# MDGs: Prioritizing the Poverty Reduction Goal

50. Sri Lanka is on track to meet a number of the Millennium Development Goals (MDGs) set out for 2015. In particular, the country is doing well in the areas of universal primary enrollment, gender equality, and infant and maternal mortality. However, despite the substantial reduction in child mortality, malnutrition remains high. Moreover, Sri Lanka is lagging behind in terms of the poverty MDG.

**Box 1 : Sri Lanka and the Millennium Development Goals**

| Selected Millennium Development Goals | Sri Lanka's Position |
|---|---|
| • Enroll all children in primary school by 2015 | • Net primary enrollment currently at 96 percent |
| • Eliminating gender disparity in primary and secondary schools by 2015 | • Gender equality achieved at all levels of education |
| • Reduce infant and child mortality rates by two thirds between 1990 and 2015 | • Between 1975 and 2001, infant mortality fell from 45 to 12 per 1,000 live births; child mortality fell from 100 to 17 |
| • Reduce maternal mortality rates by three quarters between 1990 and 2015 | • Maternal mortality (23 per 100,000 live births), on par with middle-income countries |
| • Reduce poverty incidence by half between 1990 and 2015 | • Poverty fell from 26.1 % 1990-91 to 22.7% 2002 |

Source: World Bank Development Policy Review (2004).

## A. Overview of Poverty and Growth Trends

51. In 2002, the national poverty headcount ratio stood at 22.7 percent which is high for a country with a per capita GDP of around US$900.[19] Furthermore, between 1990-91 and 2002 this ratio fell by only 3 percentage points, which is modest considering that per capita income has grown by around 3.5 percent during the period. This modest decline however underlies sharply unequal poverty trends across sectors and regions. Poverty incidence in urban areas was halved, while rural poverty ratios declined by less than 5 percentage points, and poverty in the estate sector actually increased by 50 percent. Similarly, differences in poverty ratios across provinces have been pronounced: in 2002 the poverty headcount ratio was 11 percent in the Western Province compared to around 35 percent in Sabaragamuwa and Uva.

**Table 9: Poverty Trends 1990-91 to 2002 (%)**

| | 1990-91 | 1995-96 | 2002 |
|---|---|---|---|
| Urban | 16.3 | 14.0 | 7.9 |
| Rural | 29.4 | 30.9 | 24.7 |
| Estate | 20.5 | 38.4 | 30.0 |
| National | 26.1 | 28.8 | 22.7 |

**Table 10: Per Capita Growth by Economic Sector (%)**

| | 1991-96 | 1996-02 | 1990-02 |
|---|---|---|---|
| Agriculture | 0.0 | 0.4 | 0.2 |
| Industry | 5.7 | 3.0 | 4.1 |
| Services | 4.4 | 3.3 | 3.8 |
| GDP | 3.9 | 2.5 | 3.2 |

Source: Department of Census Statistics and Central Bank Annual Reports.

19. Excludes the North and East.

Figure 11: GDP per Capita and Poverty Headcount, 2002

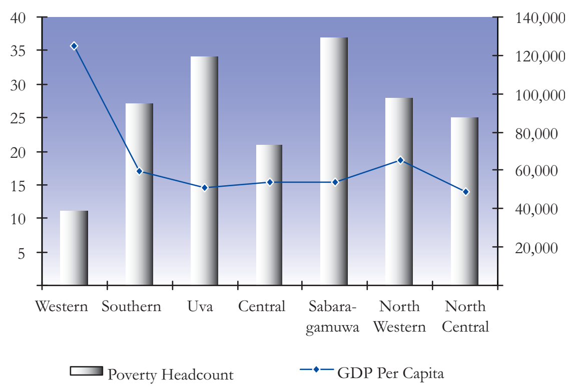



**Table 11: GDP Shares by Province**

| Province/Year | 1990 | 1996 | 2002 |
|---|---|---|---|
| Western | 40.2 | 43.7 | 48.1 |
| N. Western | 11.1 | 11.3 | 10.1 |
| Central | 12.1 | 10.0 | 9.4 |
| Southern | 9.5 | 9.0 | 9.7 |
| Sabaragamuwa | 8.1 | 9.0 | 6.9 |
| Eastern | 4.2 | 4.8 | 4.9 |
| Uva | 8.1 | 5.1 | 4.3 |
| N. Central | 4.8 | 4.6 | 3.9 |
| Northern | 4.4 | 2.4 | 2.6 |
| National GDP | 100.0 | 100.0 | 100.0 |

Source: Central Bank of Sri Lanka and Department of National Planning, Ministry of Fniance.

52. Sri Lanka's highly unequal poverty record over the period reflects uneven development across sectors and regions (with a heavy bias in favor of Colombo and neighboring districts). Notably, agricultural value added barely increased in real per-capita terms while that in services and industry grew by over 3 percent annually. Moreover, the share of the Western province in nominal GDP increased from 40 to 48 percent between 1990 and 2002.

53. Much of Sri Lanka's skewed growth record and ensuing increased income inequality is a reflection of the unfinished reform agenda. More liberal trade and industrial policies spurred higher growth in industry and services, while pervasive controls and weak infrastructure stifled the dynamism of agriculture. A corollary of this uneven economic management also is that income growth has become heavily skewed in favor of Colombo and neighboring districts while poverty persists in rural areas where 90 percent of the poor live.

54. The disappointing trend in the national poverty incidence also reflects a long-term growth performance significantly below the country's potential. Despite its early lead in social development, Sri Lanka has been left behind the high-performing East Asian countries like Korea, Malaysia, and Thailand. Contributing factors to this outcome include: (i) the pursuit (from the mid-50s to the mid-70s) of inward-oriented policies, while the East Asian comparators followed more open policies; and (ii), the 20-year civil conflict which afflicted the country since 1983. A direct impact of the conflict was to reduce economic growth by an estimated 2-3 percent annually and per capita income by about 40 percent. Furthermore, the conflict diverted public resources and the attention of policy-makers away from economic priorities and reforms contributing to large fiscal deficits and rising interest payments, declining public investment in roads and power infrastructure, falling quality of education, and weakening of administration and governance.

## B. Towards Faster and More Equitable Growth

55. Sri Lanka's recent poverty trends underscore the need for faster and more broad-based economic growth. The Government's own MDG report emphasizes the importance of accelerating growth and job creation to reduce income poverty. This will be a challenge in light of the country's structural weaknesses, including: high fiscal deficits and public debt levels that constrain the role of fiscal policy; limited export diversification against the backdrop of the abolition of the MFA since January 2005; and continued stagnation of non-plantation agriculture and the rural economy.

56. Addressing the structural weaknesses will require containing the burgeoning fiscal deficits, diversifying the export base, and realizing the growth potential of non-plantation agriculture. To do all will require putting in place a more conducive public investment program and encouraging foreign and domestic private investment. In addition, critical for both growth acceleration and poverty reduction will be the success in attaining durable peace. It will be also essential that in managing the economy, policy reversals be avoided and that gains from past reform efforts be sustained and further strengthened.

## (a) Managing Public Finances

57. A sustainable fiscal stance remains the cornerstone of any viable growth strategy. Despite the enactment of the 2002 FMRA, the fiscal situation remains under considerable stress. In 2004, the fiscal deficit remained high at around 8 percent of GDP and the public debt stood at around 105 percent of GDP, a long way from the FMRA targets for 2006 (of 5 and 85 percent of GDP, respectively). Key priorities include:

58. **Reducing public debt.** Sri Lanka's public debt and debt service burden - absorbing over one half of tax revenue-needs to be brought down to manageable levels within the medium term parameters of the FMRA. This will require eliminating the primary deficit (from 3-4 percent of GDP) and imposing strict limits on non-concessional borrowing.

59. **Raising tax revenue.** The challenge in revenue generation are to reverse the massive decline in the tax-to-GDP ratio in the face of the sharp drop in trade taxes since 1990; the stagnation of income taxes at around 2.5 percent of GDP, which is very weak by international standards; and the difficult transition from a system of turnover taxes and special levies to a VAT, which has been further complicated by the introduction of a three-tier system.[20] Key priorities include: (i) strengthening VAT, by expanding its coverage to the retail level; (ii) raising the income tax yield, by gradually phasing out tax holidays and exclusions; and (iii) improving tax administration, through a better integration between customs and the tax department, and separation of the audit and collection functions.

60. **Containing the wage bill.** Sri Lanka has one of the largest bureaucracies in the region, with a ratio of 3.9 civil servants per 100 people. Although the size of Sri Lanka's civilian wage bill is not unmanageable relative to other countries (over 3 percent of GDP until 2004),[21] the trend is worrisome. After maintaining a cap on public sector recruitment, employment accelerated to 2 percent in 2004 and in 2005 the wage bill is projected to increase to nearly 4 percent of GDP on account of both higher recruitment and wage rates.

## (b) Improving Public Service Delivery

61. **Reforming wage and employment policies.** While keeping the wage bill in check, strong political commitment is needed to address well-known constraints to public service delivery. These include overstaffing (particularly at the lower grades); excessive salary compression (8:1) which limits the public sector's ability to attract skilled staff; and administrative fragmentation, duplication, and wastage (partly exacerbated by the ineffective devolution of functions).

62. **Rationalizing public spending and linking it to the poverty reduction strategy.** The scope for expenditure rationalization is significant, not least because of the duplication and overstaffing problems of the public administration. The Ministry of Finance is developing a medium term budget framework (MTBF) which could potentially combine macro (i.e., attaining fiscal sustainability) and micro objectives (such as enhancing the development impact of public spending). Building on the recent introduction of budget ceilings and of a three-year planning horizon, the budget formulation process needs to better align policy priorities with resource allocation within and across sectors. In general, there is a need to reorient expenditures from recurrent to investment to support faster economic growth. Within the recurrent budget, there is an urgent need to improve the targeting of existing welfare programs to better reach the poor, through objective eligibility criteria and making transfers more progressive, which is fully consistent with the Government's MDG report which calls for addressing mistargeting.

63. **Improving the performance of public enterprises:** A program of fiscal consolidation and improved service delivery requires that remaining public enterprise be substantially restructured. Regardless of the restructuring method used, concerned enterprises need to be allowed to operate on a commercial basis (with no political interference) and be subject to a hard budget constraint. The success of current plans to restructure twelve strategic public enterprises under the oversight of SEMA hinges on improving their autonomy and accountability.

20. The VAT introduced in 2002 to replace the General Sales Tax (GST) and the National Levy consisted of two rates (10 and 20 percent). In 2003, the two rates were unified into 15 percent rate, but multiple rates were introduced with the 2005 budget.
21. The civil service salaries are not comparable to other countries since it is not subject to income tax. If income tax is included in the salaries the total wage bill would be higher than 3 percent of GDP.

### (c) Reviving Non-Plantation Agriculture[22]

64. The slow growth of non-plantation agriculture is a primary factor explaining the persistence of poverty in Sri Lanka. The modest decline in rural poverty between 1990 and 2002 is consistent with a barely positive growth trend in per capita agricultural value added over the period. Heavy public sector interventions in agricultural commodity and input/factor markets-primarily geared toward the attainment of self-sufficiency in paddy production-have hampered growth in the sector. Although many of these interventions (e.g., subsidies, land, technology, trade, and irrigation policies) have sought to protect the interest of paddy farmers, their unintended outcome has been to squeeze the returns from agricultural production, limit productivity and income-enhancing investments, hold back diversification to higher value activities, and "pushed" many into low-paying, casual non-agricultural wage labor. More rapid agricultural productivity growth and rural development will require stronger commitment to removing existing policy and regulatory constraints which stand in the way of a more diversified production base.

65. **Allowing full and transferable ownership rights to land.** The transfer of state-owned land to smallholder farmers through grants and permits since the 1930s succeeded in promoting greater equity in land distribution and food security. However, restrictions on the transferability and use of these grants/permits have led to the fragmentation of land into non-economical 'miniature' holdings,[23] with adverse equity and efficiency implications. The conversion of grant/permits into title and the ensuing development of land markets are essential to enhance farmers' ability to expand and consolidate land into economically viable holdings as well as to access credit (using land as collateral) for much needed productivity-enhancing investments. Lack of access to credit (which is linked to the lack of land collateral) is actually a top constraint for the development of rural firms. Concerns that some farmers may become landless if private land ownership is allowed could be addressed by developing appropriate safety nets and impact assessments.

66. **Facilitating access to improved technologies.** Currently farmers are faced with restrictive seed and quarantine regulations and limited extension[24] and research services (which have primarily focused on paddy for the domestic market). Farmers' access to improved technologies could be facilitated by adopting more liberal seed and plant regulations, as envisaged under the National Seed Policy and the 1999 Plantation Act, as well as by expanding the scope of research and the supply of extension services through increased private sector participation, including of NGOs.

67. **Phasing out trade distortions.** Selected commodities (i.e., rice, potatoes, chillies and onions) remain subject to high and variable tariffs. These policies lead to price distortions; create considerable uncertainty for farmers, consumers and local firms; and discourage private investment (e.g., in storage). The correction of ensuing inefficiencies in resource allocation will require a more stable trade regime and a gradual reduction in tariffs.

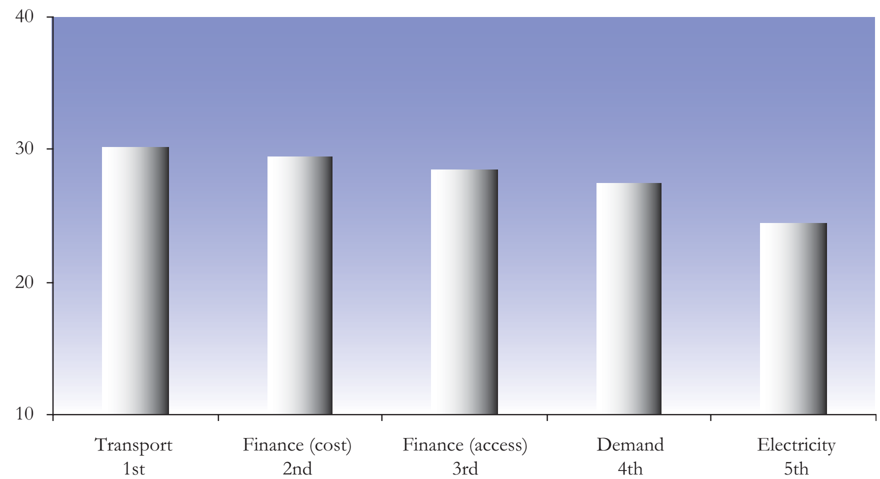
68. **Ensuring the sustainable use of water.** Substantial public resources have been invested in irrigation infrastructure (including the Mahaweli program launched in the early 1980s).[25] However, the sustainability of past large investments is threatened by poor maintenance, leading to the rapid deterioration of canal systems and costly rehabilitation requirements as well as poor quality of services. Also, the provision of free water has reduced the incentive for farmers to save and use water more efficiently. Building consensus on a national water policy-which effectively addresses maintenance, rehabilitation, and water management issues to deal with growing competition for water-will be essential for the sustainable development and management of water resources.

69. The removal of policy and regulatory constraints will need to be accompanied by **increased investments in basic rural infrastructure.** According to the ADB/World Bank Investment Climate Assessment (ICA), poor **transport** infrastructure constitutes the single most important constraint to rural firms.[26] Although, the country's road network is dense (1.5 km/km2 of area) by regional standards, only 10 percent of the paved road network is in good working condition due to lack of maintenance. In general, Sri Lankans living outside the Western Province do not enjoy

22. Issues related to plantation agriculture are beyond the scope of this report. However, in light of the poverty statistics for the plantation sector, a special study of the issues has recently been launched.
23. Over 40 percent of small holdings have less than one acre and over 60 percent below two acres.
24. According to the Sri Lanka Integrated Survey (SLIS), 1999/2000, only about 13 percent of agricultural households reported receiving technical assistance from a government extension agent (15 percent from all sources).
25. Between 1980 and 1997, about Rs. 215 billion (constant 1996 rupees) in public funds were spent in irrigation.
26. ADB and World Bank (2005).

the connectivity that others have. Given scarce public resources, public spending needs to focus on designing and promoting a regionally equitable strategy for rural infrastructure development and increasing funding for maintenance and rehabilitation.

**Figure 12: Top Five Investment Constraints in the Rural Sector**




Source: ADB, World Bank Sri Lanka Investment Climate Survey 2004.

### (d) Promoting Export-led Growth

70. Liberal external sector policies since the late 1970s have underpinned Sri Lanka's export-led strategy and explain the resilience of the economy in the face of prolonged stress and occasional shocks. These policies have contributed to bringing down the unemployment rate to single digits from close to 20 percent in the 1970s. Notably, garment exports have become one of Sri Lanka's major industries, currently accounting for half of all exports and employing 5-6 percent of the labor force while providing indirect employment to about one million workers (15 percent of the labor force). Similarly, liberal emigration policies have contributed enormously to the generation of foreign exchange (about 10 percent of GDP) and of employment opportunities for about one million workers, helping to more than halve the female unemployment from over 30 percent in the 1970s.

71. Although the medium term prospects for Sri Lanka's garment industry in the post-MFA period seem positive-as larger firms have been able to move up to higher value segments of the market-there could be significant disruptions among smaller exporters who account for about two-thirds of all exporters and around 35 percent of employment in the sector.[27] There is, therefore, an urgent need to strengthen Sri Lanka's ability to compete in a changing world environment by improving existing external sector policies and addressing remaining 'behind the border' constraints that undermine the competitiveness of Sri Lankan firms. Some key priority issues are discussed below:

72. **Avoiding trade policy reversals.** The pursuit of a flexible exchange rate policy, which has been central to Sri Lanka's export-led strategy to date, will need to be continued. In addition, further efforts are needed to meet the medium term goal of a single low, uniform tariff. While the country lowered average tariffs and effective rates of protection during the 1990s, the tariff regime has become more complicated since 2001 due to a new tariff surcharge, reintroduction of specific duties, a minimum duty, ad-hoc duty exemptions, case-by-case duty adjustments and the introduction of preferential tariffs under several trade agreements.

73. **Preferential trade liberalization.** Sri Lanka has concluded the India-Sri Lanka Free Trade Agreement (FTA) and initiated FTA negotiations with the US and several other countries. While there are substantial economic and political benefits to be reaped from FTAs with India and the US, the proliferation of bilateral agreements could distract from Sri Lanka's successful program of unilateral trade liberalization, incur sizable administrative and economic costs of multiple complex rules of origin, and complicate the tariff structure. In the post-MFA era, an FTA with the US

27. While smaller firms account for 5 percent of total export value, it is speculated that about 10 percent of jobs (or about 30,000) might be lost.

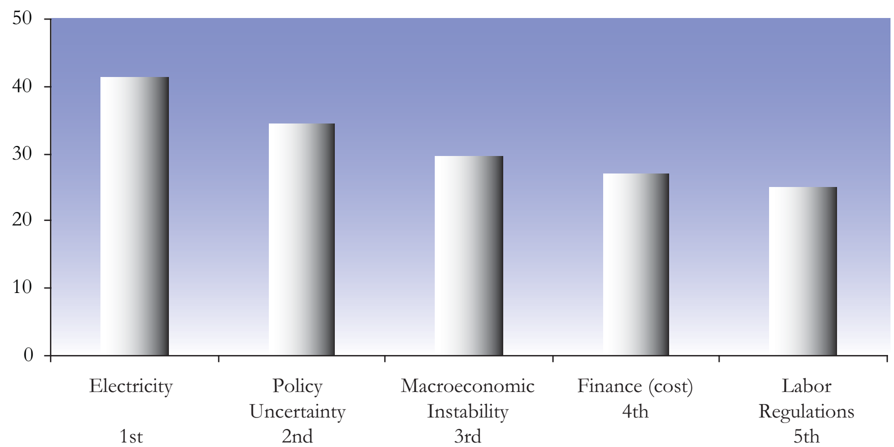
would help Sri Lankan garment exports to compete since half of US imports of these products occur under various preferential arrangements. These benefits would have to be balanced against the costs of possible requirements to free the capital account and to source inputs from the US. It is also important to note that preferential access to markets cannot substitute for needed improvements in labor productivity, lead time, and cost effectiveness.

74. **Refocusing investment policy.** A liberal investment regime has been an integral part of Sri Lanka's successful export-led strategy, with FDI driving the growth of the garment sector and other labor-intensive export activities. However, a major policy issue relates to the provision of generous tax holidays (often in perpetuity) to companies operating under the Board of Investment (BOI). These tax holidays have adversely impacted the budget and the 'level playing field' among firms, without bringing significant gains in terms of FDI which by all standards has remained modest. Legislation to bring fiscal incentives in line with Inland Revenue laws and away from the BOI needs to be implemented. In addition, given fiscal considerations, some form of a moratorium on direct tax incentives needs to be seriously considered.

75. Greater focus needs to be placed on **removing behind the border constraints** which adversely impact the competitiveness of firms. According to the ICA, top constraints to doing business for rural and urban firms include: poor electricity and transport infrastructure, policy uncertainty, macroeconomic instability, limited access and high cost of finance, and restrictive labor regulations.[28]

76. Progress in fiscal consolidation and financial sector reforms will contribute to reducing the **cost of finance** and improve overall macroeconomic stability. In addition to addressing transport constraints discussed earlier, a priority is to improve **electricity** infrastructure. Key measures include: (i) expanding generation capacity, (ii) implementing efficiency-raising restructuring plans for CEB; and (iii) addressing inequities by providing off-grid connections to rural households and subsiding rates when electrification cannot be provided on a commercial basis.

**Figure 13: Top Five Investment Constraints in the Urban Sector**




Source: ADB, World Bank Sri Lanka Investment Climate Survey 2004.

77. To enable firm to be more competitive, especially in the post-MFA period, policies should encourage enterprise consolidation, facilitate restructuring of credit to small exporters, improve infrastructure and trade facilitation, and bring current costly **labor regulations** in line with international standards. The implementation of labor reforms combined with improving the quality and relevance of **education**, for example by increasing use of English[29] and technology, will go a long way in increasing the productivity of labor and will enhance prospects for job creation.

28. ADB and World Bank (2005).
29. This would entail permitting schools to offer English medium education from grade 1.

**Table 12: Regulations for Labor Redundancy for Selected Asian Countries**

| Country | Administrative Authorization Required | Statutory Redundancy Payment Per Year of Service |
|---|---|---|
| Sri Lanka | Yes, if over 15 employees | 42-75 days |
| India | Yes, if over 100 employees. Not applicable to managerial and administrative employees. | 15 days |
| Pakistan | Yes, if closing down or retrenching more than half of workers | 20 days |
| Malaysia | No | 10-20 days |
| Thailand | No | Approximately 30 days; capped at 180 days total |
| Vietnam | No | 2 weeks |

Source: ADB and World Bank (2005)

78. In sum, the Government has taken positive steps towards boosting growth, protecting those affected by the tsunami, and maintaining relative peace. As it embarks on finalizing its poverty reduction strategy, it is hoped that equal emphasis is placed on raising investments in infrastructure and on addressing remaining policy constraints. Efforts need to be stepped up to strengthen the macroeconomic environment, address behind the border barriers including road and power infrastructure and labor regulations, and revamp the rural economy towards faster growth and more rapid poverty reduction.

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