are envisaged for upgrading provincial roads in North Central, North Western, Uva and Western Provinces. Trunk roads, secondary roads and village roads and structures are to be rehabilitated to serve as links between the new national highway system[13]. Already, Sri Lanka has a large number of class B, C, and D roads, many of which require overdue repair and regular maintenance. There are a number of ongoing programs aimed at repairing bridges and rehabilitating the road network. In the future, however, a more selective road upgrading approach will be undertaken in order to build an efficient and integrated set of transport nodes, linked from the villages to a hierarchy of urban centers connected by a high-speed national highway system.

Provincial councils will have to exercise more decision-making authority on which roads are indeed maintained and which are not. An annual road maintenance plan will be developed, and this will be used as the basis upon which road O&M priorities are set. The private sector is to become much more involved in road provision and maintenance while the RDA is to be transformed to play more of a regulatory and oversight role. By 2004, some Rs.2.0 billion of RDA outlays will be assigned to the private sector. Training will be provided to private sector contractors in road construction and road O&M, and RDA's capacity in tendering, contracting and supervising private contractors will be improved. To reverse the declining trend in road maintenance outlays, a Road Fund will be created, initially financed from the budget, and will be aimed at ensuring efficient O&M on "core" roads. Increasingly, the private sector will be contracted-out to develop and maintain roads, except for very small projects. A traffic management master plan will also be developed and implemented for the rapidly growing Greater Colombo region.

Road Safety. Unsafe driving conditions are an everyday aspect of the human environment faced by the poor. As a result of unsafe road conditions, the road fatality rate is approximately ten times higher in Sri Lanka than in parts of Europe. Unsafe road conditions have a greater impact on the poor than on other groups because they are more likely to commute long distances from home to their place of work, often in overcrowded and unsafe buses. Efforts to improve the road safety environment will begin with the

[13] Kumarage, A. *Formulation of Policy Framework for Poverty Alleviation--Transport*, Poverty Framework Technical Report, 1998.

development of a National Road Safety Secretariat, an agency mandated to develop a comprehensive approach to improving public safety conditions. A Road Safety Action Plan will be developed, including measures aimed at improving traffic and safety management, including: mandatory seat belt use, strict controls on drunken driving, monitoring and restricting the practice of overloading trucks, requiring regular vehicle safety inspection, revamping driver license requirements, improving road design (through better intersections and two-level crossings) in black spot areas, installing additional road safety equipment, improving vehicle safety and registration standards, improving emergency rescue services, removing unauthorized development on the sides of the roads, traffic education and increasing road safety awareness (especially amongst children)[14].

Enhancing Performance of the Bus System: Buses are the single-most important form of transport for the poor in Sri Lanka. In total, bus transport accounts for 73 percent of total land passenger transport. The state bus services were 'peopolized' in 1990, leading to the creation of 93 cooperative bus companies. These were then reorganized into 11 regional companies in 1997, which operate about 6,000 buses. In addition to the cluster companies, some 17,300 private bus companies operate, most of which have only one or a few buses. Low tariffs, a shortage of buses, over-crowded buses, the lack of bus services at night and on a number of rural routes, inefficient management of the bus companies, and the lack of organization of the private bus industry have contributed to a decline in the quality of the bus services. The Government will improve the bus service by downsizing the number of public bus companies, introducing public-private partnerships to manage bus stations and stands, restructuring the Sri Lanka Central Transport Board, the Regional Transport Companies, and the National Transport Commission to supervise and enforce bus safety and passenger load regulations, set tariffs, establish a minimum fleet size for private bus operators, and oversee the franchising (with subsidization if necessary) of under-served rural routes. Private operators will be encouraged to form associations operating a minimum of 50 buses. A tariff policy will be introduced that provides commercial fares in competitive routes and explicit subsidies for transport services provided to remote, non-commercial regions.

Modernizing the Railways: The railways have operated as a government department since their inception, but have lost most of the transport market to road transportation. Poor families, particularly in and to the Colombo urban area, continue to use the railway for transport services, largely because of low costs. The railway system has deteriorated over the past two decades, and has a dated rolling stock and rail network. With the support of the Government of Japan, Government will rehabilitate railway tracks, improve station yards and establish new systems for track maintenance. Several new locomotives have been added to the fleet and an open-access policy for freight services was introduced in 1998. Public-private partnerships would be fostered to upgrade the railway infrastructure by converting the rail track network to standard gauge track, modernizing carriage facilities, establishing modern ticketing systems, developing port-to-railway container systems, electrification on some lines, and modernizing the signaling system. Public-private partnerships for total freight-based services and a selected route are also planned. The private sector will be encouraged to play a much greater role in the management and operation of the railways, both by continuing the open-access policy and by contracting-out the operation of specific lines. Tariff policy will be appropriately revised to encourage cost-recovery in the provision of rail services and to stimulate for the modernization of the rail service.

b) Connectivity: Bridging the Digital Divide

Improving access to telecommunications facilities. Ensuring that the poor have access to market information is essential if they are to compete in the global economy. The National Telecommunications Policy aims to: (i) provide telecommunications facilities to all, at an affordable price; (ii) allow private sector competition and attain an acceptable quality of service; (iii) be attentive to consumer needs; (iv) progressively increase local value-addition; and (v) protect defense, security and environmental interests of the country.

[14] Government of Sweden, *Urban Transport in Swedish Development Co-operation, Summary and Policy Conclusions*, 1999 and Asian Development Bank, *Third Road Improvement Project: Road Safety Component*, 1999.

An e-Sri Lanka initiative will be launched to apply the benefits of modern technology to the workings of government and the private sector. Public services will be gradually automated, including those services, such as registration and the issuance of identify cards, that are of great concern to poor and excluded groups. A broadband network will be developed and extended through the countryside to ensure that e-Sri Lanka is accessible to the poor.

The partial privatization of Sri Lanka Telecommunications and the liberalization of the mobile tele-communications market have unleashed a rapid expansion in telecommunications facilities together with a notable improvement in service quality. Some 36 firms are now involved in the telecommunications sector. SLT still has some two-thirds of the market, but competition is rapidly increasing[15].

By 2005, it is anticipated that telephone density will double to 13 per hundred, and the number of email users will triple to 0.6 per hundred. In many low-income urban and peri-urban communities, private telecommunications shops provide a wide range of communication access services. However, in remote, low-income rural areas, telecommunication penetration rates are very low, because of high start-up costs and the limited market for such services.

Better telecommunications and IT policies will be needed if Sri Lanka is to harness the power of modern communications for poverty reduction. To provide this sub-sector the attention it deserves, information and communication technologies will be integrated into the portfolio of the Ministry of Policy Development and Implementation. An ICT strategy will be developed and a Strategic Council on ICT policy will be constituted, with representation from both national and international expert groups, to advice the Prime Minister on matters of IT policy.

There is a very clear demarcation between public and private roles in the ICT sector. The private sector will continue to play the lead role in the provision of telecommunications services, with Government providing an appropriate regulatory and supervision role. Government will ensure greater independence and authority for the TRC to regulate all the ICT sectors. The TRC will be restructured, qualified staff appointed, including full-time commission members. Staff will be properly trained and regulatory functions will be executed in a transparent manner. The TRC will also be accorded enhanced spectrum management functions and capabilities. International voice telephony and fixed wire line services will be liberalized. This will promote competition and help lower costs, especially for value-added (i.e. Internet) services. The Government's remaining stake in Sri Lanka Telecom Ltd. will be divested, as market conditions permit.

A more rational licensing system will serve to enhance competitiveness in the telecommunications sector. Followingthe formulation and implementation of a comprehensive interconnection framework that will (a) compensate domestic network operators for originating and terminating international calls, (b) create incentives for refraining from illegal interconnection and for extending domestic networks rapidly, the government shall establish a class license scheme for International gateways for international telecommunications. The class license scheme will include requirements for non-discriminatory operation of gateways, license fees that will not impose an undue burden to be determined, and may include guarantees against violation of license conditions. There shall be no limit on the number of licenses. In addition, the provision of domestic and international leased lines will be completely liberalized including the carriage of voice thereon. There shall be no requirement for Ministry approval or regulatory commission approval for satellite access, except in terms of frequencies.

The government also intends to relax restrictions against entry into mobile markets by fixed operators and against entry into fixed markets by mobile operators. However, this will be postponed until spectrum management is brought up to adequate levels and the actual workings of cross entry are observed in rural areas. For an initial period of 12 months, that may be extended, the supply of fixed services by mobile operators and the supply of mobile services by fixed operators will be allowed only in demarcated low-

[15] Asoka Fernando (2000), *International Perspectives of Telecommunications Privatisation and Regulation: A case Study of Sri Lanka Telecom*, Monash University.

teledensity areas, especially in the context of the expected least-cost subsidy programs to develop the e-Sri Lanka initiative. The current receiving party pays scheme for mobile telephony shall be replaced as quickly as possible by a calling party pays scheme based on the work done by the technical and commercial committees set up by the Telecommunications Regulatory Commission in 2001.

The Ministry of Finance and the Ministry of Policy Development and Implementation shall establish a Telecommunications Development Fund to accelerate the rollout of domestic networks, including broadband, which will be supervised by a board that will include industry representation. The funds that will be utilized for this purpose will include possible World Bank assistance under the e-Sri Lanka initiative andcurrent accumulated funds of the Telecommunications Regulatory Commission

Transforming the Postal System into a Modern IT-Financial Network. The Sri Lanka Post (SLP) has an island-wide network of 597 post offices and 3452 sub post offices. The SLPs operations are inefficient and characterized by low quality, and a lack of customer and commercial orientation. As part of the postal commercialization process, where economically viable, the Government will introduce telephone services (and eventually Internet access) to sub-post offices. This will help broaden telecommunications access to hitherto under-served rural communities' facilities. The postal department will be restructured and commercialized; postal operations will be opened to the private sector; the SLP will be transformed into a high quality provider of postal communications, postal financial services and other communications services, and eventually, the postal service will be integrated into various financial institutions. A combination of liberalization, modernization and commercialization of SLP operations will bring viable commercial telecommunication's facilities within the reach of a larger number of poor, information-isolated communities.

Bringing Internet into the countryside. Information technology can make a valuable direct contribution to poverty reduction because of its potential to give poor groups access to information and communications. Indirectly, the use of IT can lower the cost of obtaining and managing information throughout the public and private sector-a critical constraint to growth and public sector management. Increasing access to Internet facilities offers scope for broadening commercial knowledge and market awareness, improving opportunities for remote education and health care, and fostering better communication amongst government agencies and between the population and government[16].

Low rates of Internet penetration put most of Sri Lanka's rural population on the far side of the digital divide. Individual connections to the Internet in the rural areas is neither necessary nor desirable. The real challenge is to provide access to IT for everyone on a collective basis. The private sector has mounted an ambitious effort to promote Internet use nationwide-an effort that Government fully supports. Government's will complement private initiatives in these areas by promoting internet use amongst low-income communities through a combination of: (i) developing a broadband network in the rural areas that can be used by private providers; (ii) improving computer facilities in the secondary schools, with at least one secondary school in each division fully equipped; (iii) providing support for the private sector to establish post-secondary computer training institutes in the districts, which will be linked to proposed IT techno-parks; (iv) developing digital community radio stations with community internet facilities; and (v) providing internet connections and facilities to selected small business development promotion agencies in small towns and cities. The incubator concept which has been used to provide seed capital for IT companies will be expanded, e-learning will be promoted in various areas of tertiary education, computer use shall be integrated into professional training in the areas of engineering, medicine and management; and pilot programs shall be mounted on incorporating e-learning in teacher training and quality upgrading for secondary schools.

One of the strategies for broadening access to internet-based resources to low income communities is to foster an indigenous, export-oriented capacity in the IT sector. This will create a demand for students with IT skills, expand opportunities for IT training and, by building economies of scale and scope, lower costs of expanding the IT network. Sri Lanka's information technology industry has shown impressive

[16] Sida, 2001, *Strategy for IT in Development Co-operation*.

growth in the last five years. Export earnings of software companies have increased to US$55 million in 2000 from virtually zero in the year 1996. There are presently some 75 IT training institutes, of which 50 are in the rural areas, providing training to 10,000 persons per annum. Three IT parks are under construction that, once in operation, will provide training to some 3,000 IT professionals per annum.

Government aims to foster the development of the IT industry as one of the major new sources of skill-intensive employment in Sri Lanka. Improvements in telecommunications policy and the regulatory framework are required to inspire sufficient private investment in this area. The rapid pace of technological development in the IT sector has made it increasingly difficult to draw regulatory boundaries between one form of telecommunications investment and another. In the future, licenses for all international telecommunications carriers will be made uniform and a registration system will be adopted for all providers. New laws will be passed to enable internet-based contracting and e-business. Fostering competition in the telecommunications sector, and ensuring that government laws and regulations foster competitive provision of Internet services are key parts of this strategy[17].

Reaping the benefits of connectivity by fostering regional competition. Advances in transport and information will provide an external setting favorable to national economic integration. But to reap the benefits of national and international markets, regions will need to *compete*-for investment, employment and the fruits of prosperity. Fostering a competitive investment environment, both within and between regions, will create the conditions necessary to capitalize on the investments that will be made to foster connectivity, both in an information and transportation sense.

Public-private partnerships will be central to fostering regional and inter-regional competition. Locally defined economic promotion initiatives, such as quality and certification efforts, establishment of technology and science parks, business incubators and innovative new venture financing models, can help foster technological innovation, promote innovation and build regional competitiveness. To succeed, such ventures must have the support and active involvement of local business chambers, entrepreneurs who are accepted as opinion leaders, banks, universities, local administrators, unions and local political leaders. The design of such measures should be such that as little additional investment and maintenance costs as possible are created for the government budget. Government's strategy for promoting regional and inter-regional competition is to foster partnerships and nurture key stakeholders (such as local business associations) in order to introduce locally defined and financed initiatives aimed at increasing the attractiveness of each region as a business location.

II. Revitalizing Rural Development

Almost 90 percent of Sri Lanka's poor reside in the rural areas. The vast majority of the rural poor derive their living from agriculture and off-farm employment. Successful rural development means revitalizing the rural areas to provide a foundation for accelerated income growth, abundant job opportunities in farm and non-farm activities, sustainable use of natural resources and strong, positive spillovers between urban and rural activity.

Structural change, or the shift of the rural population from low productivity primary product production into higher-productivity industrial and services sector production is one of the most powerful engines for rural poverty reduction. There is ample experience of this in Sri Lanka and worldwide. Sri Lanka has the potential to emulate the growth and structural transformation pattern of Taiwan and South Korea. Both these economies are as poorly endowed with arable land per capita as Sri Lanka, and they were as poor as Sri Lanka in the mid-1950s. Both of these economies liberalized and improved competitiveness and outward orientation in the 1960s, which created high rates of growth in off-farm employment, urban employment and demand for high-value produce and agro-processing. Private investment and growth outside of agriculture and the rural areas can serve as a powerful engine for structural change.

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[17] Garrison, William, 2002, *Telecom and IT Development in Sri Lanka*, and Competitiveness Initiative, 2002. *Roadmap for ICT Success in Sri Lanka*, Colombo.

A large segment of the rural poor have small land holdings, from which they are barely able to meet subsistence requirements. With each succeeding generation, land holdings become increasingly fragmented, making it difficult for rural families to meet their basic needs. Raising productivity in agriculture is part of the solution to the rural poverty problem, but it is unlikely to be a major part of the solution. To reverse the relentless fragmentation of agricultural lands into ever smaller plots, one option is to equip the rural population with the skills and ability to migrate to urban areas, where higher-productivity employment opportunities are more abundant. Government will promote rural-to-urban migration that does indeed reduce poverty by enhancing the quality of rural education and vocational training and by improving the quality of labor market information services.

Land Resources Management. To provide more poor families with secure title to land, Government will reduce state control over land and will continue to provide for freehold ownership of alienated state lands by issuing Jayabhoomi grants to both men and women. Government will remove restrictions on farmland and remove restrictions on the sale, lease transfer, sub-division and mortgage of state lands in rural areas. Appropriate amendments will be made to the Land Development Ordinance, the Land Grants Act and the State Land Ordinance to accomplish this. All restrictions on farm size and sale, lease and transfer of Land Development Ordinance (LDO) and Land Grant (special provision) rural lands will be removed. Immediately, some 1.2 million freehold land titles will be issued by Government in 2002, covering an extent of 2 million acres of land. A policy to sell and allocate state-owned land on the basis of marketable title will be developed. Anomalies in the legal structure relating to land inheritance which discriminate against women shall be corrected. Future allocations of state-owned lands will be limited to outright sales except for transfers targeted to the poor. An integrated data management system for all of the agencies dealing with land will be created in order to make information on land tenure, land use and land capability transparent and accessible. A more flexible landmark combined with increased commercial agricultural investment will contribute to poverty reduction by expanding productive rural employment opportunities[18].

Over the next three years, the Government will pilot test a new land titling program. This titling and title registry operation will provide increased tenure security, efficiency in transactions, land market choices and fairness. With this new approach, the cost of titling per parcel should be reduced from $110 per parcel at present to under $40 per parcel. The percentage of parcels with unresolved issues after adjudication that prevent titling will be reduced from about 50 percent to 5 percent. At the end of the pilot program, three new title registries will be functioning, with procedures to handle transactions within specified time limits. By the third year, some 6,000 new parcels will be surveyed and adjudicated using the most cost and time effective methods. Legal reform will also be undertaken to consolidate the 25 related laws that directly affect titling. To ease dispute resolution, alternatives to the use of courts, such as conciliation boards, will be used. Restrictions on leases and freeholds for parcels currently under LDO and related legislation will be eased. Greater use of modern technology will be made to accelerate the land titling and registration process, including IT for digital mapping, data updating and records preservation. Based on the outcomes of this pilot project, a new national program for accelerated land titling and registration will be launched. Improved land titling is expected to directly benefit the poor since systematic adjudication and dispute resolution is more inclusive than ad hoc efforts to distribute titles on allocate lands. Moreover, secure land titles will provide the poor with improved access to credit, inputs, market information and technology, all prerequisites to productivity improvement in agriculture.

Agriculture. Government's strategy in agriculture is based on the need to be competitive in production and marketing by increasing productivity, lowering production costs and adding value to raw materials[19]. Raising the rate of growth in agriculture (including crops, livestock, fisheries and forestry) can make an important contribution to rural poverty reduction.

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[18] National Planning Department, *Vision 2010*, Colombo.

[19] Ministry of Agriculture, 2001, *Update of Six-Year Development Program for Preparation of Poverty Reduction Strategy Paper for 2001-2005,* Colombo.

High rates of protection for food crops penalize the poor because the vast majority of the rural poor are net food consumers. High and variable rates of trade protection for agricultural products discourage agribusiness investment and confine domestic producers to thin and volatile domestic markets. High rates of protection for domestically produced packaging materials discourage agro-processing investment. Tariff irregularities, such as those which afford higher rates of protection to milled flour than to wheat grain, foster a local monopoly in milling and raise processing costs. Tremendous volatility in agricultural trade policy adds to market risks and discourages the private sector from storing domestic produce. Even in the case of the traditional plantation crops, barriers to direct marketing weakens corporate marketing strategies. Paradoxically, by discouraging private initiative in trade and marketing, government interventions add volatility and uncertainty to already thin agricultural commodity markets and, in so doing, discourage commercial production.

Government is committed to developing a market-oriented pricing and incentives environment for the agricultural sector. Direct involvement in the commodity markets will be gradually reduced, and by 2005, agricultural trade policy will become more stable and transparent for the main food commodities. The high rates of specific duties used to protect strategic agricultural commodities will be replaced by a duty of about 60 percent for the main strategic foodstuffs. Tariffs will remain at these levels for some time to provide greater certainty to farmers, processors and traders. Fertilizer subsidies will be streamlined and efforts made to improve the targeting of these subsidies. To ensure that poor farmers can afford modern agro-inputs, the Government will introduce a support scheme, in which poor farmers are provided vouchers for the purchase of agro-inputs and other services. The use of a voucher or a credit card mechanism will allow government to better target technology assistance to the poorest farmers.

While substantial efforts were made to bolster paddy output during the 1960s, 1970s and 1980s, other aspects of agriculture received scant public support. Government will give priority to encouraging small holders to cultivate high-value horticulture crops, livestock and fisheries products low-income farm households can increase returns by diversifying production out of low-value crops into higher value agricultural commodities. For example, unemployed secondary educated women could engage in downstream activities, such as fruit processing, to enhance incomes. For this, better technology and better marketing opportunities are the key.

Frequent reorganizations and a lack of focus within the agricultural research and extension services appear to have substantially compromised the nation’s capacity to induce technological innovation in agriculture. Government will substantially increase the supply of improved technology suitable for small-farmers through a more diverse and intensive program of adaptive research based largely on borrowed technology. The responsibility for agricultural research and extension have largely been devolved to local Governments. In the future, the private sector will play a far greater role in agriculture research and development. With donor support, the private sector will engage in contract research for perennial crops. Management of crop and livestock extension will be progressively contracted out to the private sector. While Government will bear the costs of extension during its first few years of private management, cost recovery systems will need to be instituted to ensure that agriculture extension can become self-financing. It is expected that a greater measure of local control and popular participation will ensure that the agro-technology policy which is generated is more geared to meet locally felt needs. At the same time, the Government will take advantage of research services available in neighboring states for issues that the national research service is unable to adequately address. Consideration will be accorded to obtaining technology services from India on medium-term weather forecasting, land use planning, precision farming, remote sensing and GIS applications for modern agriculture.

Government restrictions on the import of seeds and planting materials are some of the most strict in the world. This clearly limits farmer's opportunities to access world-class agro-technology. To ensure that commercial agro-business investors can access world-class agro-technology in a timely manner, the Board of Investment will establish a special facility for facilitating the import and phyto-sanitary clearance of seeds and planting material. In close consultation with the private sector, a new Seed Law as well as Draft Regulations under the Plant Protection Act of 1999 will be prepared. In accordance with the new Seed Law, Government will confine itself to the production of basic seed, and all other seed development activity will be opened to private investment. Government will encourage seed development to be undertaken as a joint venture with the private sector. Legal and administrative procedures governing the production and import of seeds and planting material will be simplified, and excessive restrictions in agricultural legislation on technology import, contained in Plant Quarantine Regulations, Seed Act and Pesticide Act, will be eased.

Greater private sector participation will be encouraged in many aspects of agricultural support services. Government will divest itself of its residual corporate holdings in the dairy, sugar milling, and various agro-input industries. Government will also lease-out or sell a number of its seed farms and livestock farms for private sector operations. Government will also gradually turn over the management of state forestry plantation to the private sector. Government will encourage private sector involvement in breeding, commercial feed production and will encourage private-public partnerships for the management of fisheries harbors, cold storage facilities and other fish marketing infrastructure. And Government will continue to provide financial and technical support to both smallholder and private estate crop companies to modernize the factories and upgrade the quality of the tree crop stock. Export production zones will be established to expand areas suitable for private investment.

Improving the management of established irrigation schemes can raise productivity and improve prospects for agricultural diversification into higher-value crops. The Mahaweli Restructuring and Rehabilitation Project (MRRP) is providing valuable lessons in System II of Mahaweli where farmers, through water user associations, manage their water resources in partnership with the Mahaweli Authority. Ensuring that water user associations are provided the resources and authority to manage irrigation systems in other parts of the country will help spread the benefits of user-management to other large, watershed basins.

Livestock has considerable potential as a source of supplementary income, particularly for small farmers with limited land holdings. Government will nurture private initiative in livestock development by eliminating import duties on raw materials and by divesting some of the public livestock farms to the private sector. Legislation relating to the slaughter of animals and transport of livestock will be revised to enable small enterprises to invest in these areas. Several ongoing livestock development programs will be redirected at poor farmers, including those to develop and disseminate improved breeds, programs for disease control, improved feed and pasture, and dairy development in the plantations[20]. Contract out-grower schemes with the private sector will be encouraged to increase feed supply and reduce growing reliance on livestock feed imports. Government livestock services are not expanding at a rate sufficient to meet the needs of the farm community. Increasingly, animal health, vaccine delivery, laboratory services and testing for quality will be handed over to the private sector to improve service delivery.

Coastal fishing communities are amongst the poorest of all those in the rural sector. The current fisheries policy and strategy are contained in the National Fisheries Development Program and the Coastal Zone Management Program. The main strategies that will be pursued to foster fisheries development include: (i) introduction of new and modern technologies to exploit fish resources in off-shore and deep-sea waters; (ii) provision of supporting infrastructure, such as harbors and access roads; (iii) protection of the exclusive economic zone through strong monitoring control and surveillance efforts; (iv) export diversification; (v) intensification of aqua-culture; (vi) introduction of low-cost equipment; and (vii) exploitation of unutilized and under-utilized fish resources. A special effort will be made to involve poor communities in fisheries development through the promotion of community hatcheries for fingerling production. All commercial activities, such as production and marketing of fish, fishing boats and gear, fuel, ice plants, and processing facilities, will be within the purview of the private sector, with government providing supporting infrastructure, technology and an enabling policy setting[21]. To exploit the full potential of the sea resources, large-scale fisheries will also be encouraged. As the investments

[20] Ministry of Estate Infrastructure and Livestock Development, 2001, *Update of Six-Year Development Program for Preparation of Poverty Reduction Strategy Paper for 2002-2005*, Colombo.
[21] Ministry of Ports, Shipping and Fisheries, 2001, *Update of Six-Year Development Program for Preparation of Poverty Reduction Strategy Paper for 2002-2005*, Colombo.

required to exploit deep sea fisheries are high, joint ventures will be promoted and large-scale operators will be encouraged to link-up with small-scale operators to upgrade their market ties and knowledge.

Transforming plantations into engines for pro-poor growth and regional development. Estate crop workers are amongst the poorest of any segment of the work force Sri Lanka, especially when measured by a number of the non-monetary poverty attributes. The political stability of the hill country, its importance from the perspective of general security concerns, and the rising mismatch between rising expectations resulting from educational achievement and the possibilities in a slowly-growing plantation economy must be properly analyzed and understood in developing reform strategies for the sector. In addition, there are acute problems in the estate work force arising from alcoholism, indebtedness and the poor quality of schooling and other social amenities. A strong sense of alienation is pervasive amongst the estates' work force. Working together with NGOs, the private plantation companies are mounting programs aimed at reducing addiction and developing better lifestyle skills. Government, plantation managers and leading NGOs are introducing participatory management styles to enhance the involvement of the work force in the operation of the plantations. Government is integrating the health and education services provided to the Estates into the national systems and developing the physical and social infrastructure serving the Estates to uplift the social status of the estate community. Special projects are also being mounted to improve housing conditions. Investments in worker welfare have been shown to be positively correlated with labor productivity and work outturn[22].

Progress has been made in the policy environment for plantation crops, starting with the elimination of export taxes and the reduction of cesses, followed by increased private sector participation in state-owned plantations. The ad-hoc acquisition of prime plantation lands for non-agricultural purposes by local governments and state companies will be discouraged. The immediate challenge is to begin to diversify output to reduce dependence on a narrow range of crops, upgrade field productivity, modernize factory management practices, and encourage factory rehabilitation in the plantation sector. Government also aims to put greater focus on process improvement and product quality, by accelerating adoption of new production, processing and marketing technology, encouraging strategic business partnerships and enhancing knowledge and awareness of market opportunities. The remaining estates and warehouses of JEDB/SLSPC will be divested in an expeditious manner. Government will continue to strengthen the Tea Smallholder Federation to advance the interest of the 250,000 tea smallholders, while setting up rubber smallholder societies similar to those in the tea sector. In the case of tea smallholdings, the main focus will be on replanting uneconomic tea with high yielding clones and on improving field management practices.[23] In rubber, the focus will be on replanting uneconomic rubber with high-yielding clones, expanding rubber cultivation into non-traditional areas, diversifying out of uneconomic rubber and encouraging a more diversified product mix. Joint public-private ventures will be encouraged to enhance the production, processing and marketing of rubber In coconuts, inter-cropping and mixed-cropping will be encouraged to raise incomes while replanting and rehabilitation will be encouraged. In addition, Government will release surplus NLDB lands for commercial, coconut intercropping projects. Greater private sector participation will be encouraged in the various research and development institutions in the tree crops sector, namely TRI, SLTB, TSHDA and NPIM.

In the medium-run, Sri Lanka's plantation industry faces stiff competition because of weak global commodity markets and rapidly rising domestic costs. To improve investment incentives, the duration of the existing Regional Plantation Company leases will be extended to 99 years. A Tea Association will be formed to lead the development of the sub-sector. For tea, the industry's strategy is to maintain leadership in the global tea export market while aggressively increasing value-added in tea production. The use of branding and marketing and becoming a preferred buyer destination are some of the strategies that are being adopted to re-position Sri Lankan teas as the "best in class" source for export markets. Building brand recognition and operating joint marketing companies are some of the initiatives proposed for re-positioning Sri Lanka's tea exports. Towards this end, Government will provide promotional

[22] Arunatilake, Nisha, 2001, "Effectiveness of Welfare Programs in Improving Estate Labour Performance, *Sri Lanka Economic Journal*, Vol. 2, No. 1.
[23] Ministry of Plantation Industries, 2001, *Update of Six Year Development Program for Preparation of Poverty Reduction Strategy Paper 2002-2005*, Colombo.

assistance to the Tea Sector to develop Sri Lankan owned brand names for the export markets. The role of the Tea Board will be reduced. Price control and panel ratification will be eliminated for non-auction direct sales between producers and international buyers. Labeling regulations for pack design requirements, especially for brands claiming “Pure Ceylon Tea” will be promulgated. To accelerate the pace of technological change, private tea estates will be allowed to utilize cess resources and implement tea research on produce development and process improvement. Some 20 percent of the plantation lands are estimated to be unutilized. The plantation sector will also be encouraged to maximize returns from these lands via diversification, including timber and mineral extraction, mini-hydro development, eco- and land tourism. The Regional Plantation Companies (RPC) will be encouraged to lease-out under-utilized lands for the commercial production of high-value fruits and vegetables, spices, organic herbs, medicinal plants and other agribusiness ventures. Regulatory barriers that hinder the diversification of RPC lands into other uses will be eased.

To become a preferred buyer destination in the global tea market, the industry’s strategy is to improve quality standards, achieve economies of scale through consolidation, encourage deregulation, encourage direct sales by producers, introduce IT to modernize trading and supply chain management, rationalize the number of grades to improve inventory cost management and facilitate increased use of paper bags/sacks instead of chests to improve buyer satisfaction and tea quality[24]. To promote value-addition, the feasibility of allowing imports of tea for blending and re-export will be considered if this can be accomplished without adversely affecting the “pure Ceylon tea” brand.

In the long run, rising real rural wages and increased off-farm employment opportunities will threaten the economic viability of several of the plantations. Provision of an ownership stake in the plantations to the work force and smallholders is a strategy that has been successfully employed in countries such as Thailand and Malaysia to enhance the poverty reduction and regional development impact of plantation development. Over the medium term, Government will examine institutional options for reducing the plantation’s dependence on a captive, low-wage labor force. Government will also be providing training and advisory support to plantation workers to develop other lines of small businesses to diversify family incomes.

Upgrading the Agricultural Marketing System. The heart of Sri Lanka’s agricultural marketing infrastructure is its extensive network of municipal wholesale markets. Most of these are poorly sited, have inadequate sanitation, drainage and loading and are operated under ineffective public management. A high-cost, low-quality agricultural marketing system discourages poor farmers from shifting out of low-value food crop production and into higher-value food and cash crop activities. Poor consumers suffer from the high cost and low quality of fresh produce. There is an urgent need to rehabilitate and improve management of the existing municipal agricultural feeder markets - rehabilitating these as well as relocating them from congested city centers will also be required. Private-public partnerships to revamp the agricultural marketing infrastructure will be central to this effort.

Dedicated economic centers (i.e. modern agricultural wholesale markets) have already been set up at Dambulla, Walpita, Keppetipola, Norochcholai and Hiriyala. With private sector participation, new economic centers will be established in various strategic locations, including Embilipitiya, Ampara, Vavuniya, Marassana, Kegalle, Pannegamuwa and Nuwara Eliya. These new wholesale markets will be linked to a network of competitive and efficient, private sector based agricultural retail markets. The Dambulla Dedicated Economic Center (DDEC) will enter a second phase of development aimed at overcoming congestion and delays, expanding the range of services provided, and forging a viable form of private-public partnership that can consolidate and further develop the market[25]. This will involve introducing new systems for managing the market, changes in by-laws, establishment of a legal and regulatory framework, and the development of a suitable business plan. In the long run, as new dedicated agricultural market centers are developed, the main agricultural wholesale market will be re-located out of Colombo.

[24] ATKEARNEY, 2001. *Strategy Study for the Tea Industry-Sri Lanka*.
[25] IFC. 2001. Technical Assistance Project: the Dambulla Market.

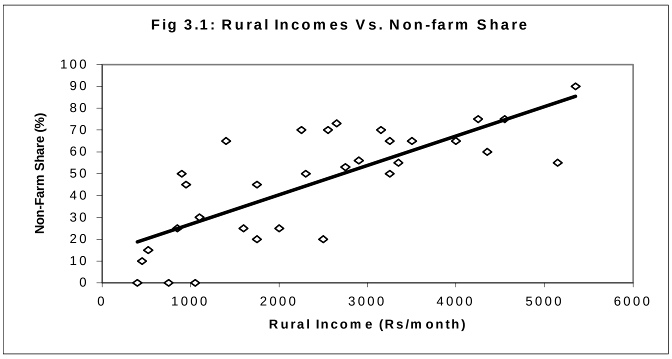
Government has gradually withdrawn from direct involvement in agriculture marketing. CWE is one of the last, publicly supported, entities that commands a significant presence in retail food markets. In the near-term, CWE food outlets are to be rented-out to private managers in order to reduce losses and enhance operating efficiency. In the long-term, private ownership and operation would be appropriate. Instead of operating directly in food markets, government's role has shifted to introducing new and innovative ways of encouraging contract-farming and farm risk management. Gradual introduction of forward contracting and other methods of managing farm risk (i.e. bonded warehouses, commercial crop insurance) can improve the pricing and marketing of agricultural produce.

Water Resource Management. Efforts to sustain and improve the productivity of water resources will become increasingly important in the future as competition for water between agriculture, industry and urban uses increase, and as farmers shift more to high-value crops[26]. Government's strategy for ensuring that water is used efficiently and is available to the poor revolves around the introduction of transferable water entitlements and the establishment of effective river basin management organizations.

The National Water Policy calls for a major change in the way in which water is to be used. Under the new water management policy, transferable water entitlements are to be created under the supervision of a National Water Resources Authority. This will involve the issuance of licenses for large-scale water uses (bulk water entitlements) on each of the main watersheds and river basins. River basin committees, representing all stakeholders and with ample representation of the poor, will be established to issue the licenses. Bulk water entitlements will be issued taking into account the water supply/demand conditions and environmental requirements. The committees will also protect traditional water entitlements and evolve development and management plans for water resource investments in their respective regions. Arrangements between Government and water users will be developed to ensure that water resources infrastructure is operated and maintained to a reasonable standard. A Water Resources Tribunal will be established to adjudicate water-sharing disputes. While small-scale water users are exempted from the licensing system, they will play a much more active role in allocating water entitlements and in planning the development and management of the water resources in their own river basins. This new system should contribute to poverty alleviation in three ways. First, water over-use will be discouraged, ensuring that more water is available for small farmers and those at the tail end of the irrigation systems. Second, industries and other large-scale bulk water users will be more likely to settle in poor regions knowing that they will have secure, licensed access to water. And third, small-scale farmers will participate directly in developing and managing water resources in their own river basins. The most immediate challenge is to begin implementing the National Water Policy and to restructure existing institutions and government organizations to be consistent with the new policy[27].

Off-farm rural employment and the rural electrification challenge. Agriculture alone will not be sufficient to raise incomes in the rural areas. There is compelling evidence that those rural families that derive the greatest share of their income from off-farm income are able to work their way out of poverty the fastest (see figure 3.1 below). Access to electricity is necessary for practically any off-farm activity. Without access to electricity, rural areas cannot host the industries and other off-farm income-generating activities that are essential to a pro-poor process of structural change. Electric lighting, unto itself, also makes a very important contribution to the quality and effectiveness of rural education.

[26] National Water Resources Council, *National Water Resources Policy and Institutional Arrangements*, November 1999.
[27] See Water Resources Secretariat, National Water Resources Policy and Institutional Arrangements, Ministry of Irrigation and Water Management, 2001.



Source: World Bank, Integrated Survey, Preliminary Findings, 2000.

There are vast differences in regional access to electrification. In the Western Province, where the incidence of poverty is relatively low, nearly 80 percent of the households have access to electricity. By contrast, less than 20 percent of the households in the North-Central Province have access to electricity. In the Sabaragamuwa, Uva, North Western and Central Provinces, between 40 and 50 percent of the households are without access to electricity. But progress is being made on bringing electricity to under-serviced areas. Between 1980 and 1998, the total number of village electrification schemes increased from 2,115 to 14,690. These now cover some 53 percent of all villages in the country. By 2005, the Government aims to bring electrification to some 80 percent of the nation's villages. Some 600 rural electrification schemes, covering eight provinces will provide electricity supply to about 112,500 additional households and other consumers. This will be an increase of about 5 percent in the nation's total connections (by 2005). Some 600km of 33-kv development lines will be supplied to strengthen CEBs existing distribution networks in rural areas, which are becoming overloaded, and to reduce losses on those lines. A range of alternative energy sources (solar, wind, mini-hydro) will also be developed through community-based organizations and the private sector to expand rural electricity access, particularly in the more remote, dry zone regions. Where capital costs for rural electrification are prohibitive, transparent subsidies will be provided to expand access.

III. SME Development

Small and medium-scale enterprises (SME) are an important source of employment for low-income rural and urban households. In Sri Lanka, SMEs account for nearly 90% of industrial establishments and 70% of employment in the manufacturing sector. SMEs are constrained by the lack of an overall strategy and policy for the sector, a weak skills base, high transaction costs due to over-regulation, and a complex tax and regulatory structure. Improving public governance and the business environment is central to the Government's strategy to address these constraints. Lack of management and other business skills and limited access to information and technology are the critical constraints at the level of the individual enterprise. Government is supporting the development of a vibrant market for business services for SMEs.

Government expects that a vibrant SME sector will take the lead in generating employment opportunities and avenues for productivity growth and rising incomes for a large segment of the low-income population. By the year 2005, the number of registered small and medium-enterprises is forecast to rise by 120 percent.

The policy environment for SMEs will be improved by the preparation of a SME White Paper in 2002 and the establishment of an SME policy unit to monitor SME development, review legislation and co-ordinate donor programs in the sector.

A Deregulation Committee, led by the private sector, has been established to undertake studies and hold hearings to evaluate constraints and impediments to SME development. The Deregulation Committee will complete studies of regulatory and tax impediments to SME development and make recommendations to government. Government is to announce the measures to be implemented and the reasons for not adopting specific recommendations of this committee. A tax reform program, aimed at simplifying the tax regime and reducing discrimination between large firms, major exporters and SMEs, will be prepared. The Industrial Development Board is to be rationalized and made more of a facilitator of business development services.

Over 52 percent of all employees in SMEs acquire skills on-the-job in the industry (NIBM Survey 1994). Most of the training provided is unstructured, lacks adequate coverage and is technically incomplete. Institutional arrangements to promote adoption of advanced technology, improved marketing, development of management information services, and improved technical advisory services for upgrading of SMEs, will be provided. Government will establish a Business Services Support Facility to serve these SME needs. A fund of about $5 million will be used to link SMEs with business service providers.

Access to long-term credit is especially important to small and medium-scale industries, for without this, the smaller firms are unable to obtain the technology needed to produce competitive products[28]. Long-term finance and market development support for SMEs will continue to be provided through the banking system[29]. Thanks in part to long-term finance mobilized by Government, bank lending for SMEs will be increased, and the banks will be encouraged to expand their use of automated computerized information and loan accounting systems to improve their SME business services, lower costs and improve asset quality. Bank will also develop quality credit scoring systems suitable for SMEs. Arrangements will also be made for the securitization of loans to SMEs[30].

IV. Increasing Employment and Mainstreaming Poverty Reduction Objectives in Sectoral Development Strategies

Rapid job creation 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. 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 on-going education will be increasingly important in increasing productivity throughout the economy. These are services that the private sector is will suited to supply and greater opportunities for investment in these areas will be provided.

A national advisory body will be established to foster an integrated approach to addressing issues of labor supply and demand and to promoting a more flexible and productivity oriented labor market. Special initiatives will be undertaken to support women's employment, including skills training and provision of incentives for employers to expand day care facilities. Post-conflict manpower training programs will also be mounted in the North and the East. 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. A Lanka Service Network will be created as a computerized, interactive database of job seekers, employers and other employment service providers. An on-line employment search service will be developed, containing information on local and foreign employment opportunities. An island-wide network of centers, operated by commercial banks or other private sector providers, will make available information about employment opportunities on-line. This may, in the future, be expanded to include information on employment services, with the capability of handling issues such as pension payment services, disability benefit payments and crisis management payments[31].

[28] See SAPROF Study Team for OECF, *Poverty Alleviation Micro Finance Project*, 1998.
[29] Chandisiri, S. *Industrial Development and Poverty Alleviation: Emphasis on SMI Sector Industries*, report prepared for the Poverty Framework, 1998.
[30] Asian Development Bank, 2001, *Small and Medium-Enterprise Sector Development Program*, Manila.
[31] For more details on institutional reforms to support employment growth, see Ministry of Employment and Labour, 2002, *Draft National Employment Policy for Sri Lanka*, Colombo.

Government faces severe fiscal constraints. As a result, it will not be possible to launch special poverty-reduction oriented programs in each and every sector. To ensure that adequate opportunities are created for the poor to participate in the growth process, sectoral strategies will be defined in a way that explicitly incorporates poverty reduction objectives. By mainstreaming poverty reduction objectives within sectoral development strategies and programs, Government will enhance the degree to which the poor benefit from wider development processes.

Mainstreaming Poverty Reduction in Industrial policy. Over the past decade, industrialization has generated more employment (some 600,000 jobs) for unskilled and semi-skilled labor than any other sector, effectively providing opportunities for large numbers of poor families to significantly augment incomes. Three main industrial sub-sectors dominate industrial activity, namely textiles and garments, food and beverages, and chemical, rubber and plastics, with each sub-sector contributing 44 percent, 24 percent and 16 percent to industrial production respectively. About 80 percent of all industrial activity is located in the Colombo and Gampaha districts. Industries have predominately located in these regions to be close to the main port. The industrial sector is now largely in private hands. While the state sector accounted for 65 percent of industrial production prior to 1977, the private sector accounted for 93 percent in 1998.

The textiles and garments sector accounts for nearly two-thirds of industrial growth in the 1990s. This sub-sector provides employment to nearly 350,000 persons, the vast majority of whom are low-income women. As the Multi-Fiber Agreement quotas (MFA) are withdrawn in 2005, the global textiles market will become much more competitive. Sri Lanka's garments industry will upgrade product quality and expand entry into more quality-sensitive product segments. Supported by an expanding domestic design and marketing capacity, some firms have already made this transition. The Garment’s Association has identified a clear strategy for meeting this challenge and Government will provide full support to the association to do so. In addition, Government will assist this industry by seeking quota free access into buoyant OECD markets. Quota free access for Sri Lankan garments into the EU market has already been secured. Government will continue to negotiate for quota-free access for Sri Lankan garments into both regional and OECD markets.

The Government's strategy for encouraging more opportunities for the poor in the industrial sector is based on providing an enabling environment for labor-intensive industrialization. This combines liberal access to imports of raw materials and capital goods, fiscal incentives for new enterprise start-up and expansion, support for the establishment of industrial estates and export processing zones, public subsidies for industrial pollution reduction, and long-term finance for small and medium-scale industrial enterprises. Deregulation measures and tax reform will be used to lower the costs of starting and operating enterprises. To spread the benefits of industrialization into poorer regions, Government is encouraging the formation of public-private partnerships to establish industrial zones in secondary towns and cities.

Tourism. If a lasting peace is achieved, the tourism industry could realize a major expansion in capacity and employment. Visitor arrivals have been fluctuating at between 300,000 and 400,000 per year since the early 1980s, due largely to the adverse effects of the ethnic conflict on visitor confidence. There are a large number of new hotels under construction and many hotels require deferred maintenance and rehabilitation investment. Tourism demand shows signs of recovery, with more than 450,000 visitors predicted for 2002. If tourism demand continues to grow, new investment alone could create as much as 150,000 new jobs in the tourism sector and a substantial number of new jobs in the construction industry. A new Tourism Act will be prepared to guide the expansion of the industry and to ensure that tourism will play an effective role in poverty reduction. In anticipation of a strong upturn in tourism demand, Government will utilize its existing network of tourism training facilities to ensure that adequate vocational training opportunities in the hospitality trades and construction exist in poor communities. This will require reorienting rural vocational training programs to give greater emphasis to English language skills, construction and hospitality trades. Government will encourage greater community-based tourism whereby villagers participate actively in creating tourism experiences. Eco-tourism offers a way to fund environmental protection, stimulate the incomes of the poor and encourage cultural exchange. Guidelines for operating a sustainable network of Village Tourism activity centers will be developed, an education/training program for culturally and environmentally sensitive village tourism operators mounted, and special efforts made to encourage small business development in areas that add value to the current tourism product range. For eco-tourism to play a valuable role in boosting incomes of the poor, low-income communities must be directly involved in planning its development. Government will ensure that low-income communities are not exploited or displaced by developers keen to expand eco-tourism facilities through suitable national and regional eco-tourism policies and strategies.

Mainstreaming Poverty Reduction into the Promotion of Overseas Employment. Expatriate employment is one of the main avenues for increasing incomes for nearly 700,000 Sri Lankans, the majority of whom are women from low-income families. Overseas employment generates official foreign remittances of more than US$1 billion per annum. The Government strategy in this area is aimed at promoting foreign employment while protecting migrant workers from abuse. The Government will conduct special promotional missions in destination countries and will allow qualified foreign employment agencies to establish operations in Sri Lanka. The Foreign Employment Bureau will be reorganized to allow it to provide legal support for migrants and to provide special skills development programs for persons wishing to go abroad. Public-private partnerships will be forged to provide skills training for qualified migrants. Improvements will be made to the migrant worker insurance schemes, housing credit and self-employment credit schemes for overseas workers[32]. The Bureau will make efforts to assist migrant women workers vulnerable to sexual abuse. Towards this end, the ratification process for ILO convention 143 concerning abusive treatment of migrant workers will be initiated. Punitive action will be taken against labor agents violating standard migrant worker procedures. Labor recruitment activities will be deregulated in a phased manner to enable migrant workers to negotiate directly with his or her foreign employer for placements abroad.

V. Assisting Ultra-Poor Communities: Incorporating Key Aspects of Participation and Empowerment

Area and group-specific interventions will still be required to bring poor, socially excluded groups into the economic mainstream. Target groups for "direct interventions" would include families residing in remote parts of the poorest Provinces, villagers in new settlement schemes, low-income fisherman and the urban ultra-poor. Too often area-specific development projects imposed "solutions" on poor communities that were not in line with the desires, aspirations and capacities of the communities that such initiatives were designed to assist. Even "participatory" projects and programs have sometimes unintentionally contributed to dependency and passivity in the poor communities.

Experience in Sri Lanka suggests that poor communities can effectively identify and overcome constraints to poverty reduction. This rich experience suggests that community-led development works best when community-based organizations actively participate in the choice of assistance, contribute directly to the capital investment, take responsibility for monitoring and guiding project activity and are vested with the responsibility for operating and maintaining project-delivered assets[33]. The single most important element of community-based development is to ensure that resources are provided directly to the ultra-poor communities, and that it is their decision-making which drives the choice of projects and the selection of service providers. In the future, a number of community-led development initiatives must

[32] Foreign Employment Bureau, Government of Sri Lanka.

[33] The experience of assisting small farmers through the Small Farmers and the Landless Credit Project (ISURU) provides a vivid example of the importance of fostering social capital to poverty reduction in very poor communities. Under that project, mutual-aid in farming and other self-help activities are promoted. This approach was first promoted by a leading NGO, the Sarvodya Movement in the late 1970s and was then adopted on a larger scale under the ISURU in the 1980s and 1990s. Under the ISURU, villagers form self-help groups, combine in voluntary group savings organizations, develop business skills and finance local enterprises. At a certain stage, the local credit organizations are formalized to become limited liability Isuru Development Societies, which can then be federated to form Isuru Development District Unions. These community and district organizations perform a wide range of functions, from enterprise finance to fund-raising campaigns for scholarships, cultural shows and other community events.

be mounted if the poor are to be "empowered" to re-enter the economic mainstream. Government will support such initiatives, in cooperation with non-governmental and community-based organizations, to assist specific target groups of very-poor communities. The role of Government will be to provide seed-capital and matching grants directly to community-based initiatives aimed at empowering those outside the economic mainstream. Through such activities, Government subsidies will provide assets - in the form of start-up investment, community goods and social capital---to augment the resources available to the hardcore poor. To ensure that public support is effective and sustainable, community based interventions should have full participation of target beneficiary households in all phases of project design and execution. This includes, *inter alia*:

- cost-sharing for all phases of the project;
- a suitable business plan for any investments that are to be made; and
- community-based organizations vested with the responsibility, authority and capacity to operate and maintain assets created through community-specific investment support.

Examples of projects and programs underway to provide direct assistance to such communities include: the Southern Regional Economic Advancement Project; the North Central Participatory Rural Development Project; the Pilot, Self-help Village Project in the Mahaweli areas; the Lunawa Community Improvement and Infrastructure Project; and the Poverty Alleviation Microfinance Project. In addition to these projects, it is anticipated that a number of new, community-development oriented ventures will be identified and implemented during the 2003 to 2005 period, based on identified demands by NGO and CBO leaders.

Youth. High rates of unemployment contribute to low incomes and poverty among the youth population. The Central Bank estimates that more than 70 percent of the unemployed are youth. The problem of youth unemployment has many causes but is intensified by the lack of an entrepreneurial culture and attitude amongst the youth. This, in turn, is related to limited economic opportunities for enterprising activities as well as the absence of entrepreneurial-related curriculum in the vocational and secondary schools. To reduce the high level of youth unemployment, the Government will launch a new National Youth Corps (NYC) to provide vocational training and career guidance to unemployed youth aged 17-22. In addition to vocational skills development, the NYC training will inculcate leadership qualities while providing personality development and career guidance to these young men and women.

6. Investing in People

A country invests in its people through its education systems and the provision of social services. Investing in people is usually one of the most important public-private partnerships affecting welfare and the incidence of poverty. Nearly half of all education and health care, and a significant portion of the other social protection services, are provided by private, non-governmental and community based organizations. As the demand for social services rises, Government will need to increasingly target its human resource investment to the poor, and will need to work more closely with the private and non-profit sectors to ensure that services are provided to meet the needs of all Sri Lankans.

Basic education and health services are widely available and well utilized in Sri Lanka. High rates of literacy, low levels of infant mortality and steady increases in life expectancy are some of the significant achievements of sustained commitment to making education and healthcare accessible to all. Women's access to education and healthcare services has inspired a rapid decline in the birth and infant mortality rates. Broad-based social protection systems have ensured that severe destitution and food insecurity are largely a thing of the past. Despite the large numbers of population settlements in remote, rural regions, clean drinking water and sanitation systems are available to nearly two-thirds of the population.

But access to good quality social services is not the same for everyone. The quality of public health, education, drinking water, sewage and sanitation services in poor, rural villages is inferior to that available in the major urban centers. Social protection systems have tended to blunt incentives to work and suffer from targeting problems. Unplanned urbanization has contributed to the spread of slums and shanty towns, where sub-standard shelter abounds.

I. Education

Sri Lanka enjoys impressive basic education attainment indicators in comparison to other developing countries at similar levels of per capita national income. Net primary enrolment in basic education (grades 1 to 9) is about 85-90 percent; gender parity has been achieved in school enrolment and completion through major grade cycles. Estimated adult literacy rates, measured in terms of minimal language competency, are over 90 percent.

Modest levels of public spending on education support the comparatively high basic education attainment levels. In recent years, the Government has invested between 2.5-2.9 percent of GNP.

Ambitious goals have been set for the education sector. The net enrollment rate in primary education is expected to increase from 96 percent in the year 2000 to 100 percent in 2005. Universal secondary school enrollment will be reached by the year 2010, and nearly 85 percent of the students will attend secondary school in 2005. Students will become increasingly computer literate. Nearly half of all students will be exposed to computers by 2005, compared to just 5 percent in the year 2000. To deliver these results, there will be more trained teachers, more students in tertiary education and far better equipped schools. The number of trained teachers will be increased from 59 percent of the total in 2000 to 90 percent in 2005; at least half of all schools will have libraries by 2005 and some 15 percent of the students aged 20-24 will be enrolled in tertiary education. The numbers of students enrolled in vocational training will rise from 48,500 in 2000 to just under 72,000 by 2005. At the same time, just under half of all vocational training courses will be converted into competency based training.

Although Sri Lanka has universal access to primary education, the poor quality of education services received by many poor students contributes to high dropout rates and the low returns accorded to basic education in the labor market. About 2,000 schools, most of which are in poor rural areas, lack basic facilities such as desks, chairs and blackboards. There is a key shortage of quality inputs, particularly teaching materials in subjects such as science, mathematics, environmental science and English. Many schools in remote and/or "difficult" areas do not have trained teachers, while some schools in more favored areas have surplus teachers. Efforts to raise education achievement levels and to introduce a child-centered curriculum have been hampered by frequent teacher absences from schools. Under Sri Lanka's public service rules, teachers are entitled to over 40 personal leave days in addition to their normal holidays. 50,000 teachers, or close to 27 percent of the total cadre, are untrained, and it is the untrained teachers who are primarily assigned to the poor, rural schools. Teachers' lack training in instructing children with special needs and the special learning needs of children in conflict affected areas needs to be addressed. While general education from grades 1-9 is compulsory, only a network of primary schools (grades 1-5) has recently been established in the estate sector[34].

Quality Constraint: Sri Lanka has recorded impressive levels of primary (grade 1-5) and junior-secondary (grade 6-9) enrollment rates. However, these enrollments have not been translated into satisfactory learning achievements, especially among poor and marginalized communities. There is a disconnect between level of school *attainment*, measured by indicators such as enrollment and number of school years completed, and perceptions of learning *achievements*, measured in terms of language competency and mathematical ability. The limited available evidence suggests that learning levels show wide regional disparities, and are weakest among poor, marginalized social groups, and conflict-affected communities.

Institutional Constraints: Systemic weaknesses limit the potential of the general education system to promote satisfactory levels of learning achievement, essential to promote personal and economic development. These include: (a) restrictive legislation constraining private sector participation in education; (b) inadequate teacher deployment, especially in poor areas and to schools with predominantly poor children; (c) an unwieldy centralized education management system that contributes to inordinate administrative delays, poor stakeholder involvement in decision making, and limited responsiveness to community needs; (d) acute shortages of quality inputs in classrooms; (e) inequitable distribution of educational resources between school and across regions; and (f) insufficient attention to the role of education in promoting social harmony in a multi-cultural society.

Language Constraints: Development has been hindered by current language policies. Lack of fluency and competence in modern international languages, especially English, has limited the potential of school graduates to participation in the global marketplace and in the lucrative domestic private sector employment in the economy. The policy of segregating schools according to language streams has also contributed to the lack of mutual understanding and appreciation of cultural similarities and diversities among communities.

Tertiary Education Constraint: Serious inadequacies in tertiary education limit potential for national economic development. The relatively high enrollment in secondary education has resulted in intense pressure for access to tertiary education. There is an excessive waiting period of up to two years, before university entrance. The tertiary GER is well below that of countries with whom Sri Lanka has to compete in a technological sophisticated global economy. Notwithstanding this low participation level, unemployment among graduates is high despite the critical skill shortages in some key areas of the economy. Furthermore, employers express dissatisfaction with the competencies and skills of graduates. Curricula in many disciplines are not in tune with broader economic and social needs. Pedagogical practices do not encourage the acquisition of competencies and skills in demand in the labor market. Legal restrictions limit private sector participation in university education and the current budgeting process does not provide incentives for performance

The Reform Program: Starting in the 1990s, the Government embarked on a major education sector reform program. Recent and planned steps include, inter alia,

- General education reforms were introduced on a pilot basis in the Gampaha District in 1998 and have gradually been extended to the whole island.

[34] See Aturupane, *Education and Poverty in Sri Lanka*, Poverty Framework Technical Report 1998.

- Tracking performance is central to the Ministry of Education's efforts to enhance the quality and relevance of education.

- An effort will be made to redress regional inequities in the provision of basic education facilities and instructors.

- A major effort will be made to expand education facilities for children with special education needs.

- The Government is also mounting reforms to promote social harmony through education by opening the school curriculum to nation-wide analysis and scrutiny for bias, establishing multi-cultural textbook review panels, and exposing stakeholders (including teachers and students) to efforts in other countries to promote social harmony and respect for diversity through the education system.

- A program is being implemented to improve the quality of secondary education, focusing on the teaching of English, Science and Mathematics, and the provision of new technology courses, teacher training programs, computer learning centers and career guidance activities.

- School and teacher consolidation to ensure that there are adequate recurrent expenditure allocations for basic education.

- School-based management systems will be introduced to enhance efficiency and promote stakeholder participation including communities at the local level.

Government is committed to ensuring that private sector can play an integral role in the education system. The MEHE has opened school textbook publication to the private sector and engaged in dialogue with international and private schools on sector-wide issues and problems. In the future, a clear accreditation process for the establishment and functioning of private and international schools will be established. Improving the quality of the general education system will be an expensive, but essential, process. With limited resources, Government recognizes that it will need to concentrate spending on rural schools and other education institutions utilized by the poor. Private education will need to play a growing role in catering to the demands of those who are relatively well off. Towards this end, Government will continue its liberal licensing policy for private schools, while ensuring that education quality standards are rigorously adhered to.

Post-secondary skills training institutes suffer from a mismatch between the training offered and the skills required in a modern, market economy. Management deficiencies, outdated equipment and curricula, and a shortage of capable trainers lead to high dropout rates and low returns to training. The government's strategy in post-secondary skills training is to promote the private sector as the main provider of pre-employment and job-entry training.

Performance standards for vocational training will be revised along the lines of competency based training and will be based on standards derived from industry. A Higher Institute of Applied Technology will be established to lead the vocational training process and to provide a recognized system of professional certification in the vocational trades. A network of 30 rural vocational training institutes, centered in Galle, will offer high-level computer training to some 4,000 rural youth in 2003 and more centers will be established thereafter. Vocational and Education Training Plans will be prepared; skills training will be linked to tested competency levels; and high quality skills will be maintained through a system of accreditation and national vocational qualifications[35].

[35] Ministry of Human Resource Development and Technical and Vocational Education, *Six-Year Development Program: Technical Education and Vocational Training Sector*, Colombo 2001.

Progress in tertiary education in Sri Lanka stands in sharp contrast to the progress made in basic education. Among the steps that will be necessary are:

(a) establish an independent accreditation authority for quality control and standard setting functions;
(b) strengthen tertiary education programs in fields such as business management, computer science, engineering, economics and the natural sciences,
(c) raise academic standards in the universities by introducing Department and Faculty based performance review systems, tracking systems of graduate's employment, expanding professional training opportunities in existing Postgraduate Institutes and upgrading the management skills (including financial management) of University administrators;
(d) create endowment funds in each university and increase autonomy of the universities in the utilization of income generated and collected by the University,
(e) expand University decision-making authority in hiring and placement of all staff;
(f) extend quality control supervision to the private tertiary education institutes; and
(g) expand university offerings to meet public demand, including an expansion of open-university facilities in regional centers for distance education.

An additional 25,000 students will have access to Open University facilities by 2005. A number of Open-University tele-centers will be established by the Open University and Sri Lanka Institute of Advanced Technical Education by 2005, providing training and community internet access to more than 500,000 Sri Lankans nationwide.

The private sector can play a valuable role in broadening access to tertiary training services. In the future, the private sector will be encouraged to invest in Universities, technical training facilities and other post-secondary educational institutions. A voucher system will be introduced for the poor to ensure that they have equal access to privately provided sources of post-secondary education. A Human Resources Endowment Fund will be established to support this important venture.

II. Health and Nutrition

Sri Lanka has provided good healthcare since independence, achieving developed country standards in death rates, maternal mortality and life expectancy by the late 1970s. Notwithstanding its overall good performance, the healthcare system faces several major challenges. In recent years there has been a resurgence of malaria, over 60 percent of pregnant and lactating mothers suffer from anemia and about 20 percent of the children under five are chronically undernourished. Moreover, the sizable remaining nutrition gap is concentrated among the economically most vulnerable in the island, the poor and conflict-dislocated populations.

Healthcare is financed equally by the government and by households' direct out-of-pocket payments. The government has encouraged expansion of private healthcare as the public sector recognized its inability to keep pace with increasing demand for hospital-based care and higher quality services. Private health care services provide nearly half of all out-patient care but just five percent of all hospitalization services. Recent surveys find that the poor directly finance a considerable share of their own out-patient service care. In the future, Government support in the health sector will need to be concentrated more on the poor, with the public sector reducing its role in providing subsidized health services that cater to all segments of society.

The main goals of the health sector have been framed in way to reflect the health concerns of highest priority to the poor, including:

- improve the nutrition levels for infants, children and pregnant women,
- to ensure that the incidence of non-communicable diseases is kept very low,
- to free the nation of malaria and communicable diseases such as dengue hemorrhagic fever,

- to ensure that patients receive medical care of an international standard and
- to provide maximum care for disadvantaged groups.

By the year 2005, the rate of infant malnutrition should be reduced from 20 percent to 10 percent and automation will be used to modernize health management and information systems in about half of all public health facilities.

The ability of the health system to adapt to emerging needs is limited by rigidities and structural weaknesses. The five priority areas identified for health sector reforms include the following:
- to expand access to curative health care services (through hospitals and other providers) at the district level in order to make these services more accessible in poor, rural areas;
- expand health care services to meet the needs of specific groups such as the elderly, victims of war and conflict and promoting specific areas of health care such as occupational health problems, mental health care and estate health services;
- development of health promotional programs, with special emphasis on outreach through the schools. Better disease prevention amongst the poor can reduce the health financing burden and contribute to more rewarding and productive lifestyles;
- reforming health care funding, with the aim of concentrating public support on the poor, and including a better effort to mobilize and manage resources in both the public and private sectors; and
- rationalizing the development of human resources.

These reforms have gradually been implemented during 1998 to 2001, and will be continued during the next three-year period. A Health Sector Reform Implementation Unit has been established to lead the implementation of these reforms.

The current system of curative care is heavily reliant on metropolitan hospital-based care. Given overcrowding of hospitals, alternative strategies are needed. Experience from developed countries points to the need to develop a continuum of care that incorporates long-term health care management. Additional actions include the need to improve the quality of care and reach at all levels, including regional hospitals, through a combination of investments to upgrade existing facilities and rationalizing existing services.

To enhance access of the poor to essential healthcare services, the provision of curative health services will be rationalized by introduction of a hospital based management system. Existing maternal and child health care programs will be strengthened and estate health facilities will be fully integrated into the national health service. Four regional mental health centers are being developed. When completed, the nation will have six such centers in total. Government is updating the Mental Health Act, is training more officers in psychiatry and is appointing more medical officers in mental health wards. Government is also launching an intensive training program to overcome the acute shortage of nurses in the country. By 2005, the shortage of nurses in government and private health facilities should be largely overcome. Steps have also been taken to train more technical personnel, such as pharmacists, radiographers, laboratory technicians and physiotherapists.

To meet the challenges posted by the demographic transition and the changing morbidity profile, the Government will continue to encourage the private sector to develop secondary and tertiary care private hospitals. Government will expand training in geriatric medicine and will encourage the adoption of health insurance to meet the financing requirements of increasingly sophisticated medical care.

A number of emerging challenges to the health sector can most effectively be addressed through behavioral changes adopted by the population. An important example is the growing disease burden from tobacco and alcohol consumption, traffic accidents, and poisoning. Health information, education and communication programs will be strengthened, with specific programs aimed at reducing the incidence of malaria, HIV/AIDS, water borne and other communicable diseases. In addition to hospital based duties, para-medical staff will come to play a growing role in the provision of public health and first-stage community referral health care services. This would include expanding the public health response to tuberculosis, HIV/AIDS and STDS with greater attention to poor and vulnerable groups. Greater priority will also be accorded to the prevention of tobacco, alcohol and drug abuse in public health programs.

Widespread anemia (especially among females), a high prevalence (17% in the late-1990s) of low birth weight babies, and a high prevalence (around 29% in the late-1990s) of low weight-for-age among preschool children, are some of the principal nutrition problems. Nutrition supplement programs aimed at providing iron tablets to anemic women and fortified weaning foods for infants (such as Thriposha) have been fraught with logistics and user acceptance problems. The Government's strategy for improving nutrition status will combine better targeting and clearer identification of the vulnerable groups and more integrated approaches in which caring practices and healthcare services are linked to community public health efforts. Halving the rate of infant malnutrition is one of the most important health-sector goals for the next five year period[36].

There is a need for a coherent policy framework for redefining the roles of the public and private sectors in health care provision and mechanisms and capacity for effective regulation. Towards this end, the Government will enact a new Private Medical Institutions Bill, which will create a regulatory body to strengthen and oversee the provision of private health care. The Government supports a policy of universal health services for all its citizens. Ensuring the continued financial sustainability of the health sector while protecting equity of access and quality of care poses an important challenge. To enhance the financial sustainability of the healthcare system, the Government will, by 2003, adopt a national health sector program approach that would introduce measures aimed at overcoming regional disparities in access, rationalizing investments and services, encouraging the adoption of health insurance, and strengthening hospital-based management systems.

III. Water Supplies, Sewage and Sanitation

The provision of safe drinking water, and adequate sewage and sanitation systems, is frequently cited as the single, highest social-service priority by poor households. In some districts over half of the rural population not have access to safe drinking water supplies. Groups that have poor access to sanitation include those living in the underdeveloped districts of Nuwara Eliya, the tea, coconut and rubber plantation estates, peri-urban slums, remote rural areas and the conflict affected areas of the North and the East.

The Government's objective is to ensure safe water to 85 percent of the population by 2010. The draft *National Policy on Rural Water Supply and Sanitation Sector* recognizes that water is a basic human need, but also has an economic value. Users should contribute to investments and bear the recurrent costs of drinking water and utilizing sewage and sanitation services.

The provision of clean drinking water, sewage and sanitation services has exceeded Government's institutional and financial capacity. New modes of delivery safe water and primary sanitation facilities are being developed, that will increasingly rely on public-private partnerships. For several years the *Water Board and the Community Water Supply Program* have both formulated policies and acted as project implementers. Growing competition for water amongst sectors, and the lack of a clear policy, results in substantial water shortages in some parts of the country. This is mainly felt by the poorer community which depends on natural springs for their drinking water supplies and small-scale farmers.

Government estimates that the investment requirements in the water sector will be as much as Rs.50 billion over the 2001-2010 period. Public investment may be sufficient to meet at most half of this requirement. This underscores the importance of attracting private sector investment into the provision of clean water. A pre-requisite to this is the introduction of a water pricing policy that is based on the cost of delivering water and other economic criteria.

[36] Ministry of Health, 2001, *Poverty Reduction Strategies on Health,* Colombo.

Under existing arrangements, domestic water consumers are heavily subsidized by non-domestic consumers. Since the latter account for only a small share of total sales, heavy cross-subsidization is financially unsustainable for the National Water Supply Development Board. Government should rationalize water tariffs to ensure that these reflect the economic costs of providing clean water and will phase-out the heavy cross-subsidies amongst different classes of water users. Within the acknowledged limits of affordability the Government will seek full cost recovery in its tariff policy. The heavy cross-subsidization of the domestic consumers by the industrial consumers should be substantially reduced. This will make more money available for extending direct connections to the under-served urban poor.

At present, the water supply coverage is only 57 percent of the rural population. The approach to provide water to rural communities will combine community development, capacity building of local authorities and health education. The main strategy for supplying drinking water in the rural areas is the provision of tube wells and dug wells, protection of springs and the supply of piped water. Government will continue to expand access to water supplies and sanitation services in the rural areas, but with more of a demand-driven orientation in service provision. Water consumer societies, representing both those served and to-be-served with piped waters will be promoted. New institutional arrangements will be made to provide greater focus to rural water supply and sanitation development within Government.

Eventually the mandate for rural water supplies would be fully shifted to local authorities rather than the Water Board. The Water Board would then be responsible for delivery of water and sanitation services to small towns with more than 1000 households. Future provision of new rural water supplies and sanitation services will be on a more demand-led basis, with NGOs and CBOs playing an important role in the provision and operation of such systems. The Government's strategy is to encourage rural communities to contribute to the construction of piped water systems and to then manage those systems on a community basis. Local communities will be required to finance the operations and upkeep of their water supplies and sanitation systems. The RWSSD will set quality standards and assist in the capital development programs, but local communities will be fully responsible for the operations and maintenance of local water supply and sanitation systems[37].

The strategy for improving access to clean drinking water and sewerage services in the major cities and towns differs from that pursued in the countryside because of the size and scale of the water-delivery systems involved. Inadequate sewage and sanitation infrastructure in the urban and peri-urban areas is one of the leading causes of public health problems in poor urban communities. Piped water service is available to only 29 percent of the population and large-scale sewerage services are available only in the Colombo municipality. These are prone to floods and wastewater overflows into the storm water system due to insufficient canal capacity, lack of suitable drainage, inadequate canal maintenance, and incorrect house connections and wastewater disposal into the storm water drainage system[38]. The Colombo piped water supply suffers from low water pressure and poor water quality. Most urban townships depend on on-site sewage disposal facilities that are falling below acceptable health levels. Ground water supplies are susceptible to contamination from on-site sewage disposal facilities.

There is an urgent need to rehabilitate and expand the water supply, sewerage and drainage services around the country, yet investment requirements are very large indeed. The private sector will have to play a major role in this effort since it is estimated that some US$50 million per year for the next decade will be required to rehabilitate and expand water supply and sewage services in the main urban settlements[39]. Demarcation of potentially profitable service areas has been made and the private sector will be invited to enter into partnerships with Government to operate, maintain and extend water systems through long-term concession contracts, leases, management contracts and BOO/BOOT service provision. To facilitate private sector involvement in the water sector, Government will establish an independent regulatory authority that will set tariffs and regulate water delivery quality.

[37] Ministry of Urban Development, Construction, Public Utilities, Housing and Sports, 2001, *Background Information for the Poverty Reduction Strategy Paper*, Colombo.
[38] See Eber, Hilke, (1999) *Improvements to Urban Infrastructure and Service Delivery in Underserved Settlements in the City of Colombo*, GTZ.
[39] National Water Supply and Drainage Board (1999), *Six Year Development Program.*

The existing sewerage infrastructure is grossly inadequate for the urban centers. The sewerage network is limited to a small area serving just a quarter of Colombo and a large section of that is need of a complete overhaul. The Government strategy is to focus public investment on improving sewerage networks in major townships, particularly in the Greater Colombo metropolitan areas, while encouraging private sector participation in the operation and maintenance of sewerage disposal systems. Charges will be introduced within the Greater Colombo sewerage network in order to meet the operational costs of running that system. Government will also license private sector operators to provide water supply, wastewater treatment and sewerage services for the major cities and towns.

Solid waste management. Sold waste management has become a major concern due to its impact on public health, the environment and the low-income community. Collection and transport of solid waste are carried out by the local authorities with different levels of service and little capacity for meeting minimum accepted health or environmental standards. Local authorities are obliged by law to collect and dispose of solid wastes put out by residents in areas in their jurisdiction. These wastes have largely been disposed of within their own boundaries and increasingly the local authorities are running out of space. In addition, open dumping of solid waste has created a myriad of public health and environmental problems.

The Government has prepared a *National Solid Waste Management Strategy* which shifts the role of local authorities from being a provider of solid waste management services to a facilitator of a range of public and private waste management efforts. Implementation of the strategy implies that Government will contract-out with, and regulate, private provision of solid waste management services, that private investments will be facilitated, that local authorities and Provincial Councils will local suitable sites for waste management; that NGOs and other community organizations will be encouraged to foster waste segregation and recycling programs and that provision will be made for the use of common treatment facilities. New waste disposal processes, including biological treatment, biogas generation and composting are underway. The current practice of open landfills will be brought to an end and a new system of properly engineered sanitary landfills will be established. The National Solid Waste Management Strategy provides a framework for improved cooperation between the environmental authorities, urban development authority, zonal ministries and provincial councils in coordinating matters related to solid waste management.

Suitable charges must be levied for water supply and sewerage, otherwise there will be a tendency towards excessive water use and a lack of attention to maintaining the drinking water and sanitation infrastructure. Suitable revisions to the government tariffs on drinking water and sewerage will be developed. These will balance the needs for affordable drinking water and widespread sewerage hookups, on the one hand, and adequate resources to maintain sewerage and water supply systems on the other.

IV. Social Protection

Sri Lanka has a long tradition of providing income support to poor groups. Nearly one-fifth of the Government's current expenditures are used for transfers to households - a share of public spending normally witnessed only in upper-income OECD nations. A wide range of government agencies operate transfer schemes. The Department of Social Services provides assistance to orphans, poor widows, the disabled, elderly-poor and disaster victims. The Samurdhi program provides cash grants to some 2.1 million families[40] and separate cash grants to 82,000 families under the infant nutrition program. It also operates a range of compulsory savings programs, a Samurdhi bank society and national youth job creation and village development efforts. In the area of social protection, the Government's aims are to (i) improve access and quality of care for the poorest groups; (ii) enhance the efficiency and impact of income transfer, public works and community development schemes; (iii) help the poor to more effectively manage catastrophic risk; and (iv) address the special poverty needs of socially excluded groups. In the future, social protection expenditures will be focused mainly on those who are unable to

[40] Including some 403,000 Janasaviya families transferred to the Samurdhi program.

earn an adequate living, such as the disabled, orphans, the elderly-poor, and the socially excluded and other vulnerable groups.

Caring for the poorest groups. The Government provides income transfers and special social services to alleviate the effects of economic misfortune for the most disadvantaged and vulnerable groups. In 1999, some 200,000 indigents received Rs.643 million per annum in public assistance grants of up to Rs.5,000 to start self-employment projects. Assistance was also provided to the victims of floods, landslides, cyclones and man-made disasters for low-income victims. Care for the poor aged and disabled is provided in state-run institutions and voluntary homes, which are assisted by the government. Handicapped persons are provided vocational training by these centers so they can return to society with useful skills for self-employment. Total expenditures of the Department of Social Welfare reached Rs. 1.4 billion in 1999, some 40 percent of which was allocated to public assistance grants for the indigent.

Government has a long history of collaborating with NGOs on relief, charity and community service-based programs aimed at assisting the poorest segments of society. The main goal of social assistance reform is to protect the rights of disadvantaged groups and upgrade their skills to make them full partners in economic development. To make social services more accessible, Government will establish a network of Social Development Service Centers at the Divisional Level. Public spending on social services is projected to increase from Rs.1.4 billion in 2002 to Rs.1.7 billion in real terms by 2004, in line with an expansion in the quality of care to destitute and other hard core poor groups. Government's strategies to achieve these objectives include[41]:

- **Better protect the disabled, abused, exploited and abandoned children:** by expanding both community-based treatment and institutional protection. More rehabilitation centers will need to be established, in cooperation with NGO groups, to provide equal opportunities for children in need. Emphasis will also be placed to improve the quality of care in existing state receiving homes, remand and detention center. Attention will be devoted to protect and rehabilitate children involved in child labor and victims of sexual abuse. Foster parents programs, increased training of officers involved in promoting child rights and an expansion of child welfare centers will be supported.
- **Disaster risks will be reduced:** by adoption of better disaster management techniques, preparation of a disaster management plan and information system, and the development of early warning systems for natural disasters. Support will also be provided to assist those suffering from natural disasters, through provision of agro-wells, flood resistant houses, agro-inputs purchase, and other forms of flood and drought relief.
- **Community based rehabilitation (CBR):** Launched in 1992, this program is now operative in 126 Divisional Secretary Divisions, and will be gradually extended nationwide. Under CBR, trained volunteers direct disabled persons to medical treatment, provide them with physiotherapic and psychiatric treatment and train them for self employment with the assistance of families and village rehabilitation committees in various vocational subjects. Vocational and entrepreneurial training programs will be expanded and special training of teachers of the disabled will be promoted. Efforts will also be taken to promote awareness on the creation of a barrier-free environment to provide accessibility for persons with disabilities. Other steps will be taken to promote and advance rights of the disabled, under the guidance of the National Council for Persons with Disabilities.
- **Improved Mental Health.** Technical committees will be established to help integrate Mulleriyawa Hospital patients and to assist in social reintegration. Halfway houses will be established in the provinces for persons treated and recovering from mental illness.
- **Augment support for the elderly-poor:** by revising the public assistance scheme to support the minimal living requirements of the elderly poor who cannot meet old-age survival requirements. The main emphasis will be on providing public support for home-based care for the elderly. Families will continue to be encouraged to care for the elderly. However, the situation of carers, who are often women income earners in poor families, needs to be recognized. Additional elders' homes for the elderly-destitute will only be provided where there is a clearly demonstrated need.

[41] Ministry of Health, Indigenous Medicine and Social Services, 2001, *The Social Services Sector*, 2002-2005.

Government will encourage the population to save more for old-age income replacement requirements. Geriatric welfare concerns will take on increasing importance as the population ages. A superannuation Benefit Funds Bill will be enacted to regulate private pension funds. Private pension fund management, together with improved collection and operation of public retirement funds, will be encouraged.

Samurdhi Reform. Special attention needs to be paid to the Samurdhi program for it is, by far, the single largest welfare program in the country, with total expenditures running in excess of Rs. 11.7 billion in 2000, or nearly 1 percent of GDP. With an inflation adjustment for cash transfers, Samurdhi costs increased by 22 percent in 2000, straining the government budget. The number of Samurdhi beneficiaries has steadily increased from 1.5 million families in 1995 to around 2 million families in 2001 and early 2002, due mainly to the lack of an effective screening and exit mechanism. Recent research finds that the program does not assist some 40 percent of the poorest income quintile at all and that there is some ethnic bias in the distribution of assistance[42].

Considering the risk of budgetary overruns, the Government has reduced funding for the Samurdhi program by approximately 25 percent between 2001 and 2002. This has already inspired better targeting of the more limited social assistance resources. To further improve the effectiveness of the income transfer component of the Samurdhi program, the Government has prepared a Welfare Benefit Law. This spells out the entry and exit criteria for all welfare schemes in the country. With the legal backing from this Act, the government can further reform the Samurdhi program. Once targeting improvements have been made, it is estimated that about 1 million families will require such assistance. In the medium-term, all welfare schemes will be brought under the Welfare Benefit Law, effectively ensuring that social assistance is well targeted to the needy[43].

Other components of the Samurdhi program also merit reform. The second component of Samurdhi consists of a series of efforts aimed at community development through investments in economic and social infrastructure, agriculture, nutrition and small enterprises. Many of the Samurdhi capital and enterprise development projects are planned and executed in an ad-hoc manner, resulting in technically inferior investments and limited community involvement in maintaining assets. In the future, only those community development projects that are well designed and thoroughly endorsed by the local community will be financed. A far greater measure of community co-financing will be required. This will help reveal the extent to which local communities, in fact, desire such projects.

The third component of the Samurdhi program is its savings and financial markets program. Samurdhi has encouraged savings through some seventy thousand Samurdhi household groups and more than one thousand Samurdhi bank societies (SBS). There were 920 Samurdhi bank societies at the end of 2000, with some 1.5 million accounts opened since these bank societies were established. The total savings in the SBS reached Rs.1,588 million and loans were granted to a value of Rs.2,745 million at the end of 2000. Repayment rates under Samurdhi credit programs are quite high (due in part to the use of future welfare payments as quasi-collateral) and there is evidence that the Samurdhi banks are flexible enough to cater to the needs of the poor. These institutions also play an important role in providing emergency credit to the poor. But efforts should be made to ensure that the Samurdhi financial institutions are, in fact, financially sound and that the use of their resources is in line with community preferences and sound financial market practice. Government's strategy to safeguard the savings of the poor is to encourage larger banks and non-bank financial institutions to forge formal links with the Samurdhi financial institutions. Government will also require that the Samurdhi financial institutions undertake financial audits as they expand in size[44].

The fourth component of Samurdhi is the Social Security Trust Fund. Under this scheme, households contribute Rs. 25 per month against which they can claim insurance payments for death of a family

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[42] Glinskaya, Elena (2000), *An Empirical Evaluation of Samurdhi Program*, World Bank draft report.
[43] Samurdhi Authority of Sri Lanka (2001), *Poverty Reduction Strategy Paper for 2002-2005*, Monitoring and Evaluation Division, Colombo.
[44] Tennekoon, M.U.A., *Samurdhi Program in Poverty Alleviation*, 1998 and Gunatilaka, R. *Note on Poverty Issues Relating to the Samurdhi Program*, UNDP 1999, technical reports prepared for the Poverty Framework.

member (Rs. 5,000), marriage of one child (Rs. 3,000), birth of a first child (Rs. 2,000) and illness (Rs. 50 per day hospitalization up to Rs. 1,500 for a year). In its first three years of operation, some 11 percent of those covered have claimed benefits, and the program has been able to build reserves. The Samurdhi Social Security Trust Fund plans to expand coverage to education insurance, old age pensions and a broader medical insurance.

A range of private and non-governmental organizations also provide social insurance for workers in the informal sector. Death donation societies, for example, help spread the costs of burial widely throughout the village community. The 8,000 SANASA thrift and credit cooperative societies have developed the All Lanka Mutual Assurance Organization Ltd. (ALMAO) to make insurance cover available to the poor. ALMAO provides life insurance, social security coverage, loan and savings protection, and property insurance, and personal accident benefits have been provided to more than 40,000 poor households in seventeen districts of the nation.

Government's strategy is to encourage the development of social insurance, both by Samurdhi and by a range of non-governmental organizations, on a commercial and competitive basis. Government will provide a regulatory environment for social insurance programs, and will help defray part of the premium costs for the poorest groups. Increasingly, the Government will shift its social protection efforts from transferring income to large groups of the poor - a reactive endeavor - to helping the poor better manage catastrophic risk by enhancing the accessibility of social insurance. Indeed, over the next decade, it is anticipated that the main focus of social protection measures will switch from being based on cash transfers to broadening the coverage of social insurance. Since the later is largely financed on a commercial basis, this will imply a steady reduction in government outlays for Samurdhi programs.

The Samurdhi program employs around 24,000 animators and 1,500 managers. As the number of income transfer recipients falls, and the focus shifts more to provision of social insurance and financial market services, there will be a need to correct staff imbalances and ultimately reduce the number of Samurdhi staff. Government will prepare a plan for the restructuring of the management and staffing of the Samurdhi program in light of the new Welfare Benefits Law and the anticipated changes in the program's mandate and responsibilities.

V. Improving Under-Serviced Urban Settlements

Urbanization is proceeding at a rapid pace. By the year 2010, it is anticipated that half of the estimated population of 21 million will be living in urban areas. While the poor are now largely concentrated in rural areas, a rapid shift of rural households to an urban environment will likely increase the ranks of the urban poor. Already, large concentrations of the poorest households are now to be found in the urban slums and shanties, where poverty, inadequate services and social and psychological insecurity are serious concerns[45]. There are some 780,000 persons residing in urban slums in 2,160 sites in Colombo. In the Colombo slums, 84 percent of income earners are unskilled/casual workers, 85 percent of families earn less than Rs. 2,000 per month and 35% are households headed by women.

The Government's urban development policy will exploit the inherent strength of cities to generate greater economic activity, to alleviate growth and competitiveness, to reduce urban poverty and to maximize employment opportunities. With respect to the poor, Government is seeking to reverse the development of slums and shanty towns, to provide urban services on a sustainable basis to poor communities and to ensure that adequate shelter is provided for all.

Urbanization in Sri Lanka has proceeded largely in an unplanned manner, with peri-urban sprawl imposing strains on municipal services and adding to congestion. Urban management by local

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[45] A recent review finds that 84% of the urban poor are casual workers who rely on informal sector employment; 85% have family earnings less that Rs.2,000 per month; the average dwelling size is just 20 square meters; one water tap is available for about 128 persons and one toilet for 36 persons; infant mortality rates range from 32-54 per 1000 live births (compared to a national average of 19) and some 23% of the children drop-out of school before the age of 14 years (Colombo Municipal Council, Poverty Audit, 1999).

government has been weakened by a neglect of the way in which urban and town boundaries have been defined. A combination of an underestimation of the urban problem with obsolete settlement regulations has prevented municipal authorities from playing an effective role in urban development. Government's future urbanization settlement strategy will include:

- rational municipal spatial development plans, with a suitable regulatory framework, including zoning laws
- the creation of an enabling environment for private investors to participate in all aspects of urban development, including slum improvement
- strengthening local municipal councils and urban councils to deliver effective services, and
- under-serviced settlement improvement including the provision of affordable housing.

Delivery of affordable housing poses the greatest challenge. The overall shortage of houses in Sri Lanka could reach 650,000 units by 2010 from the current level of around 400,000 units. A large number of the existing housing units are of sub-standard quality, needing substantial physical improvement and access to utility services and public amenities. The shortage of affordable housing for daily wage earners is the major cause of shanties and low-income settlements around the city of Colombo. In the plantation sector, there is a large worker community forced to live in sub-standard quarters, often without basic amenities.

Several housing programs are already being implemented by both the public and the private sectors to provide reasonable shelter for all. The government encourages private sector investment in housing through a range of fiscal incentives and provides direct assistance to low income families to build or upgrade their housing. The National Housing Development Authority, the Ministry of Fisheries and Aquatic Resources, the Plantation Housing and Social Welfare Trust, the State Mortgage and Investment Bank and the Housing Development Finance Corporation are the main public sector institutions involved in the provision of housing to low-income groups. The basic strategy of public housing programs is to support a self-help system in which NHDA or other organizations provide a maximum loan of Rs.50,000 per beneficiary to build or upgrade their own house.

In addition to specific housing programs, the Government's strategy to ease the urban housing shortage involves an accelerated release of public lands in areas designated for strategic development, by rationalizing the legal framework to promote the rental market, by strengthening the housing finance market and by providing selected subsidies to make housing affordable to the very poor. A number of programs will be implemented to broaden access and upgrade the quality of housing available to the poor, including:

- **The sustainable townships program**. This is a self-financing voluntary re-housing program in the city of Colombo in which slum dwellers voluntarily exchange their dwellings, and land space, for re-housing in high-rise apartment blocks.
- **Special housing programs for the ultra-poor.** Concessionary financing will be provided to assist ultra-poor groups upgrade their housing conditions. This may take the form of housing grants and concessionary financing through popular financial institutions. This support will be provided to the disabled and handicapped, those displaced by natural and man-made disasters, fishing communities and overseas migrant workers.
- **Affordable housing for plantation workers.** Over the next five to seven years, some 200,000 housing units will be provided in cluster townships for the 300,000 workers engaged in the plantation sector. Each housing beneficiary will obtain housing loans against their EPF and ETF balance and may opt to purchase their house at the end of the repayment period. Under the Plantation Development Support Program (PDSP), there is a new housing and an upgrading package. Under the new housing package, a maximum of Rs.64,400 is granted to an estate sector employee to build a house. Under the upgrading package, a maximum of Rs.31,000 is granted per family. PDSP also supplies water supply and sanitation facilities, health and welfare facilities and other supporting services for existing settlements.

In the past, municipal services were provided by Government authorities to those in urban slums whether or not these were the priorities held by those communities. In the future, provision of urban services will be in response to community demand for services; it will use affordable service standards; costs will be shared between the community and government; and partnerships will be struck between community-based organizations and government in delivering these services. Local communities will be able to choose which services, such as clean drinking water, sanitation, solid waste management, access, sullage, storm water drainage and electrification, that they wish to have provided. Dwellers in under-serviced urban settlements will pay part of the capital costs and the operating costs for these services, and in exchange, over time they will receive title to the land on which they reside. Community based organizations will play a major role in organizing low-income households and in managing the provision of urban services. With the support of the donor community, Government will progressively adopt a community-driven approach to the supply of essential urban services in the under-serviced urban settlements.

Reducing urban pollution. Urban pollution constitutes a direct and immediate threat to the health and livelihood of the poor. The two most severe urban environmental problems are ambient air pollution and water contamination arising from industrial waste disposal. Government's goal is to improve the health of the poor, and indeed of all urban residents, by reducing urban environmental hazards.

Rapid motorization and urbanization has created an alarming increase in air pollution in many of Sri Lanka's metropolitan regions. Exposure to vehicular emissions, especially fine particulates and lead, is known to cause severe health effects. Lead poisoning affects the poor disproportionately - available data suggests that more lead is absorbed when there is iron or calcium deficiency and when children are malnourished. The quality of gasoline and automotive diesel used in Sri Lanka is poor, even by South Asian standards. This, combined with a large number of vintage autos and trucks, has contributed to an alarming rise in urban air pollution. In the first stage of the implementation of the Clean Air 2000 Action Plan, vehicle emission standards, fuel quality standards and vehicle importation standards were gazetted. Government will encourage the phase-out of leaded gas, tighter fuel specifications and institutionalize regular vehicle emission monitoring to reduce ambient pollution. In addition, Government will liberalize the petroleum sector in order to encourage a greater supply of unleaded and other less-polluting fuels in the marketplace.

Sri Lanka's industries have located their operations based primarily on considerations of port and market access. This has resulted in a number of severe pollution and water contamination problems, particularly in the greater Colombo metropolitan region and in the coastal zones. During the next five years, Government will encourage the relocation of "high waste" industries to more ecologically benign sites, as is being done with many of the tanneries. Such sites will be located along the nodes of the new highway network to ensure that the relocated industries can access major markets. Resources will be provided from the Pollution Control and Abatement Fund, the Environmental Friendly Solutions Fund and other sources of institutional finance to finance industrial clean up where that is required.

7. Pro-Poor Governance and Empowerment

I. Developing Human Capital in the Public Sector

International experience shows clearly that those institutions that are well governed are far more likely to be effective in poverty reduction than those that are not[46]. Moreover, when poor people are allowed access to the institutions that richer people enjoy, their efforts to work their way out of poverty will succeed. Indeed, much poverty can be avoided[47]. The poor bear a disproportionate share of the cost of sub-standard governance, not only in terms of opportunities stifled, but also in terms of bearing the ever-increasing cost of financing a poorly performing public service.

The Sri Lankan Government is gradually changing its role from being a leading provider of goods and services to being a facilitator of private sector economic activity. This is a difficult transition, vastly complicated by an overhang of institutions resistant to change.

Sri Lanka's public administration does have several elements of good governance, including a dedicated professional staff, a transparent regulatory framework and incentives system and relatively low corruption. It suffers, however, from tremendous over-staffing, an excessive number of institutions, an excessive reliance on administrative procedures, weak institutional control mechanisms and politicization[48]. There continue to be outmoded systems of management in government and a near-absence of human resource management. Government organizations function without clear visions and plans, tend to resist change, and are reactive rather than proactive; some of the work force is unmotivated; powers for decision-making are not adequately delegated; and training and skill-retention are low priorities. Government organizations tend to operate under multiple and conflicting objectives; work and performance incentives are poor; and a high degree of emphasis is put on process rather than on actual performance. Governance deficiencies are severe but they are certainly not unique to Sri Lanka. Past attempts to address these, in the form of system-wide public sector reforms, have failed largely due to the absence of credible political commitment from the highest levels.

Government is committed to transforming the public service to achieve high standards of good governance. Improved accountability, transparency, predictability and popular participation in public affairs will guide efforts to improve governance.

Patronage and interference in the affairs of civil administration are major obstacles to more effective governance. Government is aware of the seriousness of this situation and has established new Constitutional safeguards to advance the independence and neutrality of the public service. The 17th Amendment to the Constitution provides for the establishment of independent commissions to oversee the process of constitutional reform, elections, judicial activity and the management of the public service. The revival of an independent Public Service Commission will ensure that admission to and promotion within the public service is based purely on criteria of need and professional merit. It is essential that clear professional criteria are adopted for the appointment of permanent cadre.

The administration of the public sector is fragmented into many specialized services, within which recruitment and promotions are made. This service-specific fragmentation contributes to difficulties in fostering coordination and cooperation. To enhance the internal competitiveness of the civil service, recruitment and promotion for posts at the level of director and above will be placed on an open,

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[46] Australian Overseas Aid Program, 1997, *One Clear Objective: Poverty Reduction through Sustainable Development,* Canberra.

[47] The World Bank, *World Development Report 2001,* finds that economies which allow open flows of information with free competitive media, good property right protection for the poor and broad access to judicial systems were most likely to record economic growth favourable to the poor.

[48] Sri Lanka's public service has 129 Departments, 89 statutory boards, 73 commercial corporations (of which 45 are under liquidation) and 8 Provincial Councils, employing about 775,000 persons in 1998.

competitive basis, with opportunities provided for both those in government and out-of-government to manage key public service organization. On a pilot basis, a new scheme will be established to allow for designated special senior management and technical posts within Government. Clear and objective recruitment criteria, testing and open recruitment would be used to fill these posts. New training programs will be devised where new entrants to core posts who do not already hold designated qualifications are provided appropriate training and an opportunity to be re-tested to ensure competency. Those individuals, however, who fail to demonstrate objective competence for their posts would be transferred out of these special management posts and would revert to normal conditions of service. Such pilot-tested reforms, to be phased in gradually over the next three years, will enable a generation of new, well-trained Sri Lankans to inject a measure of dynamism into the management of the public service.

Within the Ministries, Government shall endeavor to establish incentive systems that reward positive performance. Rigorous standards will be specified and applied to ensure that performance management and appraisal is based on job-related work performance, rather than seniority or other non-performance concerns. The promotion process will be made public, as will be the screening criteria by which officers are eligible for promotion. Appropriate incentives will be provided to core agencies to retain valuable staff and human resource management policy and procedures will be better integrated into Government recruitment, training and performance management systems[49].

Government intends to reduce the number of parastatal enterprises and create greater scope for private sector participation in sectors hitherto reserved for government. Some 45 parastatal enterprises are now under various forms of liquidation, and it is expected that all will be closed over the next few years. For the remaining parastatal enterprises, Government will ensure that management practices mimic those in the private sector to the greatest extent possible. Government will institutionalize a corporate governance framework for public enterprises to improve their efficiency, accountability and transparency. The practice of appointing commercial management teams, as piloted in the Bank of Ceylon and the People's Bank, shall gradually be extended to several of the other major parastatal enterprises over the next three years. These new "commercial" management teams shall be held accountable to deliver results consistent with good corporate enterprise practice.

Government will encourage a consolidation of government departments and agencies to reduce over-lap and duplication at all levels of the public service and to ensure that devolved functions are indeed undertaken by local governments. Every department in Government will be required to rationalize cadres for employees over the next three years. Departments will be required to submit proposals for consolidation of functions within and between relevant agencies. A fund will be established to finance one-off expenses arising from the consolidation and rationalization of functions within Government.

Much can be done to reform governance practices, even within Sri Lanka's existing institutional setting. Recent public sector management reforms demonstrate the scope for improvement in service delivery by adopting modern management practices. While the details of public sector reform will undoubtedly differ by agency (or enterprise), all Government bodies will be required to: a) conduct regular consultation meetings regarding their performance with stakeholders; b) develop a three year rolling business plan and a one-year action plan for improving the quality of services that they deliver; and c) monitor their progress in delivering services and reforming their operations and make this information freely available to the public at large. Each institution will review the procedures of ministries and departments to help guide the management of change.

The interface between Government and the population is often arduous, regulatory and involving outmoded procedures and paperwork. Throughout Government an attempt will be made to change from a regulatory focus to more of a developmental focus. Where possible, automation will be introduced to simplify and accelerate the provision of services to the public by front-line government agencies.

[49] See PEMS Project, *HRM Process Paper I*, Prepared for the HRM Process Working Group.

II. Decentralization and Governance Reform

Shifting the focus of authority from central to local government offers a promising route for empowering the poor. By tapping local knowledge, awareness and expertise, the poor, together with local governments and community organizations can tackle those problems that are of greatest immediate importance to them.

The existence of an excessive number of institutions, operation of government organizations under multiple and conflicting objectives, inadequate incentives for work and performance, existence of complex and frequently conflicting parallel systems of administration in the provinces and fiscal decentralization, where the Central Government continue to implement certain devolved functions, weakens the poverty-reduction impact of decentralization. This has resulted in high levels of complexity and fragmentation of the system, an unwieldy and inefficient system of financing, cumbersome and inequitable personnel management procedures, and complex and frequently conflicting parallel systems of administration in the provinces. The "transaction costs" of the system have been, and continue to be, high. The poor are probably the worst affected by incomplete decentralization because the process has exacerbated government current spending, undermined development and mobilization of local community organizations, and had little impact on transparency or opportunities for consultation with local government[50].

Local governments operate under severe fiscal constraints. The quantum of capital grants (i.e. PSDG, Criteria Based Grant and Matching Grant) allocated for each Province is inadequate to carry out the development activities planned by local governments. Funds voted by Parliament for Provincial Councils are not released in time and, except for the Western Province, the revenue base of all other provinces is very weak. The Government has tried to redress deficiencies in fiscal decentralization. Capital spending has gradually been increased since 1999 and a greater share of resources previously channeled through line ministries are now disbursed directly to the provinces (using Province Specific Development Grants). As transfers to local government's increase, local governments will be obliged to improve their financial, audit and management capacity in order to access these soft-loans from central government.

Provincial government capital investments are planned to address locally defined poverty reduction priorities. Upgrading and augmenting government schools and hospitals, repairing and rehabilitating roads, fostering small enterprises and stimulating agricultural development are common themes in the 2002 to 2005 development plans of almost all local governments. Local governments are developing different approaches for tackling similar poverty constraints. In the Central Province, for example, the Provincial Council will expand the supply of ambulances, instead of building hospitals, in order to improve access by the poor to suitable hospital facilities. In other Provinces, capital investment programs have been mounted to upgrade divisional health posts into district hospitals to improve accessibility to quality health care. Similarly, in education, the Central Province is expanding the stock of teacher housing, in order to attract teachers to remote schools. Sabaragamuwa Province, by comparison, is upgrading basic education facilities mainly by augmenting facilities for libraries and providing books and essential sanitation facilities at the primary schools[51].

As part of the ongoing decentralization process, Provincial governments will require greater fiscal autonomy. Fiscal equalization measures, based on some form of needs-based revenue equalization formula, will be applied by central Government to ensure that an adequate, minimal level, of local public services can be provided countrywide.

Local governments should be encouraged to utilize annual allocations and expenditures of funds from various sources to the greatest extent possible by establishing transparent and participatory planning, resource allocation, and monitoring and evaluation (M&E) processes at the local levels. The most

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[50] World Bank (2000), *Sri Lanka: Fiscal Issues in Decentralization and Their Impact on the Poor,* draft note.

[51] Central Province, 2001, *Four Year Development Program 2002-2005,* Kandy and Provincial Council, Sabaragumuwa Province, 2001, *Preparation of a Sustainable Provincial Development Plan for Sabaragamuwa*.

important first step would be the regular publication of local government revenues and expenditures. Only if the public is aware of the way in which local government funds are utilized can they demand improvement.

Provincial governments, with the support of the stakeholders, are defining public-private partnerships to expand the regional economic base and foster an increase in productive employment opportunities for the poor. A range of enterprise-development initiatives have and will continue to be supported, including public-private partnerships in new enterprise development, enterprise development funds, technology services and market promotion activity. These efforts aim at tapping local knowledge to create opportunities for pro-poor growth by improving market access and market development, economic and social infrastructure development, improved quality education and healthcare, more sustainable environmental management and fostering small businesses and commercial agriculture.

A solid legal foundation is needed to clarify the roles and responsibilities of government, especially at the local level. Government will introduce a uniform set of local government laws, rules and regulations. These now exist in a disjointed and incomplete manner and will be collated and codified into a single Code of Local Government Law.

The greater the degree to which local populations can exert effective political control over what takes place in their jurisdictions, the greater the degree to which payoffs from local governance can take place. Towards this end, Government will re-introduce the ward system, in which election of members to the local governments will be both on the basis of ward and proportional representation.

III. Community-Driven Development and Environmental Sustainability

Empowering local communities and civil society to play a greater role in the management of their day-to-day affairs is central to the battle against poverty. Nowhere is the need for community-driven development more important than in the management of Sri Lanka's fragile natural resource base.

The vast majority of the poor depend on natural resources for their survival. They are often both the cause and the victims of resource degradation. Insecure land use and usufruct rights and uncontrolled access to natural resources are the two primary causes of resource degradation. Socially disadvantaged groups tend to move to areas where they can access land or marine resources, adding pressure to a fragile resource base. A greater measure of community participation and co-operation between poor communities, NGOs, the private sector and Government will be needed if these major environmental problems are to be overcome[52].

Coastal Preservation. Sri Lanka is losing 300,000 to 500,000 square meters of land per year along the Western and South Western coastal regions. It is estimated that 55 percent of the coast has already been eroded. Severe erosion has become an impediment to thousands of low-income fishing families who are unable to berth boats due to the lack of beach area and who have lost their homes due to erosion. To reverse these trends, Government has banned the use of coral reef lime. It is also encouraging sustainable exploitation of marine resources through community-based (common) resource management, enhanced regulation of fishing efforts, the preparation of resource profiles and the improvement of fishing vessels and navigation equipment suitable to the needs of small-scale fisherman. Coastline stabilization will be focused around the development of community coordinating committees which will plan reef stabilization efforts, jointly conserve and manage endangered reefs, improve water exchange in lagoons and cooperate to improve social infrastructure[53].

An improved regulatory and institutional environment, and establishment of sustainable resource management systems, will expand the opportunities for poor coastal communities to participate in the decision making processes, improve resource use, and maintain and improve livelihoods. Government is

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[52] Royal Netherlands Embassy, Arcadis Euroconsult and IUCN (2000), *Environmental Sector Study-Sri Lanka*.
[53] Asian Development Bank (1999), *Coastal Resource Management Project*, Manila.

preparing a revised Coastal Zone Management Plan. It will make suitable amendments to the Coastal Conservation Action to implement coastal environment resource management and also amend the Fisheries Aquatic Resource Act to enable community-based reef management.

Over the next five years, a major public investment project will be mounted in six Districts of the North-Western and Southern Provinces to minimize adverse impacts of coastal erosion in critical stretches. The coastal resources management project will assist some 76,500 households in the coastal villages of the north-western, western and southern coasts of the country. Under this project, repairs will be made on a coastal stretch of 52 kms from Galle to Chilaw including artificial beach nourishment and other structures (groins, revetments, offshore breakwaters) to achieve optimum stabilization. Community coordination organizations will prepare coastal management plans, undertake habitat conservation and implement a variety of measures to improve water exchange in affected lagoons. These communities will be provided social infrastructure and enterprise development support. Improved fisheries management will be encouraged through installation of simple, community based monitoring, control and surveillance measures, diversification of the fisheries effort and special fish research and investigations. Better databases and resource inventories will be assembled and government agencies will be trained in improved resource management methods and popular participation techniques.

Forests cover approximately 28 percent of Sri Lanka’s total 6.6 million ha of land area, with 1.65 million ha under protected forest cover. Population growth and economic expansion have exerted severe pressure on the forest cover. Deforestation and forest degradation have reduced biodiversity, contributed to irregular water flows, exacerbated soil erosion and triggered an alarming shortage of fuel wood[54]. Poverty and food insecurity is increasing, especially among people living near traditional forest areas or plantations. Consequently, they are increasingly encroaching on the forest, resulting in forest conversion and degradation.

Over the 2001-2006 period, Government will re-survey existing forest areas to delineate, demarcate, survey and map forestry regions. Within each region, an integrated forestry resource management plan will be prepared by the Forestry Department and community stakeholders. Best practices in forest management will be advanced by establishing a network of environmental societies, establishing demonstration plots for best forestry practices and mobilizing NGOs and CBOs to improve awareness of communities residing near forest boundaries. On an area of some 8,600 ha of smallholder agro-forestry woodlands, poor farmers will secure long-term leases, provided tree seedlings for growing timber and fruit trees in combination with agricultural crops and will be responsible for establishing trees for the second rotation. On an area of about 7,300 ha, small farmers will be assisted to improve management of existing wood lots. On another 12,600 ha, farmers and the private sector will be encouraged to convert the Forest Department’s unproductive plantations into financially viable plantations. Buffer zones will be developed by community-based organizations on about 2,800 ha in order to promote multiple-use forestry. About 1,300 ha or degraded forestry areas will have enrichment planting in order to support conservation and protection of the natural forest.

The Government is committed to improve the certainty and security of forest sector stakeholders. Traditional forestry boundaries have become outmoded because of many decades of encroachment and settlement. After forestlands are surveyed, Government will demarcate and gazette State Forest lands to provide an enforceable forest boundary. Linked to this is the provision of forestry agreements in the form of long-term forest use leases as opposed to short-run permits. Low-income community members will be provided leases through a participatory process.

The new social forestry policy aims to involve poor communities directly in the decision-making process to safeguard protected forests and to provide these communities with funding to replant degraded forest areas, manage buffer zones, and develop timber farms while simultaneously adopting conservation-oriented farming practices (using stone dams, gully control measures and terracing). Partnerships

[54] Asian Development Bank, *Sri Lanka Forest Resources Management Project Final Report*, 1999.

between the Range Forest Office and local community organizations will be forged to enhance protection and surveillance of protected forests.

Community involvement in the management of natural resources can play a significant role in reducing poverty and enhancing the sustainability of Sri Lanka's natural environment. By the year 2005, the rate of deforestation due to encroachment and illegal forestry use is expected to be halved from the present levels (1.5% per annum), and the rate of coastal erosion along the seven specific coastal segments targeted under the Coastal Resources Management Project will be significantly reduced from the 10 ha per annum recorded in the late 1990s. Enhanced social protection of coastal areas and designated forest areas will contribute to poverty reduction amongst fisher folk and those dwelling in or near to the forested areas.

Private sector initiative will also be harnessed to contribute to environmental sustainability. The private sector will be encouraged to invest in new forest plantations. Restrictions on the conversion of estate lands to tree crop plantations will be eased. The monopoly of the State Timber Corporation will be eliminated and the private sector will be encouraged to invest in value-added processing of forest products.

Eco-tourism and Wildlife Preservation. Empowering the poor to serve as custodians of the nation's precious wildlife heritage is another way in which local communities can become empowered to combat poverty. Some 13 percent of Sri Lanka’s total land area is in land demarcated as national wildlife sanctuaries. In the past, visitors had limited access to the parks for fear that this would endanger the wildlife. Paradoxically, such restrictions contributed to species loss (notably the diminishing elephant population) while inhibiting growth of an eco-tourism industry. Eco-tourism holds some potential for raising the incomes of the rural poor, many of whom reside in communities adjacent to the national parks. Following models successfully employed in countries such as Costa Rica, local communities will be encouraged to establish buffer communities on the outskirts of the national parks. Restrictions on visitor access to the parks will be eased and the private sector will be encouraged to invest in eco-tourism facilities. Local community organizations established in the park buffer zones will be provided a share of any eco-tourism earnings and will be trained and empowered to assist in wildlife preservation activity[55].

IV. Making the Law Accessible to the Poor

Sri Lanka possesses a well developed, legal system which has combined indigenous traditions with the laws of her former colonial rulers. However, the legal system needs to keep up with demands of a modern, private sector oriented economy to combat growing social criminalization and to ensure that justice is available to all.

Making justice accessible to all is government's main goal for the reform of the legal system. Existing legislation will be revised to promote equality of legal treatment, while improving Sri Lanka's competitiveness. The legal system and legal procedures will be simplified to expedite the settlement of civil suits and criminal investigations, provide alternate dispute resolution mechanisms, and protect the innocent and vulnerable.

The high cost of litigation combined with extensive court delays has an adverse affect on the most vulnerable litigants. The creation of island-wide mediation boards composed of community volunteers, under the supervision of the Ministry of Justice, has provided a legitimate, state-sanctioned way to solve local problems through negotiation and compromise. The adoption of alternative dispute resolution mechanisms will be encouraged, both to reduce costs of settling disputes to the poor and to reduce the volume of work in the courts. Another measure that will be taken to improve access by the poor to the legal system is the provision of legal aid to low-income and vulnerable groups, together with those possibly subject to violence, such as children and women, through Legal Aid Centers and community based legal assistance groups.

[55] Asian Development Bank, *Biodiversity Conservation Project*, 1999.

Efforts are underway to revise and reform major segments of Sri Lanka's commercial legal code. Not only will this effort help to harmonize Sri Lanka's legal practices with those in other advanced market economies, but in so doing, it will also introduce an element of simplicity and clarity that will make the law more accessible the poor. Legislation that will be reformed will include, *inter alia*, the Arbitration Act, the Consumer Authority Act and a range of other financial and commercial legislation.

V. Combating Gender Discrimination

Compared to the rest of South Asia, Sri Lankan women enjoy universal suffrage, high life expectancy, universal literacy and access to employment opportunities, unmatched in the rest of the sub-continent. More recently, women have become the mainstays of Sri Lanka’s economic performance. The three largest foreign exchange earners - garments, foreign labor, and tea - are highly dependent on female labor. The irony in Sri Lanka’s relative progress in engendering development is the phenomenon of women being trapped in low-skilled, low-paid jobs clustered in domestic service, garment making, and agriculture, as well as traditional female occupations, such as teaching, nursing and typing. Moreover, gender discrimination persists and is associated with gender stereotyping in the labor force, wage discrimination, and the adverse effects of alcoholism and spousal abuse on women[56]. Women are poorly represented in parliament and politics, with women holding less than ten percent of all elected posts. While women are well represented in most parts of Government, they are poorly represented in agricultural extension, irrigation and certain other technical disciplines, and at management levels.[57] In addition, the conflict has raised the proportion of female-headed households, not only in the North and East, but also in many of the poorer rural areas and low-income communities of the South. Many young widows and children suffer from various degrees of psychological trauma and are heavily dependent on state or NGO assistance.

Government recognizes that women need a greater political voice if their specific concerns are to be addressed. In line with the Women’s Charter and the Women’s Manifesto, Government will submit legislation that will reserve a minimum of 50 percent of all seats in local and national government elections for female candidates[58].

Government is committed to mainstreaming gender considerations in all anti-poverty efforts, and to make society free of violence against women and children. Mainstreaming gender considerations in public policy will require continued efforts to train staff in gender analysis and gender monitoring and evaluation, as well as a conscious effort to incorporate gender considerations in program and project design[59]. Government has undertaken a detailed analysis of gender bias in public services, with a view to reducing these biases in the representation of women in public service. A number of sensitization programs and training sessions have been conducted in recent years to encourage managers in the public service to incorporate gender considerations in their budgeting, personnel policies and program design.

Women’s income-earning activities cannot be considered in isolation from their roles within households and communities since each affects the other. Within households, women usually assume most of the responsibility for household management and childcare. Women often contribute more than men to community initiatives of various kinds. Meeting their responsibilities for childcare, household management and community action limits their capacity to earn an income. And the services that would help them combine these responsibilities with income earnings are often deficient. Moreover, within low-income households, it is often the women and older children who absorb the most severe economic shocks, for instance through women having to increase the time devoted to earning an income (while also remaining fully responsible for household and community tasks). Poor women are also most vulnerable to violence and substance abuse. In recognition of the constraints and vulnerability faced by women in low-income households, government will support a number of initiatives, including:

[56] Gender discrimination and its links to systemic impoverishment are reported in UNDP, *National Human Development Report*, Sri Lanka, 1998 and Asian Development Bank, *Women in Sri Lanka*, 1999.
[57] National Planning Department, 2000. *Engendering the National Budget of Sri Lanka*, Colombo.
[58] See M.Gomez and S.Gomez. 2001. *Gender and Politics in Sri Lanka: Preferring Women*. Shakti Press.
[59] JICA (1999), *A Milestone in Gender Mainstreaming of JICA’s Co-operation*, November 1999.

- **Protection of women's rights.** Steps will be taken to protect women's rights in conformity with the U.N. Convention on the Elimination of All Forms of Discrimination against Women (CEDAW) and to amend laws that discriminate against women.
- **Promoting employment and income opportunities.** A coherent employment policy will be put in place promoting equal training and employment opportunities for women, as well as decent work for women. In this connection, the working conditions and social circumstances of FTZ workers, migrant women workers, sub-contracted workers, and plantation workers will be investigated and improved.
- **Entrepreneurship development programs for women.** Government will continue to provide support for the entrepreneurship development program for women. This program, aimed at poor women, started in 1987 to provide self-employment opportunities and empower women economically by providing facilities to produce quality goods and market them. Several small, female-headed businesses have been started under this program. In the future, the emphasis will switch to linking financial institutions to established female-entrepreneurs and strengthening marketing ties between small, female-headed businesses and larger, private sector concerns.
- **Quality early childhood and pre-school education for all children**. Government will formulate guidelines, minimum standards and certification criteria for quality education and also develop pre-school teacher training programs. Daycare centers operated by local governments will also be strengthened. Early childhood, which spans the time from when the child is conceived in the mother’s womb to five years of age, is the most critical period in the life of a child and deserves special attention if the transmission of poverty from one generation to the next is to be brought to a halt. There is growing recognition that learning begins at home, and that the care, attention, affection and stimulation that children receive in the early stages determine their later intellectual and emotional capabilities. Pre-school programs will be restructured to incorporate elements of cognitive and psychosocial development and to shift away from the notion of using pre-schools to prepare for grade one work.
- **Health programs** will focus on maternal nutrition and health needs of adolescent girls and women workers.
- **Support for victims of violence against women.** This category of violence, which includes gender-based violence such as rape, incest and domestic violence, needs much greater support. Violence victims will receive assistance in Guidance and Counseling Centers for women, legal support, easier access to law enforcement authorities and protective shelter. Government will support awareness programs and work shops on violence against women for community leaders, police officers and school children.
- **Support for female-headed households.** Priority will be given to identification of female-headed households in poverty groups and conflict areas, and policy and support programs will be developed to support women's income-earning opportunities and independence.
- **Community organizations.** Community organizations can play an important role in sensitizing poor women, raising awareness, overturning prejudice, addressing social problems specific to particular sub-groups of the poor (e.g. alcoholism, violence in the home, dislocation), transforming attitudes and lobbying for change. Government will work with NGOs and community organizations to assist women’s groups build larger and more dynamic organizations that can give political voice to anti-discrimination measures. Government will continue to promote opportunities to increase the role of women in decision-making processes in its community-based development initiatives, and to target women and children affected by the conflict in its assistance for rehabilitation and reconciliation.
- **Gender sensitization programs** for the public and private sectors will be mounted to add to the visibility and awareness of gender concerns.

VI. Micro-credit Services to Empower the Poor to Manage Risk

Micro-credit schemes, with their emphasis on group-based collateral and lending, local savings mobilization and the use of a range of financial intermediaries, have evolved as a preferred alternative to the use of subsidized and directed bank lending to the poor. Micro-credit programs in Sri Lanka have played a valuable role in broadening access to development financing to the poor while contributing to village savings and group formation, particularly amongst poor rural women[60]. Low-income households tend to tap sources of micro-credit as an outlet for household savings and as a means of both investing in new or expanding existing enterprises and covering household cash requirements during emergencies and other periods of shortfall. Sri Lanka has an extensive array of micro-credit institutions, many of which have received considerable support from the Government.

According to the Sri Lanka Integrated Survey, more than 70 percent of the country's poor have access to some form of savings service, and about 26 percent borrow from various sources. About 41 and 25 percent of loans to poor households are made by formal and semiformal micro-finance providers, respectively. The saving and borrowing patterns of the population as a whole are indeed similar to those of the poor groups, suggesting that poor households are not systematically excluded from participating in the formal or semiformal financial market[61].

Many different micro-finance schemes receive support from the Government. In general, these targeted micro-credit programs suffer from low recovery rates, poor identification of borrowers, low incentives for bank officials to recover loans, and low incentives for borrowers to repay. While loans from state banks are a key source of credit for poor households, improvement in performance is required to ensure that they contribute both to the empowerment of the poor and to the development of sustainable micro-finance institutions, with focus on women.

The larger micro-finance institutions, cooperative rural banks, SANASA, and Sarvodaya Economic Enterprises Development Service (SEEDS) are all based on a multi-tier cooperative structure. These institutions largely rely on member savings and donor grants for their operations. None lends exclusively to the poor. Indeed, some of these mobilize savings from poor and middle-income groups, and then on-lend their resources to larger financial institutions. For example, the cooperative rural banks showed the highest ratio of deposits to credits (20.7), followed by SEEDS at 4.62. These larger micro-finance institutions all plan to evolve into actual banks and to serve the poor primarily by providing a safe and secure return on their savings.

Government will continue to provide support for micro-finance schemes and institutions, but will do this in a way that contributes more towards the development of financial bodies that are sustainable, solvent and secure. The National Development Trust Fund shall be restructured to become an apex organization for the development of micro-finance, with responsibility for providing finance for the micro-finance organizations. Complementary to this will be the development of a legal framework that clarifies the role and responsibilities of the different organizations involved in micro-finance. Government will prepare a Micro-Finance Institutions Act to provide that clarity. A body will be established under the Act to develop policy and exercise regulatory functions over the many micro-finance institutions. There is also a need to ensure that the resources mobilized by micro-finance organizations are indeed redirected towards developing local communities. Government will gradually delink the Cooperative Rural Banks from the Multi-purpose Cooperative Societies to ensure that there is an arm's length relationship between micro-finance organizations and retail trading activity. At the local level, Government will continue to (i) encourage micro-finance entities to mobilize savings from target communities; (ii) encourage micro-finance institutions to link their operations with commercial banks that can help them improve business operations and the management of prudential risk; (iii) provide funding to such entities on a commercial basis; and (iv) encourage the micro-finance institutions to adopt strategies, such as group based lending or project-lending, in addition to formal property or countervailing deposit-secured lending.

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[60] Sri Lankan German Technical Cooperation (1999), *Decentralized Regional Support to the Private Sector in Sri Lanka*, Colombo.

[61] World Bank, 2001, *Sri Lanka Poverty Assessment*, Washington D.C.

8. Focusing On Results: The Monitoring, Evaluation And Planning Processes

I. Tracking Progress: Key Poverty Reduction Goals, Targets and Indicators

Monitoring and evaluation (M&E) constitutes an integral part of the poverty reduction strategy process and will serve as the basis for tracking the progress of key pro-poor policies, programs and projects in the various sectors. Just as government agencies, donors, civil society groups need to work closely together in implementing the poverty reduction strategy, the flow of information necessary for the implementation of a poverty-oriented M&E system will also require a similar collaborative effort on the part of key stakeholders.

An effective M & E system is essential to ensure that the targets set in the poverty reduction strategy are met and that progress is made towards achievements of these targets. Data collected and analyzed will be used to inform planning and policy-making and to adjust the direction of policies that negatively impact on poverty reduction. Indeed, since monitoring is a process of tracking the course of an event or process towards a pre-determined target, the purpose of monitoring is to detect any deviations from the desired path. Early detection of such deviations enables relevant actors to take corrective actions to steer the event or process back on course and towards the planned objective. Though monitoring and evaluation are different, they are complementary processes. The main purpose of evaluation is to learn lessons and ascertain the effects and impacts of programs and policies; information and analysis generated by a monitoring system can be used for the purposes of evaluation.

Essential requirements for institutionalizing a poverty monitoring system are:

1. *A core set of poverty monitoring indicators* that will be used to measure changes in a given situation over time. It is essential to establish a core set of strategic indicators (intermediate, outcome, impact) which can feasibly be measured and used by policy makers involved in designing and monitoring poverty reduction efforts. Since many impact and outcome indicators are difficult and expensive to measure on an annual basis (as multi-use household surveys typically are conducted at intervals of five years), it is important to develop proxy indicators for some of the outcomes and impact indicators. Such indicators are less costly to measure and can be collected at shorter intervals. Many of these indicators can be captured through cost-effective survey instruments such as rapid poverty assessments, and through the use of Report Cards that assess the use, satisfaction and access to basic social services.

2. *Poverty monitoring survey methods (such as integrated household surveys, income and expenditure surveys, participatory poverty assessments, rapid poverty assessments, etc.) that are appropriately articulated and spaced.*

It should be noted that several aspects of poverty cannot be easily captured in quantitative indicators -- particularly aspects of social exclusion and inclusion. Qualitative data, from, for instance, Participatory Poverty Assessments (PPAs), which reflects the perceptions, concerns of the poor can be a significant complement to quantitative data on poverty and can allow for a more comprehensive understanding of poverty dynamics. Through participatory poverty assessments, progress can be measured against benchmarks set by the poor themselves. Such participatory approaches can also be used to analyze the impact of policy changes on the living conditions of the poor. The integration of a regular PPA in the monitoring system for the PRS will provide invaluable qualitative data, which will serve to cross-check quantitative data, and will help to judge the effectiveness of policy measures. More generally, a PPA will help one in understanding the causal links between the action program of the PRS and changes in poverty. But most importantly, it will help us listen to the concerns, perceptions and opinions of the poor themselves.

Since the package of pro-poor activities, that is the poverty reduction strategy are accompanied by a series of policy measures – whose purpose is to establish an enabling environment for pro-poor growth – it is essential to extend M&E of the PRS to the impact of these policy measures on poverty. This requires targeted research activities that try to establish the link between specific policy measures and changes in poverty. In order to assess the impacts of policy reforms on the poor, ex-ante and ex-post impact assessments will be encouraged.

3. *An institutional framework for monitoring and evaluation*. The M&E system for the PRS needs an appropriate institutional framework, which consists of two elements: institutional arrangements and an institutional environment. Appropriate institutional arrangements specify clear lines of responsibility for the various sectors and agencies in order to promote demand-driven data generation, compilation and analysis. Clearly specified institutional arrangements will maximize benefits arising from specialization and minimize overlaps and conflicts. A proper institutional environment sets “rules of the game” by defining standards and putting in place appropriate incentives for the smooth implementation of the monitoring system.

Sri Lanka's position with respect to the Millennium Development Goals (MDGs) for poverty reduction is shown below. Since Sri Lanka has already made substantial progress towards the MDGs, specification of poverty reduction indicators must take into consideration that the nature of poverty is significantly different in Sri Lanka than in any other low-to-middle income developing nation. As noted above, Sri Lanka's health and demographic indicators are comparable with those of far wealthier Asian nations due to a wide range of pro-poor policies and programs, including subsidized health, subsidized education, targeted food subsidies, subsidized transport, and broad-based family planning services, which have been in existence for several decades. In many cases, therefore, a dramatic improvement in the MDGs cannot be expected, other than a reduction in the share of the population living in extreme poverty.

There is considerable room for improvement in the area of consumption poverty. The measures identified in the PRS are designed to accelerate GDP growth to the 6-7 percent level in the medium term and to simultaneously draw the poor into the mainstream of economic development. The successful implementation of this strategy is critical for sustained poverty reduction in Sri Lanka.

Table 8.1: Sri Lanka’s Poverty Reduction Achievements Compared With Millenium Development Goals

Millennium Development Goals	Sri Lanka’s Position*
Reduce the proportion of people living in extreme poverty by half between 1990 and 2015.	Poverty incidence declined from 31 percent to 25 percent between the mid-1980s and mid-1990s. Aim is to halve extreme poverty rates by 2010.
Enroll all children in primary school by 2015.	Net enrollment rates in primary education exceeded 90 percent in 1997.
Make progress towards gender equality and empowering women by eliminating gender disparities in primary and secondary school by 2015.	Gender equality achieved in primary, secondary, and even tertiary enrollments.
Reduce infant and child mortality rates by two-thirds between 1990 and 2015.	Between the mid 1970s and 1998, infant mortality rate fell from 48 to 17 per 1,000 live births; under-five mortality fell from 27 to 17 (middle-income country levels).
Reduce maternal mortality rates by three-quarters between 1990 and 2015.	Maternal mortality rate is 23 per 100,000 live births, on par with middle-income countries.
Provide access for all who need reproductive health services by 2015.	Contraceptive prevalence rate is high at 66 percent; poorest country in the world to have achieved below replacement fertility; 95 percent of births attended by health staff.

Millennium Development Goals	Sri Lanka's Position*
Implement national strategies for sustainable development by 2005 to reverse the loss of environmental resources by 2015.	Since 1994, two successive national environmental action plans have been developed and are presently under implementation.
Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases like TB	Major public health programs have been mounted in Sri Lanka to combat malaria, TB and other contagious diseases. TB incidence is 55 per 100,000 and Malaria is 344 per 100,000. Incidence of both has been reduced by more than 100 percent over the past 25 years. New programs have been introduced in the mid-1990s to combat these diseases, as well as diarrhea, measles and GI infections, and to improve cardio-vascular health.
Have halted by 2015 and begun to reverse, the spread of HIV/AIDs	Although the prevalence of HIV/AIDs is low, risks of an increase exist. Government has introduced major programs aimed at public awareness, and interventions targeted at high-risk groups.

* Excluding the war-affected North and East.

Sources: *World Development Report*, World Bank (2001). *Human Development Report* 2000, United Nations Development Program (2000). "Annual Health Bulletin," Sri Lanka Department of Health (1999). "Aging and Pension Study," Institute of Policy Studies (1998).

The priority poverty reduction objectives are shown in Annex 8a. They are divided into a set of poverty reduction outcomes, including both income and socio-economic setting improvements. These will be monitored based on periodic Department of Census and Statistics (DCS) surveys and line ministry reports. Annex 8b contains a set of performance measures for key strategic activities that shall be monitored. These are designed to track performance in implementing key strategic activities outlined in the PRS. The variables identified in Annex 8b comprise a set of core indicators, aimed at guiding mid-course corrections in the poverty reduction planning process. They can be thought of as leading indicators of progress in meeting the PRSs strategic goals and objectives. They are not a substitute for the more comprehensive ministry program or project M&E systems. While specific numerical targets have been identified, it may be more appropriate to establish ranges for reasonable future outcomes. The monitoring system will be further refined to suit the requirements of the agencies responsible for tracking the performance indicators and outcomes.

II. Participation and the Monitoring Process

The PRS, being the outcome of an intensive dialogue process of line ministries as well as representatives of civil society organizations and donors, calls for a participatory approach towards monitoring progress and impacts thereby enabling stakeholders to translate lessons learnt into adjustments of policies and implementation.

Primary data collection

There are several government agencies, including the Central Bank of Sri Lanka (CBSL) and the DCS, which are engaged in the routine collection and publication of economic, social and demographic statistics.

A key issue in this regard is the lack of annual data on a wide range of poverty and poverty-related indicators (including nutritional indicators). The DCS, which is officially in charge of collecting and disseminating poverty statistics, conducts a Household Income and Expenditure survey (HIES) once in five years, on average. The same agency also conducts a Demographic and Health Survey (DHS) once in

5-6 years. Other data sources include the Quarterly Labor Force Surveys (DCS), the Annual Health Bulletin (Department of Health Services), and the Annual Reports (CBSL).

Many donor agencies also publish primary data from time to time, some of which are poverty related. The World Food Program's Vulnerability Assessment Mapping (VAM) system will periodically collect divisional level data on household access to basic foods and vulnerability. This information will be used to track progress made in redressing regional inequity and destitution. UNICEFs child poverty database will track a number of indicators related to children and other vulnerable groups.

The existing information system, although it is broad-based, only partially satisfies the requirements of a poverty-focused M&E system, given the complex and multidimensional nature of poverty.

New mechanisms have to be introduced for tracking performance indicators specified in the M&E system and for filling in quantitative and qualitative information gaps or deficiencies. Further investigations will be required to establish suitable baseline information for poverty incidence during the 2002/2003 period.

Given that progress in reducing consumption poverty can only be measured every few years, proxies will be employed to track reduction in poverty on a year-by-year basis. Examples of areas in which proxy indicators for income can be sought are: Ownership of a standard set of consumer assets; and the use of modern building materials in the construction of the dwelling unit, in particular for the floor, walls and roof. As most of the poor live in the rural areas and depend on agriculture for their livelihood, it is critical that growth in agriculture is stimulated in particular. The growth rate in the agriculture component of the GDP therefore also deserves special attention as an indicator.

Since many poor households have few other assets than their labor, trends in real wages can be used to track short-term movements in welfare of the low-income groups. If labor productivity of unskilled labor rises in line with expected economic growth, and if wages reflect rising labor productivity, then we would expect real wages in rural areas to rise in line with real growth in per capita incomes. Drawing on wage and price data reported regularly by the CBSL, the National Planning Department (NPD) will monitor and assess trends in average, real wages of rural laborers and of estate workers. The Quarterly Labor Force Survey will be used as a basis for developing an annual real wage index by sector and major industrial activities/categories. A national Consumer Price Index with wider coverage of geographical areas and income groups will also be developed by the DCS, in collaboration with the Central Bank.

In order to obtain data on selected poverty indicator on a regular basis, the DCS will consider developing a second schedule for the Quarterly Labor Force Survey to provide annual data on access to water, electricity, sanitation and other relevant household measures as required for PRS annual reporting. Whenever possible, indicators will be dis-aggregated by gender.

National data on child malnutrition and contraceptive prevalence are collected only once in 5 years or so by the Demographic and Health Survey (DHS). Government will explore the possibility of using primary health care data (collected by Public Health Inspectors) to yield national figures on underweight and contraceptive prevalence annually.

To track PRS accomplishments, more detailed information will be required at the provincial level. The DHS will be re-organized to provide information on a provincial basis. This survey will be carried out every five years, with the next to be undertaken in 2005.

Special attention should be paid to ensure that relevant indicators are disaggregated by gender, so that differences in impact of the poverty reduction strategy on men and women can be assessed. Indeed, since poverty manifests itself differently among men and women, it is important to ensure that the chosen indicators reflect the concerns of both men and women.

Institutional Arrangements

A Monitoring Team, headed by the National Operations Room (NOR) of the Ministry of Policy Development and Implementation (MPDI), with officials drawn from the NPD, the External Resources Department (ERD), the DCS and the CBSL, as well as representatives from academic/research institutions, NGOs, the private sector and donor agencies, will be established to design reporting formats and procedures and to work together in collectively implementing the monitoring system. The Peace Secretariat and the Ministry of Rehabilitation, Resettlement and Refugees (MRRR) will also be represented in the Monitoring Team so as coordinate the PRS and RRR Framework monitoring efforts.

Since the NOR will be coordinating the M&E component of the poverty reduction strategy, the PRS Monitoring Team will be chaired by the NOR. The NOR will be responsible for overall coordination and policy monitoring. It will be required to report to the Secretary of Policy Development on a regular basis and to seek his assistance in addressing implementation lags/drawbacks faced by line ministries. The NOR may require a budget to fund special studies, clear the backlog of indicators (such as infant and maternal mortality rates), service the Monitoring Team, and prepare the PRS progress reports (with the assistance of technical advisory services, if necessary).

The line ministries and agencies will collect and analyze data, identify constraints and problems, and forward this information to the NOR. That Division will collate the inputs from the line Ministries, coordinate the performance monitoring of Government programs, and report to the PRS Monitoring Team.

The DCS and the CBSL play a key role in primary data collection that provides the basis for outcome monitoring. Their improved coordination will reduce previous incompatibilities and help the Government work towards a combined development database with a strong focus on poverty data sets. The DCS will be responsible for maintaining a database for monitoring poverty reduction target figures, as per Annex 8a. The primary role of ERD will be to monitor existing and proposed donor contributions to projects and programs identified in the PRS.

Donor organizations will be invited to support the PRS monitoring process and contribute to the Monitoring Team in their funding and advocacy role. ERD will invite donor organizations to jointly develop a more systematic approach and practical procedure towards monitoring the poverty impacts of donor supported interventions. Previous experiences of the GTZ-supported Center for Poverty Analysis (CEPA) could serve as important references.

Independent academic and research institutions, including CEPA, the Institute for Policy Studies (IPS) and Universities, will be invited to conduct special surveys/studies in order to support the PRS monitoring efforts with a professional poverty analysis that goes into the root causes, trends and dynamics of poverty in Sri Lanka.

NGO representatives are invited to bring in their wealth of experiences in reporting on micro-level poverty interventions and their impacts. Last but not least, the private sector, being a crucial partner in poverty reduction, will be invited to support the PRS process by monitoring poverty related economic policies.[62]

The poor will also be invited to participate in the M&E process. A qualitative survey designed to collect perceptions of poverty reduction progress and the performance of key strategic anti-poverty measures will be included in the M&E system. An appropriate donor or research organization will be identified to collect and report on this information.

[62] The donors, research organizations, NGOs and private sector advocacy groups will each be invited to nominate three representatives to the PRS Monitoring Team on a self-selection basis.

The Monitoring Team (see organizational chart below) will meet regularly to assess progress in implementing the PRS and report regularly to the Secretary of Policy Development. A poverty reduction progress report (PRPR) will be prepared on an annual basis by the NOR. This report will be critical for determining whether the poverty reduction effort is on track and what action needs to be taken to address implementation lags/drawbacks.

IX. III. Learning Lessons, Planning and Future Strategies

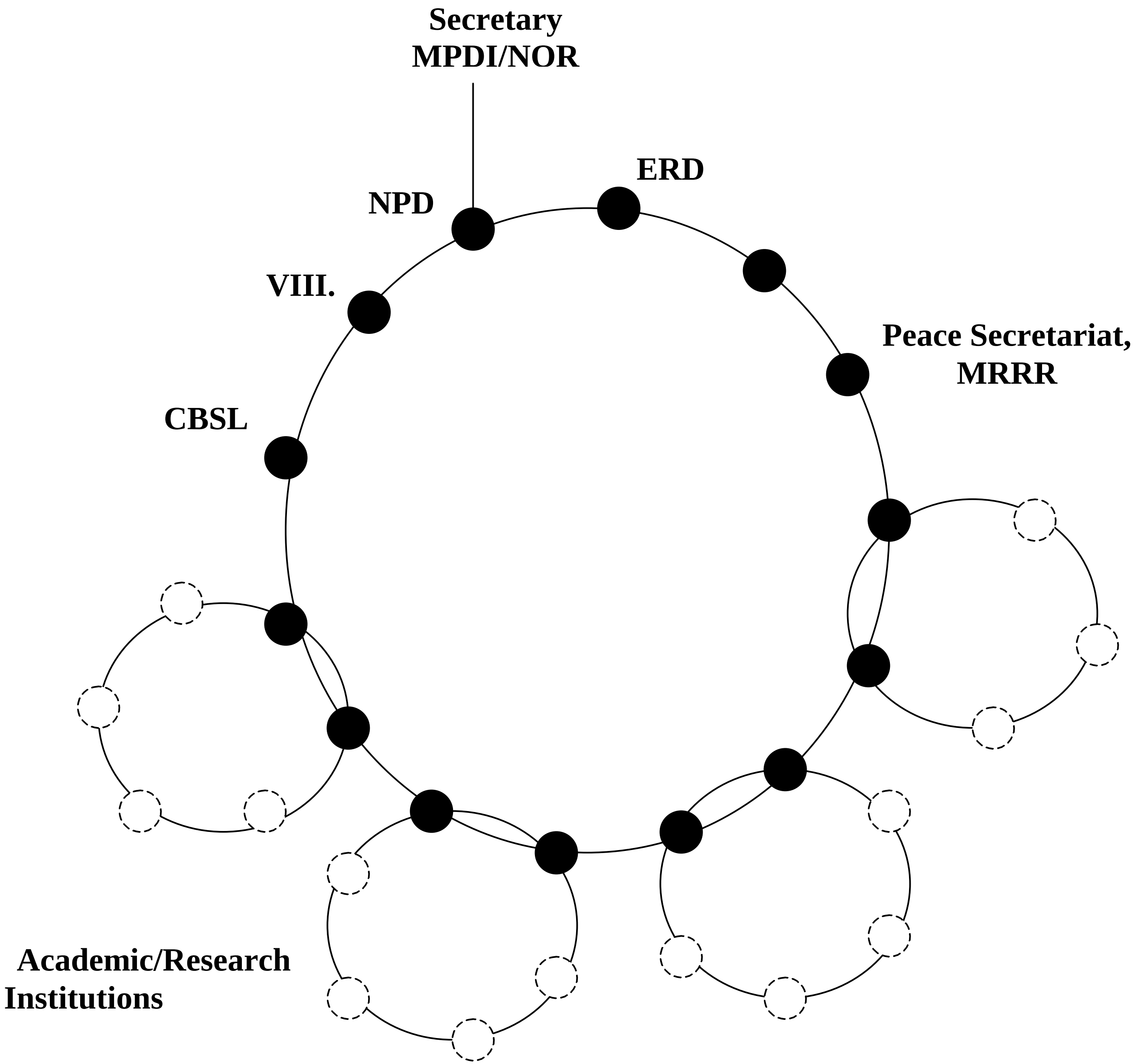
A well planned and coordinated poverty-based M&E system will be of invaluable assistance to the Government in a) undertaking critical appraisal of goals, targets and results; b) finding solutions to key implementation problems and bottlenecks; c) identifying and evaluating "lessons learned" in the medium term; d) strengthening the planning and evaluation reform process; and e) updating the strategy in a manner that incorporates suitable mid-course corrections.

The Monitoring Team will prepare the PRPR no later than June 30th of each calendar year. The Team will host an annual stakeholders meeting, at which the monitoring report, the qualitative survey on poverty reduction and the findings from poverty databases generated by the donor community will be presented. A broad range of stakeholders will be represented at these meetings, including Government agencies, the donor community, NGOs/CBOs, research organizations, and the private sector. The stakeholders meeting will review the main findings of the monitoring reports and identify areas in which revisions and other mid-course corrections for the PRS are required.

It is anticipated that the next PRS will be prepared for the 2006 to 2009 period. The monitoring and evaluation process will contribute directly to the preparation of the next PRS, as will a range of other national and program-specific planning exercises. Other institutional innovations, such as the introduction of program budgeting and the development of a medium-term expenditure framework, are expected to make an important contribution to the framing of the next PRS.

Cessation of the ethnic conflict will also bring about changes in the poverty reduction monitoring and evaluation process. Should this occur, socio-economic surveys would be mounted in the North and East, and detailed information would be collected to design appropriate rehabilitation and reconstruction programs. More detailed information on poverty conditions in the North and East, and on the progress of implementing post-conflict rehabilitation, reconstruction and reconciliation measures, would thence be incorporated into the PRS monitoring and evaluation process. Since poverty reduction and reconstruction of the North and East are complementary processes, the possibility of handing over the responsibility of monitoring the PRS and the RRR Framework to a joint monitoring team will be explored.

PROPOSED PRS MONITORING TEAM



9. Implementing the PRS

I. Participatory Implementation

The PRS will be implemented as an integral component of the Government's Economic Reform Program (ERP), as outlined in Part I. The ERP/PRS has identified a wide range of priority actions to generate high economic growth, to substantially increase employment and to boost incomes of the poor. Successfully implementing the ERP/PRS will require sustained effort in a number of different areas. It will require a high degree of coordination between policy makers and government agencies and the active participation of the private sector. What will make this process especially challenging is the fact that it will have to embody a flexible, adaptive approach, as priorities will evolve as conditions change.

A major distinction to make is that implementation of the ERP/PRS will include actions by public and private sector participants and that in many ways these should be approached differently. The Government has management responsibility for the public sector and can carry out the required reforms directly. It can only facilitate the actions that must be taken by the private sector. This chapter goes into some detail on implementing approaches for encouraging increased productivity at the firm level.

Another important distinction that should be kept in mind is between managing the implementation of the Program's policies and regulations and implementing the activities themselves. For example, it is one type of action to change policy and revise the BOI law to shift its focus to investment promotion. It is quite a different activity to restructure the organization, which will no doubt require additional technical and/or financial assistance.

Basic Strategy and Management

In order to facilitate implementation of the ERP/PRS, Government has established or will be establishing task forces in twelve broad areas where major reforms are required, namely:

i. Macro and Trade Policy Framework
ii. Employment and Labor
iii. Education/Human Resource Development
iv. Financial Sector Reform
v. Infrastructure Development
vi. ICT/Telecom Development
vii. Enterprise Development
viii. Agriculture
ix. Tourism
x. Public Sector Reforms
xi. Gender Equity
xii. Central Data Committee

Implementation of the ERP/PRS is expected to require considerable managerial and technical resources, to require a flexible approach and to last for several years. To manage and monitor this process, a Steering Committee in each of these areas will be established.

Structure of the Steering Committees and Task Forces

The Steering Committees will comprise public officials and private sector individuals selected by the *Ministry of Policy Development and Implementation (MPDI)* and/or the *Ministry of Economic Reform (MER)*. Each Committee has between 5 and 15 members, including a designated Convenor. The Convenor will in most cases be from the private sector.

It is understood that the normal work burdens carried by Ministry Secretaries would in most cases preclude their being able to fully participate in the work of the Steering Committees. Therefore, each relevant Ministry will designate a senior person responsible to the Secretary and Minister for *Program Implementation*. These officials will also be Members of the relevant Steering Committees. The Secretaries and other appropriate officials in the relevant Ministries may also be *ex officio* Members of relevant Steering Committees.

Officials from the *National Planning Department (NPD)* will also be assigned to support the Steering Committees. Staff from the MPDI will also be assigned to support the ongoing work of the Committees.

Each of the broad areas being addressed includes a number of specific areas, such as apparels, productivity improvement and competitiveness, and air-sea hub development, for which it will be necessary to establish more narrowly focused Task Forces. These may be set up to carry out a specific action or they may be standing Task Forces that remain in place to address a particular ongoing area of responsibility of the Steering Committee. Members of the Task Forces may be from either the public or private sectors, depending on the particular nature of the assignments.

The Heads and members of each Task Force may be considered full or *ex officio* members of the Steering Committee. This is to be determined by the Members of the Steering Committee.

The Program Management Committee

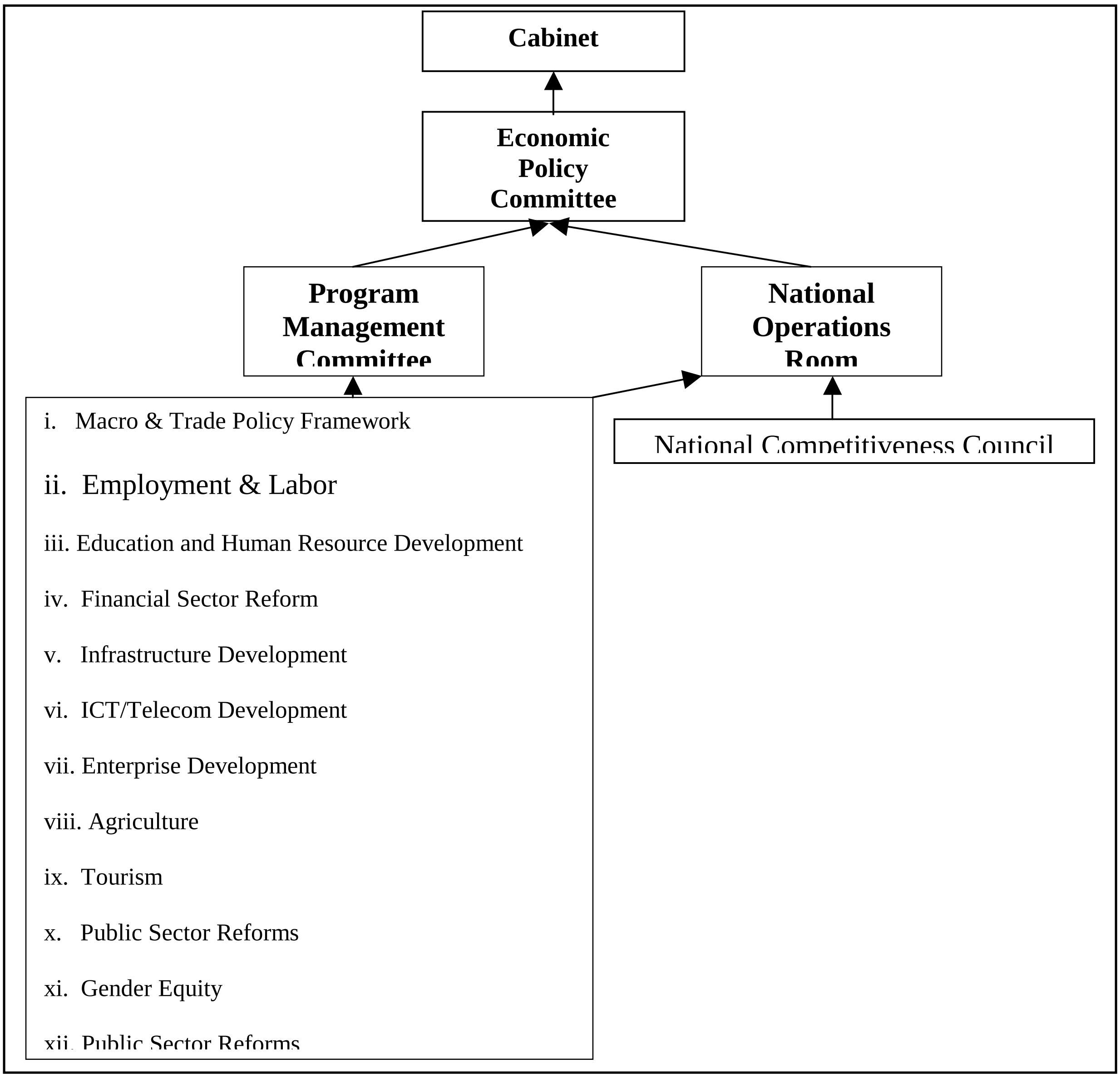
A *Program Management Committee (PMC)* will be established to, *inter alia*,

- Report regularly to the ***Economic Policy Committee***, chaired by the Honorable Prime Minister, on the progress achieved in implementing the Action Plans. It would also identify where there are constraints and identify and coordinate the technical assistance requirements to effectively implement the Plans.
- Work with the Steering Committees to ensure that the resources required to effectively implement the ERP/PRS are available and to identify and overcome any constraints that may be encountered.
- Work with the staff of the *National Operations Room (NOR)* to ensure that there is full and up-to-date reporting on the implementation of the ERP/PRS.
- Work with public relations advisors to develop and carry out effective publicity campaigns to develop and maintain public support.

In addition, for each Task Force established, the Convenor of the Steering Committee will be responsible for submitting to the *Economic Policy Committee* through the PMC a detailed terms of reference and action plan for the Task Force, with a clear indication of the results expected and the time frame in which it will function.

The Steering Committees will have the primary responsibility for implementing the Action Plans. The Action Plans will necessarily be a rolling plan, evolving as the ERP/PRS is implemented over time. The Steering Committees will undoubtedly form subcommittees to address specific areas.

There will be reasons for amending the Action Plans as implementation proceeds. For example, economic conditions might change priorities or proposals for new regulations outside of the scope of the current program may arise. There must be a mechanism to determine if these are consistent with the macro framework, have any impacts on the actions being implemented under the Program, and/or should be explicitly included in the Program – and if so, where. This will be the responsibility of the Program Management Committee in conjunction with the relevant Steering Committees.



Monitoring, Reporting & The National Operations Room. A critical aspect of effectively implementing the Program will be the close monitoring of progress and regular reporting. This is true of any policy or regulatory reform. It will be more the case for such the far-reaching and comprehensive economic reform program that will require major effort for several years or more.

- The Steering Committees will provide the most consistent oversight of progress in each of the areas. At the outset of the implementation program, they will review and amend the relevant sections of the Action Plans as necessary.

- For the first six to 18 months, the Steering Committees should provide regular progress reports through the Program Management Committee. These reports, in whole or part, should be disseminated to the public, via the Internet and/or the press. The progress reports should include the status of each of the initiatives that are the responsibility of the Steering Committee and identify any impediments to implementation.

- Each Steering Committee will periodically submit a thorough report on implementation to the Program Management Committee and through them as necessary directly to the Economic Policy

Committee. In addition to identifying current and past performance as well as implementation problems being encountered, it will also present its rolling three-month work program.

- Successful implementation will require wider reporting and monitoring activities, including *inter alia*, periodic workshops for MPs, the public and key interest groups, such as private business associations, trade unions, NGOs, etc. (This function could be the responsibility of the Program Management Committee.)

- The *National Operations Room (NOR)* is currently being developed and should become operational to some degree in the relatively near future. The Government's objectives for the NOR are entirely consistent with the requirements for successfully implementing the Program. It makes sense to use the implementation of the Program to contribute to development of the NOR. However, the time when the NOR will be fully functional is uncertain.

- Comprehensive reports every six months should be produced and presented to the public. These should be used to continually re-emphasize the importance of the Program embodied in ERP/PRS, present its rationale and report on its progress.

Program For Firm Level Productivity Improvements

A major goal of the Government's ERP/PRS is to significantly increase the rate of economic growth. To do this will require large and sustained improvements in productivity in all areas that provide goods and services, including both the public and private sectors.

While the Government is responsible for directly managing the provision of services by the public sector, it is the private sector that must achieve the required results in the key sectors of the economy – agriculture, manufacturing, services and tourism. The Government is now improving the policy and regulatory environment in which these businesses operate. This is a critical process and is the focus of much of the other elements of this implementation program.

It will, however, be necessary for the Government to do more to facilitate the changes that lead to increased productivity in these core economic sectors, especially in the early stages of this process. In this context, it is worth considering briefly the types of changes that the private sector will be confronted with if increased competitiveness is to be achieved. For example, key decisions that determine productivity include, *inter alia*,

- The choice of technology and the efficiency with which it is implemented;
- The effectiveness of its marketing activities;
- The ability of management to understand the needs of its markets and respond quickly and effectively to changes in market conditions;
- The timeliness and efficiency of its financial and management information systems, increasing a question of its abilities to incorporate advanced ICT tools; and
- Management's abilities at maintaining sound labor relations.

It has to be recognized that the decisions that business must take to improve productivity are for the most part taken at the firm level. Although firms might be in the same industry or "cluster", each has a different history and each faces somewhat different challenges to improving productivity. This is not to say that there will not be programs or reforms that can be efficiently pursued at the industry level – there will be. But firms that must compete against each other for customers in price and quality are often unwilling to share strategic information with competitors.

It must also be recognized that maintaining or even increasing competition is an essential element in encouraging maximum productivity growth. It is in many ways the lack of effective competition among the firms producing for the domestic market with high levels of protection that led to these being among the least productive enterprises. Firms that compete in export markets are inevitably more productive.

There is no doubt that there is little scope for government to directly assist firms make and implement the necessary productivity enhancing changes. There have been many such attempts, such as through some of the Export Development Board’s activities, and it is widely recognized that these have been at best of very limited effectiveness.

Experience in Sri Lanka and other countries over many years has amply demonstrated that the most effective way to provide technical support of this nature is indirectly, by assisting firms to access the technical resources that are needed to take the decisions and steps required themselves. There are several model programs of this type in Sri Lanka, including the USAID funded *TIPS* project that operated throughout much of the 1990s, the *E-Friendly* and *SMILE* projects funded by the Government of Japan (ongoing), and the *SMI* project funded by ADB (ongoing). The key characteristics of this type of project include:

- **Demand driven**: The firms themselves determine their objectives and approach the project for assistance. There is wide scope in the types of technical assistance that could be accessed.
- **Co-financed**: The firms have to bear a significant share of the costs of any initiative. It is inevitably the case that firms would be much more committed to ensuring that any assistance would be effectively implemented if they had a significant financial stake in the outcome.
- **Independent and confidential evaluation**: The project must be able to draw on outside commercial and/or technical expertise in both the design and implementation stages of any initiative to ensure that best practices are being adopted. The project must also have a strong reputation for maintaining confidentiality in its discussions with firms that are potential rivals.

Another somewhat similar program, which is currently being considered again for Sri Lanka, is the Service Corps program (supported by donors), where retired businessmen and women come to work and assist local firms, usually on very specific commercial problems. While the retired business people usually work without fees, in some cases the costs of maintaining them are shared to some extent.

There has been considerable attention in recent years to strengthening the private sector at the industry or “cluster” level through donor-funded projects. These activities offer some scope for building linkages among firms, particularly along the “value chain”, with potential suppliers. Examples of activities where there are commercial advantages in taking action at the cluster level include developing industry marketing campaigns, such as for tourism, or common standards for exports, such as for tea. However, since the work with clusters is essentially collaborative, it tends not to address many of the key commercial challenges facing businesses that must be overcome if major improvements in productivity are to be achieved.

Implementing Activities To Increase Private Sector Productivity. It is clear that there is no single approach that will address all or even most of the challenges facing the private sector to substantially increase productivity. It is equally clear that assistance from a number of different donors will be required to achieve the results envisioned in the Government’s economic reform program.

The Government, with donor assistance, is faced with the task of developing and implementing a range of different initiatives to assist the private sector in accessing the technical and commercial support required to compete more effectively, especially in export markets. This **“Productivity Program”** will not be a “static” program, in the sense that at any given time there may be some number of projects being developed, in operation or even winding down.

It will be important for the Government to ensure that the different projects that comprise the *Productivity Program* complement each other. It should also attempt as much as possible to see that the lessons that are learned as the Program is implemented are reflected in new initiatives as they are introduced.

The Coordination Role – An Apex Body. A separate apex body will be created to oversee the implementation of the *Productivity Program*. In essence this would be an umbrella that would house a number of projects that could operate with a high degree of autonomy – a one-stop shop for private businesses seeking technical assistance. There could be some degree of participation by the different ministries and agencies, but this would be limited. Alternatively, this might best be done in conjunction with a donor-supported project. This would have the advantage of providing the necessary resources and infrastructure.

National Competitiveness Council. Establishing a National Competitiveness Council (NCC) has been discussed and an ongoing project has provided some initial support for such an endeavor. Until now, the motivation for pursuing this was weak, with the possibility that it would emerge as yet another forum for talk with little or no action.

The economic reform program offers the opportunity for a more proactive role for an NCC. Since a hallmark of the Program will be efforts to improve productivity throughout the establishment of this representative, (semi-)independent body could be used to review and support the Program. As suggested above, the NCC could also be made responsible for an independent annual report on the Program.

II. Costing the PRS

The PRS is being launched at a period when Sri Lanka's the security situation is evolving rapidly, the economy is slowly rebounding from negative growth, the public debt burden has escalated and short-term fiscal and macro-economic stabilization must be accorded the highest of priorities. The pace at which reform measures identified in the PRS can be implemented hinges, in part, on the fiscal space created by restoring peace, economic growth and macroeconomic stability. Progress on these fronts is difficult to predict in advance, depending as it does on a number of factors well beyond Government's immediate control.

The PRS introduces a number of policy and institutional reforms, such as tax simplification, a gradual reduction in the size of the civil service and public enterprise reform, which are designed to augment revenues and create space in the budget for high-priority poverty reduction concerns. Government departments and agencies have been directed to accord priority to poverty reduction oriented spending within their overall expenditure envelopes. Mainstreaming poverty reduction in public expenditures means giving priority within limited line-Ministry budgets to the public goods and services most relevant to, and most likely to reach, the poor.

Despite fiscal uncertainty, Government is committed to implementing the measures identified in the PRS. To ensure that these measures are affordable, realistic and will not compromise fiscal stability, the Government has undertaken a series of measures, including:

- Implementation of the standby agreement, which has already been successfully concluded with the IMF, will contribute to low inflation growth;
- Government is emphasizing a sector or program approach in order to prioritize investments and also provide much-needed budget support for initiatives outlined in the PRS.
- Government is shedding responsibilities and encouraging the private sector to invest actively in the provision and operation of economic infrastructure and social services, measures which will free-up resources for pro-poor public goods and services.
- Specific, medium-term fiscal targets have been provided to the line Ministries. These are reproduced, by economic sector, in Table 9.1. Line Ministries have been instructed to accord top priority to PRS poverty reduction initiatives within their likely budget envelopes. They have been instructed not to plan for initiatives outside of their budget ceilings or to otherwise exceed these limits. Greater freedom has been provided to the line Ministries to mainstream poverty reduction efforts by reallocating resources towards pro-poor initiatives within the limits posed by their sectoral budget constraint.

- Sri Lanka's donors have also agreed to accord top priority to poverty reduction. Donor scrutiny of projects and programs will contribute to the quality of public investment while ensuring that it does benefit the low-income community in a sustainable manner.

The Government is presently developing a medium-term expenditure program. Progress on that exercise is proceeding well, and once it is fully established, it shall be possible to forecast multi-year changes in public spending with a reasonable degree of accuracy. Moreover, starting in 2003, implementation of the Fiscal Responsibility Act will require the preparation, submission and reporting on a three-year budget. Programs specifically designed for poverty reduction will be outlined in that budget.

Table 9.1 Total Government Expenditure by Functional Classification as % of GDP

	2001 Prov	2002 Revised Budget	2003 Estimate	2004 Estimate	2005 Estimate	2006 Estimate
Total Expenditure	**27.3**	**25.7**	**24.7**	**24.3**	**23.9**	**23.5**
1. Economic Services	**5.0**	**3.9**	**4.6**	**5.0**	**5.4**	**5.6**
Agriculture, Fisheries & Irrigation	1.1	1.0	1.0	1.0	1.2	1.3
Industry	0.1	0.1	0.1	0.0	0.0	0.0
Water Supply	0.2	0.2	0.1	0.2	0.3	0.3
Energy	0.9	0.6	0.6	0.7	0.8	0.9
Transport & Communication	1.9	1.5	1.3	1.6	1.8	2.0
Other Economic Services	0.9	0.6	1.5	1.4	1.2	1.0
2. Social Services	**7.3**	**8.0**	**7.5**	**7.6**	**7.6**	**7.7**
Education	2.0	2.6	2.3	2.4	2.6	2.8
Health	1.3	1.6	1.5	1.6	1.7	1.8
Housing	0.2	0.1	0.2	0.3	0.3	0.3
Welfare & Community Services	3.7	3.7	3.5	3.2	3.0	2.8
3. General Public Service	**6.3**	**5.6**	**5.0**	**4.5**	**4.2**	**4.1**
4. Other	**8.6**	**8.1**	**7.6**	**7.2**	**6.6**	**6.1**

Source: Ministry of Finance, Fiscal Policy Department, December 2002.

Despite fiscal uncertainty, and the lack of a fully articulated medium-term expenditure framework, an effort has been made to ensure that the priority-items identified in the PRS are affordable and consistent with the macro-economic forecasts for public expenditures by sector. The following procedures were used to "cost out" the PRS initiatives:

- Priority poverty reduction initiatives in the form of projects, which have major implications on the budget, are given in Annex 6. The priority actions relating to relief, rehabilitation and reconciliation are given separately in Annex 5. These initiatives, including rehabilitation projects, are to be funded mainly by donors.
- Government has already secured or is in the process of securing external financing for most of these initiatives. Existing and new capital assistance commitments are reported for the period 2003 to 2006 in Annexes 6a and 6b respectively.
- Major policy emphasis in such areas as revenue reform, public expenditure reform, trade and investment policy reform, financial sector reform, power sector reform, and labor and land market reform, are detailed in Chapter 3 and some other chapters, as well as in Annex 1 of Part I. Some of the program loans targeted for the donors are mainly to support this reform process. The capital expenditures shown in Annexes 6a and 6b include roughly US$ 200 million per year---

from 2003 to 2006-of program loans, which will reduce the requirements of domestic borrowings.

- The total projected disbursements from Annexes 6a and 6b are aggregated by sector and given in Annex 6c, net of program loan commitments.
- The capital expenditures by sector have been adjusted for counterpart fund contributions to implement the projects as well for funds provided for smaller domestic capital and donor-funded projects. Smaller capital expenditures can be accommodated within the normal budgetary ceiling and are hence not detailed out. Total projected capital expenditure is summarized in Annex 6c.
- The incremental sector-wide totals (i.e. for recurrent and capital spending) were added to the 2002 base year estimate to calculate the share of capital expenditures by sector and also the related recurrent expenditure estimates. These figures have been reported as sector-wide forecasts for public expenditures in Table 9.1
- The program and project loans lay heavy emphasis on donor funding because of sluggish export growth (caused by adverse international economic conditions), urgent rehabilitation needs, and the necessity for fiscal consolidation over the medium term.

The forecast changes in public spending are fully consistent with the priorities laid out in the PRS, since capital spending reflects the sector-wide priority-setting process for public sector reform. Higher figures in 2002 in respect of education and health (a one-off phenomenon, as per Table 9.1) are based on estimates, a high proportion of which actually falls on the current expenditure side to meet outstanding liabilities.

III. Risks and Uncertainties

The PRS represents a fundamental shift in the Government's approach to poverty reduction. This will have tremendous implications for the way in which government interacts with civil society, the private sector and most notably, with the poor.

There will be resistance to change within Government. Bureaucratic habits and traditions cannot be changed overnight. The risk that institutional inertia will delay or derail PRS reforms is a real one. But this risk can be overcome if there is broad-based support on the part of civil society and the nation's political leaders for progressive change. Ensuring that the general public is fully aware of the poverty strategy and that progress in its implementation is carefully monitored and accurately reported to the public can help to counter institutional inertia.

Vested interests could turn against some of the strategies advanced in the PRS. Key reform issues underpinning the PRS-fiscal reform, widening opportunities for pro-poor growth, enhancing the competitiveness of factor and product markets, reforming public sector governance, and fostering a negotiated peace-are controversial and difficult to implement. The years 2000 and 2001 were difficult ones, as the Government was forced to introduce severe belt-tightening measures and the drought, devaluation and power cuts contributed to the spread of hardship. There is a risk that agitation by interest groups may reduce the Government’s political will to implement further difficult reforms. To counter this risk, Government will stress that delaying reform will only increase the nation's vulnerability to hardship, both in the short and in the long run.

Sri Lanka is especially vulnerable to shocks. The public sector has a large debt overhang and the economy is highly open to merchandise trade and service flows. Exports are narrowly based and are dominated by a small number of cash crops, tourism and textiles, all of which experience a high degree of volatility. Imports are dominated by basic necessities, raw materials and intermediate inputs, providing little scope for short-run substitution. Short-term domestic debt is high, gross official reserves remain low, and some public corporations have high levels of domestic debt.

Unless substantial progress is made towards fiscal consolidaton, the public debt could literally spiral out of control. Already, debt service is pre-empting a substantial share of domestic revenues and public borrowing to close the deficit is contributing to high inflation, the crowding-out of the private sector from the banking sector, and high real interest rates. Public debt service already exceeds the wage bill, and many vital public expenditure priorities are neglected because past debts must be serviced. In the medium-term, target growth simply cannot be achieved unless firm and concerted action is taken to reverse the spiral of public debt. Without high rates of economic growth, poverty simply cannot be reduced. Immediate spending pressures are great, and there is a risk that political leaders will pay insufficient attention to the importance of fiscal consolidation. But the debt burden is increasing at a rate that simply cannot be sustained. In the event of an unsustainable increase in the public debt, a scenario of negative growth, high inflation and currency depreciation could result. Indeed, it would be the poor who would be most adversely affected if profligate patterns of public sector spending are not quickly and firmly corrected.

Sudden changes in the external and internal setting could derail Government's efforts to achieve a more sustainable fiscal balance. Fiscal consolidation could be adversely affected by several factors, such as external trade disruption, a downward surge in global primary commodity prices or an unanticipated upsurge in global energy prices. Security uncertainty, both in Western Asia and the Middle East, is casting a pall on the global economy, and could reduce trade, inward investment and visitor inflows for 2003, further aggravating the fiscal situation.

Macroeconomic management will need to remain vigilant and adroit, in order to maintain financial stability in a volatile international environment. This does not imply that fiscal consolidation targets will be abandoned, but only that such targets may need to be periodically adjusted as external market conditions evolve. Indeed, the main lesson of history is that there are going to be surprises. The PRS has a certain amount of flexibility built into it to assess and prepare for the unexpected, and to respond to those surprises that were not earlier anticipated.

The second major risk, after insufficient fiscal consolidation, is that the peace process will not succeed. Firm progress towards a negotiated peace and a permanent cessation of civil hostilities are key planks of the Government's poverty reduction strategy. If there is a resumption of civil hostilities, this would undermine the implementation of the PRS. There is, indeed, little that can be done to mitigate this risk, and in light of this uncertainty, government planners must be prepared to adjust the implementation of the poverty strategy as security conditions evolve. An encouraging sign, however, is that peace talks have commenced and are proceeding well.

The third major risk is a political one. Short political cycles could divert attention from long-term poverty reform challenges and multi-year reform efforts. Since 1998 the country has been through several elections, among them provincial councils (April 1999), presidential (December 1999), and parliamentary (October 2000 and December 2001). Frequent elections, reconfigurations of the Ministries and Departments and cabinet change have complicated the process of structural reform. While political continuity and stability would build confidence and credibility, this has been difficult to achieve. The risk remains that political stability and continuity may remain elusive. Nonetheless, the checks and balances that a working-democracy imposes on political behavior are vital to ensuring that those who make public policy act in the perceived interests of the people. There is no better way to ensure widespread participation in poverty reduction process than to respect the safeguards posed by well-functioning democratic processes.

IV. The Pro-Poor Reform Process

The preparation of the PRS has been anchored in a wide-ranging national consultation process. Active involvement of government, civil society, donor partners and private sector stakeholders has helped to enrich Government’s understanding about the causes and consequences of persistent poverty and the strategies needed to foster positive change. Most importantly, extensive consultation with the many social partners has contributed to a broad-based consensus in favor of pro-poor reform.

The consultation process has clearly underscored the fact that "the poor are the main actors in the fight against poverty".[63](World Development Report 2000/2001, p. 12). Other parties – governments, donors, civil society – should facilitate, catalyze, energize the poor to overcome their problems, but not to take over from them. Other stakeholders should help open up opportunities for the poor, empower them so they can seize and make use of such opportunities and help minimize their exposure to a variety of risks. But it is the poor that will have to advance out of poverty, and indeed, it is the poor that will have to lead the battle to improve living standards.

There is increasing recognition within Government that it is not only the theoretical soundness of an anti-poverty "strategy" that matters, but that it is the process by which such poverty reduction strategies are defined that matters the most. Strategies that are formulated without extensive stakeholder consultation are unlikely to gain widespread acceptance and a sufficient level of national ownership. Strategies that don't define clearly and consistently the ultimate objectives and goals of pro-poor reform will tend to be implemented in ways that probably benefit everyone but the poor. And strategies that don't take into consideration the voice of the poor run the risk of substituting administrative judgment for the priorities, challenges and opportunities within reach of the intended beneficiaries.

This underscores the need for continuing dialogue, enhanced stakeholder participation, openness, a willingness to experiment and greater awareness of what is and is not proving effective in reducing poverty, as the implementation of the PRS proceeds. Monitoring takes on a special function, ensuring not only that progress is measured against defined goals, outputs and indicators, but that strategies can be continuously refined and reformed, new understandings reached and that strategies remain sensitive to the voice of the poor.

The Government recognizes that many changes have been identified in this PRS, and that the approaches adopted must be modified, over time, to take into account changing circumstances and the lessons of experience. Government will periodically review the PRS with a view to preparing a new strategy in 2006. Frequent consultation with a wide group of stakeholders (including political leaders) and careful performance monitoring will be used to capture and incorporate lessons learned in the periodic review process.

[63] World Bank (2001), *World Development Report* 2000/2001, p.12, Washington, D.C.