



COUNTRY PRIVATE SECTOR DIAGNOSTIC

# CREATING MARKETS IN SRI LANKA

Private Sector-Led Inclusive Growth from  
Islands of Excellence

July 2022



**WORLD BANK GROUP**

THE WORLD BANK  
IBRD · IDA

**IFC**

International  
Finance Corporation

## About IFC

IFC—a member of the World Bank and member of the World Bank Group—is the largest global development institution focused on the private sector in emerging markets. We work in more than 100 countries, using our capital, expertise, and influence to create markets and opportunities in developing countries. In fiscal year 2021, IFC committed a record \$31.5 billion to private companies and financial institutions in developing countries, leveraging the power of the private sector to end extreme poverty and boost shared prosperity as economies grapple with the impacts of the COVID-19 pandemic. For more information, visit [www.ifc.org](http://www.ifc.org).

© International Finance Corporation 2021. All rights reserved.  
2121 Pennsylvania Avenue, N.W.  
Washington, D.C. 20433  
[www.ifc.org](http://www.ifc.org)

The material in this work is copyrighted. Copying and/or transmitting portions or all of this work without permission may be a violation of applicable law. IFC does not guarantee the accuracy, reliability or completeness of the content included in this work, or for the conclusions or judgments described herein, and accepts no responsibility or liability for any omissions or errors (including, without limitation, typographical errors and technical errors) in the content whatsoever or for reliance thereon. The findings, interpretations, views, and conclusions expressed herein are those of the authors and do not necessarily reflect the views of the Executive Directors of the International Finance Corporation or of the International Bank for Reconstruction and Development (the World Bank) or the governments they represent.

Cover Photo: Rakitha Wickramaratne/Shutterstock.com

# CONTENTS

---

<b>ACKNOWLEDGMENTS</b>	<b>VI</b>
<b>ABBREVIATIONS</b>	<b>VII</b>
<b>EXECUTIVE SUMMARY AND MATRIX OF ACTIONS</b>	<b>IX</b>
<b>1. A DECADE OF STRONG GROWTH AND HUMAN DEVELOPMENT HITTING CHALLENGING TIMES</b>	<b>1</b>
1.1 Government Role Facing Headwinds	5
1.2 Quality of Growth Falls Short	8
1.3 State of the Private Sector	14
1.4 The Impact of COVID-19	17
<b>2. KEY CONSTRAINTS OF THE ECONOMY FOR THE PRIVATE SECTOR AND THE WAY FORWARD</b>	<b>19</b>
2.1 How the Sri Lankan Economy Seems to Have Grown in Spite of the Distortions	19
Businesses Finding a Way to Work Around the Distortions	19
Making Use of the Global Marketplace	19
Multiple Distortions Compounding Each Other	20
2.2 Main Cross-Cutting Constraints	20
Macroeconomic Imbalances	22
Distortionary and Inconsistent Policies and Institutional Complexity	25
Protectionism and Lack of Trade Integration	26
A Poor Investment Climate Affecting All but a Few Companies	29
Policies that Stifle Land Access, Use, and Entrepreneurship	31
2.3 Inadequate Supply of Enabling Inputs	34
Education: The Skills Base Does Not Match Demand	34
Financial Sector: Public Borrowing Crowds-Out SMEs	41
Transport: Hub Opportunities Remain Untapped	47
Electricity: Meeting Future Demand at Market Prices	52
<b>3. OPPORTUNITIES TO PUT SRI LANKA ON A 21ST CENTURY TRAJECTORY</b>	<b>55</b>
3.1 Exploit the Potential of Tourism to Create Jobs in Lagging Regions and Balance External Accounts	55
Current Sector Performance	55
Constraints and Way Forward	58
3.2 Support the “Islands of Excellence” in IT, Specialized Manufacturing, and Agribusiness	60
Strengthen the Innovation Ecosystem	61
IT-Enabled Services	66
Knowledge Intensive and High-Quality Manufacturing and Agriculture	69



<b>REFERENCES</b>	<b>74</b>
<b>APPENDIX</b>	<b>78</b>
Appendix A. World Bank Lending and IFC Investment Portfolios	78
Appendix B. SOE Presence in the Economy, by Market Share	81
Appendix C. Islands of Excellence	83
<b>NOTES</b>	<b>87</b>

## Figures

Figure 1.1. Poverty rate (1985–2013)	2
Figure 1.2. Health indicators (2017)	2
Figure 1.3. Access to Electricity (2017)	2
Figure 1.4. People using at least basic sanitation services (2017)	2
Figure 1.5. Share of Growth by Sector and Expenditure (2011–2019)	3
Figure 1.6. Drivers of Growth: Garment Exports, Remittances, and Tourism	4
Figure 1.7. Solow Decomposition of Growth	4
Figure 1.8. Tax Revenue (% of GDP, 2018)	5
Figure 1.9. Fiscal Deficit (% of GDP, 2018)	5
Figure 1.10. Public Debt (% of GDP, 2018)	5
Figure 1.11. Balancing Private vs Public Sector Led Growth, 1965–2017	7
Figure 1.12. Sri Lanka Demographics 2015–2050	7
Figure 1.13. Change in the Sri Lankan Product Space Compared to Thailand's (1995–2019)	10
Figure 1.14. Garment and Textile Sector Wages	11
Figure 1.15. Manufacturing Wages (2018)	11
Figure 1.16. Some Agriculture Export Diversification, 2001–2017	12
Figure 1.17. Export Growth (2013–2018, Percent) and Volume (2018, US\$) of Key Products	12
Figure 1.18. Employment Concentration by District	13
Figure 1.19. Poverty Headcount Rates by District	13
Figure 1.20. Investment in State-Owned Enterprises	14
Figure 1.21. SOEs Estimated Share of GDP (2015–17)	14
Figure 1.22. Top Four Firms' Market Share in Specific Sectors (%)	16
Figure 2.1. Sri Lanka and comparators: Tax revenue to GDP (% , 2018)	23
Figure 2.2. Public Debt and Fiscal Deficit (% of GDP, 2020)	24
Figure 2.3. Sri Lanka Para-Tariffs (% , 2016)	26
Figure 2.4. FDI (% Of GDP, 2015–19)	28
Figure 2.5. Main Sources Of Foreign Exchange Inflows 2009–2018 (US\$ million)	28
Figure 2.6. Comparison of Higher Education Enrollment and GDP, Various Countries, 2017-19	36
Figure 2.7. Credit as Share of GDP (2019)	42
Figure 2.8. Sri Lanka Credit as Share of GDP	42
Figure 2.9. SME Access to Finance (fully or partially constrained as % of potential demand)	44
Figure 2.10. Share of banks' total credit to government and SOEs	44

Figure 2.11. Nonperforming Loans, 2017–20 (% of loans)	45
Figure 2.12. Made or Received Digital Payments in The Past Year, by Country (% age 15+)	46
Figure 3.1. Technology Intensity in Exports, 2017	62
Figure 3.2. Sri Lankan Firms Use Fewer Innovation Inputs	63

#### **TABLE**

Table ES.1. Matrix of Investment Opportunities and Government Measures to Create Markets	xvii
Table 1.1. Formal and Informal Firm Employment and Productivity by Broad Sector	17
Table 2.1. Constraints Heatmap: Sectors in Which Sri Lanka Scores Below Markets Where IFC Recorded Successful Investments	21
Table 2.2. Sri Lanka’s Top 10 Most Protected Manufacturing Sectors, 2010 (Based on Effective Rate of Protection)	27
Table 2.3. Private Enrollment as a Share of Total Tertiary Education Enrollment by Region	37

# ACKNOWLEDGMENTS

---

This Country Private Sector Diagnostic (CPSD) was prepared by a World Bank Group (WBG) team led by Jean-Christophe Maur (co-TTL) and Volker Treichel (co-TTL). Gautam Mehta and Ravindra Yatawara were core team members. Pia Trivedi contributed to the concept note preparation and the first mission. The team benefited from substantial inputs from Victor Antonypillai as well as his lead in the discussion with private sector firms. Radiance de Mello (program assistance, IFC Colombo office), Gayatri Pathak (program assistant, CCER1), and Sophoin Sok Choeng (program assistant, CCEDR) provided precious administrative support. The analysis and the conclusion were also informed by consultations with industry associations, business leaders, think tanks, and government officials during one mission in Sri Lanka and a virtual mission following travel restrictions.

The CPSD was prepared under the guidance of Hector Gomez Ang (IFC Regional Director for South Asia), Mengistu Alemayehu (former IFC Regional Director for South Asia) and Faris Hadad-Zervos (WB Country Director for Nepal, Sri Lanka and Maldives), Peter Mousley (Lead Private Sector Specialist). Idah Z. Pswarayi-Riddihough (former WB country director for Sri Lanka and Maldives), Mona Haddad (former IFC director for Country Economics And Engagement), and Zoubida Allaoua (WB regional director for Equitable Growth, Finance and Institutions in South Asia, ESADR). The support of Amena Arif (former IFC country manager for Sri Lanka and Maldives, CSADR), Rolf Behrndt (former IFC manager for advisory services in South Asia, CSAA1), John Nasir (IFC manager for country economics and engagement in Asia, CCER1), and Esperanza Lasagabaster (former WB practice manager for the Finance, Competitiveness, and Innovation Global Practice, ESAF1) throughout the preparation of this report is gratefully acknowledged.

The peer reviewers for this report were Ralph Van Doorn, Emiliano Duch, Frederico Gil Sander (concept note), Xavier Cirera, Tom Farole and Tom Jacobs (final report).

The team benefited from precious inputs from the following colleagues: Adam Sack, Adja Mansorou, Amali Rajapaksa, Amila Dahanyake, Anathan Nallapa, Andrew Goodland, Anoma Kulathunga, Arandara Tisarani, Asela Dissanayake, Avinash Ranjan, Bhanu Mehrotra, Bradford Roberts, Brendan Dack, Deepika Eranjanie Attygalle, Dinesh Warusavitharana, Dirk Sommer, Emmanuel Pouliquen, Eric Siew, Fabian Seiderer, Federica Ranghieri, Fernando Im, Frederico Gil Sander, Gerald Ollivier, Harsha Aturupane, Henrick Pedersen, Isabel Chatterton, Jessica Rachel Smith, Kamal Dorabawila, Kanchana Abeywickrema, Kannagi Ragunathan, Kevin Kime, Kishan Weditha Namanayaka Abeyguna, Lopa Rahman, Lopa Shah, Lubo Varbanov, Mahima Kanna, Mark Giblett, Meena Sankar, Moazzam Mekkan, Mohammed Ali Khan, Mohan Gopalakrishnan, Monique Mrazek, Natasha Kapil, Navaid A. Qureshi, Nihar Shah, Nishantha Jayasooriya, Oksana Nagayets, Philip Ahoua, Prasad Gopalan, Priscilla Wuersch-Ng Yixian, Priyanka Coorey, Ramesh Ramanathan, Rathnija Arandara, Roopa Raman, Ruchira Shukla, Rukshila Shihanthinie Gooneratne, Sabine Schlorke, Samia Melhem, Sanjay Katuria, Saroj Ayusk, Satya Sahu, Saule Imanova, Seenithamby Manoharan, Sergey Mytarev, Shalaka Joshi, Shanta Devarajan, Shaun Mann, Suranga Sooriya Kumara Kahandawa, Tatiana Nenova, Thalyyta Ernandya Yuwono (Nandya), Vikram Kumar, Vladislava Ryabota, Walid Fayad, Wei Wang, Wendy Jia.

# ABBREVIATIONS

---

4G	fourth-generation internet
BIA	Bandaranaike International Airport
BOI	Board of Investment
BPM	business process management
CBSL	Central Bank of Sri Lanka
CEB	Ceylon Electricity Board
CMPH	China Merchants Port Holdings
CPC	Ceylon Petroleum Corporation
CPSD	Country Private Sector Diagnostic
EDP	external degree program
EPZ	export processing zone
FDI	foreign direct investment
fintech	financial technology
FMA	Financial Markets Authority
FSAP	Financial Sector Assessment Program
FTA	free trade agreement
GDP	gross domestic product
GER	gross enrollment rates
HEI	higher education institution
ICT	information and communications technology
IMF	International Monetary Fund
InfraSAP	Energy Infrastructure Sector Assessment Program
IPP	independent power producer
IPR	international property rights
IT	information technology
JIS	joint information system
KPO	knowledge process outsourcing
LCL	less than container load
LNG	liquefied natural gas
LPG	liquefied petroleum gas
MCC	multicountry consolidation

MHEH	Ministry of Higher Education
MICE	meetings, incentives, conference/conventions and exhibitions/events.
MSDVT	Ministry for Skills Development and Vocational Training
MSMEs	micro, small, and medium enterprises
MSS	Merchant Shipping Secretariat
NBFI	nonbank financial institution
NCRE	nonconventional renewable energy
NPL	nonperforming loan
NQI	national quality infrastructure
OECD	Organisation for Economic Co-operation and Development
PPP	public-private partnership
R&D	research and development
SAR	special administrative region
SEZ	special economic zone
SLA	Sri Lankan Airlines
SLGN	Sri Lanka Government Network
SLINTEC	Sri Lanka Institute for Nanotechnology
SLITHM	Sri Lanka Institute of Tourism and Hotel Management
SLPA	Sri Lanka Ports Authority
SLTDA	Sri Lanka Tourism Development Authority
SLTPB	Sri Lanka Tourism Promotion Bureau
SMEs	small and medium enterprises
SOB	state owned bank
SOE	state owned enterprises
STEM	science, technology, engineering, and mathematics
TEU	twenty-foot equivalent units
TVET	technical and vocational education and training
UBL	university business linkages
UMIC	upper-middle-income countries
UOM	University of Moratuwa
VAT	value-added tax
VC	venture capital
WTO	World Trade Organization



# EXECUTIVE SUMMARY AND MATRIX OF ACTIONS

---

*Sri Lanka is a country of paradoxes. With the lowest poverty rates, best social indicators, and highest per capita income in South Asia, Sri Lanka's economic performance since independence had generally been hailed as a success before the current debt crisis. However, past performance occurred amidst many distortions and an economy less open than its peers, largely reflecting the strong involvement of the state in the economy. Even if this interventionist model of economic policy and the presence of many state-owned enterprises (SOEs) served the country well through the years of conflict and their aftermath, it is no longer sustainable. Indeed, after the rapid growth of the peace dividend in the years post-2009, the economy has faltered and progress on social indicators has stagnated. Many of market distortions remain and have been exacerbated by COVID-19. Understanding how, despite these handicaps, Sri Lanka achieved positive economic and social outcomes in the past provides the building blocks of a realistic, forward-looking growth strategy—one of the objectives of this Country Private Sector Diagnostic (CPSD). The research for this report was conducted prior to the current crisis, but the recommendations remain relevant to implement public policies that will support private sector led inclusive and sustainable growth.*

---

## **ES.1 STATUS OF THE ECONOMY**

In 2019, Sri Lanka became one of two upper-middle-income countries in South Asia, before falling back to lower-middle-income status in 2020. While in the immediate postwar period (2009–2013) gross domestic product (GDP) growth averaged a healthy 6.5 percent, it slowed from 2014–2018 to 4.3 percent and reached an 18-year low of 2.3 percent in 2019. This was before the COVID-19 outbreak, which has further weakened immediate growth prospects substantially and exacerbates an already challenging environment of low growth and pressures on fiscal and external accounts. The World Bank projects that the economy will contract by 3.6 percent in 2020 and the recovery in 2021 will be tepid at 3.3 percent. Fiscal sustainability is a concern with public debt reaching approximately 100 percent of GDP in 2020, not including large SOE debt estimated at 12 percent of GDP. In April 2022, as this report went to publication, Sri Lanka has indicated that it would no longer service its foreign debt and might negotiate with investors for restructuring the debt. The authorities also indicated that they were engaging the IMF.

The key drivers of growth in the last decade have been the favorable export performance of the apparel sector and tourism sectors; the boost to consumption, partly on account of remittances; and the government's infrastructure investments following the end of the war. From 2009–13, about half of the growth performance was the result of higher productivity, possibly reflecting the impact of the reconstruction effort, the industrial upgrading in the apparel and garment sectors, and the performance of the information technology (IT) and light manufacturing sectors, which compete in some of the most competitive destination markets.

Notwithstanding the generally good growth performance, the extent of integration into the global economy has declined considerably since the new millennium, and private investment has been structurally much lower than in peer countries. This is symptomatic of the changes in economic policy direction that Sri Lanka has experienced in the past 50 years. The positive growth that Sri Lanka experienced over the past two decades was preceded by a period beginning in 1977 where the state began to gradually disengage from the management of the economy, through trade liberalization and privatization or commercialization of SOEs. However, this push for change stopped rapidly and was even reversed in the late 1980s. A second wave of reforms and the boom of the textile and clothing sectors generated growth in the 1990s. Since the 2000s, despite its strategic location on trade routes and proximity to large markets, the country has become significantly less open: trade accounted for only 52.9 percent of GDP in 2017, down from 88.6 percent in 2000, a low number for a midsize economy. The share of private investment in total gross fixed capital formation fell from 89.8 percent in 2000 to 81.8 percent in 2017, reflecting both the impact of the last stages of the civil war and strong public sector and debt financed investments. Moreover, from 2015 to 2017, private investment at 16.5 percent of GDP was significantly below the levels in China and India of 29.5 percent and 20.1 percent of GDP, respectively. This weakening investment performance reflects not only the difficult business environment and the presence of the state, but also—more recently—the lack of macroeconomic stability. It is also correlated with a decline in the World Bank's Logistic Performance Index from 2.75 in 2012 to 2.6 in 2018, in contrast to the performance in Vietnam where it increased to 3.27 over the same period.

The deceleration of growth starting in 2013 reflected lower public investment and a subsequent contraction in construction, as well as a slowdown in manufacturing. It highlights the weakness of the foundations of Sri Lanka's growth performance and the inability of the state—despite its central presence in the economy—to provide an environment conducive to such growth. This all the more so because the state's public investments suffer from a considerable efficiency gap, estimated at 30 percent (World Bank 2019g) and have not generated the return on investment needed to finance the corresponding loans. This has been associated with the build-up of unsustainable macroeconomic imbalances and large external financing requirements, resulting from a high fiscal deficit. Considerable increases in external debt, weak revenue mobilization, and large losses suffered by SOEs have constrained fiscal space and created an acute balance of payments crisis. Since April 2020, Sri Lanka has lost access to the international capital markets, and in April 2022, authorities announced a suspension of repayment of certain Fx-denominated loans.<sup>1</sup>

**Growth has failed to deliver the qualitative results expected by Sri Lanka’s population:**

- **The employment intensity of growth has declined, and there is a lack of high-quality jobs, especially outside Colombo.** While the official unemployment rate is low, the share of informal employment in low-quality jobs is large. At the same time, many skilled workers choose not to work in the private sector, as they prefer prestigious civil service or SOE positions, the latter employing around 250,000 people. Moreover, high-quality job opportunities for workers have not always materialized, leading to outward migration.
- **Structural transformation has been slow.** The export product mix of Sri Lanka has not changed much and remains much less complex than in aspirational peers like Costa Rica, Malaysia, and Thailand. Some transformation in production and employment has happened: the share of agriculture in GDP declined from 14.3 percent (2002) to 7.7 percent (2018), and agriculture’s share of employment declined from 38 to 26 percent, while employment in services increased from 38 to 46 percent over the same period. Agriculture employment remains, however, higher than in some aspirational peers (Costa Rica, Malaysia). In fact, a large part of the economy—including the apparel and agriculture sectors—continues to operate in the low-skills labor-intensive space at wages comparable to those in lower income countries like Bangladesh.
- **There is significant spatial disparity in economic and social development, with several regions of the country significantly lagging the relatively prosperous region around Colombo.** Regions affected by the civil war (in the Northern Province, Mullaitivu, Mannar, and, to a lesser extent, Kilinochchi), Batticaloa in the Eastern Province, and Monaragala in the Uva Province remain far behind in levels of poverty, infrastructure, and economic development.

Finally, the economy is facing the economic fallout of the COVID-19 pandemic<sup>2</sup>, which has adversely affected several sectors, including tourism, and further constrains the already tight fiscal space. Moreover, rapid aging poses an additional constraint on the country’s future growth performance.

## ES.2 KEY CONSTRAINTS ON THE ECONOMY

Attempts to resume growth and accelerate structural transformation in the Sri Lankan economy face a number of obstacles, some of which have been present for a long time.

### The Cost of Doing Business for Outsiders

The policy environment is often unpredictable and nontransparent, and policy decisions lack consistency; both contribute to a complex investment climate. Policies are subject to frequent shifts (reversals in trade and tax policies, in particular for sectors that benefit from protection owing to political connections). Periods of inward- and outward-oriented policies have alternated. Policy decisions also lack consistency: for instance, in 2012, “hub” regulation laws were passed with the goal of becoming a logistics hub, while maintaining a 40 percent equity cap for foreign investors and high levels of protection. Examples of lack of coordination were found in several policy areas reviewed in this report: education policy, innovation policy, transport and logistics, and tourism.

**A highly restrictive trade regime with average customs duties on imports of 22.3 percent because of para-tariffs** creates a bias against exports and diversification by directing private investments into protected sectors served by Sri Lanka-based firms. Import protection has been driven partly by the desire to protect national production, and partly by fiscal exigency: taxes on international trade accounted for a high average of 18 percent of tax revenue during 2014–19, much higher than in other upper-middle-income countries, where the average is about 1–3 percent. Access to foreign-sourced inputs also becomes more costly because of high taxation and controls at the border.

**The investment climate is poor for most firms.** The poor quality of the regulatory environment constrains investment decisions. However, some foreign investors and larger companies can access far better terms, notably under Board of Investment (BOI) sanctioned regimes and BOI zones. The success of some of the exporters attests that investment climate conditions can be improved when needed.

### Gaps in Supply of Essential Inputs

**Constrained fiscal space and inefficient management of some large-scale projects have limited the ability of the government to address key infrastructure gaps**, especially in transport and energy. There is a particularly urgent need to upgrade airport and port infrastructure (expansion of the Port of Colombo terminals) and improve internal road connectivity. At the same time, while the country enjoys almost 100 percent electrification, the cost of electricity is high, and generation is at capacity. Procuring additional generation capacity through an improved public-private partnership (PPP) framework, and a better economic incentive structure implying a gradual shift to cost-reflective tariffs, combined with rebalancing the generation mix toward renewables would be needed to support a faster growth trajectory.

**With the government owning about 40 percent of the banking system, large budget deficits are to a significant extent funded by state-owned banks.** Furthermore, the state provides guarantees to state banks to facilitate lending to SOEs and occasionally allows for outright dismissal of loan obligations. As a result, the private sector, in particular small and medium enterprises (SMEs), is deprived of resources that are needed to support innovation and productivity-enhancing investments. Furthermore, the preferential access to finance for SOEs distorts competition with the private sector and in turn affects the quality and cost of services in these sectors.

**Most land is publicly owned (80 percent).** Land use is highly fragmented and can be subject to regulations, such as the restriction of the use of agricultural land in some regions to certain crops (rice for instance) and restrictions on foreign use of land. Also, ownership of vast tracks of land by some public entities leads to underutilization and misallocation.

### ES.3 HOW DID SRI LANKA GROW DESPITE CONSTRAINTS IN THE PAST?

Many of the above constraints have been prevalent in the past, including periods when Sri Lanka enjoyed rapid economic growth and poverty reduction. Understanding how this came about provides guidance in charting a growth strategy in the future. Some of the constraints have endured for a long time because they are politically sensitive and may be challenging to relax in the near term. A growth strategy must take this into account and identify reforms that are both economically salient and politically feasible.

In reviewing Sri Lanka's past economic performance in the wake of several obstacles, three lessons emerge:

- a. **Making use of the global marketplace.** In some sectors (textile and clothing, tourism, IT, high-end manufacturing) companies have been expanding their footprint to the global marketplace where the distortions prevalent in the domestic market are not present and demand is unlimited. In this process, companies have been able to become competitive and upgrade production to more sophisticated products and markets.

Recent successes in mainly export-focused niche sectors, such as IT-enabled services and light value-added manufacturing show that Sri Lankan firms can be internationally competitive, including in the most competitive destination markets (for selected sectors). Sri Lanka's private sector is changing, including recent growth of sophisticated IT-services exports (business process management [BPM] in legal, accounting, and financial services; knowledge process outsourcing [KPO] services in data analysis and software operations) and new investment and exports in precision and high-quality manufacturing and agro-food processing (advanced technical apparel and textile-based products and customized rubber-derived products for instance).

To fully harness Sri Lanka's comparative advantage and integrate it further into global value chains, the country needs to build on the innovative drive in the large existing manufacturing sectors, such as apparel, and entrepreneurial dynamism in niche sectors, such as information and communications technology (ICT) and high-tech products. These sectors, if scaled up, hold the potential to drive Sri Lanka's full transformation to an upper-middle-income country. Improved access to external markets is essential in this respect: the size of the country's domestic market is too small to allow production of higher technology products at the scale necessary to fully support their growth potential. In this context, it will be essential to step up efforts at greater integration in global value chains: concluding bilateral free-trade agreements could be the key to accessing large markets and becoming a more attractive destination for new investments.



- b. **Finding a way to work around the distortions.** One important characteristic of the Sri Lankan economy is the coexistence of structures typical of advanced economies with those of lower-income economies. There are large conglomerates that are generally efficient and operate at the global production frontier, while most of the private sector is small with low productivity firms in the informal sector—many of them in the agriculture and service sectors. Conglomerates—a few large enterprises—are active in sectors as diverse as transport, apparel, retail, light manufacturing, and tourism. Many are long-established companies that have significant market shares, and sometimes protected positions in some of their sectors of activity, and as a result, have been less affected by complex regulations. In addition, many globally competitive firms, including foreign-owned corporations, operate in export processing zones, which has allowed them to circumvent restrictive labor regulations and access more efficient trade regimes.

Leaving aside these large firms, Sri Lanka's private sector is dominated by the informal sector (in terms of number of firms), albeit to a lesser extent than in some South Asian peers. While there are numerous SMEs, they are not dynamic enough to drive structural transformation toward a more typical upper-middle-income country.

- c. **Addressing interdependent distortions.** Some of the distortions in the system are the result of a complex equilibrium and fundamental redistribution effects and cannot be easily removed without simultaneously addressing other constraints. Important sensitive policy areas such as land, infrastructure, and education reflect redistributive or compensating policies that will be difficult to disentangle.

For instance, even though Sri Lanka has a good education system with among the best indicators in South Asia and boasts pockets of highly qualified labor, skills gaps are noted by employers as one of the important constraints to their development. Notably, lack of graduates from public education in science, technology, engineering, and mathematics (STEM) fields and technical and vocational skills that can more easily be used in the private sector are among the most significant shortcomings noted by employers. While there are private providers of education, to the extent authorized, the regulatory environment fails to properly monitor their quality.

Meanwhile, students graduating from public universities in Sri Lanka cannot find good jobs in part because they are taught skills that are less relevant for the modern-day private sector, and in part because they prefer prestigious government jobs over private sector jobs. Absent any civil service reform, there will be little uptake for improved education. Furthermore, proposals to introduce private universities have been met with strong resistance from education professionals.

## ES.4 THE WAY FORWARD

With this backdrop of an economy that needs to accelerate economic growth but is faced with numerous constraints. This CPSD proposes the following steps to promote a more dynamic private sector in the country (table ES.1).

**With a limited domestic market, Sri Lanka cannot compete at scale in most industries. It must differentiate itself by further diversifying into higher value-added industries and harnessing opportunities for regional integration.** Recent successes in knowledge and quality-intensive sectors (spanning sectors from value-added agricultural products, to specialized manufacturing and IT-enabled services) could be scaled up with appropriate upstream policies. The second pillar of private sector-led growth should be on scaling up tourism, as soon as recovery from the COVID-19 crisis will permit, and then investing in more sophisticated and varied tourism offerings.

**A focus on green and sustainable development will leverage Sri Lanka's natural assets and a well-preserved environment while contributing to the fight against climate change.** The environmentally sustainable use of natural assets is central to the tourism industry, but also to several key natural-resources connected sectors such as agriculture and marine-based production mentioned below. Mitigation of the impact of climate change will also be integral to future private sector growth through an increase in renewable energy use (a key objective for the energy, urban, and transport sectors) and better management of coastal areas.

**Through SOE reforms, the government can mitigate the mounting fiscal risks and costs negatively affecting macrofiscal stability, a key determinant for foreign investments. It can further use its state-owned business enterprises as catalysts for private investments and partnerships instead of displacing them.** This would require the government to modernize and consolidate the legal and regulatory framework governing SOEs, reduce the competitive neutrality concerns affecting the level playing field, and strengthen the corporate governance and performance of its key SOEs through specific measures recommended by the World Bank integrated SOE diagnostic, which complements this report (World Bank 2020c).

### Strengthen Innovation Ecosystem to Enable Dynamic Industries

**There are innovative industries in Sri Lanka, but overall, the country scores relatively low on innovation metrics, and the public sector underinvests in innovation.** In 2018, Sri Lanka adopted its Innovation and Entrepreneurship Strategy 2018–2022 with the involvement of significant private sector players. The National Innovation Agency was created to implement it. To more fully realize the potential of producing value-added goods and services, public policies supporting innovation must be less fragmented and more oriented toward commercial efforts. This supposes stronger links between public policies and the private sector, with a more diverse array of incentivizing plans and publicly funded facilities to provide space for innovation, as well as better links between university research and commercial use.

### Support “Islands of Excellence” in IT, Specialized Manufacturing, and Agribusiness

Sri Lanka has several islands of excellence in sectors that have the potential to grow and further contribute to exports. There is manifest and latent comparative advantage in several sectors, such as ICT (as demonstrated by artificial-intelligence-based KPO services), resource-based industries (coconut and rubber derived industrial applications and products), and light specialized manufacturing (with high value-added content such as high-end textiles or electronic sensors) that have driven growth in recent times and have the potential to drive it in the future. These sectors do not systematically compete on price, even though the cost of the work force remains attractive compared to competitors, but rather on providing tailored value addition to their customers: they have in common the ability to adopt innovative production techniques and customize production to clients’ needs. Another common characteristic is their ability to maintain high quality standards that are demanded by the most sophisticated markets and customers.

Beyond strengthening government support to education, innovation, and standards that will help accelerate the growth of high-value manufacturing and services, offering a better business environment and land for new investments is critical. In the short-term, an expansion of BOI processing zones is needed. However, in the long term, instruments and practices that have proven successful in the context of the BOI (such as customs and trade facilitation measures) should be rolled out to the rest of the economy and remaining restrictions on foreign investment and ownership considered for elimination.

### Exploit Tourism Potential to Create Jobs in Lagging Regions and Balance External Accounts

Tourism remains one of the most important sectors in the Sri Lankan economy as the second-largest export earner, a significant employer (169,000 direct and 219,000 indirect jobs), and a key source to finance the balance of payments. The number of annual tourist arrivals has grown more than 500 percent over the last decade—from about 450,000 in 2009 to around 2.3 million in 2018, equivalent to roughly a 23 percent annual growth rate over this time period. The direct contribution from the industry, estimated at US\$4.4 billion (2016), accounts for about 5 percent of the country’s GDP. Furthermore, tourism-specific investments accounted for close to 10 percent of total foreign direct investment (FDI) in 2018. Tourism is also important because of its inclusivity, being the sector that is most geographically diverse, having the largest share of SMEs and registering a significant growth in the female employment share since 2018. However, women’s employment in the tourism sector remains well below the industry average, accounting for less than 10 percent of the industry, compared to the global average of 65 percent.

To ensure growth in the tourism sector in the medium term, there is a need to improve logistics and connectivity and address shortages of skilled and service-oriented workforce, which would be important to provide high-value tourism services. The capacity of tourism and hospitality training institutes in regions outside Colombo needs to increase to address future demand. There is also the need to build strategic capacity for policy formulation within government agencies dealing with tourism and enhance interagency coordination. Post-COVID-19, it will take longer than expected to regain the confidence of tourists to return; now is the moment to review how this could be facilitated.

**TABLE ES.1 MATRIX OF INVESTMENT OPPORTUNITIES AND GOVERNMENT MEASURES TO CREATE MARKETS**

PRIORITY SECTORS	SHORT-TERM MARKET CREATING OPPORTUNITIES FOR INVESTMENT AND GOVERNMENT MEASURES (12-24 MONTHS)	MEDIUM-TERM MARKET CREATING OPPORTUNITIES FOR INVESTMENT AND GOVERNMENT MEASURES (3-5 YEARS)
<b>Enabling sectors and objectives</b>		
<p><b>Finance</b></p> <p>Deepen the supply of the sector, while targeting dynamic sectors (working around distortions).</p>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>• Post-angel-stage VC funding.</li> <li>• Increased credit to MSMEs.</li> </ul> <p><i>Measures</i></p> <ul style="list-style-type: none"> <li>• <b>Increase capital requirements for the sector, which could facilitate consolidation and/or exit of nonviable institutions and harmonize capital requirements between banks and NBFIs.</b></li> <li>• Review asset quality of NBFIs (after pandemic).</li> <li>• Eliminate lending interest rate caps.</li> <li>• Create a risk-sharing facility for MSME credit.</li> <li>• Facilitate creation of venture capital fund for post-angel-stage investment in promising start-ups.</li> </ul>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>• Consolidation in the NBFIs sector.</li> </ul> <p><i>Measures</i></p> <ul style="list-style-type: none"> <li>• Establish comprehensive financial consumer protection framework.</li> <li>• Rationalize the agencies overseeing different subsectors of the financial system into two supervisory agencies: the CBSL and a newly created FMA. FMA could oversee financial consumer protection across all financial services.</li> <li>• <b>Enact amendments to the Banking Action to: (a) enhance bank resolution framework for banks and NBFIs; and (b) subject state-owned banks to the banking law.</b></li> <li>• Enact modern secured transactions law and create modern uniform online registry of security interests for movable assets (tangible and intangible).</li> <li>• <b>Develop new legal framework, including for emerging areas such as digital finance and fintech.</b></li> </ul>
<p><b>Power</b></p> <p>Boost renewables while preparing for the future (compensating for distortions).</p>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>• None in the short term.</li> </ul> <p><i>Measures</i></p> <ul style="list-style-type: none"> <li>• <b>Launch a multi-project competitive tender for renewable energy procurement, including large (utility-scale) projects.</b></li> <li>• <b>Assess feasibility, and identify appropriate business models and financing structures for the proposed Sri Lanka-India transmission line.</b></li> </ul>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>• Renewable energy PPPs.</li> </ul> <p><i>Measures</i></p> <ul style="list-style-type: none"> <li>• Prepare a short- and medium-term implementation and financing plan based on the Long-Term Generation Expansion Plan 2018–2037 with prioritized investments.</li> <li>• Progressively move to cost reflective tariffs to improve the financial standing of CEB; consider as transition a transparent direct subsidy to CEB.</li> <li>• Develop India-SL transmission line.</li> </ul>

PRIORITY SECTORS	SHORT-TERM MARKET CREATING OPPORTUNITIES FOR INVESTMENT AND GOVERNMENT MEASURES (12-24 MONTHS)	MEDIUM-TERM MARKET CREATING OPPORTUNITIES FOR INVESTMENT AND GOVERNMENT MEASURES (3-5 YEARS)
<p><b>Education and skills</b></p> <p>Boost TVET offerings and industry-university links (compensating for and working around distortions).</p>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>• TVET PPPs.</li> </ul> <p><i>Measures</i></p> <ul style="list-style-type: none"> <li>• <b>Reinforce university–private sector coordination to match skills to demand and promote innovation (improve fiscal incentives; review IPR policies; fund innovation spaces).<sup>a</sup></b></li> <li>• <b>Develop Sector Skills Councils in priority sectors (TVET) with a view to aligning the supply of skilled labor with demand. Offer firms incentives to build in-house training capabilities.</b></li> <li>• <b>Improve governance of the TVET sector and coordination among the ministries</b> responsible for training institutions to improve efficiency and enhance the quality of training programs.</li> </ul>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>• Internationalization of universities: attracting international students; foreign investments in universities (with the BOI); links with foreign universities for research.</li> <li>• Private sector investment in universities focused on the provinces.</li> </ul> <p><i>Measures</i></p> <ul style="list-style-type: none"> <li>• Improve university faculty in priority fields such as STEM: promote PhD scholarships; fill vacancies; hire foreign nationals.</li> <li>• Establish an independent quality assurance council. Review quality of EDPs; reform National Vocational Qualifications (course accreditation; quality assurance).</li> <li>• Differentiate missions between teaching, research and innovation, and community services and regional development.</li> <li>• Restructure the Skills Development Fund to allocate resources competitively.</li> </ul>
<p><b>Transport and logistics</b></p> <p>Develop future transport and value-added logistics services (better use of the global marketplace)</p>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>• <b>Development of the East and West Container Terminals using a landlord port model and evaluate strategic private sector participation.</b></li> </ul> <p><i>Measures</i></p> <ul style="list-style-type: none"> <li>• Improve institutional strength and capacity development to bolster SLPA as a regulator.</li> <li>• Develop a master plan to improve city-port and port-hinterland connectivity (including feasibility studies and financing options).</li> <li>• Perform needs assessment for new gateway supply chain advanced logistic infrastructure.</li> <li>• <b>Complete the extension of the BIA terminal.<sup>b</sup></b></li> <li>• <b>Roll-out the Sri Lanka customs National Single Window with the appointment of a high-level steering committee.</b></li> </ul>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>• Value-added storage facilities (cold storage, third-party logistics, and MCC/LCL services).</li> <li>• Value-added services (bunkering, marine, and so forth) related to Hambantota port activities.</li> </ul> <p><i>Measures</i></p> <ul style="list-style-type: none"> <li>• Finish highway expansion projects.</li> <li>• Expand Jaffna International Airport runway.</li> <li>• Automate port-gate clearances and transfers between extended port gates, inland ports, and other customs authorized economic zones, industrial parks, and container freight stations.</li> </ul>
<p><b>IT infrastructure</b></p> <p>Prepare for a more open market (compensating for distortions).</p>		<p><i>Measures.</i></p> <ul style="list-style-type: none"> <li>• Review regulations to allow local loop unbundling and address last-mile connection competition issues.</li> </ul>



## PRIORITY SECTORS

## SHORT-TERM MARKET CREATING OPPORTUNITIES FOR INVESTMENT AND GOVERNMENT MEASURES (12-24 MONTHS)

## MEDIUM-TERM MARKET CREATING OPPORTUNITIES FOR INVESTMENT AND GOVERNMENT MEASURES (3-5 YEARS)

Traded sectors		
<p><b>Tourism</b></p> <p>Plan for volume growth and develop new upscale offerings (better use the global marketplace).</p>	<p><i>Measures</i></p> <ul style="list-style-type: none"> <li>Strengthen intra-island and international air connectivity.<sup>c</sup></li> <li><b>Reinforce capacity of tourism ministry to manage future growth in value-added and environmentally sustainable tourism</b> (new destinations, branding, MICE, wellness tourism).</li> <li>Establish a single regulatory agency to manage national parks and identify future development sites; review the Flora and Fauna Protection Act to assess the potential for protected areas to be opened to tourism in an environmentally sustainable way.</li> </ul>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>Underdeveloped sites (east and South coast, nature reserves), MICE, wellness tourism.</li> </ul> <p><i>Measure:</i></p> <ul style="list-style-type: none"> <li><b>Develop more sustainable tourist destinations with public investment in connectivity, marketing, and destination development.</b></li> <li><b>Train the 50,000–60,000 new hospitality staff needed, including measures to attract and retain women to the hospitality sector.</b></li> </ul>
<p><b>IT-enabled services</b></p> <p>Facilitate the supply of labor, key skills, and inputs to a growth sector (better use of the global marketplace).</p>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>Post-angel-stage VC funding (see above).</li> </ul> <p><i>Measures</i></p> <p>Prioritize IT skills at the university level</p> <ul style="list-style-type: none"> <li><b>Improve labor laws and facilitate granting visas for qualified expatriates (for example, French Tech Visa).</b></li> <li><b>Develop a comprehensive strategy to prop up the start-up ecosystem: improve access to business facilities, advice, and finance and regulatory reform to address taxation, capital repatriation, and bankruptcy.</b></li> </ul>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>Continued expansion of the BPM sector.</li> </ul> <p><i>Measures</i></p> <ul style="list-style-type: none"> <li>Improve the regulatory environment to address issues regarding data localization and management and digital transactions (signatures, payments).</li> </ul>
<p><b>Manufacturing</b></p> <p>Expand space and facilitation measures for high-growth firms (better use of the global marketplace and working around distortions).</p>	<p><i>Opportunities for private investment</i></p> <ul style="list-style-type: none"> <li>Value-added manufacturing relying on skilled manual labor and quality assurance.</li> </ul> <p><i>Measure</i></p> <ul style="list-style-type: none"> <li><b>Create new BOI zones outside Colombo to accommodate demand from prospective investors. Consider specific needs of industries (logistics, industry clusters) and the economic viability of multiple zones.</b></li> </ul>	

PRIORITY SECTORS	SHORT-TERM MARKET CREATING OPPORTUNITIES FOR INVESTMENT AND GOVERNMENT MEASURES (12-24 MONTHS)	MEDIUM-TERM MARKET CREATING OPPORTUNITIES FOR INVESTMENT AND GOVERNMENT MEASURES (3-5 YEARS)
<p><b>Innovation policy</b></p> <p>Increase emphasis on innovation policies in connection with export sectors (better use the global marketplace)</p>	<p><i>Measure</i></p> <ul style="list-style-type: none"> <li>• Incentivize private investment in R&amp;D (tax incentives, credit guarantees, and lending facilities) targeting innovative sectors.</li> <li>• <b>Redirect public support to private innovation adoption: business advisory services (for example, Colombia) and technology extension services (for example, India), as well as innovation vouchers and collaborative grants.</b></li> <li>• <b>Reduce fragmentation of government R&amp;D programs and duplication of agencies.</b></li> </ul>	<p><i>Measure</i></p> <ul style="list-style-type: none"> <li>• Develop channels for greater access of innovative firms to international markets and international sources of knowledge by enhancing market knowledge and facilitating regional integration with key trading partner countries.</li> </ul>
<p><b>Access to land</b></p> <p>Better use fallow public lands while improving land information systems (compensating for distortions)</p>	<ul style="list-style-type: none"> <li>• Adopt the policy of parcel-based land registry and cadastral map for all land ownership and land use rights in Sri Lanka.</li> <li>• <b>Revise the registering property processes to 3 steps (from the current 9).</b></li> <li>• <b>Carry out or review an inventory of State Land Assets with a view to putting them to commercial use .</b></li> </ul>	<ul style="list-style-type: none"> <li>• <b>Establish a new policy on state land and building asset management incentivizing public asset monetization and revising permitting, leasing, and granting concessions on state lands.</b></li> </ul>
<p><b>Taxation and trade</b></p>		<ul style="list-style-type: none"> <li>• Gradual reduction of para-tariffs as fiscal situation improves. Target para-tariffs based on analytical work and consideration of priority sectors for the government growth strategy.</li> </ul>

Note: Priority measures are in boldface. BIA = Bandaranaike International Airport; BOI = Board of Investment; BPM = business process management; CBSL = Central Bank of Sri Lanka; CEB = Ceylon Electricity Board; EDP = external degree programs; fintech = financial technology; FMA = Financial Markets Authority; IPR = international property rights; IT = information technology; LCL = less container load; MCC = multi-country consolidation; MICE = meetings, incentives, conference/conventions and exhibitions/events; MSMEs = micro, small, and medium enterprises; NBFi = nonbank financial institution; NCRE = nonconventional renewable energy; PPP = public-private partnership; R&D = research and development; SL = Sri Lanka; SLPA = Sri Lanka Ports Authority; STEM = science, technology, engineering, and mathematics; TVET = technical and vocational education and training ; VC = venture capital.

a. Also relevant to innovation policies below.

b. Also of relevance for the tourism sector.

c. See also transport above.

# 1. A DECADE OF STRONG GROWTH AND HUMAN DEVELOPMENT HITTING CHALLENGING TIMES

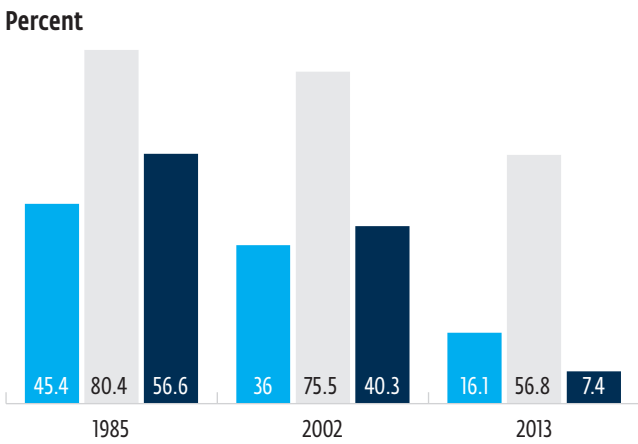
---

*Following an initial postwar growth spurt, Sri Lanka's growth performance has slowed down since 2013. A much greater role for the private sector is imperative because of the lack of fiscal space, the rapid aging of the population, and the shortcomings of the interventionist growth model to deliver the qualitative results expected by the population. While the country began to liberalize its economy in 1977, key features of the earlier interventionist model have remained in place. These features include a heavy presence of state-owned enterprises (SOEs) across the economy, including in the financial sector; restrictions on the role of the private sector in the education and health sectors; widespread state ownership of land; and an important role for the state in building infrastructure. Reducing the role of the state while creating more space for the private sector will be critical to accelerate and enhance the inclusiveness of growth.*

---

**Notwithstanding the recent economic challenges, Sri Lanka has been a development success story.** Sri Lanka's poverty rate at the middle-income poverty line (US\$3.2 per day at 2011 purchasing power parity) more than halved from 36 percent (2003) to 16 percent (2013), according to World Bank data. As per the national poverty line, Sri Lanka has almost eliminated poverty with the 2016 poverty rate at 4.1 percent (figure 1.1). Sri Lanka outperforms all comparators on most Millennium Development Goals, particularly poverty reduction, health, and education. Primary school enrollment is universal. Both lower secondary school enrollment and completion rates are almost universal and higher than in aspirational peers.<sup>3</sup> Maternal and infant mortality rates are at very low levels (figure 1.2), and life expectancy at 76 years is comparable to aspirational peers and higher than upper-middle-income countries.

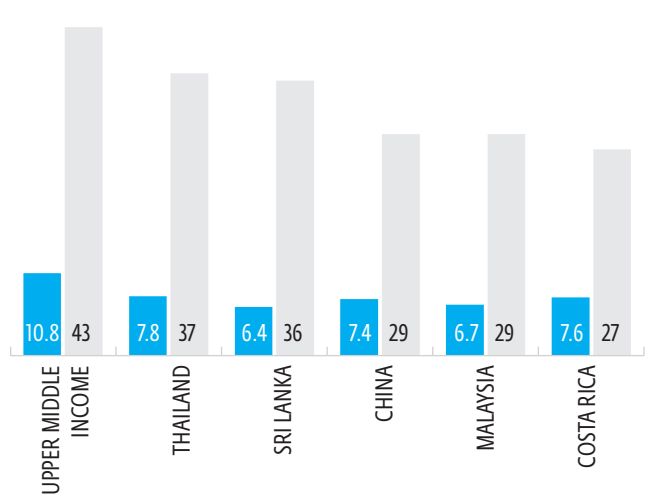
**FIGURE 1.1. POVERTY RATE, 1985–2013**



**SRI LANKA**  
**SOUTH ASIA**  
**UPPER-MIDDLE-INCOME COUNTRIES**

Source: World Bank PovcalNet data.

**FIGURE 1.2. HEALTH INDICATORS, 2017**



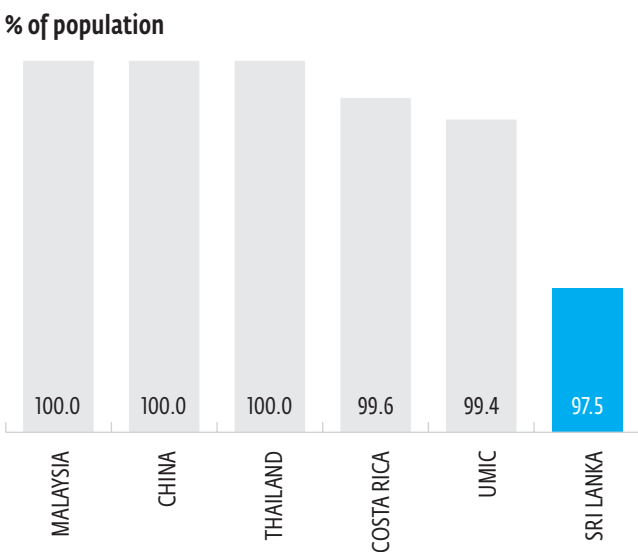
**INFANT MORTALITY RATE (PER 1,000 LIVE BIRTHS)**  
**MATERNAL MORTALITY RATE (PER 100,000 BIRTHS)**

Source: World Development Indicators

Note: UMIC = upper-middle-income countries.

**Access to public services is on par with aspirational peers.** Sri Lanka substantially outperforms its South Asian comparators in providing electricity, water, and sanitation (figures 1.3 and 1.4). Access to these services is comparable to aspirational peers and, in many cases, higher than in some upper-middle-income countries.

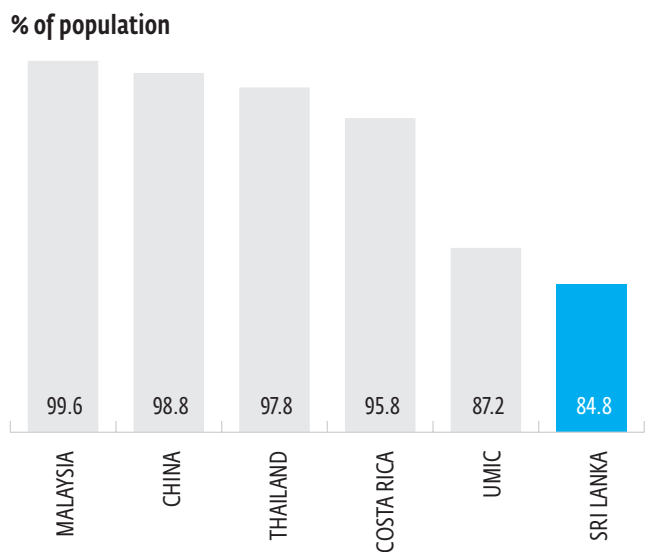
**FIGURE 1.3. ACCESS TO ELECTRICITY, 2017**



Source: World Development Indicators.

Note: UMIC = upper-middle-income countries

**FIGURE 1.4. PEOPLE USING AT LEAST BASIC SANITATION SERVICES, 2017**



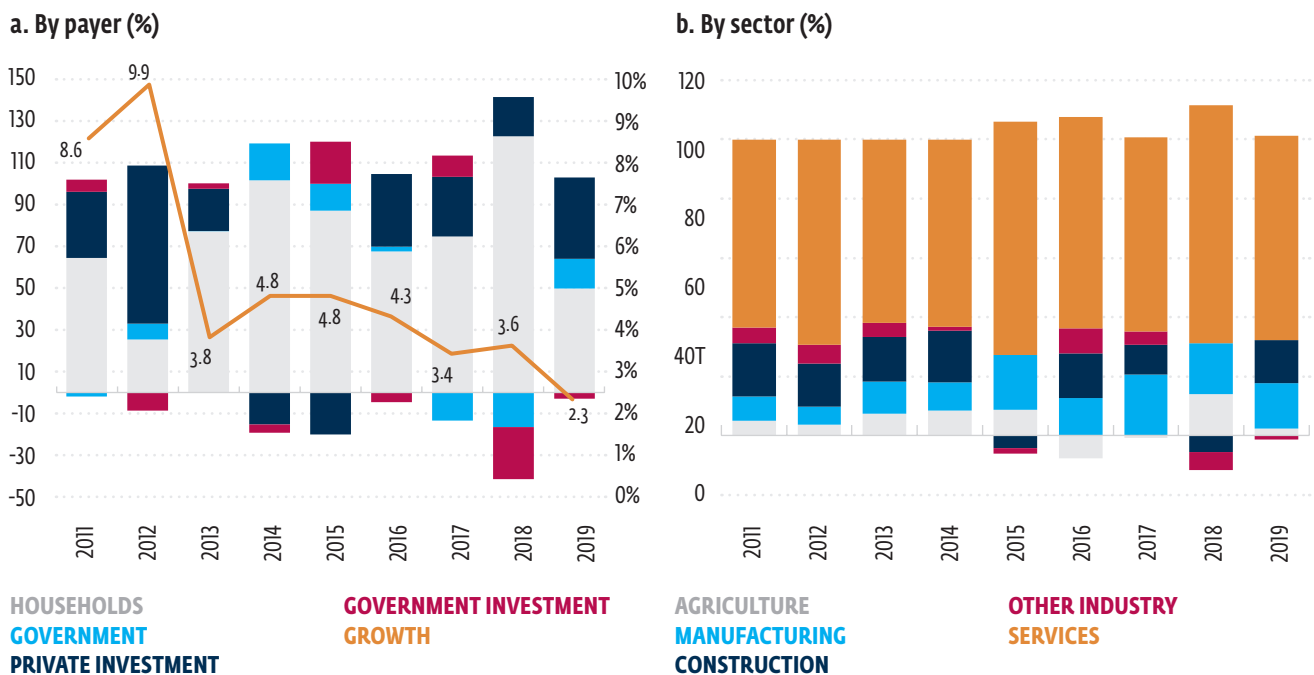
Source: World Development Indicators

Note: UMIC = upper-middle-income countries..

Beginning in the 1960s, Sri Lanka’s growth was stronger than that of aspirational and South Asian peers, but this is no longer the case. For three decades, from 1965 to 1994, Sri Lanka’s gross domestic product (GDP) growth averaged 4.6 percent versus the South Asian average of 4.2 percent, reflecting the strong export performance of apparel and garments, the strengthening of the tourism sector, persistent inflows of remittances, and the government’s investment in infrastructure in the context of postwar reconstruction efforts. Notably, Sri Lanka’s export performance benefited from the significant quality upgrading of its apparel and garment industry, while the inflow of remittances boosted the construction sector. Sri Lanka’s per capita income growth during this period averaged 2.9 percent versus the South Asian average of 1.9 percent, reflecting also slower Sri Lankan population growth rates compared to other countries. Between 2009 and 2013, GDP growth was strong, averaging 6.5 percent, partly on account of the peace dividend, and above the performance of aspirational peers, Costa Rica, Malaysia, and Thailand. Yet, from 2014 to 2019, GDP growth started to stall and averaged 3.9 percent, reaching an 18-year low of 2.3 percent in 2019.<sup>4</sup> (figure 1.5).

While the construction sector was the most important sector in the years immediately after the end of the civil war, in recent years, growth has primarily been driven by services, including tourism and the apparel and garment sectors (figure 1.6). Owing to the intensity of the postconflict infrastructure development thrust, the construction sector alone contributed 16.8 percent of the total growth from 2011 to 2014. The contributions to growth since 2011 from agriculture have been marginal, and those from manufacturing modest.

**FIGURE 1.5. SHARE OF GROWTH BY PAYER AND SECTOR, 2011–19**

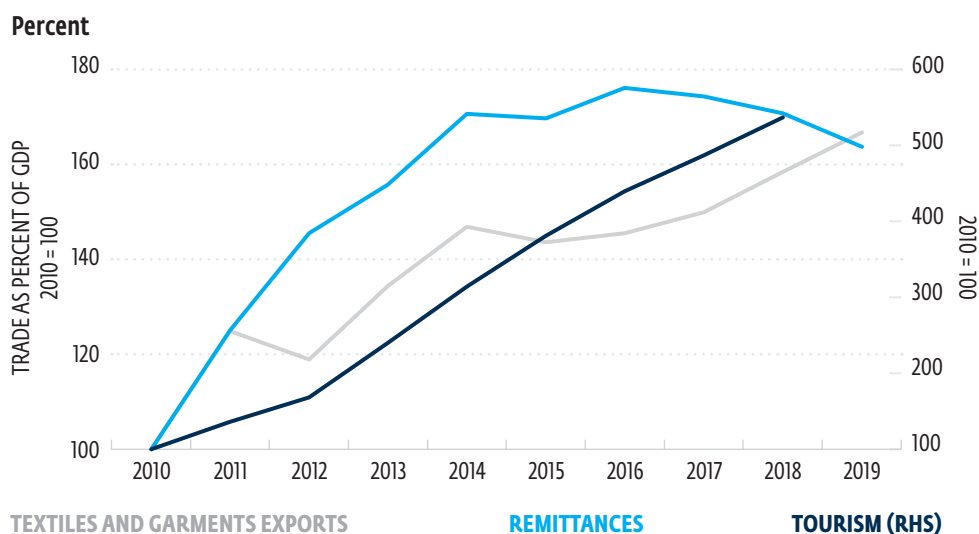


Source: Central Bank of Sri Lanka, International Monetary Fund

Source: Central Bank of Sri Lanka, International Monetary Fund



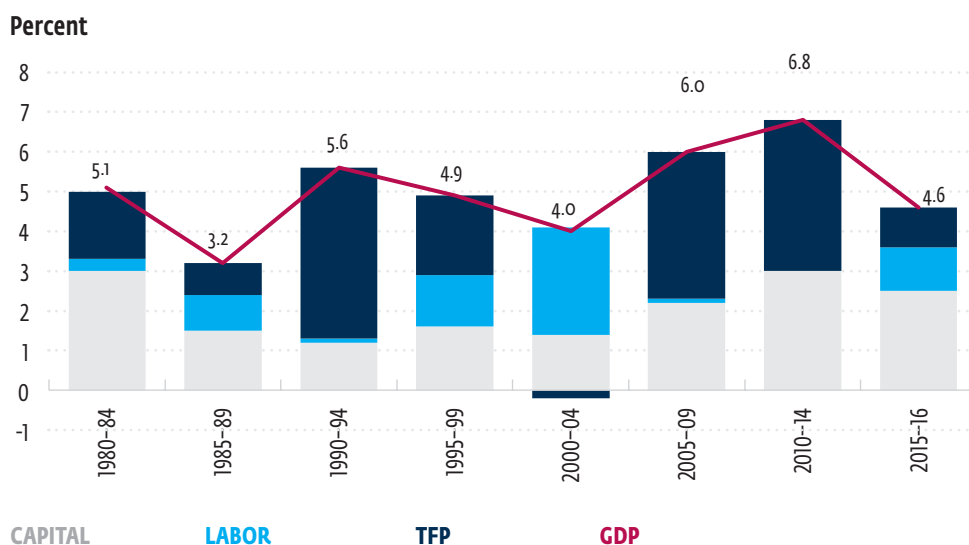
**FIGURE 1.6. DRIVERS OF GROWTH: GARMENT EXPORTS, REMITTANCES, AND TOURISM**



Source: Central Bank of Sri Lanka, World Development Indicators.

Solow decomposition of Sri Lanka’s growth performance shows that growth since 2010 was largely explained by the contribution of capital and of productivity (figure 1.7). Productivity growth surged after the end of the conflict—possibly the outcome of upgrading the apparel and garment sectors and some of the large-scale infrastructure investment—and drove growth acceleration. However, productivity growth has been volatile over the years (reflecting episodes of trade openness and investments in infrastructure) and slowed in the most recent period (2015–16), contributing less to growth. Moreover, the contribution of labor has declined since 2005. Labor contribution is likely to continue to be less in the future as Sri Lanka will enter demographic transition.

**FIGURE 1.7. SOLOW DECOMPOSITION OF GROWTH**



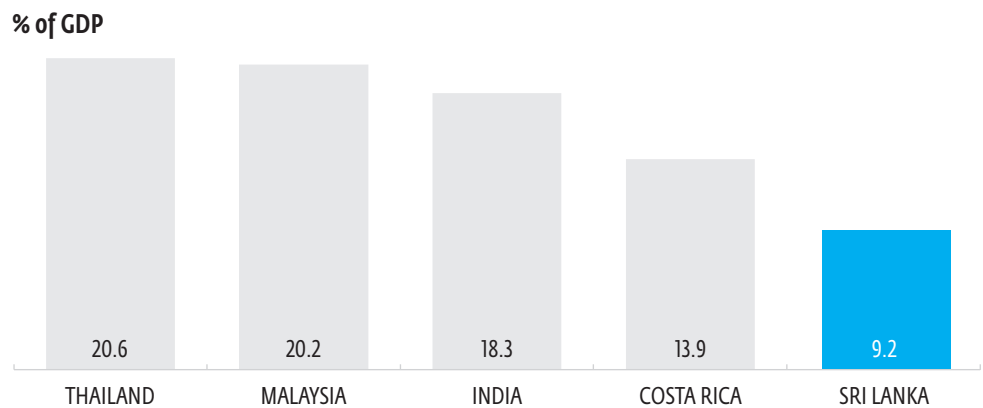
Source: Central Bank of Sri Lanka.

Note: GDP = gross domestic product; TFP = total factor productivity.

## 1.1 GOVERNMENT ROLE FACING HEADWINDS

In the past, the public sector (including the large number of SOEs) could undertake important infrastructure investments and that way contribute to growth. Yet, Sri Lanka’s rapidly shrinking fiscal space, increasingly adverse debt dynamics, and precarious balance of payments situation make it more and more difficult for the state to directly promote growth (figures 1.8-1.10). High fiscal spending has led to the build-up of unsustainable macroeconomic imbalances and large external financing requirements—and this situation has worsened significantly as a result of the pandemic. Considerable increases in external debt, weak revenue mobilization, and large losses by SOEs have constrained fiscal space and created macroeconomic vulnerabilities. A greater role for the private sector is crucial to boost growth and enhance productivity at a time when the government does not have the resources to make the investments necessary to propel Sri Lanka to upper-middle-income status.

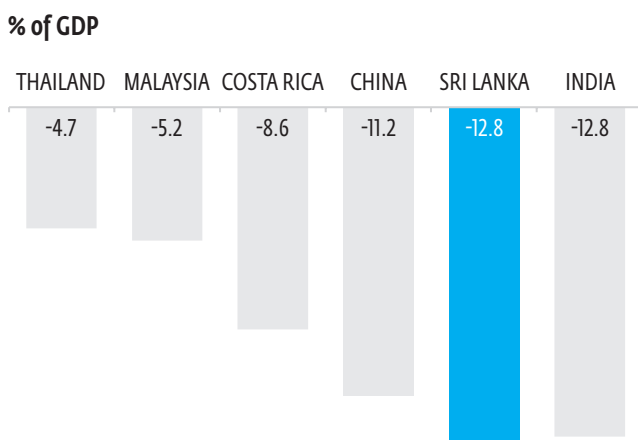
**FIGURE 1.8. TAX REVENUE, 2018**



Source: World Development Indicators.

Note: GDP = gross domestic product.

**FIGURE 1.9. FISCAL DEFICIT, 2020**



Source: Source: International Monetary Fund.

Note: GDP = gross domestic product.

**FIGURE 1.10. PUBLIC DEBT, 2020**



Source: Source: International Monetary Fund.

Note: GDP = gross domestic product.

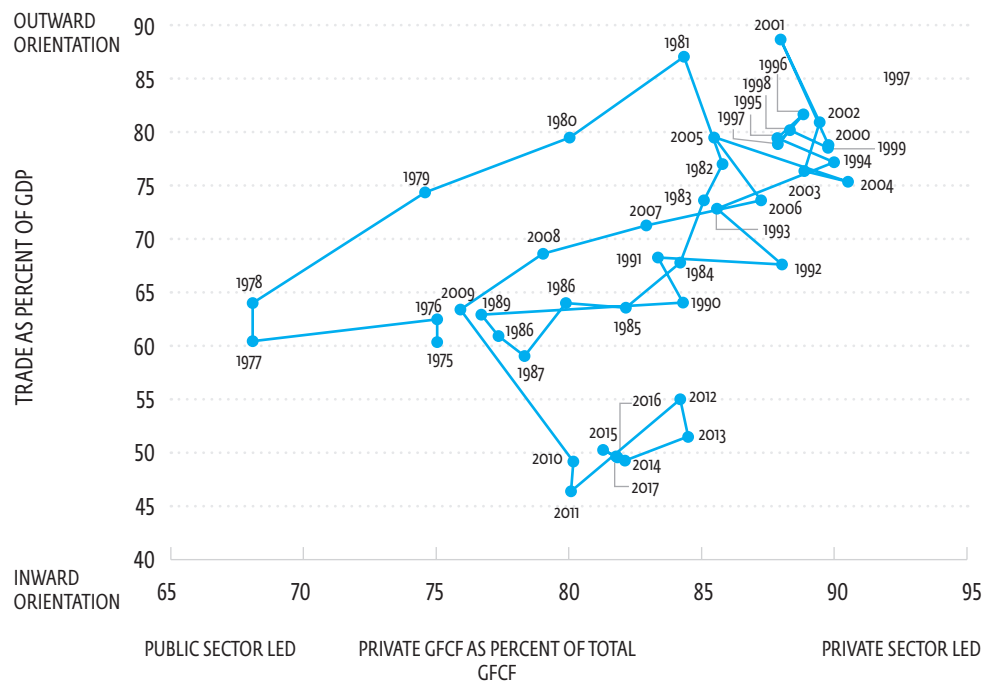
The need for productivity-enhancing investments by the private sector is evident in that Sri Lanka's export product mix differs significantly from that of more typical upper-middle-income countries, like Malaysia or Thailand. To move up the value chain, investments to enhance productivity are needed, including upgrading the electricity and transport infrastructures and improving the technical quality of production structures. Yet private investment has declined in the most recent years, not only because of the difficult business environment, but also as a result of macroeconomic uncertainty.

Sri Lanka's policies over the past four decades have oscillated between inward-looking policies characterized by high trade barriers and a dirigiste interventionist regime and outward-looking policies characterized by liberalization and privatization, with the recent periods indicating a reversal toward a more public and domestic focused emphasis (figure 1.11). Since 2004, Sri Lanka has become less open, reflecting in large part increased trade restrictiveness and inward-oriented policies. From 2000–2017, exports as share of GDP fell from 39 percent in 2000 to 22.7 percent of GDP in 2017. This lack of outward orientation does not bode well for Sri Lanka's prospects to strengthen the role of the private sector, given the size of its domestic market. In the context of ongoing fiscal pressures, Sri Lanka's relatively high dependence on import revenues—duties and taxes on imports are about 20 percent of total revenues, compared to around 5 percent for aspirational peers—creates barriers to greater global trade integration.

Further compounding the urgency of adopting a new economic strategy, the tailwind of the demographic dividend will continue to dissipate, and the contribution of labor will further diminish—as a result of the aging of the population. Sri Lanka's population is among the most rapidly aging populations in South Asia with the proportion of elderly population (that is, over 65) increasing from about 11 percent in 2020 to 23 percent in 2050.

In 2018, 10.5 percent of the population was 65 or older, which was higher than the South Asian average of 5.8 percent or upper-middle-income country average of 10 percent. It is estimated that by 2050, nearly one-quarter of the population will be 65 or older, reaching the Organisation for Economic Co-operation and Development (OECD) average (ADB 2017a). As a result, the contribution of labor to growth will diminish. Moreover, as a result of this rapid aging of the population (figure 1.12), existing labor shortages will become more acute through 2050, all the more so as young graduates prefer to embark on a civil service career, rather than a career in the private sector, in view of job security and a wage premium in the civil service.

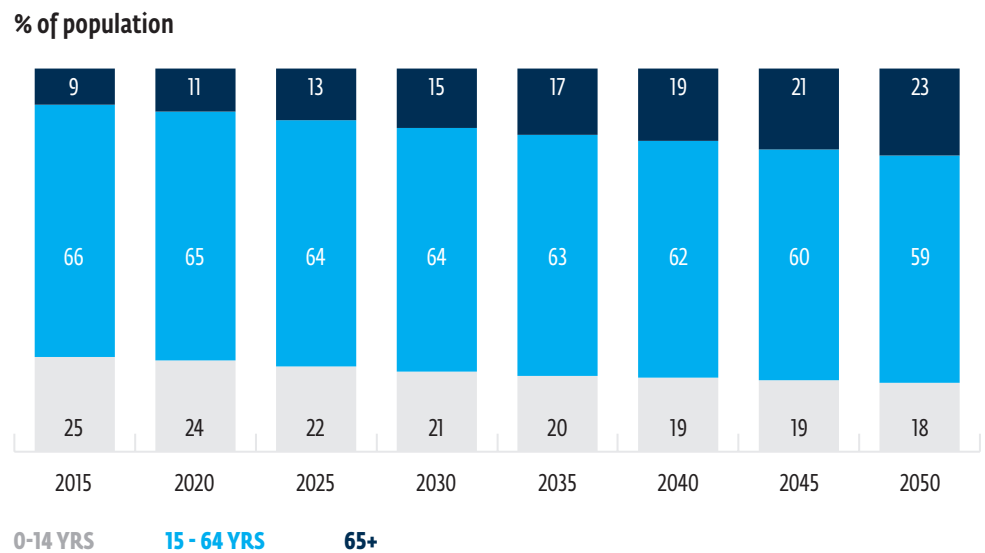
**FIGURE 1.11. BALANCING PRIVATE VERSUS PUBLIC SECTOR-LED GROWTH, 1965–2017**



Source: World Bank/IFC and World Bank (2016a)

Note: GDP = gross domestic product; GFCF = gross fixed capital formation.

**FIGURE 1.12. SRI LANKA AGE DEMOGRAPHICS, 2015–50**



Source: United Nations World Population Prospect. (<https://population.un.org/wpp/>)

## 1.2 QUALITY OF GROWTH FALLS SHORT

### Low Job Creation and Labor Shortages

Sri Lanka's labor market presents a contradictory picture of low job creation on the one hand and labor shortages on the other.

#### Low job creation

Since 2011, growth has become less employment intensive. From 1996 to 2002, a one percent increase in GDP growth led to a 1.16 percent increase in employment, while during 2011–2014, a 1 percent increase in growth caused only a 0.16 percent increase in employment (ADB 2017b). In part because of a failure to create quality jobs, Sri Lanka has seen increased outmigration. In 2013, close to 300,000 people went abroad for jobs, and emigration has increased steadily since 2002.

**Sri Lanka's economy has not generated enough jobs for its labor force, leading to an increase in vulnerable employment, in particular for low-skilled labor.** The number of formal jobs has grown slowly, and vulnerable employment has accounted for a high share of jobs since 2000. Job creation has not kept pace with the rising working-age population, and almost 25 percent of all jobs remain in low productivity agriculture. Just over half of the jobs created were in the public sector.

#### Labor shortages

As a result of the rapid aging of the population, existing labor shortages will become more acute, all the more so as young graduates prefer to embark on a civil service career, rather than a career in the private sector, in view of job security and wage premia. In fact, while from 2006 to 2017 total employment rose from 6.7 million in 2006 to 8.5 million in 2017, much of this growth reflected an increase in government employment, even though high-productivity sectors, such as finance and real estate, have also seen job growth. Voluntary unemployment among highly skilled graduates is at a high level, as many wait for public sector jobs rather than opt for a career in the private sector. And this leads to shortages of skilled labor in key sectors of the economy that could drive growth and structural transformation. In contrast, among low-skilled labor, voluntary unemployment is at a very low level. The reliance on public sector jobs at a time of intense fiscal pressures highlights the challenges facing Sri Lanka.

**An additional factor explaining labor shortages is women's low labor force participation rate,** at 34 percent, well below the rate of aspirational peers and on a declining trend since 2010. Removing economic barriers to women's participation in the labor market can help address the labor supply shortages Sri Lanka faces and can translate into increased productivity and GDP growth. In fact, the International Monetary Fund (IMF) estimates that Sri Lanka could raise its gross domestic product by as much as 20 percent in the long-run by closing the gender gap in the workforce.

Sri Lanka's growing labor shortages and low unemployment also represent an important turn-around from the situation that prevailed from the 1970s to the 1990s, when the country experienced a youth bulge, owing to the fact that at the time the domestic economy was not generating employment, partly because of labor regulations (for example, 70 weeks of severance pay) that worked against hiring new workers. Notwithstanding these adverse developments, the unemployment rate fell quite steadily between 1992 and 2012, from 14 to 4 percent. Factors that helped bring about this development include (a) special enterprise zones that hired garment workers outside of the standard labor regulations and (b) outmigration, predominantly to the Middle East. In addition to these factors, a low birth rate starting around the 1970s helped reduce this youth bulge by the 1990s. Moreover, young people who had migrated to the Middle East and built up savings returned to the country for their retirement. So despite stringent labor regulations and other distortionary policies discussed in this report, Sri Lanka managed the demographic transition relatively well.

### Slow Structural Transformation

While the economy has experienced some structural transformation, the process has been slow. The share of agriculture in GDP declined from 14.3 percent (2002) to 7.7 percent (2018), while the share of employment in agriculture declined from 38 percent to 26 percent during the same period. At the same time, the contribution of services increased from 52.8 percent to 58.2 percent of GDP, and the share of employment in services rose from 38 percent to 46 percent. However, agriculture as share of employment remains higher than in some aspirational peers (Costa Rica and Malaysia).

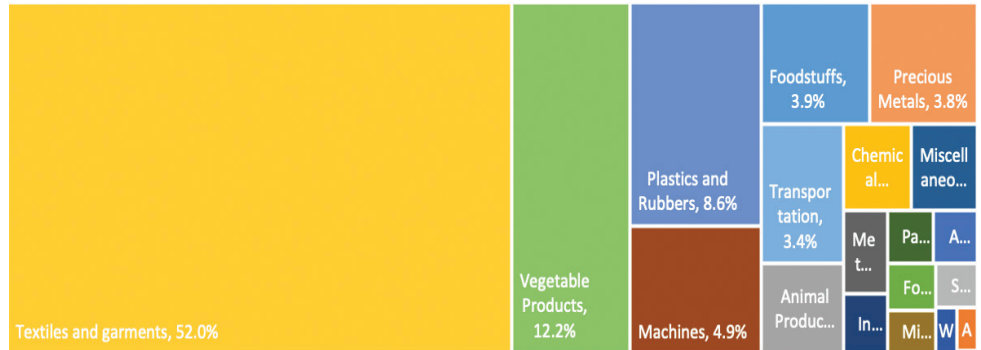
An illustration of the slow pace of structural transformation is that much of the increase in nonagricultural employment between 2002 and 2012 was among self-employed workers (accounting for 48 percent of the increase). Self-employed workers increased from 21 to 25 percent of nonagricultural workers between 2002 and 2012.

Export composition further illustrates the lack of structural transformation toward higher value-added products (figure 1.13). For instance, there is a lack of transformation from apparel to complex high-tech products, as witnessed in aspirational peers, such as Costa Rica, Malaysia, and Thailand. Exports are dominated by apparel and tea, with additional success in rubber-based and coconut-based manufacturing, pepper, cinnamon, and gems. At independence, Sri Lanka was primarily an exporter of tea, rubber, and coconuts. The 1977 trade liberalization led to the development of labor-intensive manufacturing—primarily apparel. By the mid-1990s apparel had overtaken tea as the dominant export. Sri Lanka has a national brand image for its tea (Ceylon tea), cinnamon, and blue sapphires.

Aspirational comparators, like Malaysia and Thailand, have been highly successful at diversifying their economy and moving up the value chain. Thailand had an export structure similar to Sri Lanka's in the 1980s but a much different one by 2015 (figure 1.13 shows the respective changes for Sri Lanka and Thailand between 1995 and 2019). Thailand now has much lower exports of resource-based and labor-intensive exports and has upgraded to exporting electronics, microcircuits, and machinery.

**FIGURE 1.13. CHANGE IN SRI LANKAN EXPORTS COMPARED WITH THAILAND'S, 1995–2019**

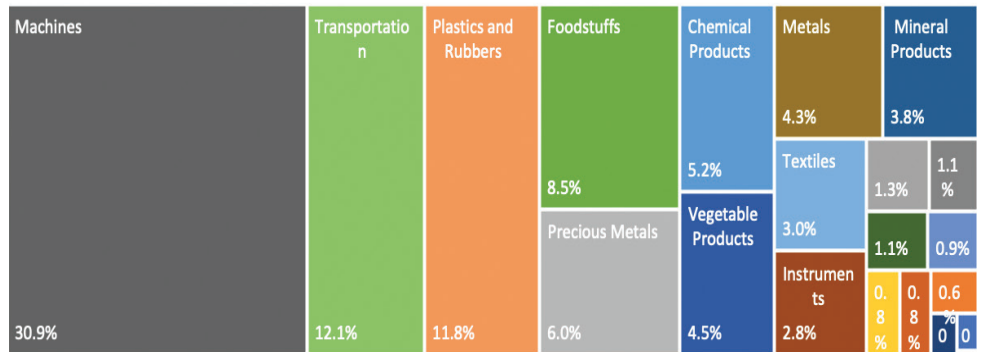
Sri Lanka exports 2019



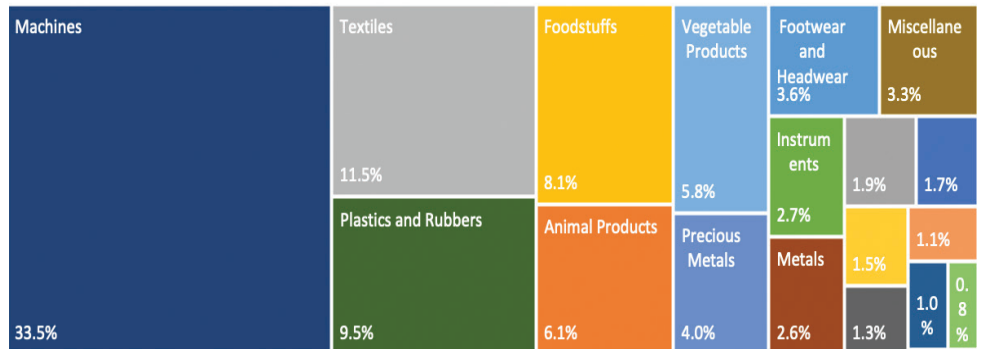
Sri Lanka exports 1995



Thailand exports 2019



Thailand exports 1995

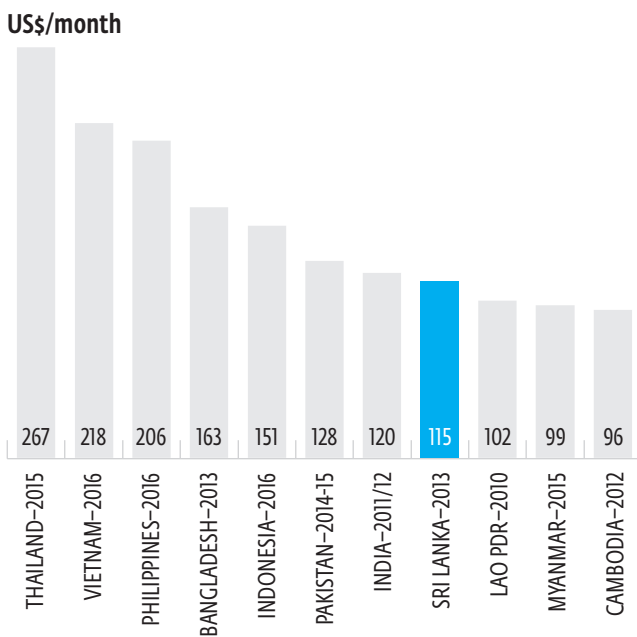


Source: MIT Observatory of Economic Complexity.



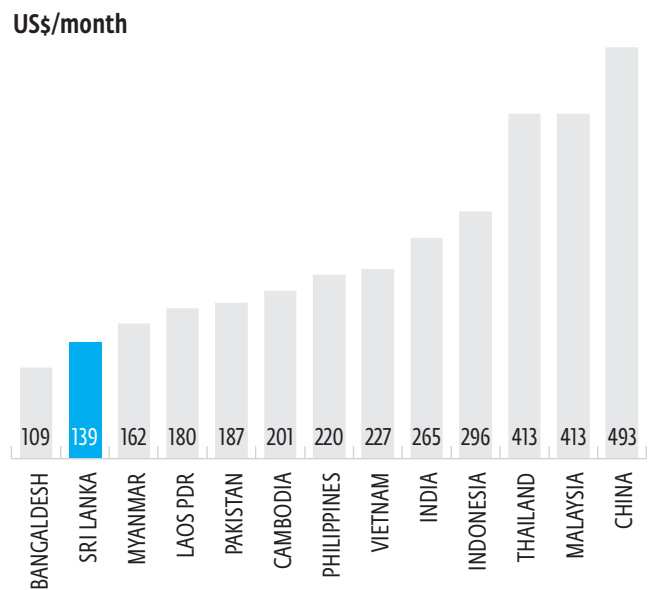
Despite being an upper-middle-income country, Sri Lanka has an industrial structure and wages similar to a lower income country. Underscoring the undiversified nature of the economy, Sri Lanka’s manufacturing sector is fairly concentrated in relatively low sophistication segments: the share of garments and textiles in total manufacturing employment was 40 percent in 2013 (versus 12 percent for China and 16 percent for Thailand in 2015). Similarly, Sri Lanka’s average wages are comparable to lower-middle income countries (figure 1.14 and figure 1.15).

**FIGURE 1.14. GARMENT AND TEXTILE SECTOR WAGES**



Source: ILO (2017)

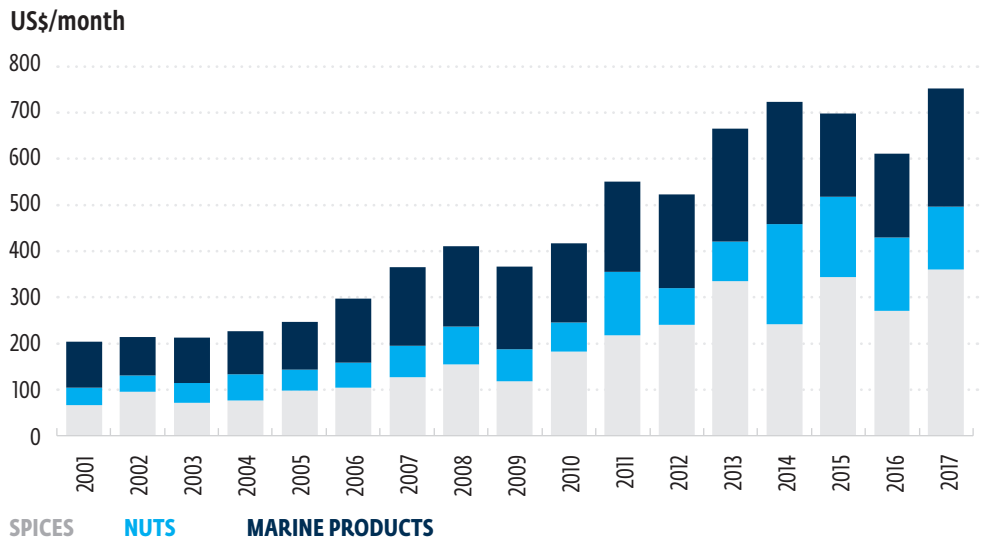
**FIGURE 1.15. MANUFACTURING WAGES, 2018**



Source: JETRO Survey on Business Conditions of Japanese Companies in Asia and Oceania (2018)

Notwithstanding the slow pace of structural transformation and lack of product diversification (figure 1.16), there are nascent developments which, while not changing the overall conclusion of slow structural transformation, provide evidence of evolving changes in economic structure that could be the basis for transformation toward a more typical upper-middle-income economy. **First, exports of services increased from 5.7 percent of GDP in 2000 to 9.4 percent of GDP in 2018 (driven by the tourism and transport sectors) and partially compensated for the decline in trade openness.<sup>5</sup>** There has been a four-fold increase in tourism arrivals since 2007 to 2.3 million in 2018—before 2009, arrivals were never above 600,000. Because of the liberalized bilateral air services in 2011, along with the visa-on-arrival for Indian tourists in Sri Lanka, India became the largest source of tourists in Sri Lanka. The number of Indian tourist arrivals in Sri Lanka more than doubled from about 176,340 (2012) to 384,628 (2017). The Easter Sunday terrorist attacks as well as the closure of the tourism sector due to the pandemic have, however, cast a pall on the Sri Lankan tourism industry. The recovery of tourism remains uncertain and depends on the trajectory of the global pandemic. Another recent notable development is the growth of IT-enabled services exports, which grew from 0.3 percent of GDP in 2000 to 1.1 percent of GDP in 2017.

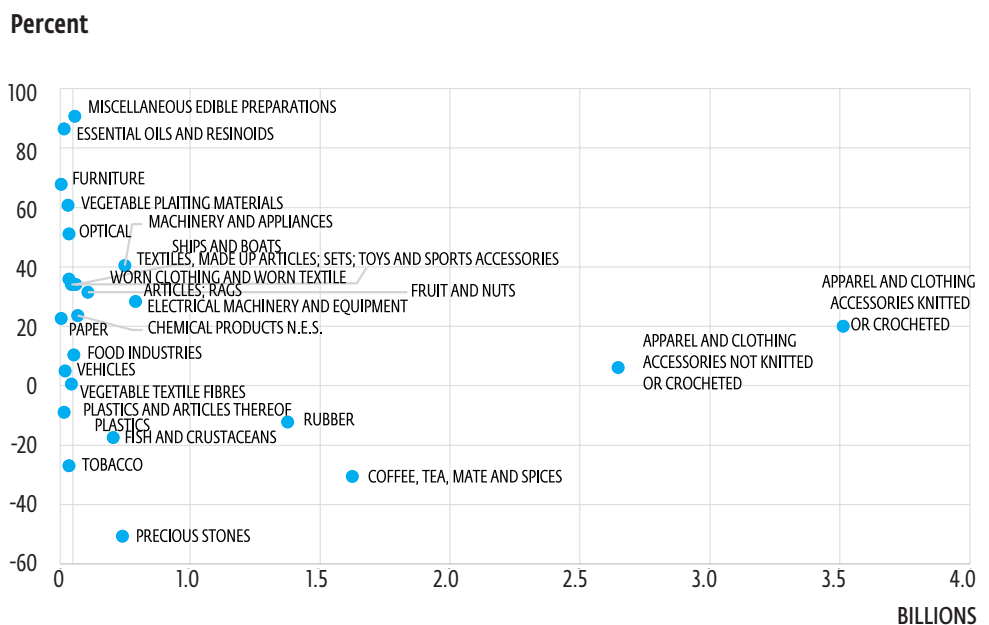
**FIGURE 1.16. SOME AGRICULTURE EXPORT DIVERSIFICATION, 2001–17**



Source: UN Comtrade data.

Finally, in another important development beyond the growth of some services and goods exports, there are indications that some Sri Lankan multinationals have become increasingly outward oriented, reflecting their growing global competitiveness. Sri Lankan firms invest in Singapore and Bangladesh, including apparel investors, electricity generation, and retail investments to cater to the emerging middle class in the buoyant economy. Other investors include commercial banks that have established operations in countries with large numbers of migrant workers to reduce transaction costs of remittances and capture some of the rents involved in these transactions.

**FIGURE 1.17. EXPORT GROWTH (2013–18, %) AND VOLUME (2018, US\$) OF KEY PRODUCTS**



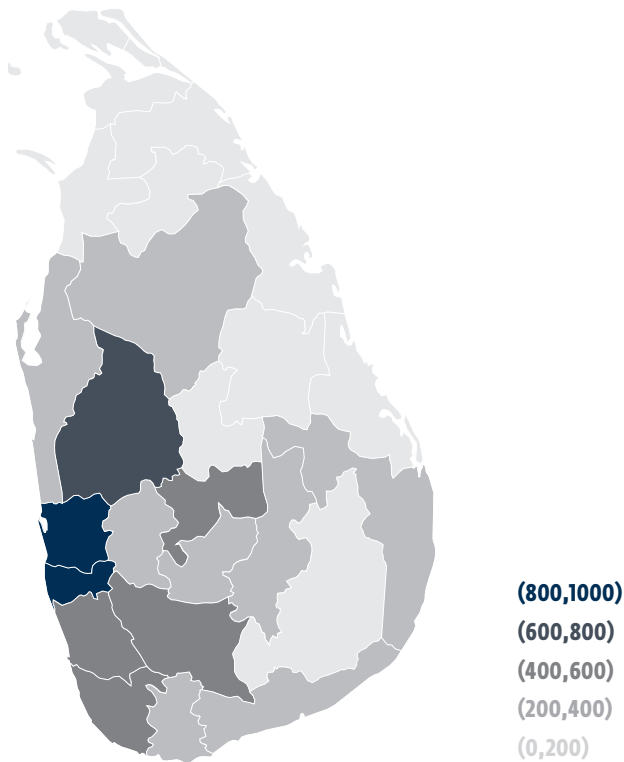
Source: Source: World Bank/IFC and Observatory of Economic Complexity, <https://oec.world/en/profile/country/lka>.

### Important Spatial Inequalities

A further shortcoming of the recent growth performance has been that many of the benefits of stronger growth have been concentrated in the region around Colombo. Yet, the rest of the country, in particular the region formerly ravaged by civil war, is still at a level of development typical of low income countries. (Figure 1.19)

**FIGURE 1.18. EMPLOYMENT CONCENTRATION, BY DISTRICT**

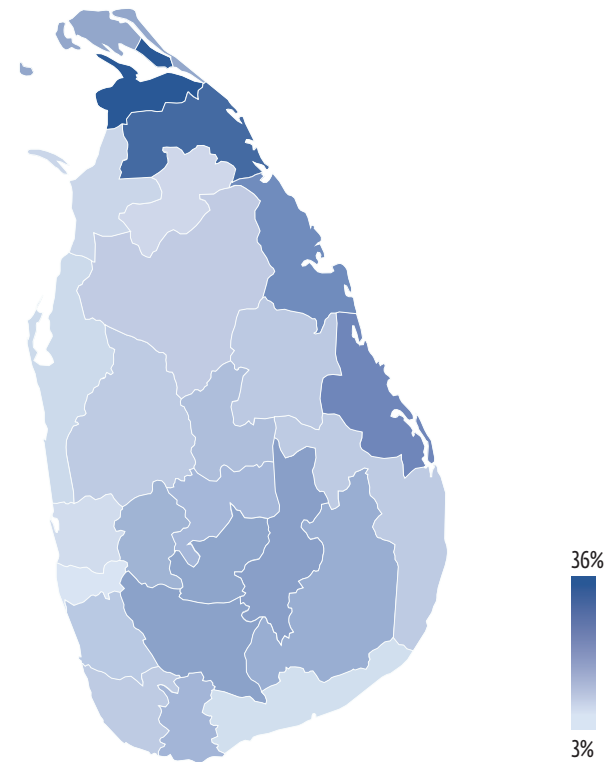
Employment Concentration ('000) by district (2017)



Source: World Bank 2019a, data from 2017 Labor Force Survey.

**FIGURE 1.19. POVERTY HEADCOUNT RATES, BY DISTRICT**

Poverty Headcount Rates, By District (2017)



Source: World Bank staff estimates based on 2016 Household Income and Expenditure Survey.

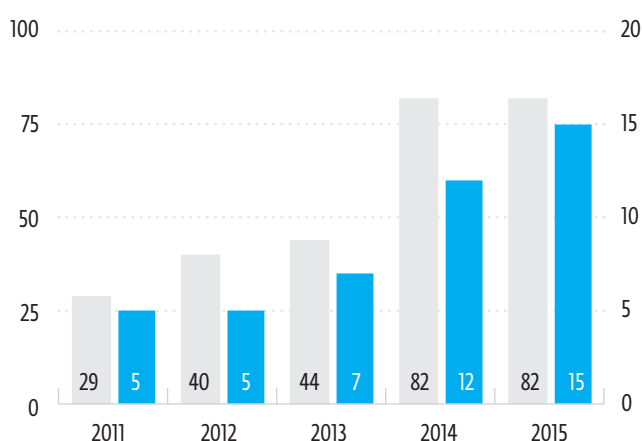
Economic activity is concentrated in western provinces (Figure 1.18) particularly in Colombo and the Gampaha districts (in the coastal areas of the country). Almost one third of nonagricultural establishments are based in the western provinces. Large establishments and formal industries are almost exclusively concentrated in Colombo and its adjoining districts. Poverty rates that exhibit strong geographical disparity are a mirror image of this unequal state of development.

### 1.3 STATE OF THE PRIVATE SECTOR

Sri Lanka’s private sector is dual, characterized by an overwhelming majority of informal sector firms on the one hand and large conglomerates and SOEs on the other.

Reflecting the legacy of socialism, SOEs are present in many sectors, several of which fall outside the segments in which there is commonly a rationale for public provision (World Bank 2019). While there may be over 400 SOEs, the Ministry of Finance considers 55 to be of strategic importance; these SOEs<sup>6</sup> are involved in numerous segments of the economy, including energy, transport, telecommunications, financial services, construction, livestock, lotteries, media, marketing and distribution, plantations, pharmaceuticals, industrial estates, mineral extraction, general trading, and timber sales (see appendix B).

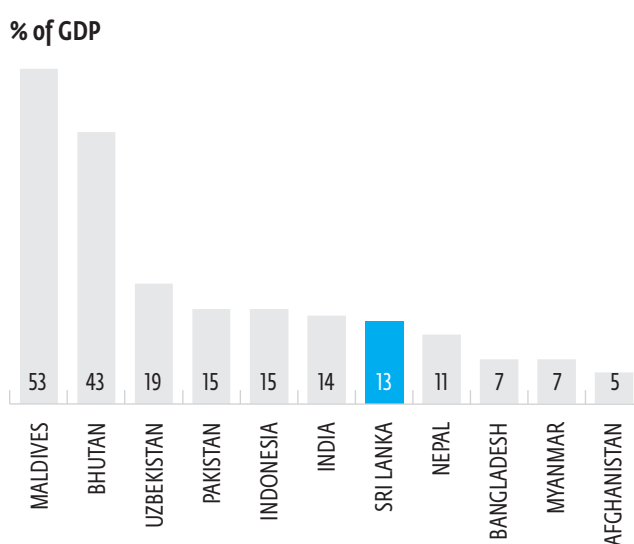
**FIGURE 1.20. INVESTMENT IN STATE-OWNED ENTERPRISES**



SHARE OF PUBLIC INVESTMENT  
 SHARE OF TOTAL INVESTMENT (RHS)

Source: ADB 2017a.

**FIGURE 1.21. SOES' ESTIMATED SHARE OF GDP, 2015-17**



Source: Source: Arrobio, Min, and Steinhilper 2017; Indonesia CPSD 2019; Myanmar CPSD 2020, Note: GDP = gross domestic product; SOE = state-owned enterprise.

While it is common to see SOE presence in capital-intensive traditional network industries such as electricity, water distribution, and railways, in Sri Lanka there are activities in which SOEs compete with the private sector ranging from bus transport, fuel, and plantations, to hotels. This raises questions about the rationale for continued SOE presence in these sectors and if there is a level playing field between public and private operators supporting the government’s economic growth objectives.

Although the SOE share of GDP is lower than in most South Asian countries (Figure 1.21), the presence of dominant SOEs in selected sectors—telecom, energy, banking—limits market competition there. In fact, the recent application of the integrated State-Owned Enterprise Framework (World Bank, 2020c) finds broad evidence of distorted market competition and that the principle of competitive neutrality is not being respected.

**The strong presence of SOEs results in the lack of a level playing field for the private sector as well as for critical backbone services.** In at least 16 out of 23 sectors and markets in which state-owned business enterprises operate, they hold a significant market share (more than 50 percent). SOEs are present in key backbone infrastructure services such as transport, electricity, and water, which are essential inputs for private firms. There are at least 16 sectors in which SOEs compete directly with the private sector, ranging from bus transport, fuel, and plantations, to hotels.

**Likewise, many SOEs are subject to often conflicting social and economic objectives that are the source of distortions and significant fiscal costs and risks.** The current legal framework does not define commercial and noncommercial activities and does not require any form of business separation, thus resulting in opaque cross-subsidies within SOEs and arrears among SOEs. For example, the Ceylon Petroleum Corporation (CPC) provides fuel to other key SOEs such as Ceylon Electricity Board (CEB) and Sri Lankan Airlines (SLA) on credit terms—75 percent of CPC’s trade receivables are from government-related institutions—resulting in outstanding payments of 0.5 percent of GDP 2018, in turn largely financed by loans from state-owned banks (SOBs). While it is common that the state entrusts its SOEs with public service obligations, these need to be transparently costed and compensated to avoid such distortions.

**According to OECD<sup>7</sup>, in 2015, SOEs provided 3 percent of total employment, a rate on par with that of France, and above most OECD countries, above China (2.7 percent) and India (0.7 percent) as well.** The relatively large public sector distorts employment markets. The rapid expansion of civil service employment—by nearly one third over a decade, excluding education and health—outstripped population growth. The government has hired a disproportionate number of university graduates at relatively generous wages even to those with a secondary education or less, providing strong incentives for new labor force entrants to seek a government job and queue as long as necessary (World Bank 2019). Public sector workers earn a 55 percent wage premium, controlling for other factors like education, age, and gender, while the government’s noncontributory defined-benefit Public Service Pension Scheme is very generous with the replacement rate exceeding 80 percent of final salary. Lifetime job tenure and generous retirement benefits lead to a strong preference for public sector employment: even for a 50 percent higher private salary, the civil service job was preferred by two-thirds of women and 48 percent of men (World Bank 2019).

**Aside from the public sector, the largest firms (500-plus employees)—often conglomerates active in a range of sectors—have outsized importance,** reflected in the fact that they accounted for a quarter of all firm-based jobs in 2013 (and generated a third of the total value added by firms).

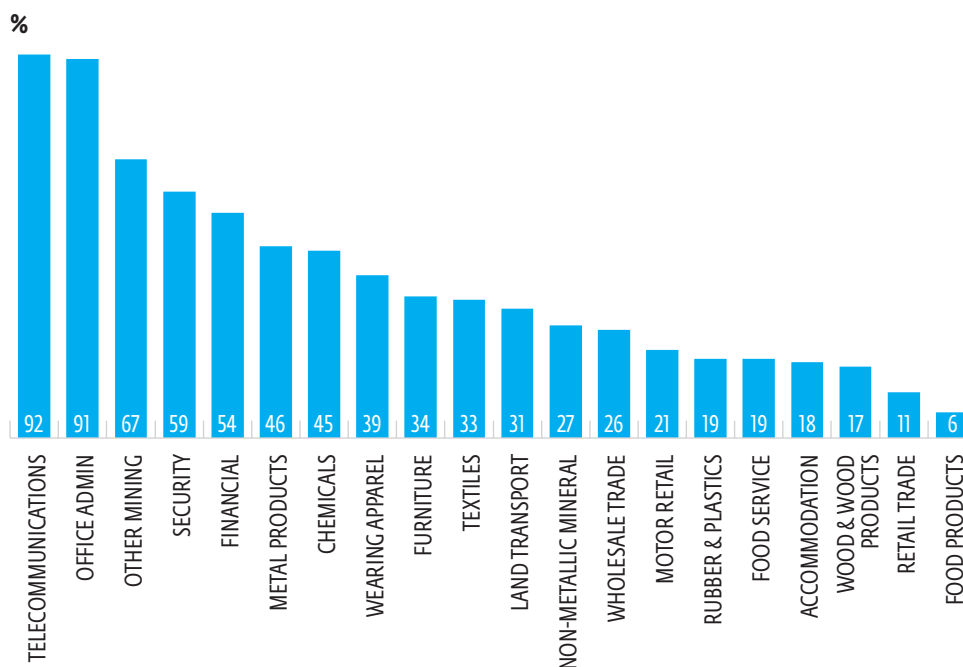
**Sri Lanka’s private sector, notwithstanding the country’s status on the cusp of becoming an upper-middle-income country, is transitioning away from agriculture and toward services.** A core of successful manufacturing industries is dominated by the informal sector, albeit less than in some South Asian peer countries. While there are small and medium enterprises, they are not dynamic enough to be able to drive structural transformation toward a more typical upper-middle-income country structure. Unregistered firms employing fewer than 10 workers account for 97 percent of all firms and employ close to half (45 percent) of the firm-based workforce, that means the workforce excluding farmers and self-employed, but generate less than 15 percent of the value added.

The level of informality varies by sector, such as nongarment manufacturing, where one in three firms reportedly starts operations informally and stays informal for three years on average. Small and midsize firms (defined as firms with 20–99 employees) are not particularly strong, even though the extent of their presence varies across sectors. They are typically well represented in manufacturing and information and communication sectors,<sup>8</sup> but less in sectors like retail and accommodation and food services. Table 1.1 provides an overview of firm numbers, employment and productivity by broad sector.

The informal sector also plays an important role in the economy by providing employment to 1.9 million people—almost 60 percent of the total labor force. The share of informal employment in the economy increased slightly from 65 percent of the workforce (2006) to 67 percent of the workforce (2014), driven by both the agriculture and industry sectors. These micro firms are younger than large enterprises, with an average of 10 years since beginning commercial operations against an average of 20 years for medium and large firms. Only around 22 percent of the micro firms are in manufacturing, while 70 percent are in the service industry.

Sri Lanka has relatively low firm entry rates and consequently a high share of old firms (age 10-plus years). There is a high degree of market concentration in several sectors, which may act as a market entry barrier and reflect low levels of competition (World Bank, 2019), but which may also illustrate the success of export start ups, such as in apparel.

**FIGURE 1.22. TOP FOUR FIRMS' MARKET SHARE IN SPECIFIC SECTORS**



Source: World Bank 2019a.

**TABLE 1.1. FORMAL AND INFORMAL FIRM EMPLOYMENT AND PRODUCTIVITY BY BROAD SECTOR**

	INFORMAL				FORMAL		
	Industry	Trade	Services	Construction	Trade	Services	Industry
<b>Number of establishments</b>	241,095	404,541	318,033	852	7,443	11,235	5,616
<b>Total Employment</b>	505,700	731,134	683,345	39,602	168,320	569,380	916,168
<b>Annual output per person (SL Rs million)</b>	0.8	0.6	0.5	7.1	3.6	2.7	4.1
<b>Annual value added per person (SL Rs million)</b>	0.4	0.4	0.3	3.0	2.8	1.8	n.a.

Source: Industrial Census 2016.

Note: SL Rs = Sri Lanka rupee.

## 1.4 THE IMPACT OF COVID-19

Sri Lanka's difficult economic situation has been exacerbated by the COVID-19 crisis. In particular, prospects for tourism are uncertain. The fiscal situation is expected to further deteriorate because of large revenue shortfalls and the need for increased expenditure to address social needs and help maintain vital parts of the economy. The rising debt burden has increased Sri Lanka's vulnerability to external shocks. As of the end of April 2020, Sri Lanka had lost access to international capital markets after interest rates on Sri Lankan bonds became prohibitively high and in April 2022 Sri Lanka announced a suspension of principal and interest payments on Fx bonds.<sup>9</sup> In addition, the financial sector is likely to require recapitalization. In addition, the financial sector is likely to require recapitalization in order to maintain resilience though the macroeconomic challenges.

**On balance, reforms in every area highlighted by the Country Private Sector Diagnostic (CPSD) will need to be reinforced** to enhance the resilience of the private sector and create the basis for sustained recovery post-COVID. Preliminary assessment indicates that the following sectors are of particular importance in the post-COVID period:

- **Financial system:** As a result of the pandemic, the financial sector may be burdened by growing volumes of nonperforming loans, and capital adequacy norms may no longer be observed. Recapitalizing banks will create further fiscal burdens, at a time when the budget is already severely stretched of resources.
- **Regulatory system:** Opening up the economy to foreign investors will be particularly urgent in the post-COVID period. The strength of the Sri Lankan private sector will



be diminished as a result of the pandemic.

- **Fiscal system:** Measures are needed to fill the growing fiscal gap and debt burden. To this end, expenditure cuts may be necessary, in particular in the area of capital expenditure, at a time when Sri Lanka needs improved infrastructure to accelerate transformation to an upper-middle-income country. Thus, the case for a greater role of the private sector in infrastructure financing will become even more imperative.
- **Tourism sector:** Prospects for the tourism sector to rebound post-COVID are uncertain. However, it is likely that substantial reforms, detailed further below, will be needed to support recovery,

**The economic effects of COVID-19 will have significant welfare implications, due to widespread job and earnings losses.** Poverty, measured using the \$3.20 per day poverty line (in 2011 purchasing power parity), is estimated to have declined from 9.4 percent in 2018 to 8.9 percent in 2019. However, the COVID-19 crisis is believed to have triggered sharp job and earnings losses. Informal workers, about 70 percent of the workforce, are particularly vulnerable as they lack employment protection or paid leave. The apparel industry, which employs about half a million workers, has reportedly cut a significant number of jobs. Weak external demand will likely affect export oriented subsectors and wages. High food price inflation, which has increased sharply and reached almost 22 percent in March 2022, is disproportionately affecting the poor, who spend a larger share of their budget on food.

## 2. KEY CONSTRAINTS ON THE ECONOMY FOR THE PRIVATE SECTOR AND THE WAY FORWARD

---

### 2.1 HOW THE SRI LANKAN ECONOMY SEEMS TO HAVE GROWN IN SPITE OF THE DISTORTIONS

The review of Sri Lanka's past economic development gives rise to the question of how the country has been able to achieve relatively high levels of growth and overall development superior to other South Asian countries in the presence of numerous policy distortions and conflict throughout much of the period. Essentially, explanatory factors fall into three categories that suggest specific lessons for the way forward in creating new market opportunities for Sri Lanka and the private sector.

#### **Businesses Finding a Way to Work Around the Distortions**

When distortions are particularly egregious, incentives grow to find ways to circumvent them, and regulations eventually cease to be binding. Land management and labor regulations are a case in point. For example, while regulations constrain farmers to grow paddy, which is not very lucrative, a few conglomerates have succeeded in agro-processing, thereby earning high returns on the country's other agricultural outputs, such as nuts, spices, and marine products. Likewise, the tourism sector and export processing zones were not subject to the same restrictive labor regulations as the manufacturing sector. They hired workers flexibly and grew into the top foreign-exchange earners for the country.

#### **Making Use of the Global Marketplace**

With most of the distortions affecting the domestic economy, many Sri Lankan firms have looked to the global market for opportunities. In addition, when domestic, formal-sector employment was not expected to grow, young Sri Lankans emigrated, boosting remittances. Lastly, taking advantage of the liberalization of global quotas on textiles and clothing under the World Trade Organization (WTO) agreement of 2005, Sri Lankan firms innovated with more sophisticated products and became among the world's largest exporters of brassieres. Moreover, observing that the domestic labor force is limited, Sri Lankan firms started investing abroad and now own factories in Asia and elsewhere. In addition to being an important source of demand, the global marketplace also exposes conglomerates to competition in the global marketplace, helping boost productivity and competitiveness at a time when the protection offered by the government for certain conglomerates limits it.

### Multiple Distortions Compounding Each Other

The existence of multiple distortions creates complexities for the design of reforms: while individual distortions are always damaging, the effect of multiple distortions may cancel each other out or one distortion may exacerbate the other. For instance, civil wars usually hurt economic growth, but Sri Lanka was able to grow at 5 percent a year during its civil war mainly because the Western Province, the richest and largest province, was largely insulated from the war and grew fast. This led to increasing inequality, but at the same time the country was able to register one of the highest long-term growth rates thanks to the agglomeration externalities associated with a richly endowed province. Similarly, many graduates choose not to search for employment in the private sector, as the public sector offers a significant wage premium and greater job security. As a result, there is a shortage of qualified labor in several segments of the private sector. Absent any reform of public employment, however, it is unlikely that improved university training will make a difference, and the relatively poor training by public universities may not be the binding constraint. So, the distortion arising from the nature of the civil service and that of the shortages of qualified labor compound each other. In that type of situation, addressing only one constraint will not address the issue, but multiple constraints need to be addressed at the same time.

## 2.2 MAIN CROSS-CUTTING CONSTRAINTS

In the remainder of this section, we isolate the main cross-cutting constraints that affect the Sri Lankan private sector's ability to find and seize new market opportunities (see Table 2.1 for a summary of the constraints). While discussing the primary bottlenecks to investment, in keeping with the objective of this report, we propose a short (1-2 years) to medium-term (3-5 years) reform agenda to start finding solutions to the impediments they create that build on the unique factors that have facilitated Sri Lanka's ascendance to near upper-middle-income status in spite of the multiplicity of distortions. This short- to medium-term reform agenda focuses on those interventions that appear to be doable, in view of the political economy.

**TABLE 2.1. CONSTRAINTS HEATMAP: SECTORS IN WHICH SRI LANKA SCORES BELOW MARKETS WHERE IFC RECORDED SUCCESSFUL INVESTMENTS**

SRI LANKA	DEMAND	PRODUCTION FACTORS			KEY INPUTS			INSTITUTIONS			
	Domestic and / or global market potential	Labor and skills	Geography and natural resource endowment	Existing capabilities	Energy	Transport	Finance (cost and availability)	Regulatory barriers	Rule of law and property rights	Market contestability	Macro and political stability
Benchmarking analysis relative to successful countries by sector for current country performance											
A - Agriculture and Forestry	1	1	1	0	0	0	0	1	0	1	2
B - Oil, Gas and Mining	0	0	1	0	0	0	0	1	0	0	4
C - Utilities	1	0	2	1	0	0	0	1	0	0	1
D - Construction and Real Estate	0	1	0	1	0	0	0	1	0	0	5
E - Transportation and Warehousing	1	0	0	1	0	0	0	1	0	0	1
F - Food & Beverages	1	0	2	0	0	0	0	1	0	0	2
G - Chemicals	3	0	1	1	0	0	0	1	1	0	2
H - Nonmetallic Mineral Product Manufacturing	1	0	1	0	0	0	0	1	0	0	3
I - Primary Metals	1	0	2	0	0	0	0	1	0	1	4
J - Pulp & Paper	1	1	2	1	2	0	0	1	1	1	7
K - Textiles, Apparel & Leather	3	2	1	2	0	2	1	3	1	1	3
L - Plastics & Rubber	1	1	3	3	1	3	2	1	2	2	6
M - Industrial & Consumer Products	1	0	2	1	0	1	0	1	0	1	3
N - Information	0	0	0	0	0	0	0	1	0	0	2
O - Finance & Insurance	0	0	0	0	0	0	0	1	0	0	1
Q - Wholesale and Retail Trade	1	1	2	1	0	0	0	1	0	0	4
R - Professional, Scientific and Technical Services	3	4	2	4	3	3	0	3	2	2	6
S - Health Care	1	0	0	1	0	0	0	1	0	0	2
T - Education Services	1	0	1	1	0	0	0	1	0	0	4
U - Accommodation & Tourism Services	0	0	0	0	0	0	0	1	0	0	2
V - Electric Power	1	0	0	1	0	0	0	1	0	0	1

Source: World Bank/IFC staff.

Note: Numbers in the heatmap indicate the number of indicators where Sri Lanka performs below the lower bound where investments have been observed.

At the core of Sri Lanka's development challenge is a public sector that remains very involved in the real economy: providing formal jobs; attracting a large share of credit, notably because of an SOE sector that remains too large and inefficient; and preventing better access to world markets and land assets. At the same time, more efforts will be required to provide for a more uniform regulatory environment for the private sector, tending rather to be the origin of distortions and lack of predictability.

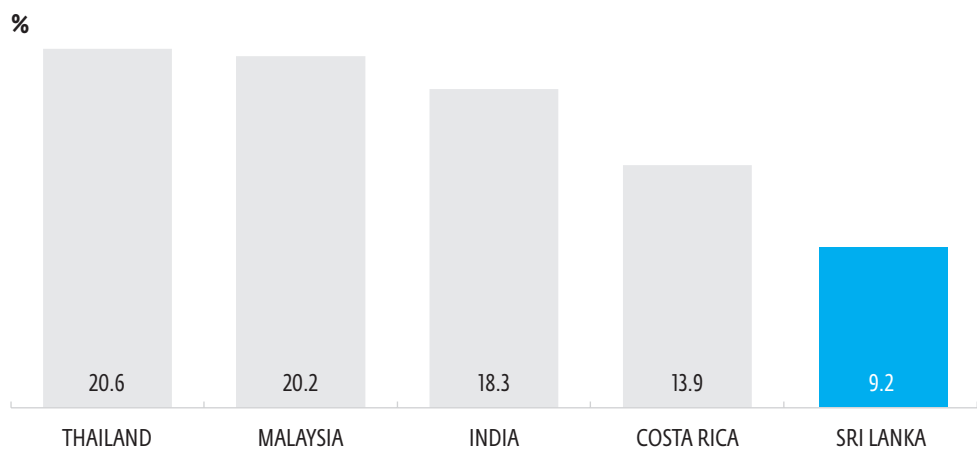
Contrary to other countries that permit the private sector to play an important role in the tertiary and vocational education system, these segments of the education system are dominated by the state, which is not able to ensure that the labor force has the skills required by the marketplace. Access to finance for SMEs is constrained as a result of crowding out of the private sector by the government and large enterprises. Acquiring land is cumbersome and nontransparent as the vast majority of land is publicly owned and land titles are difficult to obtain. Lastly, the regulatory environment is often insufficiently open to newcomers. These challenges can be subsumed under two main themes currently impeding private sector growth: (a) high cost of doing business for outsiders, the result of public policies favoring entrenched players and policy discretion and thus unpredictability; and (b) inadequate supply of essential enabling services and inputs caused by inefficient public spending (which will be aggravated by the fiscal challenges that the country will face as a result of the current and macroeconomic crisis), the performance of public enterprises, and levels of regulatory enforcement.

While addressing the cross-cutting constraints discussed further below is critical to facilitate growth of the private sector, without greater external integration, Sri Lanka's growth potential will be limited. The size of the country's domestic market is too small to allow production of products at the scale necessary to fully support their growth potential. Besides, Sri Lanka can only count on limited resource-based rents. In this context, it will be essential to step up efforts at greater integration in global value chains and conclude bilateral agreements with countries that could be key regional markets.

### Macroeconomic Imbalances

Before discussing cross-cutting constraints to the private sector, an overarching priority concern (also apparent in the heatmap in table 2.1) is addressing the high degree of macroeconomic instability, driven by chronically large fiscal deficits, in the 6–7 percent range for the last decade—slightly improved to 5 percent of GDP over the last two years under the IMF program before worsening again to 9.6 percent of GDP due to the COVID-19 pandemic (figure 2.2). High deficits mostly reflect weak revenue collection, high infrastructure expenditure, and support to loss-making SOEs.

Sri Lanka has one of the lowest tax-revenue-to-GDP ratios in the world. The tax-revenue-to-GDP ratio amounted to 24.2 percent in 1978, after which it declined to 15 percent in 2000 and to less than 10 percent in 2020. The decline largely reflects the government's inability to increase the tax base, even as the economy has grown and more recently the VAT cuts of late 2019. Sri Lanka's weak revenue performance is also affected by the pervasiveness of tax exemptions, which are often provided on a discretionary basis to politically connected firms, as well as the presence of large SOEs. Also, the large informal sector contributes little to the government's revenue. The tax cuts announced by the president in 2019 reduction in the VAT rate from 15 percent to 8 percent and abolish several other taxes, including a 2 percent “nation-building tax” originally intended to finance infrastructure construction after the end of the civil war in 2009—may cost at least 2 percent of GDP (Kamzin 2019).

**FIGURE 2.1. SRI LANKA AND COMPARATORS: TAX REVENUE TO GDP, 2020**

Source: IMF WEO Database (Oct 2021).

Note: UMIC= upper-middle-income countries.

**High infrastructure expenditures have further contributed to increasing the deficit.**

The government has played a key role in rebuilding the conflict-affected areas of the North and East. A total of 5.2 percent of all budget expenditures excluding interest payments were spent directly on reconstruction efforts in the Northern Province alone in the period 2009–13. In addition, public infrastructure spending grew at an average rate of 18 percent a year between 2002 and 2013 and made up about 4 percent of GDP by 2019 (World Bank 2016). Nonetheless, Sri Lanka’s infrastructure does not live up to the levels required for an upper-middle-income country.

**SOE losses and inefficiencies limit Sri Lanka’s fiscal space.** The three main SOEs, including the electricity board, Sri Lankan Airlines, and the fuel company, posted a combined loss of 1.3 percent of GDP in 2018, compared to 0.5 percent of GDP in 2017. The debt of nonfinancial SOEs is estimated to be 11.8 percent of GDP, some of which carries sovereign guarantees. For instance, the government has guaranteed Sri Lankan Airlines’ loans from two major state-owned banks—Bank of Ceylon and People’s Bank—as well as an international bond issued in 2017. Despite limited fiscal space, Sri Lanka’s treasury provided grants to the Sri Lanka Transport Board to purchase buses (2014) and to CEB to finance capital expenditure (2006–11). SOEs’ underperformance is attributed to a range of factors, including a governance structure that reduces accountability and costs imposed by social obligations.

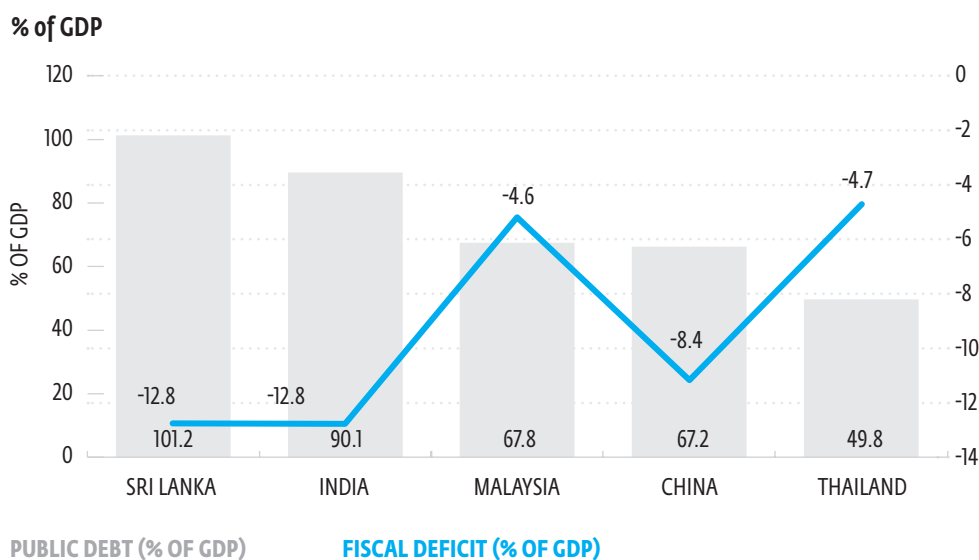
**All three factors combined have led to high debt levels and high gross external financing needs<sup>10</sup>**—an estimated US\$5–6 billion per year until 2022—which have made the country particularly vulnerable to the sentiments of global financial markets. With Sri Lanka cut off from international financial markets since early April 2020, these vulnerabilities have become acutely manifest and the country is now in urgent need of emergency financial assistance.

Fiscal policies leading to persistent macroeconomic instability have also adversely affected the disposition of private investors. With external debt strongly exposed to exchange rate fluctuations investors have long been apprehensive of a balance of payments crisis, as some of the fundamental policy challenges, such as weak revenue collection and poor performance of state-owned enterprises, are difficult to address in the short-term.<sup>11</sup> These apprehensions were borne out when Sri Lanka’s access to international markets was cut in early April 2020. Furthermore, in April 2022, Sri Lanka announced it could no longer service its foreign debt and would default and engage with the IMF. This decision was preceded by widespread fuel, food and power shortages, partly on account of a shortfall in foreign reserves.

The economic fallout of COVID-19 as well of the current Ukraine war, which has led to a sharp increase in commodity prices, has further exacerbated macroeconomic conditions and highlighted the unsustainability of debt. The crisis substantially weakens immediate growth prospects and exacerbates an already challenging environment. In addition to managing the immediate economic consequences of the crisis, efforts to strengthen the overall macroeconomic policy framework need to be further enhanced, including through improved tax policy and strengthened public expenditure management.

Sri Lanka’s public investment programs have been ambitious, but constrained fiscal space and poor management of large-scale projects have limited the ability of the government to address pervasive infrastructure gaps, in particular in the areas of transport and energy.

**FIGURE 2.2. PUBLIC DEBT AND FISCAL DEFICIT, 2020**



Source: IMF World Economic Outlook database; World Bank, World Development Indicators.

Note: GDP = gross domestic product.



### **Cost of Doing Business for Outsiders**

A critical aspect of the difficult business environment is the high cost of doing business encountered by outsiders. This complex environment is caused by several factors: the result of legacy policies, interventions by successive governments leading to policy inconsistency and slow progress of reform (in particular in further opening the economy), and finally, land scarcity in a small geographic space and against a background of sensitive social, cultural, and environmental considerations.

Generally it has been easier for SOEs and large conglomerates, but also foreign investors benefiting from a simplified regime, as well as resourceful entrepreneurs to navigate the complex business environment, while business opportunities for other smaller and less well-endowed firms continue to be adversely affected. This means that pathways to growth within the existing policy framework exist and would most likely benefit further investments and the economy in general if they were scaled up and extended.

On the other hand, certain important constraints are difficult to solve and may be there to stay for a variety of reasons. The questions of land availability and import taxation belong to this category. In such instances, this analysis recommends targeted solutions or lower prioritization given implementation constraints.

### **Distortionary and Inconsistent Policies and Institutional Complexity**

Interventions by the government at the sectoral levels, while not always undesirable, sometimes distort the level playing field and create lack of predictability over time, including being subject to policy reversals. As a result, the Sri Lankan environment is difficult to navigate, especially for outsiders, given the uncertainty. For example, in 2012, the “hub” regulation law was adopted with the goal of Sri Lanka becoming a logistics hub, while at the same time maintaining a 40 percent equity cap for foreign investors and high levels of protection. Privatization initiatives have failed to deliver increased competition on many occasions as state monopolies were replaced by private sector monopolies, often motivated by short-term revenue-raising.<sup>12</sup>

Moreover, the multiplicity of policy initiatives, strategies as well as ministries and agencies in charge of implementation, creates a complex environment, lacking predictability and coordination with overlapping responsibilities.<sup>13</sup> A case in point is the education system, which is governed by both the ministry of education and the ministry of skills development. As discussed below, the two ministries do not share the same vision regarding the involvement of the private sector. Similarly, land administration is handled by several agencies that do not have clear terms of reference; some nature reserves fall under the dual jurisdiction of the ministry of national parks and the forestry ministry, limiting the potential of investments in the tourism sector.

In addition, implementation of procurement regulations is often unpredictable and inefficient, making it difficult for private sector operators to participate in tenders and adversely affecting the quality of contract execution. While the regulatory framework is broadly adequate, processes are cumbersome and relegation at the political level is common. To achieve a higher level of efficiency, it will be essential to deploy e-procurement, update the regulatory framework in line with e-procurement guidelines, and build pertinent capacity.

### Looking forward

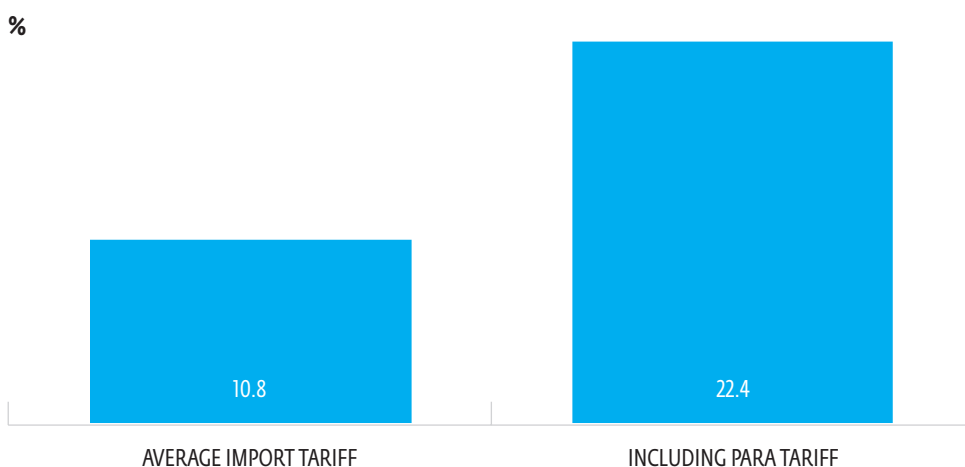
How to specifically address the cross-cutting policy constraints identified in this section is best articulated in the context of sector policies. The government of Sri Lanka has already taken steps in this direction by devising sector strategies, especially for export-oriented sectors (agribusiness, ICT, and tourism for instance), but also for logistics services, education, and innovation policy. Therefore, several recommendations in the action matrix aim to address those shortcomings when they have been identified and are being spelled out at the sectoral level in the relevant section.

### Protectionism and Lack of Trade Integration

Distortions introduced by government policies are particularly apparent in the area of trade policy. Sri Lanka’s trade regime, where average customs duties on imports are 22.4 percent, creates a bias against exports and diversification by directing private investments into the protected sectors served by domestic firms. Import protection has been partly driven by a legacy of self-sufficiency,<sup>14</sup> but mostly by fiscal expediency: taxes on international trade accounted for a high average of 20 percent of tax revenue during 2016–2018, much higher than in other upper-middle-income countries.

While trade duties are not high in comparison to peers, several para-tariffs have considerably raised protection (figure 2.3). In general, protected sectors are those that used to have strong state ownership in the past and where Sri Lanka’s production is important. Table 2.2 shows that among the most protected are sectors in which Sri Lankan firms are well established: beverages, porcelain, and food products.<sup>15</sup> Non-tariff barriers seem to be a further constraint, as is the lack of trade facilitation, which is illustrated by the low score of Sri Lanka on the Logistics Performance Index on which it ranks only 94th globally. Finally, and reflective of the general reluctance to open the economy to global markets, migration policies are restrictive, resulting in missed opportunities to address shortages in the labor market and exacerbating skills constraints.

**FIGURE 2.3. SRI LANKA PARA-TARIFFS, 2016**



Source: World Bank/IFC calculations from Sri Lanka Customs.

**TABLE 2.2. SRI LANKA'S TOP 10 MOST PROTECTED MANUFACTURING SECTORS, 2010 (BASED ON EFFECTIVE RATE OF PROTECTION)**

RANK	MOST PROTECTED SECTORS
1	Manufacture of macaroni, noodles, couscous and similar farinaceous products
2	Distilling, rectifying and blending of spirits and manufacture of wines
3	Manufacture of refractory products
4	Manufacture of other porcelain and ceramic products
5	Processing and preserving of fruit and vegetables
6	Manufacture of cocoa, chocolate and sugar confectionery
7	Manufacture of articles of concrete, cement and plaster
8	Cutting, shaping and finishing of stone
9	Manufacture of bakery products
10	Manufacture, retreading, and rebuilding of rubber tires and tubes

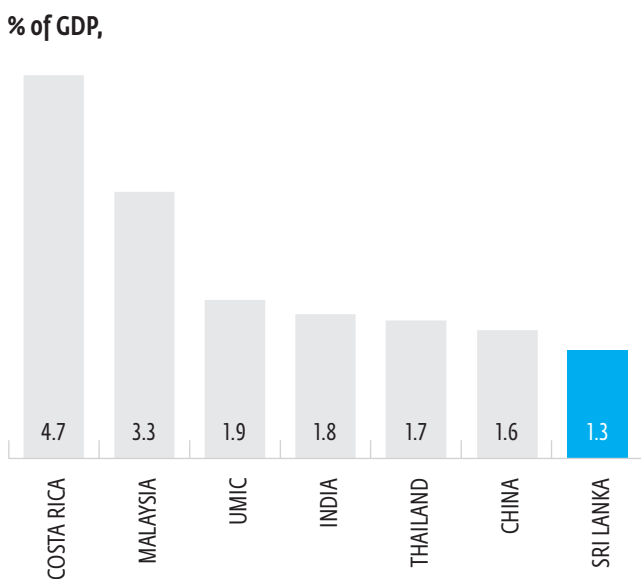
Source: Department of Census and Statistics, Sri Lanka.

Also, reflecting the relatively closed economy, foreign direct investment has been lower than in comparator countries. Despite efforts of the government to attract FDI through fiscal incentives, FDI amounted to 1.3 percent of GDP over the period 2015–19, which is low relative to aspirational peers, such as Malaysia or Thailand (Figure 2.4). FDI inflows to Sri Lanka have been largely concentrated in nontradable sectors (figure 2.5), such as infrastructure and real estate. Sri Lanka lacks anchor investors—large global investors with high visibility—in the manufacturing sector, even though anchor investors have some presence in services. Anchor investors provide a signaling mechanism to other potential investors (an information externality) that may induce other foreign firms to enter.

As a path toward a more open economy, regional engagement is important for Sri Lanka in several ways to overcome the country's small market size and limited resource base. First, the large consumer markets of India, Pakistan, and high-growth Bangladesh offer retail markets for both consumer goods and services like tourism. This is particularly important in the context of populist protectionist sentiments globally, and the economic fallout from the current pandemic. Second, the requirement for scale and scope for global buyers may be met by outward investment in South and Southeast Asian economies. This is the case for Sri Lankan apparel exporters that have invested in Bangladesh, India, and Vietnam; for coconut-related investments in Indonesia and Thailand; and even for knowledge processing firms' investments in India. Third, Sri Lanka may be able to attract FDI that considers the country an entry point to the larger economies in the region. Sri Lanka may be considered a “soft” landing into South Asia given relative size of the economy and Colombo having the highest quality of living among cities in South Asia.<sup>16</sup> Fourth, the region offers opportunities to increase the country's limited access to global and regional value

chains. For example, global firms from high-income economies that have already invested in India may be tapped for investment in niche production of parts and components in Sri Lanka (as is already the case). Further, South Asian and East Asian firms themselves have become globally competitive emerging-market multinationals and would provide innovative partners in production.

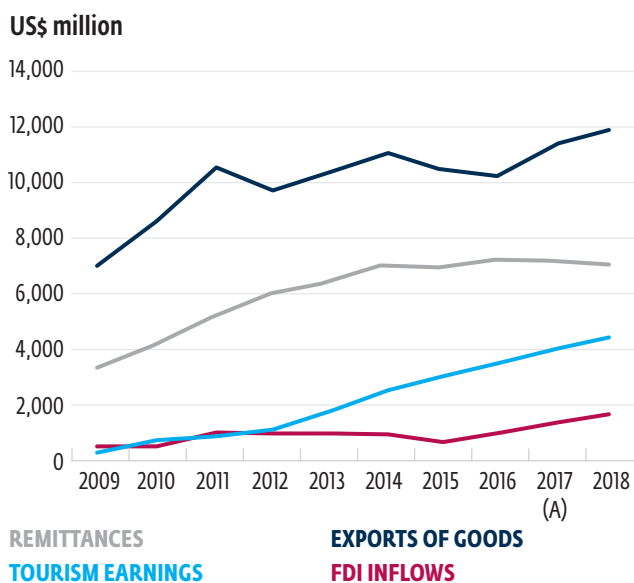
**FIGURE 2.4. FOREIGN DIRECT INVESTMENT, 2015–19**



Source: World Development Indicators.

Note: GDP = gross domestic product; UMIC = upper-middle-income countries.

**FIGURE 2.5. MAIN SOURCES OF FOREIGN EXCHANGE INFLOWS, 2009–18**



Source: World Development Indicators.

Note: FDI = foreign direct investment.

Sri Lanka’s free trade agreements with India (effective from 2000), Pakistan (effective 2005), and Singapore (effective 2018) further the potential benefits of regional engagements, albeit to different degrees. At a time of stalled multilateral trade liberalization, regional agreements provide explicit preferences or a signal of commitment to smooth bilateral trade and investment. The India-Sri Lanka Free Trade Agreement (FTA), especially after the global recession, has been an impetus to Sri Lankan exporters and investors. Deeper integration in services and investment through the Comprehensive Economic Partnership Agreement and the Economic Cooperation and Technical Agreement have failed to advance in spite of anticipated benefits due largely to political economy arguments.<sup>17</sup> In spite of the stalled negotiations, trade and investment from both sides have grown significantly, with India being the third largest merchandise export market after the United States and the European Union, the second largest source of inward FDI, and the largest source of tourist arrivals. On the other hand, the Pakistan-Sri Lanka FTA has not been a stimulus to growth of trade and investment, and the large Pakistani tea market (world’s largest importer) is dominated by Kenya. The FTA with Singapore is the country’s deepest agreement, including services, investment, and even procurement (with immediate access to

bidding by Sri Lankan firms for contracts of the government of Singapore). Given the already very low goods tariffs of Singapore, the FTA's key benefits are an increase in FDI inflows (given Singapore's investment hub status), a strong dispute settlement mechanism, and a smooth operating environment for Sri Lankan services firms.

### **Looking forward**

**In view of the tensions between the need to build Sri Lanka's export competitiveness on the one hand and of political pressures to protect some parts of its economy on the other hand, it is necessary for Sri Lanka to consider pragmatic and selective ways of furthering the opening of its economy,** especially when it directly impacts the high-growth exporting sectors, such as light manufacturing. Service sectors such as tourism and ICT are comparatively less affected by tariffs, but are, on the other hand, more vulnerable to restrictions on movement of persons and missed opportunities to welcome more foreign investments.

**While the challenge of pursuing closer economic integration with economic neighbors might require some time to resolve political differences and implement complex agreements,** more immediate measures includes studying a plan to eliminate para-tariffs and strategically reducing tariffs with the most economic impact on important sectors while taking into account fiscal considerations.

### **A Poor Investment Climate Affecting All but a Few Companies**

Sri Lanka's regulatory requirements are overly burdensome compared to other countries: as far as enforcing contracts, paying taxes, trading across the border, getting credit, and registering property are concerned, Sri Lanka scores particularly poorly compared to aspirational peers.

**Yet, this difficult environment is not being experienced equally by all.** Many successful exporters interviewed for this report have shared that procedures are efficient for them, including partly as a result of their ability to avoid cumbersome procedures through special regimes. For instance, participation in international value chains requires an ability to react rapidly to customers' demands and trade procedures and logistics services allow for that. Interactions with the administration when it comes to taxes were also said to not be an issue for such players. Moreover, such challenges were also not an issue for SOEs and large private sector-owned conglomerates. In addition, while investment conditions in Sri Lanka are broadly similar between domestic and foreign investors, some sectors remain subject to exceptions,<sup>18</sup> and there are significant constraints to access to land.

**The inequality of treatment of investors is epitomized by the preferential treatment offered to firms registered with the Board of Investment, and those that are not.** The BOI's duties include approving projects, granting incentives, and managing industrial and export processing zones. In 2018, the BOI launched the Single Window Investment Facilitation Taskforce, an online platform to facilitate the investment approvals process by line agencies.

The BOI administers 13 industrial and export processing zones, 9 of which are export processing zones.<sup>19</sup> In total, 269 companies operate in the BOI zones, the largest being the Katunayake Export Processing Zone (EPZ), next to the airport, with 79 companies. Services provided by the BOI in these zones include approval and facilitation for foreign trade documentation; facilitation of expatriate visas; provision of lands for prospective projects; engineering approvals and issuance of certificate of conformity; provision of dedicated infrastructure facilities such as centralized water and sewerage treatment facilities; round the clock cargo verification; environment monitoring, advisory, and laboratory services; industry-labor relations facilitation; and advisory services. Other services in the zone include security, day care centers, leisure facilities, and transport facilities.

### Looking forward

Scaling up approaches that have succeeded in solving business-environment issues that affect the rest of the economy looks to be the most promising route in the short-term. Of immediate impact, increasing the availability of land in industrial zones would very likely yield benefits: currently, land occupancy in the existing zones stands at 95 percent of the total 1,597 acres available according to a recent statement by the current BOI chairman.<sup>20</sup> An expansion of economic zones outside the broader Colombo area would address the current scarcity of industrial and commercial land for new investors (see the following section on land access). This will benefit larger investors and priority sectors identified by the government of Sri Lanka, mainly export sectors.

There have been plans to expand economic zones, including ambitious ones such as Hambantota with a project for a 1,500 acre zone, but with seemingly slow progress in the past few years. Under the new leadership of the BOI, a projected pharmaceutical EPZ in Hambantota, a “fabric park” in Eravur near Batticaloa, and a “rubber city” are foreseen.<sup>21</sup> When seeking land availability for new zones, considerations about regional development can also be taken into account: new zones have the potential to help address existing disparities by attracting investors to lagging regions, provided that they are established with economic viability for private investors in mind. Replicating the success of special economic or industrial zones is not necessarily a given, as conditions may vary widely in different part of country. However, in the case of Sri Lanka, all regions benefit from relatively good conditions to start with, and there are examples of successful investments (for example in the North, as discussed later in this report) suggesting the possibility of scaling up investments.

**Streamlining the incentive regime should follow: while expanding export processing zones is desirable in the short term and targets dynamic sectors, this remains a special regime, an “exception” that does not address the broader business environment issues that the economy is facing and will mainly affect investors who export more than 90 percent of their production (meaning limited possible spillovers to the rest of the economy).** Subject to studying more closely how successful exports have access to facilitating practices in the context of special programs, efforts should be made so that specific instruments and practices that have proven successful in the context of the BOI (such as customs and trade facilitation measures) should be rolled out in cooperation with the relevant government agencies to the rest of the economy. Also, remaining restrictions on foreign investment and ownership should be considered for elimination to introduce more competition in these sectors.

Next, while there has been a long tradition of public-private partnership in Sri Lanka, a proper PPP framework was never fully established.<sup>22</sup> PPPs have been conducted under a set of guidelines, with relatively large discretion in implementation, especially regarding competitive bidding. Importantly the implementation of PPPs has also suffered from weak capacity and lack of visibility for potential private investors due to the relatively ad hoc nature of contracting. Yet, in an environment of constrained fiscal space, effective rollout of PPPs will be critical to address infrastructure shortages. To this end, it will be essential to develop and implement best practice PPPs with a demonstration effect. Such PPPs are particularly important to respond to the growing challenge of climate change, and could help address issues such as coastal erosion and rising sea waters that also undermine the viability of the tourism sector.

**On a general note, it will be critical to enhance efforts for the management of SOEs, including through direct involvement or participation of private investors.** Commercialization of SOEs might be the most pragmatic way forward to reform them. Other policy actions to be considered to foster more commercial market behavior from SOEs are outlined in report sections below on land access and SOE behavior in the financial sector.

### **Policies that Stifle Land Access, Use, and Entrepreneurship**

As evident from the above, an important constraint for businesses is land access. Sri Lanka ranks in the fourth quintile globally in the Registering Property Index and is a laggard regionally and globally in the quality of land administration survey. The rights to the 15 percent of lands that are privately owned are constrained by historical deed registration, which is not linked to a cadastral plan or any mapping and has been compromised by fraud and misuse. During the conflict, the deeds registries on land were also lost in many areas. The title registration that was established to fix the flaws of the deeds' registration has not become effective due to usually unaffordable and excessive processes requiring detailed surveys and title investigations at high cost (as 65 percent of SMEs acknowledged).<sup>23</sup>

Access to land owned by the state—the remaining 85 percent of land area—is provided through concessions, permits, and leases also subject to cumbersome processes for access, as well as restrictions for use and transfer. Typically, allocation of a land use right to a party will involve multiple steps and authorities with incoherent mandates resulting in lengthy processes. Land use and transfer restrictions stifle innovation and encourage informality: in fact, experimentation with alternative land uses or passing land to another user or uses is mostly illegal. Another consequence is that nontransferable and restricted-use land held through such concessions cannot be used as collateral for financing in any commercial banking arrangement.

The situation favors strong enterprises that can circumvent these restrictions, processes, and legal maneuverings and self-finance investments. Access to land or investment financing within the legal system is generally unaffordable to micro, small, and medium enterprises (MSMEs) and they need to resort to extraordinary arrangements, resulting in a large informal sector in land use and occupancy.



**Land tenure system constraints contribute to broad land delivery system failures in Sri Lanka.** While access to land with legal and secure rights seems to be an underlying problem, it appears that the entire system of land delivery, including both tenure security and land use planning, permitting, and construction monitoring systems would require holistic improvement to change the investment climate. Discussions with several firms from the information technology and start-up sectors have, for instance, confirmed difficulties in finding offices where they could access skilled labor, revealing delivery constraints in planning and permitting and market dysfunctionality in providing a needed good.

The following are the key challenges affecting the availability of land:

- **State-held agricultural land represents 15 percent of total land and is fragmented into small land permits, land grants, annual land permits, long-term leases, land releases to government agencies, and land releases through vesting orders.** These land use rights are subject to strict regulations on crops (for example, it is obligatory to use some land for rice) and the possibility of transfer, which leads to breaching of rules and informal transfers. The permits, grants, and leases are made under several laws, including the Land Development Ordinance, Crown Land Ordinance, Land Redemption Ordinance, and Land Grants (Special Provision) Act. Many of these rights are formalized in response to applications made with divisional secretariats, with varying requirements for approval by provincial and central authorities. Land is also granted by presidential decrees.<sup>24</sup> Obtaining permits and grants is typically a complex and nontransparent process. Subsistence agriculture with low productivity can be partly explained by the land tenure arrangements, which are commonly informal or restrictive for the small holders, perpetuating insecurity and marginalization. The government has recognized the access-to-land issues as well as land-use issues with the state ownership and has had plans in the past to establish a land bank to improve the situation.
- **Use of land as collateral is restricted.** Most banks prefer land as collateral, but rights to public lands cannot be used as a collateral as they are not marketable or enforceable. MSMEs rely on informal access to land and often have legal challenges concerning their permits, leases, or titles (World Bank 2016e). While a movable collateral registry is available, it is limited in scope and thus curtails the ability of MSMEs to use moveable collateral (for example, machinery, inventory, accounts receivable) as security for their loans.
- **Foreign ownership of land is restricted.** Foreign ownership of land is generally prohibited and only companies with minority foreign ownership can buy or lease property in Sri Lanka. This constitutes a barrier to international investors. However, on July 30, 2018, Sri Lanka amended the Land (Restriction of Alienation) Act of 2014 allowing foreign companies listed on the Colombo Stock Exchange to acquire and hold freehold land. The amendment also removed a prohibition on foreign nationals owning condominium property below the fourth floor. The amendments came into effect retrospectively from April 1, 2018. Foreign companies not listed on the Colombo Stock Exchange and engaged in banking, financial, insurance, maritime, aviation, advanced technology, or infrastructure development projects identified and approved as strategic development projects may be exempted from restrictions imposed by the Land Act of 2014 on a case-by-case basis.

- **A large amount of land is owned by public entities that do not use it.** For historical reasons, many public entities, such as railways, port authorities, the postal office, or the military, own or are custodians of vast public lands. This is not unique to Sri Lanka and common in the region. These public entities do not have incentives or ways to use land assets that they do not need. The situation leads to both over- and underutilization of public lands and natural resources and informal arrangements. Underutilization results when the public land holder cannot change the land use or pass the asset forward to another user without breaching laws. Overutilization results when the current land holder is concerned about losing the asset in midterm, such as through a land use term violation, and thus opts for short-term and exploitative land uses. Also, large SOEs' significant ownership of prime land creates an unlevel playing field for the private sector on access to land. Relevant comparison is provided by India where a new policy encourages and facilitates federal SOEs in monetizing their surplus land and building assets.<sup>25</sup>
- **There is a lack of clarity on availability of land, as there are multiple records on land, which are not integrated, and many still exist only in paper form.** The deeds and title registrations are separate functions, and cadastral surveying is only linked to titles, not to the deeds. While the deeds registry books are being digitized, the land administration system remains paper-based and the processes manual.
- **Taxation and lease valuation systems are outdated, and multiple systems coexist,** applied to recurrent taxes, stamp duties, acquisition, or land leasing. Land acquisition compensation levels cause frequent litigation.

### Looking forward

Given these challenges, a gradualist approach will be needed, aimed first at improving land records, and working toward putting unused public lands to productive use. In this context, the following steps seem to be particularly pertinent:

#### Short-term (1-2 years)

- Adopt the policy of parcel-based land registry and cadastral map for all land ownership and land use rights in Sri Lanka.
- Develop a joint information system (JIS) for land administration in Sri Lanka:
  - Screen most public land areas for vacant, underutilized, and overexploited land uses, combining high resolution satellite imagery, land records search, and geospatial analysis and detection.
  - Digitize and integrate all land records and cadastral maps through standardization and georeferencing and interlink them to the JIS.
  - Link all government authorities to the JIS, and reduce overlapping processes and data entering on land and property transfers.
  - Adopt digital services, digital signatures, and digital conveyance in legislation, and initiate web-based land administration services.
  - Reduce registering property processes to three steps (from the current nine).

### Medium-term (3-5 years)

- Establish a new policy on state land and building asset management, incentivizing public asset monetization, and revise the state land management system with a view to facilitating permitting, leasing, and granting concessions on state lands. A relevant example is India, where a new policy encourages and facilitates federal SOEs in monetizing their surplus land and building assets.<sup>26</sup>
- Make land use rights transferable and enable them as collateral for financing.
- Permit and facilitate foreign investors' access to land through instruments allowing adequate security of tenure per intended use of land.
- Establish a feasible process of sporadic land registration and land surveys for all permit, lease, title, and so forth, tenure right registrations on a case by case basis.
- Invest in a comprehensive land register, cadaster, and cadastral map through a systematic fit-for-purpose first registration campaign (first targeting privately and publicly held areas).

## 2.3 INADEQUATE SUPPLY OF ENABLING INPUTS

### Education: The Skills Base Does Not Match Demand

The education system in Sri Lanka has successfully provided near universal access to secondary education and plays a fundamental role in the public service apparatus of the country. Public education institutions have served the country well by providing high levels of literacy and a strong civil service workforce. In the face of shifting needs, and the challenge of improving higher education outcomes, the sector needs to gradually improve how it services the needs of a growing private sector. Private sector providers can continue to play a role in the provision of technical and vocational education and training (TVET) education, while the links between public higher education institutions and the private sector should be strengthened.

### Current performance of the sector

Sri Lanka's competitiveness and participation in the global knowledge economy of the 21st century will be affected to a significant extent by the education and skills of its workforce. The country starts from a good base, but there is a significant gap with higher education. Sri Lanka ranks favorably on the quality of learning and human development indicators. In the 2020 World Bank Human Capital Index, Sri Lanka ranked 71st out of 174 countries for which data are available, the highest in South Asia, only slightly below aspirational peers—Costa Rica (54), Malaysia (62), and Thailand (63). Gross enrollment rates for primary and secondary education are near 100 percent; however, the big gap is tertiary education enrollment, which is below 20 percent of the official school age population in all provinces (World Bank 2019a). While enrolment in primary and secondary education is equitable across gender and socioeconomic groups, there are wide disparities in access to higher education: gross enrollment rates for the poorest quintile is 10 percent and 26 percent for the richest (World Bank, 2017b). As a result, Sri Lanka's advantage in education relative to comparator countries reverses at the tertiary level and is much lower than for countries

of comparable income levels (Figure 2.7) and aspirational peers and well below the average rate for low- and middle-income countries (24 percent) and upper-middle-income countries (52 percent). In addition to the 20 percent of students in tertiary education, another 33 percent of students attend TVET programs (Dundar et al, 2017).<sup>27</sup> On average, Sri Lankan students attend school for almost 13 years, compared to 12.4 years for Thailand, 12.3 years for Vietnam and 12.2 years for Malaysia.

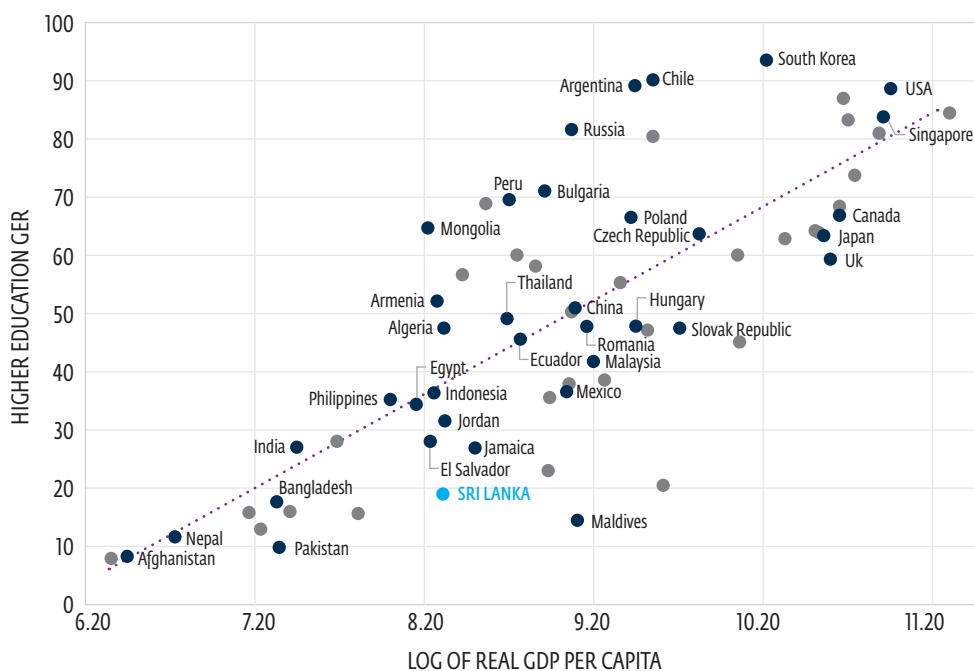
**Under the constitution, Sri Lankans are entitled to free education.** The government has put a heavy emphasis on education, including increased spending, institutional and curricular reform and expansion, and outreach efforts to encourage more enrollment into science, technology, engineering, and mathematic (STEM) and IT degrees.<sup>28</sup> The student-teacher ratio has steadily declined from 23.1 (1990) to 17 (2018).<sup>29</sup> However, public expenditure on education as a percent of total GDP was just under 3 percent in Sri Lanka, one of the lowest shares in the region. Moreover, historically, the sector has not been a major recipient of FDI.

**Tertiary education under-delivers on providing skills needed by employers: in the 2018 Global Competitiveness Index, Sri Lanka ranked 78th out of 137 on higher education and training, largely due to its low tertiary gross enrollment rate.** Few students are enrolled in STEM fields: only 4 percent (1,053 students out of a total of 26,024) completed their bachelor's degree in engineering and 4 percent in computer science.<sup>30</sup> Graduates of high-quality public universities are well regarded in the labor market, and a large proportion of these graduates, especially in STEM subjects, find employment in advanced countries, thus contributing to brain drain. At the bottom end of the spectrum, graduates of external degree programs (EDPs), which offer distance education with limited support to students in largely arts and humanities subjects, have limited relevance in the labor markets. About half of the graduates are enrolled in EDPs. Therefore, a significant share of graduates fails to meet the requirements of private employers, particularly software, engineering, and ICT skills.

**Authorities' main policy thrust is to expand the university system, particularly the establishment of a university in every province.** After that objective was achieved in 2005, there has been no further increase in the number of universities, although existing universities have expanded.

**Private provision of higher education is limited.** Until a few years ago, private sector participation in higher education was restricted. The role of the private sector in higher education remains controversial among professional organizations and within the government but is not prevented by regulations. The Ministry of Higher Education (MHEH) can certify private higher education institutions as universities and has done so for 13 institutions (Dundar et al., 2017).

**FIGURE 2.6. COMPARISON OF HIGHER EDUCATION ENROLLMENT AND GDP, VARIOUS COUNTRIES, 2017-19**



Source: Authors, adapted from World Bank 2019b.

Note: GDP = gross domestic product; GER = gross enrollment ratio.

**Current levels of enrollment in private sector–run institutions lag peers, indicating potential for a stronger share for the private sector (table 2.3).** According to Dunder et al. (2017) an estimated 26,500 students who could not find a place in a public institution enrolled in a private one. In addition, an estimated 57,000 students qualify for higher education institutions (HEI) but do not enroll (by comparison a total of 87,000 students enter HEI, public or private), partly because of a lack of space. Some enroll in a TVET institution, and others enter the labor market. Fewer than an estimated 10,000 are studying abroad.

**TABLE 2.3. PRIVATE ENROLLMENT AS A SHARE OF TOTAL TERTIARY EDUCATION ENROLLMENT, BY REGION**

REGION	PROPORTION
East Asia and the Pacific	42.2
Eastern Europe and Central Asia	29.2
Latin America and the Caribbean	50.2
Middle East and North Africa	39.0
South Asia	47.0
Sub-Saharan Africa	32.0
<b>Sri Lanka</b>	<b>20.0</b>

Source: World Bank 2019b;

### Constraints and way forward

**There is a mismatch between what graduates learn and employers need leading to skills mismatches.** Given the relatively disappointing outcomes for higher education and technical and vocational skills, employers note that skills gaps are an important constraint to greater private investment and scaling up. Firms interviewed for this report universally laud the quality of trainable workers (a positive consequence of the good education base in Sri Lanka) but point to the high cost of training of new employees. Notably, lack of competence in the STEM field and technical and vocational skills as well as language proficiency in English are among the most significant shortcomings quoted by them.

**The labor market for university graduates with IT and engineering training is particularly tight, suggesting that there might be a shortfall of qualified graduates in these fields (Millennium Challenge Corporation, 2017).** Labor turnover is significantly higher among technical workers in the ICT sector (ILO, 2015). The university curriculum is not adequately focused on cultivating soft skills that are increasingly demanded by the labor market. Most arts graduates are from EDPs and have technical skills that are of limited relevance to the labor market. These graduates often face lengthy job searches.

**Only 28 percent of workers can use computers, and only 20 percent are proficient in English, with lower ratios in rural regions,** where over 75 percent of employers expect a high-skill worker to have English language and computer skills.

**While there are private providers of higher and TVET education, they do not adequately fill the demand for skills.** There is also strong resistance to private provision of education, which is seen essentially as a public service mission.<sup>31</sup> The focus is on the universal and free provision of education. This does not, however, prevent the private sector from having a significant presence in the country: Two types of private HEIs operate and award degrees in Sri Lanka: those that are registered with the MHEH, and those that are not publicly registered but are affiliated with a foreign university.

HEIs with foreign connections are generally not regulated locally, and it can be difficult to discern the exact number of these schools in operation, the content of their curricula, and the parameters of the degrees that they award.

**Foreign universities are interested in Sri Lanka, but there are significant barriers to entry, like the limit of 40 percent ownership for foreign investors.** Conditions of operation for private operators with public education authorities and universities are generally quite burdensome, with for instance, limited prospects of registering with the MHEH. There are also questions about affordability: for instance, the market is not attractive for top tier foreign universities that operate in more affluent Singapore or Malaysia. Also, opportunities for partnerships between public universities and private ones seem limited to postgraduate and vocational training whereas there are considerable unaddressed needs at the undergraduate level.

**Partnerships of public universities with the private sector are also constrained by the University Act in their ability to rely on private sources of funding:** an issue also noted by the government in its export strategy for the IT sector (Government of Sri Lanka, 2018c). They cannot charge for undergraduate education, and as discussed later, they are also constrained to some extent in forging partnerships with the private sector dealing with the commercialization of innovation.

**University teaching and learning needs to be modernized in line with international practices.** Sri Lankan universities are largely traditional, with teacher-centered pedagogy and passive student learning. International trends in universities are increasingly moving toward active learner-centered teaching and outcome-based education, which are important to combine academic excellence with good socio-emotional skills that are needed for the world of work in the twenty-first century.

**Inadequate quality assurance mechanisms are in place for students enrolled in external degree programs.** A large proportion of students are enrolled in external degree programs with minimal academic support or supervision by universities. Higher education institutions that are franchises of or are affiliated with overseas universities depend on the overseas institutions for quality assurance, which is often inconsistent. Because of ambiguous regulations, the regulatory framework for private sector participation in higher education is unclear and deficient.

**The quality of academic staff at universities is a barrier to innovation.** Out of approximately 5,000 academic staff at Sri Lankan institutes, less than 50 percent have a PhD degree. Among academic staff below 45 years of age, only 24 percent have PhDs. Research output from Sri Lankan universities is far lower than for its aspirational peers: for instance, the number of citations per million inhabitants in Sri Lanka is three times less than Thailand and five times below Malaysia. There is also a shortage of staff with industry experience working at vocational training centers and technical colleges (Millennium Challenge Corporation, 2017).

**Links between industry and academia are minimal.** To produce higher value-added products, Sri Lanka needs to use technologies of ever-higher complexity. However, the collaboration between universities, research institutes, and companies for research and development (R&D) has been minimal.



**Vocational education–skilling for jobs features prominently as a government priority and could be a potential and easier opportunity for collaboration with the private sector.** Historically, private investment in the TVET sector has been generally more feasible than in other areas of education. The Ministry for Skills Development and Vocational Training (MSDVT) is generally seen as relatively open to a greater role of the private sector.

**The TVET sector is fragmented and uncoordinated. The public sector consists of more than 30 statutory boards and 15 ministries** (World Bank, 2017). The MSDVT is responsible for the largest part of publicly provided training (70 percent), delivered through several agencies, each with its own board and procedures. Public training providers are financed primarily by the national budget, but allocations are not linked to their performance. Consequently, public institutions do not have incentives to revamp obsolete training courses and curricula and bring the private sector into their decision making. Although Sri Lanka has few PPP initiatives in TVET, expansion of these initiatives would improve access to skills training and help reduce the skills mismatch. In South Asia, PPPs have proved useful in providing educational opportunities and improving access. A monitoring and coordinating unit within the MSDVT that works with ministries could improve interface with industry to ensure market relevance of curriculum.

**Finally, access to land is one of the major cost items in setting up new campuses** (World Bank, 2019a). The example of NSBM Green University Town shows that addressing this challenge can be instrumental to strong growth.

**The government is already working on addressing some of the challenges to higher education highlighted above.** Supporting this effort, the World Bank Accelerating Higher Education Expansion and Development program focuses on the three pillars of (a) expanding enrollment in STEM subjects in state universities, (b) developing academic staffing and quality assurance, and (c) supporting government initiatives and funding research development and innovation through grants (World Bank, 2017).

**Furthermore, the next stage of higher education development can draw upon three global waves of higher education:** mission differentiation, internationalization, and the development of the private sector through a more strategic orientation of their mission (World Bank, 2019a; Dunder et al. 2017). All these measures appear feasible in the short-term from a political point of view:

**Mission differentiation.** The modernization of the higher education sector should be pursued with mission differentiation between three types of universities: a first set of universities, mainly drawn from among the newer higher education institutions in the provinces, could be designated as predominantly teaching universities (focusing on excellence in teaching and learning). A second set, mainly the older, more developed higher education institutions could pursue, in addition to their teaching role, an important mandate for research and innovation and the commercialization of innovations (see also section “Strengthen the innovation ecosystem”). A third set of universities could emphasize, along with their teaching functions, community services and regional development.



In the medium-term, it would be important to progressively open up new opportunities in higher education with a view to increasing internationalization and the role for foreign and Sri Lanka private universities. Sri Lanka as a hospitable destination could become a hub for international students, which in turn could support the development of private universities, as there is currently not enough space available in public universities. A strategy for internationalization would include both promoting Sri Lanka to international students and seeking investments from foreign universities, for instance with support from the BOI. Linkages between national and foreign universities should also be promoted for research. Furthermore, the development of private universities in the provinces could address access to higher education there; current private institutions are mainly present in Western Province with a few in Kandy and Central Province.

**Enhancing the quality of education.** The quality of education could be strengthened through two main pillars. First, the improvement of the university faculty: by promoting PhD scholarships in priority fields such as STEM and proactively filling vacancies in these disciplines, including through hiring foreign nationals. Second, the establishment of an independent quality assurance council with the power to accredit higher education institutions, including private ones. The quality of EDPs should be reviewed.

In parallel to higher education, TVET is the other important area where increased synergies with private sector growth can be achieved. Also, since the sector has historically seen more private sector participation, this is where short-term efforts could be more naturally focused to develop more private sector participation. Informed by successful examples in Sri Lanka such as NSBM Green University (which has also forged links with several British, Australian, and other foreign universities), a model for public-private partnership could be developed and PPPs sought out more widely in fields that need expansion to meet the demands of the market.

Furthermore, active engagement with employers in TVET must be sought, including upstream involvement in curriculum development and regulation. Establishing sector skills councils in priority sectors to advise the government on sectoral skills needs and standards would contribute to better coordination to ensure that the system is responsive to private sector demands. Offering incentives to firms to build their in-house training capabilities should be considered.

Supervision of the sector must improve, along with its governance. The complex and fragmented skills development sector lacks accountability and incentives for good performance. Authorities should increase coordination among the relevant ministries (for example, education, youth affairs and skills development, higher education, finance and national planning, and ministries responsible for specialized skills development programs) to reinforce national coordination of skills development and ensure that programs are consistent with the national economic development plan. Other measures would include restructuring the Skills Development Fund to allocate resources competitively to both private and public institutions and reforming the National Vocational Qualifications to improve course accreditation and quality assurance for TVET program.

## Financial Sector: Public Borrowing Crowds-Out SMEs

There is a need to deepen the financial sector, especially with the aim of providing better access to finance for SMEs to spur further opportunities in the sectors of private sector growth identified in the next section of this report. Venture capital in particular could play a bigger role in fueling innovation in the IT sector and value-added niche manufacturing.

### Current performance of the sector

Given the considerable macroeconomic challenges, reform of the financial sector can play an important role in strengthening the contribution of the private sector and supporting the growth of promising sectors. Sri Lanka has made major strides in providing access to finance (74 percent of adults in Sri Lanka have an account and about 30 percent of Sri Lankan adults save, the highest share in South Asia). Yet, about half of all bank accounts are dormant, and women have a significantly lower participation in the financial system than men.

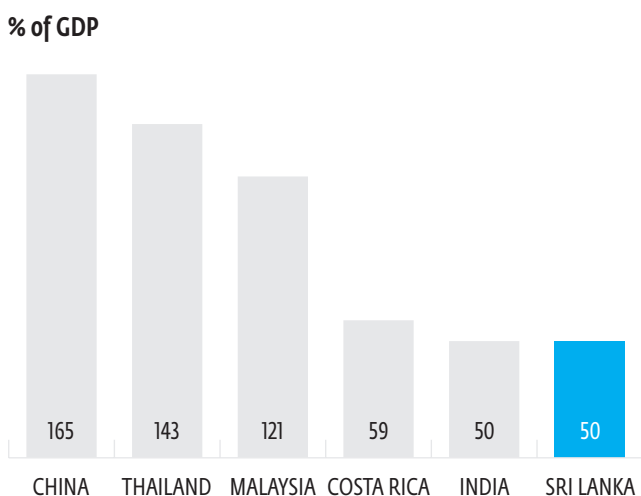
The financial service sector employed almost 220,000 persons as the first quarter of 2019 (2 percent of total employment). Total assets of the financial system reached SL Rs 18.9 trillion in 2018 (US\$116 billion) and are distributed among three subsectors: banks (72 percent), nonbank financial institutions (10 percent), and contractual savings institutions (18 percent) (CBSL 2018, chapter 8).

The financial system in Sri Lanka is dominated by banks. The sector is composed of 26 licensed commercial banks (including 13 foreign banks) and seven licensed specialized banks. The two largest banks (Bank of Ceylon and People's Bank) are both state owned. The banking sector is concentrated: the top five banks represent over 70 percent of banking sector assets. Foreign bank presence in the market is small. The approximately 10,000-strong subsector of cooperative rural banks and thrift and credit cooperative societies are a small part of the financial sector but an important channel for financial inclusion.

There are 43 deposit-taking nonbank financial institutions (NBFIs); also known as licensed finance companies, and 5 non-deposit-taking NBFIs also known as specialized leasing companies. NBFIs are a small but an important and a growing part of the financial sector, and their overall share of the financial system increased from 6.6 percent in 2015 to 7.6 percent in 2018.<sup>32</sup>

**Inefficient regulatory structure.** Sri Lanka has a sectoral supervisory structure, with different supervisory agencies overseeing different subsectors of the financial system.

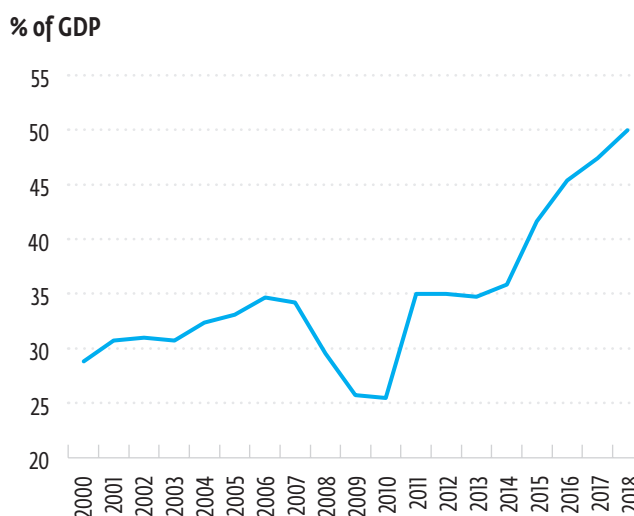
**FIGURE 2.7. CREDIT AS SHARE OF GDP, 2019**



Source: World Development Indicators.

Note: GDP = gross domestic product

**FIGURE 2.8. SRI LANKA CREDIT AS SHARE OF GDP, 2000–18**



Source: World Development Indicators.

Note: GDP = gross domestic product.

**Insurance and capital markets are relatively underdeveloped and account for a relatively small share of the financial sector’s total assets.** The 21 insurance companies have premiums of around 1 percent of GDP—far lower than aspirational peers. The insurance industry is underdeveloped with low insurance penetration. An insurance premium to GDP ratio of around 1 percent is much lower than comparators (penetration for India is about 4 percent of GDP; for Thailand and Malaysia, about 5 percent).

**An underdeveloped insurance sector limits the availability of long-term financing to meet the needs of the economy.** The state plays a large role in the insurance sector through its ownership of the underwriter Sri Lankan Insurance Corporation Limited, the Agriculture and Agrarian Fund, and the National Insurance Trust Fund that operates as both a reinsurer and an underwriter.

**Capital markets are underdeveloped, leading to an overreliance by large firms and SOEs on the banking system for funding, at the expense of smaller firms.** The two state-owned commercial banks dedicate an estimated 70 percent and 40 percent, respectively, of their lending to SOEs. Loans to SOEs have an implicit and sometimes explicit sovereign guarantee. If larger corporations, including SOEs, could shift to capital markets for financing, credit would become available to SMEs. Capital markets can also help fill the infrastructure gap by financing long-term projects. However, in Sri Lanka, most of the domestic capital market activity was also for SOEs’ funding needs (in particular, Ceylon Electricity Board and Sri Lanka Ports Authority). The domestic institutional investor base is estimated at US\$13.2 billion, but is highly concentrated, with two large state-managed pension funds (EPF and ETF). These entities mostly invest in government securities and hold their investments to maturity.<sup>33</sup> Like many emerging markets, Sri Lanka is confronted with the vicious cycle of a narrow issuer and narrow investor base.

In general, the development of the financial sector has not been commensurate with the development of the real economy:

**Financial Inclusion.** There are significant opportunities to expand financial inclusion by strengthening the penetration of the financial sector. Account usage remains low, with 35 percent of accounts being dormant.<sup>34</sup> Only 14.8 percent of people surveyed used debit or ATM cards for payments in a retail store and less than 10 percent used credit cards for retail store payments.<sup>35</sup> There is greater usage by women of informal channels for saving and borrowing, such as community banks (24 percent compared to 14 percent of men for saving and 62 percent for women and 52 percent men for borrowing, respectively) as well as other unregulated sectors such as microfinance (11 percent of women compared to 8 percent of men).<sup>36</sup> Mobile money usage was also low overall, with just 1.2 percent of women using mobile money (compared to 4.9 percent of men). Low uptake of smartphones contributes to limited uptake of mobile wallets with greater functionality.

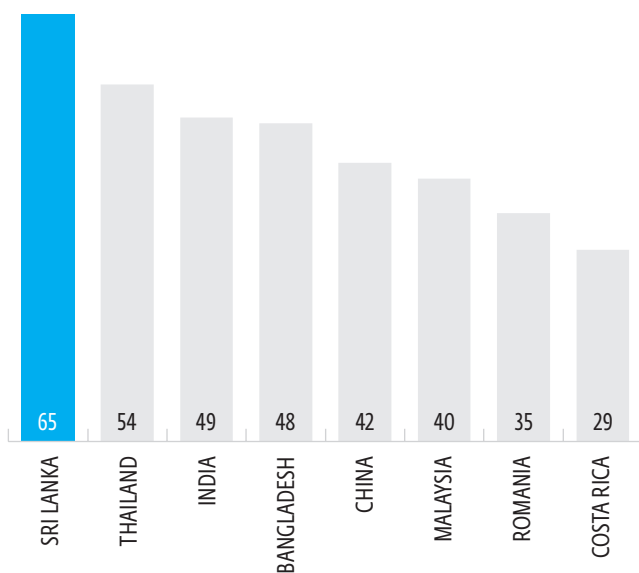
**Low credit penetration.** Despite having a per capita income 2.5 times higher than that of India, Sri Lanka's credit to GDP ratio at 50 percent is slightly lower than India's and is a fraction of the credit-to-GDP ratio of aspirational peers (Figures 2.8 and 2.9). These unmet financing needs are particularly acute among SMEs (Figure 2.10); 50 percent of MSMEs have reported that their working capital came from their own resources.<sup>37</sup> The finance needs of the agriculture sector are also large with IFC estimating the credit gap to the sector at US\$2 billion in agriculture financing; 2.45 percent of Sri Lanka's GDP.<sup>38</sup> Through reforms, there is significant scope to improve MSMEs' credit access.

### **Constraints and way forward**

**Shortage of SME finance.** A significant factor behind the shortage of finance for SMEs is the fact that, with the government owning about 40 percent of the banking system, large budget deficits are to a large extent funded by state-owned banks (Figure 2.11). Furthermore, the state provides guarantees to state banks to facilitate lending to SOEs and occasionally allows for outright dismissal of loan obligations. Large and established firms do not seem to have issues accessing credit, but the smaller private sector is having difficulties accessing credit.<sup>39</sup> While the share of banks' credit to government and SOEs has declined slightly over the past few years, it has remained high at 30–35 percent over the past decade (figure 2.11). MSMEs are also crowded out from the banking sector by larger corporates as banks and other financial institutions consider them to be high credit risks. Sri Lanka has the highest share of SMEs that are either fully or partially credit constrained, according to IFC estimates (Figure 2.10).<sup>40</sup> Credit institutions have also not developed adequate internal capacity for serving MSMEs, mainly due to insufficient competition, resulting in low incentives to modernize and innovate to serve this segment (World Bank 2017a). Much of the lending to firms is based on collateral rather than cashflows, which tends to favor larger companies over SMEs. Real property is often the only eligible collateral, and property registries are not fully electronic, which further hinders SMEs' credit access.

A credit enhancement fund for SMEs through a partial credit guarantee agency could help address banks' reluctance to engage in cashflow-based lending. Apart from increasing the flow of credit to SMEs, this would build banks' capacity for cashflow-based credit appraisals and over time induce more cashflow-based lending without the need for guarantees.

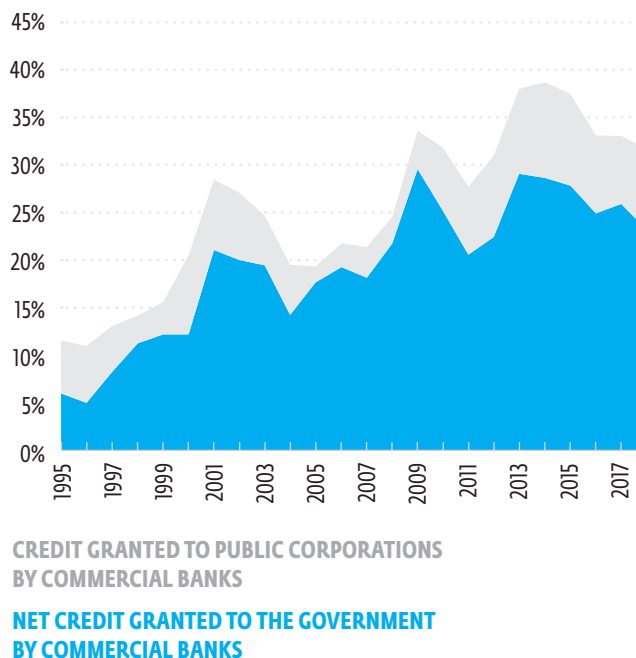
**FIGURE 2.9. SME ACCESS TO FINANCE, FULLY OR PARTIALLY CONSTRAINED AS PERCENT OF POTENTIAL DEMAND**



Source: SME Finance Forum.

Note: SME = small and medium enterprise.

**FIGURE 2.10. SHARE OF BANKS' TOTAL CREDIT TO GOVERNMENT AND STATE-OWNED ENTERPRISES**



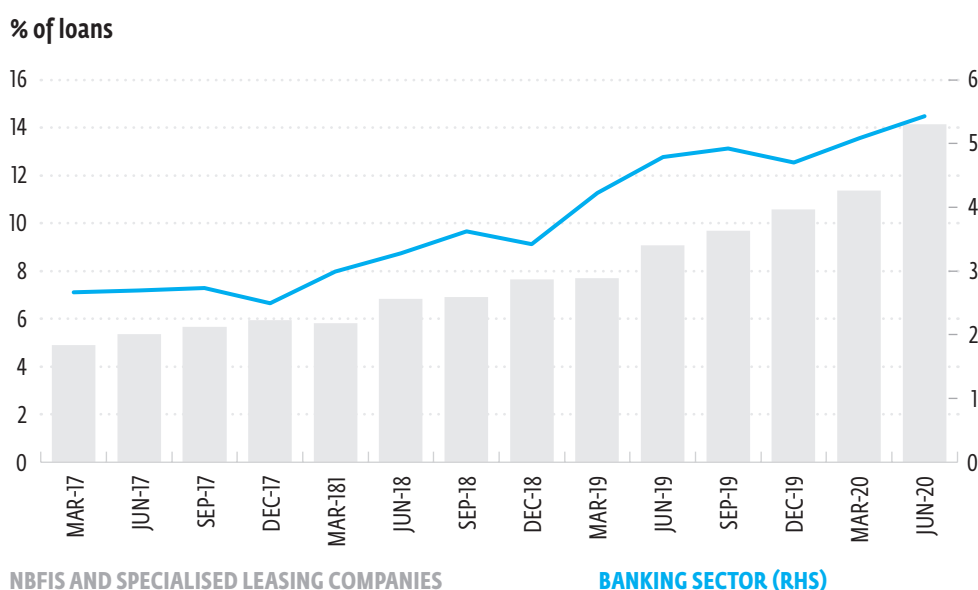
Source: Central Bank of Sri Lanka.

**Vulnerabilities in the NBFIs sector in the form of high nonperforming loans (NPLs).**

Slower economic growth coupled with the phased introduction of stricter accounting standards over a four-year period has markedly raised NPL ratios (Figure 2.12). Some small and midsize banks, specialized licensed banks, and NBFIs already show elevated levels of NPLs. The NPL ratio of NBFIs and specialized leasing have almost tripled in three years from 4.9 percent (March 2017) to 14.1 percent (June 2020). As the impact of the COVID-driven slowdown—notably on sectors such as tourism, restaurants, and hotels—is felt, NPLs have increased further. Risks are greater for NBFIs that have lower capital buffers. NBFIs are well positioned to address the needs of MSMEs, but the sector is in need of strengthened capital buffers and possibly consolidation. The slowdown in the economy because of COVID will further exacerbate asset quality issues at financial institutions. An asset quality review of NBFIs at a suitable time after the immediate COVID crisis has passed will allow the central bank to get a clearer picture of the financial sector. After getting a clearer picture of the financial health of banks and nonbank financial companies, the central bank can require financial institutions to raise more capital. There is also a need to harmonize the regulations for banks and NBFIs, given that they pursue similar activities. In particular, there is a need to harmonize prudential regulations (especially those on asset classification and provisioning) and disclosure norms.

**Regulatory oversight.** Sri Lanka has a sectoral supervisory structure, with different supervisory agencies overseeing different subsectors of the financial system. There are three main supervisory agencies: (a) the Central Bank of Sri Lanka (CBSL) that supervises licensed banks (commercial and specialized), registered finance companies, primary dealers, and specialized leasing companies; (b) the Securities and Exchange Commission of Sri Lanka; and (c) the Insurance Board of Sri Lanka. The multiplicity of supervisory agencies creates inefficiencies. Certain important financial sector intermediaries—microfinance companies, for example—are not covered under the supervisory structure. A single entity to oversee financial consumer protection across all financial services, including an effective and trusted dispute resolution mechanism in the form of a financial ombudsman, is lacking. The current supervisory structure could be rationalized into just two supervisory agencies: the CBSL and a newly created Financial Markets Authority (FMA). To establish credibility, the new FMA must be independent and have adequate capacity. There is an urgent need to include microfinance institutions under the supervisory umbrella. An FMA is needed to oversee financial consumer protection across all financial services, including an effective and trusted dispute resolution mechanism in the form of a financial ombudsman.

**FIGURE 2.11. NONPERFORMING LOANS, 2017–20**



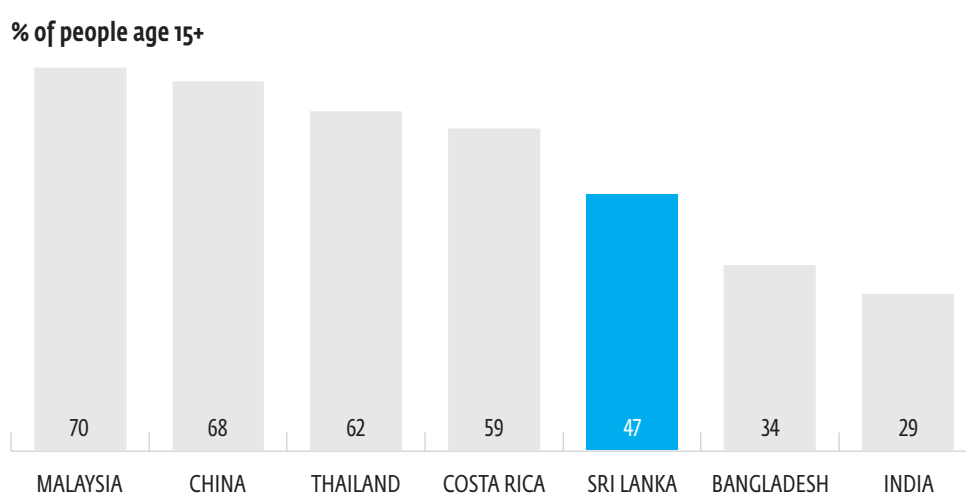
Source: Central Bank of Sri Lanka.

Note: NBFIs = nonbank financial institutions.

**Regulatory framework.** The regulatory framework of the financial sector is outdated.<sup>41</sup> New banking, insurance, and capital market laws in line with a modern regulatory framework would help. For instance, the Banking Act does not provide for a level playing field: government controlled commercial banks are exempt from complying with certain provisions of the Banking Act provisions. Newer areas such as digital finance and financial technology (fintech) are not regulated.

**Lack of a venture capital ecosystem.** While there has been a growth in angel investors and the venture capital ecosystem, access to risk capital at the Series A stage<sup>42</sup> and beyond remains limited.<sup>43</sup> This problem is particularly acute in the start-up sector, which is a source of innovation and job creation. A venture capital fund for post-angel-stage funding could be established in collaboration with domestic and global financial institutions, with the support of multilateral development finance institutions to catalyze the growth of the nascent start-up sector. This CPSD identifies niche sectors as a promising growth opportunity for Sri Lanka. However, access to risk capital was identified as a major constraint by innovative start-ups.

**FIGURE 2.12. MADE OR RECEIVED DIGITAL PAYMENTS IN THE PAST YEAR, BY COUNTRY**



Source: World Bank, Global Findex database.

**Slow resolution of nonperforming assets.** The current framework of resolving nonperforming assets (at banks and NBFIs) is slow and costly.<sup>44</sup> The legal framework for corporate insolvency is biased toward liquidation. Establishing an effective procedure for restructuring viable businesses in financial distress, particularly for MSMEs, could help avoid costly and time-consuming insolvency procedures and free up the legal system. A new bankruptcy law could also speed up nonperforming-asset resolution and facilitate the cleanup of bank and NBFI balance sheets. Setting up procedures by which companies and their creditors can negotiate a restructuring settlement out of court, subject to court approval, can be an alternative to formal insolvency proceedings. Given the slow pace of disposal of corporate insolvency prices, the Ministry of Justice should create a high commercial court in Kandy and one additional one in Colombo, as well as new district courts as needed, and ensure that judges have knowledge and experience in commercial, financial, and insolvency matters.<sup>45</sup>

**Lack of regulatory environment for fintech and start-ups.** Emerging financial markets need to be supported by a more conducive regulatory environment: fintech and start-ups especially. For instance, exclusivity arrangements imposed by remittance service providers on their agent banks should be curbed to revive digital payments, including through the revival of the National Payments Corporation. Sri Lanka currently has a relatively low share of digital payments (figure 2.13). The experience of India—with its Unified Payments Interface, an instant real-time payment system of transferring funds between two bank accounts on a mobile platform—may be worth emulating.<sup>46</sup> E-government has a role to play: government welfare and subsidy payments, which are largely cash and coupon based, could be gradually migrated to electronic payment modes. Although not a financial sector issue, existing exchange control norms make it difficult and time consuming for venture capital firms, which often have foreign limited partnerships, to repatriate profits and dividends outside Sri Lanka. These regulations have been identified as major constraints for the operation of angel investment funds in Sri Lanka.<sup>47</sup>

In parallel, the 2009 Secured Transactions Act needs to be replaced with a new law that, together with a public secured transactions registry, will determine priorities among creditors for competing security rights over movable assets and provide for balance to a security upon default.

Over the medium-term and subject to constraints of the political economy, governance of state-owned banks and the role of the Central Bank should also be reformed:

- State-owned banks need to become fully subject to the banking law, including increased responsibilities for banks' boards of directors to enhance accountability and to create the conditions for a competitive and level playing field.
- Importantly, the Central Bank role needs clarification. The CBSL implements several credit guarantee or subsidized refinancing programs, a conflict of interest with its role as the regulator of financial institutions. These roles should be transferred to a development bank.

### **Transport: Hub Opportunities Remain Untapped**

Transport has and will continue to play a fundamental role in serving the integration of Sri Lanka into the global economy and in providing new opportunities for Sri Lanka to serve the global marketplace. With the port of Colombo, the country is a maritime gateway between East and South Asia and the world for transshipment. To keep its role as one of the sectors of excellence in the economy, port and logistics services must continue to leverage Sri Lanka's unique position through an increased offering of value-added services and the full use of the new Hambantota port. In addition, transport's role is also prominent as a gateway for tourists around the world, and the airport urgently needs adapting to the future realities of the sector's expected growth.



### **Current performance of the sector**

**Infrastructure has been a significant driver of economic growth with key sectors being transport, energy, and water supply and sanitation.** Investments in the transport sector have concentrated on the rehabilitation of the road network and the development of expressways, with less effort on the development of bus or rail networks, which has led to a deterioration of public transport. The Western Region Master Plan envisions about US\$11 billion in transport-related investments up to 2020 in the Western Region alone. While the Colombo Metropolitan Region has seen an increase in infrastructure investments over the years, the country still has a lot to do in addressing economic and social infrastructure needs beyond that area (World Bank 2019f).

**The transport sector is an important contributor to the economy.** The Port of Colombo is one of the most important ports of South Asia. The logistics sector (container trucking, warehousing, ports, and shipping) contributes around 2.5 percent of the country's GDP and employs close to 50,000 people (full-time direct employment). It is estimated that logistics services account for about 7 percent of the country's exports (Government of Sri Lanka 2018e).

**The government of Sri Lanka's Vision 2025 strategy embraces a long-term structural transport master plan,** which includes the development of a multimodal transport hub, railway electrification and modernization, expansion of the Colombo Port, improvement and greening of the public transportation system, and modernization of the main international airport. However, Sri Lanka has come short of this vision, as fiscal constraints have compressed public spending on infrastructure as a percentage of GDP to around 1.6 percent of GDP (versus 8 percent of GDP in Thailand, 9 percent in Indonesia, and 13 percent in Vietnam). Estimates are that Sri Lanka will need to invest around 7 percent of GDP annually to enable the country to achieve high levels of basic services on par with those experienced in more developed economies (Biller and Nabi 2013; World Bank 2016c).

**Infrastructure financing in the country has so far been dominated by public funding,** often supported by loans from international financial institutions and countries such as China and Japan. In addition, some of the infrastructure projects were also financed by SOEs borrowing locally with the support of a sovereign guarantee. The main sovereign investor in infrastructure has been China (70 percent of the country's infrastructure projects over 2006-19). Chinese investment in infrastructure totaled US\$12.1 billion over 2006–19 (Wignaraja et al. 2020) with several flagship projects worth at or more than US\$1 billion: Hambantota port on the southern coast near the East-West shipping route, the Southern Expressway, and the Colombo Port City.<sup>48</sup>

Vision 2025 highlights the government's aim to promote private sector participation and PPPs in transportation and storage sectors. In this respect, several improvement projects are foreseen, including the following:

- Port and logistics activities: expansion of the port with the East and West Container Terminals.
- Tourism: plans to expand the terminal at Bandaranaike with Japan International Cooperation Agency assistance have been in discussion since 2016; pre-COVID-19, inbound tourism was forecast to grow from around 2 million visitors in 2018 to 5.4 million in 2035.

- Port and industrial zone: Hambantota EPZ and investment in transshipment activities.
- Western region development: there are prospects for PPPs with potential for private participation in rapid transit (Bus Rapid Transit, Light Railway, urban infrastructure, and logistics infrastructure).
- Tourism and inclusion: The Central Expressway will improve access to Kandy and Dambula, two major tourist sites, as well as reduce the time to go to Trincomalee. Future highway and road expansions would link up Trincomalee, Jaffna, and Batticaloa.

### Constraints and way forward

**Limited capacity at Colombo Port.** The Port of Colombo is by far the most important port in Sri Lanka with over 95 percent of the total cargo by volume. A total of 75 percent of port activity is as a transshipment hub port for the Indian Subcontinent. The port throughput was 7.05 million twenty-foot equivalent units (TEU) of container cargo in 2018, the 24th busiest container port in the world and the largest in South Asia.<sup>49</sup> Two other terminals must be developed if the port is to continue its growth and bring capacity to 11.7 million TEU per annum by 2023.

**Further developing Hambantota deep-sea port.** The deep-sea port project in Hambantota developed by China Merchants Port Holdings (CMPH) began commercial operations in 2012 but has suffered from low utilization and incurred heavy losses. CMPH and the Sri Lankan government plan to develop a 1,500-acre economic zone next to the port. An oil refinery, with an investment of US\$3.85 billion supported by Oman, and a cement manufacturing plant, with an investment of US\$100 million, were announced in March 2019. Recently announced projects include a tire manufacturing factory and a floating liquefied natural gas (LNG) storage facility. The business model of the port remains to be developed given that Sri Lanka is a small destination market, already has a very good container port, and is not an exporting source of large bulk cargo. The future of the port will depend on the emergence of bulk product transshipment that does not yet exist, such as liquefied petroleum gas (LPG) transshipment (Laugfs inaugurated a terminal in May 2019) and fuel bunkering<sup>50</sup> or its relationship with the Chinese maritime company China COSCO Shipping.

**Air transport.** more than 98 percent of tourists come to Sri Lanka by air travel through Bandaranaike International Airport. The airport's nominal capacity of 6 million passengers per year has been exceeded since 2011, as traffic exceeded almost 11 million passengers in 2018, a growth of 11 percent over the previous year, and an average growth of 10.9 percent since 2009.<sup>51</sup> Tourist arrivals increased from 1 to 2.3 million between 2012 and 2018 (14.8 percent per year), a growth rate of over 40 percent compared to about 1 percent between 2000 and 2009.<sup>52</sup> Forty-two international airlines now serve Sri Lanka, up from 37 in 2017;<sup>53</sup> 35 scheduled carriers, including Sri Lankan airlines, operate. Sri Lankan Airlines operates over 560 flights a week to 114 destinations in 48 countries (including codeshare operations). Under government management since 2008, the airline has accumulated large losses.<sup>54</sup> A lesser but not negligible constraint is the state of transport within the island. There is considerable road congestion, especially in Colombo and on routes serving tourist destinations.<sup>55</sup>

**Logistics services.** To develop port activities and their contribution to the economy, logistics services must improve. Transshipment, the key activity of the Port of Colombo, does not provide as much value as destination shipment and relies mainly on the efficiency of port movements and storage. The logistics performance in Sri Lanka remains weak on average (the country ranks 94th out of 160 countries in the 2018 Logistics Performance Index). Fully leveraging Sri Lanka's international connectivity to integrate the country's domestic supply chains and providing holistic logistic services has remained a challenge due to issues relating, but not limited to, inefficiency, inadequate infrastructure, lack of digitization, limited public and private sector coordination, and lack of supporting regulatory measures (World Bank 2020b). Recognizing this, the government developed a strategy (Government of Sri Lanka 2018d) for the logistics sector, with a view to attracting investments into facilities across the country (cold storage solutions and multiuser facilities) and providing value-added services through multicounty consolidation (MCC), less than container load (LCL), de-stuffing, and commercial hub activities.

The 2013 Commercial Hub Regulation was designed to facilitate entrepot trade by exempting investors from certain provisions of the customs code, the Exchange Control Act, and the Import and Export Control Act in the six port and bonded areas permitted under the regulation.<sup>56</sup> Its implementation, however, has not met the expectations of private investors. Regarding the provision of LCL and MCC services, a liberalization of the legislation appears needed to take better advantage of opportunities in the sector (see for example Gajanayaka and Mudunkotuwa, 2015).<sup>57</sup> The government has proposed reforms<sup>58</sup> and one private operator has obtained approval to undertake MCC operations outside the port. Private sector actors interviewed for this report are actively looking for opportunities to invest in additional logistics infrastructure, bunkering, and marine services.

In addition to the regulatory questions (such as authorizing third-party logistics operations outside of the port), the lack of MCC facilities is partly due to the insufficient availability of land near the port (World Bank 2020b). More generally, the lack of storage facilities, space for industrial zones (currently concentrated in Western Province), and ways to interconnect different modes of transport with each other (port, rail, and airport) are preventing the emergence of more modern logistics for both gateway and transshipment traffic and necessitate the development of a comprehensive needs assessment to fill these gaps (World Bank 2020a, 2020b).

**Lack of effective interagency coordination.** Much of the improvement needed to facilitate trade is covered under the WTO Trade Facilitation Agreement to which Sri Lanka has acceded. However, implementation schedules should be more ambitious given the importance of the sector. The National Trade Facilitation Committee operates at a level that is not high enough for committing to time-bound action. As a result, Sri Lanka's Action Plan to implement its commitments has no specific timelines and the time-schedule is generous. The existing National Trade Facilitation Committee would need to be raised to the level of a Committee of Secretaries or let such a Committee meet once in two months to assess progress. As a result, the Action Plan has no specific timelines and the schedule is very relaxed.

The institutional framework in the logistics sector of the country is fragmented, with several public institutions overseeing various aspects of the logistics industry such as the Sri Lanka Ports Authority (SLPA), the Merchant Shipping Secretariat (MSS) under the Ministry of Ports and Shipping, the Sri Lanka Customs and Department of Commerce under the Ministry of Finance, Economic and Policy Development, and the Board of Investments. There is no apex institution to coordinate activities across these institutions and, therefore, individual institutions tend to work in silos (World Bank, 2020).

The 2019 National Policy Framework identifies the development of transport infrastructure as a priority engagement and the government of Sri Lanka has already taken steps to improve transport and logistics services, such as the development of a national port master plan, which recommended restructuring some of the functions of SLPA. The government recently launched a Trade Facilitation Framework for MCC with the assistance of the Global Alliance for Trade Facilitation. The World Bank has previously assisted the government of Sri Lanka in developing a blueprint for implementing a National Single Window and setting up the National Trade Facilitation Committee. A trade information portal was launched in 2018.<sup>59</sup>

The following key areas for development are proposed for immediate follow-up (most of these recommendations are discussed by World Bank (2020a, 2020b). They also appear to have a high level of political feasibility:

- Port activities and logistics services
  - Strengthen SLPA as a regulator and manager of efficient and resilient smart port and marine infrastructure services in Sri Lanka.
  - Prioritize the development of the East Container Terminal and the West Container Terminal through the landlord port model, and evaluate strategic private sector participation to boost overall competitiveness and efficiency.
  - Develop extended port gates to enhance storage and cargo handling capacity, and review the regulations around MCC and LCL (customs regulation, taxation).
  - Review the structure of port tariffs, and configure operational support and services to incentivize off-peak work.
  - Accelerate digitization of the port: identify regulatory and policy reforms, technology platforms, and investments in smart port infrastructure and a Port Community System (to be linked in the future to the National Single Window).
- Interconnection between port and city
  - Develop a master plan to improve city-port and port-hinterland connectivity, including feasibility studies and project financing options to develop a multimodal transport network.
  - Carry out a needs assessment of supply chain logistic infrastructure for freight consolidation, storage, clearance, and distribution based on the smart port strategy and transport connectivity master plan.
  - Identify the potential for development of integrated economic zones and industrial parks.

- Trade facilitation
  - Minimize port stay for gateway traffic through automated port-gate clearances and transfers between extended port gates, inland ports, and other customs authorized economic zones, industrial parks, and container freight stations.
  - Continue the roll-out of the Sri Lanka customs National Single Window with the appointment of a high-level steering committee to identify the preferred implementation options.
  - Ensure high-level oversight over the action plan of the National Trade Facilitation Committee for the time-bound implementation of the WTO Trade Facilitation Agreement.
  - Amend the Customs Ordinance to bring it in line with modern customs practices, especially keeping in view the requirements under the WTO Trade Facilitation Agreement.
- Air transport
  - Move forward with extension projects of the Bandaranaike airport terminal.
  - Expand the runway of Jaffna airport.

### Electricity: Meeting Future Demand at Market Prices

Starting March 2022, fuel shortages caused by the reduced availability of hard currency for imports, caused rationing of electricity. However, the sector needs to adapt to future needs with increasing generation. Subsidized electricity prices that do not reflect the costs of production and require direct transfers by the government serve an important social objective, but also put in question the long-term sustainability of the sector. As tariffs do not reflect costs, persistent transfers from the government have become necessary and have promoted inefficient management practices at the utility, including in the area of PPP's for new generation that must be addressed. Strengthening the sector is a long-term project that could benefit from targeted interventions involving the private sector in renewables, thus diversifying power generation sources and curbing carbon emission. Another source of diversification would be through imports from India's grid.

### Current performance of the sector

Sri Lanka's power sector is characterized by universal access to electricity and low transmission and distribution losses, which have been reduced over the years (≈10 percent in 2016) and ongoing construction of new electricity generation to meet increased electricity demand, including through nonconventional renewable energy (NCRE) and rooftop solar projects (World Bank, 2019e).

Electricity demand has grown at an average annual rate of around 6 percent over the past 10 to 15 years (World Bank, 2019e); demand continues to grow at an annual rate of 5.6 percent. To meet growing energy needs, Sri Lanka will need to mobilize US\$7 billion by 2026 (World Bank, 2019e). It is estimated that less than 50 percent of this amount can be financed by sector stakeholders and domestic banks. Therefore, additional investment needs (US\$3.7 billion) will have to be met without publicly financed projects by increasing the share of commercial financing and encouraging greater private sector participation.

**Access to energy is good, but expensive because a significant share (33.6 percent in 2017) of Sri Lanka's power generation is based on imported fuel oil (procured by CPC).** The power sector in the country is currently dominated by hydroelectric power plants (21.2 percent of generation capacity for large hydroelectric plants in 2017) and fossil fuel-based generation from coal and liquid fuels (68.8 percent); the fossil fuel share becomes higher when compensating for low hydropower generation during lean seasons (World Bank, 2019e). The government of Sri Lanka, through the envisaged renewable energy targets and projected generation planning, has been pursuing a shift toward clean generation, including both nonconventional renewable energy and liquefied natural gas generation. The reliance on hydrocarbons has led to high average cost of power generation compared with other countries in the region: for instance, costs are 50 percent more expensive than in neighboring India ( $\approx$ US¢8.5 per kilowatt hour in 2016, compared to  $\approx$ US¢5.5 in India and  $\approx$ US¢6.5 in Bangladesh).

**At the same time, electricity retail tariffs do not fully cover costs.** In 2017, the average selling end user tariff (set under the Public Utilities Commission of Sri Lanka) was US¢11.4 per kilowatt hour, while the cost incurred for generation and transmission of the power to selling point was US¢13.8 per kilowatt hour, resulting in an accumulation of arrears for CEB. The government helps cover these by helping CEB's debt service in lieu of tariff adjustment or direct tariff subsidy.

**Public financing has been the primary source of financing for power plants owned by the Ceylon Electricity Board.** The sector opened to independent power producers (IPPs) in the late 1990s: this led to large projects (over 10 megawatts) developed by IPPs on a build-own-operate-transfer plan. However, this financing has typically required a guarantee for CEB's payment obligations from the government. There have also been developments in NCRE projects that have attracted investment from domestic developers and banks without government financing support. Such projects have contributed to a total of 400 megawatts of mini hydroelectric (with World Bank project assistance), 128 megawatts of wind (including a large 100 megawatt project in Mannar with Asian Development Bank support), 51 megawatts of land mounted solar (including two 10 megawatts projects with Laugfs Holding in Hambantota and 10 megawatts projects by SagaSolar Power and Wind Force), 17 megawatts of biomass (10 megawatt project with Aitken Spence), and 120 megawatts of rooftop solar.

**The country has not yet been able to develop utility scale NCRE projects at tariffs comparable with other projects globally or in the region or to tap into commercial financing and private sector participation in larger scale projects.** As part of the preparation of the World Bank Energy Infrastructure Sector Assessment Program (InfraSAP), two pre-feasibility assessments for potential large-scale NCRE park sites were conducted for sites in Pooneryn and Moneragala, respectively, totaling about 500 megawatts of potential generation capacity.

### **Constraints and way forward**

**Lack of generation capacity.** Generation capacity constraints loom if Sri Lanka is to meet future demand. In addition, there is the need to diversify sources of electricity generation to optimize the cost of power generation and reduce the dependency on oil. Efforts to diversify into renewable energy so far have come short of the targets and are not economically attractive.

**CEB's financial performance.** The capacity of the energy sector to respond to these challenges is hampered by the economic model (cost of generation and tariff policy) of CEB, the sole integrated power utility in the sector, which dominates the sector with 72 percent of installed generation capacity and 92 percent of distribution (the remaining 8 percent being Lanka Electricity Company, another state-owned distribution company). CEB's financial performance has been volatile, and its liabilities are large. CEB's financial performance also limits the availability of economic incentives for IPPs and therefore a stronger role for the private sector.

**Weak PPP framework.** In addition to weak economic incentives for IPPs caused by the CEB's solvability, the framework for PPPs is not fully transparent and consistent and has allowed unsolicited proposals. As a result, there have been delays in finalizing sector targets and project pipelines and setting up PPP projects, as well as proliferation of suboptimal procurement practices.

Considering this, the following areas to strengthen the power supply identified by the World Bank infraSAP (World Bank, 2019e) are the following:

- Diversify generation sources (through utility-scale NCRE, LNG, and regional connectivity)
- Launch a multiproject competitive NCRE procurement program by the end of 2019 with a flagship utility-scale project to lower generation costs and mobilize private sector expertise and finance.
- Develop and implement an LNG procurement strategy with clear institutional roles and transparent principles.
- Evaluate the feasibility, appropriate business models, and financing structures for the proposed Sri Lanka-India transmission line, and initiate project development.
- Improve the enabling environment to minimize risks and attract private investment
  - Prepare a short- and medium-term implementation and financing plan based on the Long-Term Generation Expansion Plan 2018–2037 with prioritized investments.
  - Establish a coordination mechanism for planning and implementation review to improve institutional alignment and ensure successful implementation of investment and procurement programs.
- Strengthen sector entities and improve their financial performance
  - Progressively move to cost-reflective tariffs to improve the financial standing of CEB. As a transition arrangement, consider a transparent direct subsidy to CEB instead of government repayment of debt.
  - Create cost-and-profit centers within the CEB, and develop transparent financial management and reporting tools and practices of both the CEB and CPC (to improve performance and encourage participation by private and foreign counterparts).
- Mobilize domestic and international financing and alternative financing models
  - Develop bond instruments, and increase participation of pension and insurance funds in infrastructure.
  - Develop innovative financing models and structures, and enhance domestic banks' project finance capacities (foreign currency hedging, credit enhancement instruments).



# 3. OPPORTUNITIES TO PUT SRI LANKA ON A 21ST CENTURY TRAJECTORY

---

In a post-COVID-19 environment, the government of Sri Lanka will face the challenge of stimulating the economy while at the same time being constrained by high levels of public debt and the need to address social challenges. This makes it imperative for the government to create the necessary framework for the private sector to flourish and to leverage investment of the private sector more broadly, both for domestic and foreign investors.

As outlined above, creating the opportunities to stimulate the economy requires establishing predictability of public policy, creating a level playing field for all enterprises, directing scarce government funding toward public goods such as education, and introducing measures to make state-owned enterprises more efficient. This section discusses priority sectors in which Sri Lanka has a possible comparative advantage, including sectors that are knowledge-intensive (manufacturing, value-added agribusiness, and logistics), or sectors that need well-trained people to improve their attractiveness (tourism). These sectors have been selected due to their recent performance and potential to drive Sri Lanka's transformation to an upper middle income country. They are already contributing to the economy; the question is what are the specific gaps to address to allow further growth.

Addressing these constraints will be even more necessary as the country moves to the COVID-recovery phase with a limited budget.

## 3.1 EXPLOIT THE POTENTIAL OF TOURISM TO CREATE JOBS IN LAGGING REGIONS AND BALANCE EXTERNAL ACCOUNTS

### Current Sector Performance

Sri Lanka's unique size and location, wealth of natural assets, and rich cultural heritage provide a perfect endowment for the country to position itself as one of the best tourism destinations in the region. This potential started to be properly tapped following the end of the war in 2009. Global chains (Shangri-La group, ITC group, and so forth), international brands (Marriot, Movenpick, and so forth), and local conglomerates (Jetwing, John Keells, Atkins Spence, and so forth) expanded their postwar tourism investments, increasing both the supply and quality of medium- and high-end accommodation. Sri Lanka started to become widely recognized as a top destination internationally (*National Geographic* in 2011, *Lonely Planet* in 2012, and the *New York Times* in 2013). Tourist arrivals increased from approximately 450,000 in 2009 to 1 million in 2012 and to 2.3 million in 2018.



Western Europe continues to be the largest tourist origin for Sri Lanka, growing at 24 percent to 840,956 arrivals in 2018, accounting for 36 percent of total tourist arrivals, followed by growing arrivals from South Asia with 543,160 visitors. In terms of countries, tourists from India represent the largest number of international arrivals (18.7 percent), while China is second (12.7 percent). More than 98 percent of tourists coming to Sri Lanka by air travel through Bandaranaike International Airport. Average duration of stay is 10.9 nights according to Sri Lanka Tourism Development Authority (SLTDA).

Tourism was among the most important sectors in the Sri Lankan economy as the third-largest export earner, a significant employment generator, and a source of improvement of the country's balance of payments. The direct contribution from the industry, estimated at US\$4.4 billion (2016), accounts for about 5 percent of the country's GDP (World Bank, 2019d). Furthermore, tourism-specific investments accounted for ≈10 percent of total FDI in 2018. More than 2 million people depend on income (directly or indirectly) from tourism according to the hotel association of Sri Lanka.

The industry was hit by twin shocks in quick succession. The Easter Sunday terrorist attacks (April 2019) and COVID-19. Tourist arrivals dropped sharply from 1.9 million (2019) to around 500,000 (2020) and almost 200,000 (2021) – a decline of approximately 90 percent. While tourism has recovered in 2022, tourist arrivals in the first three months of the year remain 60 percent lower than the comparable period of 2019. Preliminary estimate suggest that, because of the COVID-driven slowdown in tourism, approximately 300,000 jobs—a third of total tourism sector jobs—are at risk, in addition to approximately a million micro-businesses in ancillary trading and services.

In 2017, the government of Sri Lanka developed a comprehensive tourism strategic plan, identifying issues and policy reforms to help achieve a medium-term target of US\$7 billion tourism earnings by 2020. As part of Vision 2025, The government of Sri Lanka published the Tourism 2025 Vision,<sup>60</sup> aimed at ensuring that the tourism strategic plan was able to address gaps in terms of planning, regulation, value addition, market research, stakeholder coordination, skills development, investment attraction, and sustainable natural resource management.

The Sri Lanka Tourism Development Authority (SLTDA) has prepared a new tourism recovery action plan after COVID.<sup>61</sup> The most promising opportunities for Sri Lanka lie in exploiting its unique endowments and already strong focus on sustainably preserving the environment to offer high value opportunities in niche segments.

- **Surfing.** Sri Lanka offers a variety of surfing spots with excellent surfing conditions year-round. Wave surfing is one of the fastest growing sports in the world and can be developed as a niche market segment across the eastern and southern coasts of Sri Lanka. Kite surfing can be developed as a niche market segment across the northwestern coasts of Sri Lanka.
- **Avitourism** (bird watching). Home to more than 20 endemic bird species, Sri Lanka has immense potential for avitourism, which is becoming increasingly popular among millennials.

- **Health and wellness tourism.** Sri Lanka's long history of traditional health systems, especially Ayurveda, will help tap into global demand for ayurvedic wellness offerings and products. Its central location offers another key advantage for wellness tourism development.
- **Meetings, incentives, conferences and exhibitions (MICE).** The upcoming port city project in Colombo and others in districts like Galle, Hambantota, and Kandy can be developed as MICE destinations, building on Colombo's comparatively greener and welcoming environment compared to other large metropolitan areas in the region.

Given the uncertainty on the resolution of the public health crisis, the timeline for recovery of Sri Lanka's tourism sector is unclear. The post-pandemic evolution of tourism is also uncertain. However, historically, tourism has recovered quickly following setbacks; for instance, tourist arrivals in Sri Lanka had almost normalized by December 2019 after the Easter Sunday (April 2019) terrorist attacks.

### Constraints and Way Forward

**Value for money.** Despite positive trends, tourist arrivals to Sri Lanka lag well below regional peers because of poor tourism infrastructure and inadequate access. Sri Lanka's 2.3 million tourist arrivals are dwarfed by Cambodia (about 5 million), Indonesia (15 million), Malaysia (30 million), Thailand (35 million), and Vietnam (10 million). Sri Lanka is not perceived as providing value for money in comparison with other destinations in Southeast Asia.

**Concentration in certain regions.** Tourism investments in Sri Lanka are concentrated in a small part of the island, with 98 percent of tourist beds concentrated in the South and West of the island along the coast. As a result, Sri Lanka's tourism industry is currently concentrated around two main circuits: the South and the mid-highlands toward the east. The South is characterized by offering tourists pristine beaches (for example, Galle, Mirissa), sea sports (for example, surf, scuba diving), and wellness options (for example, yoga retreats, spas). The mid-highlands offers cultural heritage sites (mid-highlands Sigiriya, Dambulla), religious sanctuaries (Kandy), and traditional tea landscapes (mid-highlands Ella, Nuwara Eliya) via road and railroad access.

The principal gateway to Sri Lanka, Bandaranaike International Airport, has continually experienced congestion during peak hours. There is also weak connectivity to tourist attractions. Although the country is only 65,000 square kilometers (the size of Ireland), travel times between locations take too long as road transport can be of poor quality. Air transport is often unreliable with limited options. Access to potential tourist attractions in the East and North (which could be developed through better destination management) remains poor, which inhibits their potential. Poor road connectivity makes West and East transport time consuming. Domestic aviation connectivity is limited. The Sri Lankan Airforce is the operator of most of the small airports around the island (World Bank 2016d). Recently, however, the management of Jaffna airport was handed over to the civil aviation authority. In addition, Sri Lanka lacks good connections to Europe, with most travelers required to transit through the Persian gulf.

Star-graded accommodation in the capital, Colombo, costs 10 to 15 percent more than regional competition, owing partly to the regulatory price floor but also to relatively high costs of construction, energy, and imports.<sup>62</sup> Formal tax paying hotels face increasing competition from a growing informal sector. Unregistered rooms are also appearing in areas outside the main circuit. For instance, a large proportion of room stock in areas such as Kalpitiya, Jaffna, Arugam Bay, and Ella are not yet registered with the Sri Lanka tourism development authority.<sup>63</sup>

**Skills gaps.** Sri Lanka has no skilled and service-oriented workforce that is equipped to provide high-value tourism services. The number of training institutes is inadequate (about eight centers at present). The number and capacity of tourism and hospitality skills-training institutes in regions outside Colombo needs to increase to address future demand generated by the potential tourism activities in these regions.

**Lack of interagency coordination.** Coordination and communication between government ministries, institutions and stakeholders with respect to tourism planning, tourism asset management, and tourism destination management is weak. The distribution of tourism-related responsibilities across multiple agencies and government levels complicates this. Similarly, there is poor communication and coordination with other tourism stakeholders (for example, with respect to conservation), which contributes to conflict in land use and complicates and slows administrative and decision-making processes. In part because of diffuse responsibilities, initiatives to monitor overvisitation and promote animal welfare and natural habitat regeneration are not prioritized. There has been a reliance on regulation to manage quality, safety, and standards, but limited enforcement of the regulations.

**Communication campaign.** The immediate response measures to the COVID-19 outbreak need to focus on health and safety measures across the tourism supply chain along with strong communication on these measures to preserve the public's confidence. Promotion of Sri Lanka as a safe destination to major tour operators in key market countries (such as India, China, the United Kingdom, Germany, and Australia) and to independent travelers could help revive tourism. A strong communication campaign could be initiated to promote the return of tourists.

**Strengthening public hygiene.** Strict measures to improve hygiene standards should be implemented immediately at all tourism places and by all service providers (restaurants, hotels). These safety and hygiene measures could be rolled out in a phased manner starting with the main tourism cluster locations, such as Colombo, the southern resorts, Galle, and the Cultural Triangle and the Hill Country. Grants could be made available for SMEs in the travel and tourism industry to upgrade their quality standards. Authorities (SLTDA) should carry out inspections and issue a health and sanitation certification to tourism businesses that will encourage the return of tourists to key destinations in Sri Lanka.

To keep-up with skilling during the COVID pandemic, workers should be encouraged to attend online trainings sessions. While some sessions are freely available through United Nations World Tourism Organization websites, others could be offered to workers in partnership with the hotels and the Sri Lanka Institute of Tourism and Hotel Management (SLITHM) using digital platforms.

**Developing a new post-COVID-19 vision for the tourism sector.** Sri Lanka needs to focus on higher value tourism products—rather than branding itself as a low cost or budget tourism destination—and promote nature-based and wellness tourism (for example, Ayurveda, yoga retreats, sailing, national parks). The recovery process from COVID-19 will likely be uneven (in terms of markets and locations within Sri Lanka) and long. Normal travel behavior pre-COVID-19 might not be possible until a vaccine is available globally and widely administered. However, this time provides Sri Lanka an opportunity to beef up tourism infrastructure and access to key destinations as well as improve the regulatory structure to prepare for the post-COVID recovery.

**Streamlining the functioning of and improving the coordination between statutory bodies that operate under the Ministry of Tourism.**<sup>64</sup> The institutional architecture to support tourism in Sri Lanka is fragmented. The national tourism authority is divided into four separate institutions (SLTDA, Sri Lanka Tourism Promotion Bureau [SLTPB], Sri Lanka Convention Bureau, SLITHM). The fragmentation is further compounded by the distribution of important tourism responsibilities among many ministries and agencies at the central level and the devolution of substantial powers to the provincial and local levels. A framework that strengthens the coordination between central tourism institutions (the Ministry of Tourism, SLTDA, SLTPB, and other ministries) and provincial authorities will also facilitate planning for the recovery.

**Strengthening connectivity with key markets.** Increasing availability of flights to key markets in Europe and Asia is of critical importance to boost Sri Lanka's attractiveness as a tourism destination. To this effect, it will be important to continue to reform Sri Lankan Airlines and open up the market to other foreign carriers.

**Boosting capacity at the airport.** Upgrading the capacity of the airport, which pre-shutdown operated at nearly double its original capacity (11 million against 6 million) is particularly important for the tourism sector. The government, together with Aviation Services Limited and Japan International Cooperation Agency, has proposed expansion of Bandaranaike with a new multilevel terminal building to be completed by the year 2020; however, these plans have been delayed and been put on hold by the government due to a dispute on project costs.

**Intra-island transport.** A lesser but not negligible constraint is the state of transport within the island. There is considerable road congestion, especially in Colombo and on routes serving tourist destinations. Also, remoter parts of the island are not within convenient access. Plans to upgrade the Central Express Parkway and extend the Southern Expressway should address some of the constraints and facilitate both internal logistics (away from congested Western Province) and tourism access. However, these plans are facing difficulties in mobilizing public and concessional financing, and prospects for private financing look remote. Recently the airport in Jaffa was upgraded to accommodate flights from India but is able to only receive small aircraft.

**Crowding-in the private sector to increase tourist accommodations.** Government needs to crowd-in the private sector to invest in different segments of new accommodation to meet different tourist needs. Based on the projected demand, the number of tourist accommodations as well as their types—from city hotels, large resorts, high-end boutique hotels, and villas, as well as tented camps and rural bungalows—are insufficient.<sup>65</sup> For this purpose, a detailed demand assessment should be carried out to guide private sector investments in accommodations.

**Training hospitality staff.** As many as 50,000 to 60,000 new hospitality staff need to be trained to support just the projected growth in room inventory. Sri Lanka currently has the capacity to train only around 1,800 new graduates each year. Apprenticeship trainings that blend online trainings with on-the-job sessions could be created for youths and women in provinces and integrated in training schools' curricula. In addition, SLITHM and other qualified private sector stakeholders could also be encouraged to provide specific trainings in wellness tourism services, ayurvedic quality standards and classification, and wildlife homestay hospitality.

**Developing sustainable tourist destinations aligned with Sri Lanka's attractions.** Sri Lanka's current tourist destinations are concentrated on the West and South of the island. With new tourism destinations, the goal is to ensure that these are strategically developed across the island to encourage longer stays, facilitate visitor movement and spending across all districts, and encourage return visits. Identifying three to four priority destinations that could be developed and marketed with the help of the private sector (IFC could play a role to crowd-in private investment), would be optimal. There are many niche market segments that could be suitable for Sri Lanka, but information on these is scarce, and further research must be completed before major marketing and product development decisions can be made. Based on an initial World Bank assessment, priority districts for diversification destinations could be Galle, Nuwara Eliya, and Trincomalee. The authorities should formulate detailed destination development plans with inputs from private sector players.

**Strengthen management of Sri Lanka's national parks.** Sri Lanka has great potential to diversify tourism offerings with national parks around the country. Private sector participants have expressed an interest in managing some of these national parks—both conservation and destination development. Greater collaboration would help manage the destination better, as well as develop new destinations across the islands, particularly in the underexplored parks in eastern Sri Lanka. The current regulatory structure of divided jurisdiction in the management of national parks between the forest and wildlife departments creates inefficiencies and discourages private investment. The tourism authorities, in collaboration with the Ministry of Environment and Wildlife Resources, need to make sure that the right safeguards are in place to regulate and monitor various activities.

### **3.2 SUPPORT THE “ISLANDS OF EXCELLENCE” IN INFORMATION TECHNOLOGY, SPECIALIZED MANUFACTURING, AND AGRIBUSINESS**

Sri Lanka has several islands of excellence in sectors that have the potential to grow further and contribute to exports earnings. There is manifest and latent comparative advantage in several sectors (see appendix C such as ICT (as demonstrated by artificial-intelligence-based KPO services), high-end agribusiness (trademarked specialty products), and light specialized manufacturing (with high value-added content such as high-end textiles or electronic sensors) that have driven growth in recent times and have the potential to drive it in the future. Common characteristics among these sectors are their knowledge intensity, high value addition, and the ability of the industries to drive innovation using Sri Lanka's strong assets. Sri Lanka can continue building on its endowment of unique natural and cultural assets, good location, and a well-educated work force.

**Sri Lanka's growth opportunities lie in leveraging its human capital, natural resources, and geographical location.** Given that there is an only a moderate domestic market in an economy of almost US\$90 billion, the country's growth prospects are closely tied to effective integration with the global economy. Innovation and high-value-added activities are key elements of any successful growth strategy. Given Sri Lanka's relatively small size, the provision of high-quality, high-precision, customized products and services characterized by high sustainability and labor standards are likely to yield high-quality jobs and poverty reduction. An export strategy should incorporate an entire value chain approach, with innovation as a lynchpin but also greater prioritization of logistics and global marketing and linkages. An integrative strategy that involves both imports and exports, as well as inward and outward investment, will be vital to build resilient cross-border relationships. In a challenging domestic and global environment, the demands of effective, innovative policy making and implementation are high to send consistent signals and clear a pathway for domestic and foreign investors to provide the impetus for a sustainable growth momentum in the medium-term.

**Post-COVID-19, it is assumed consumption patterns and the current supply chain models will change, possibly to higher value goods; now is the moment to review how Sri Lanka could adapt to these changes to facilitate recovery.**

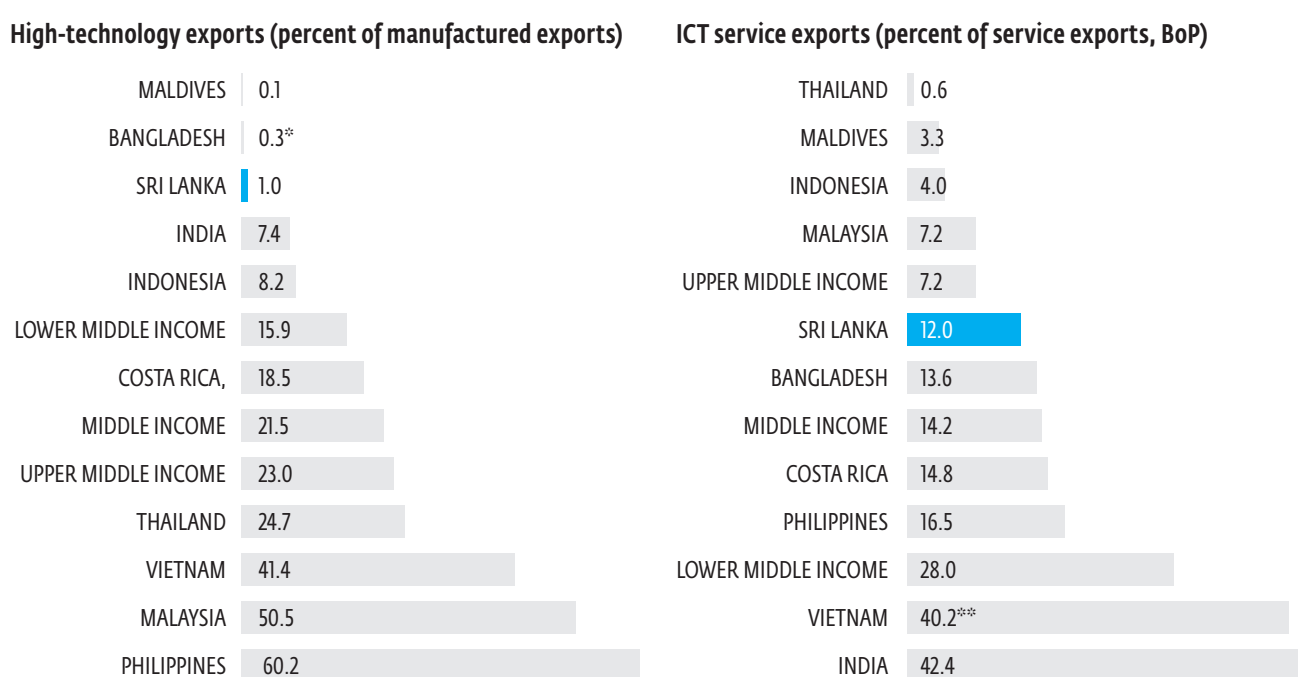
### **Strengthen the Innovation Ecosystem**

**A shared characteristic of most niche firms is their ability to adopt both technical and management innovations in their business models and successfully compete on international markets.** Innovation can be defined as the process of using, designing, developing, and successfully commercializing new or better products, processes, or services. In many instances, firms initially imported techniques and know-how from abroad and then further developed them in Sri Lanka. An important factor behind this ability is the availability of a skilled and semiskilled labor force in Sri Lanka, as discussed above, that has the capacity to internalize and adapt modern practices. This has happened organically and has been limited to the few successful niche players who have been driving innovation mostly internally and alone. A more systematic policy to support innovation would expand and systematize the diffusion of innovation throughout the economy.

### **Current policies in the sector**

**In 2018 Sri Lanka adopted its Innovation and Entrepreneurship Strategy 2018–2022** under the leadership of the then Ministry of Development Strategies and International Trade and with the involvement of significant private sector players (MAS and Dilmah among them). Drafting the strategy was supported by a World Bank project (World Bank, 2016b).

**Overall, the performance of Sri Lanka on several indicators of innovation remains well below that of comparator countries.** As discussed above, Sri Lanka's sophistication of export mix is below that of peers (except Bangladesh), even though Sri Lanka has improved its export complexity scores since 2005, climbing from a ranking of 89 to 75<sup>66</sup> (High-tech products accounted for just 1 percent of Sri Lanka's merchandise exports, a much lower share than comparator countries. For services exports, Sri Lanka is faring better, with ICT accounting for 12 percent of total services exports (Figure 3.1), but it has yet to reach the levels of some peers like India or Vietnam.

**FIGURE 3.1. TECHNOLOGY INTENSITY IN EXPORTS, 2017**

Source: World Development Indicators.

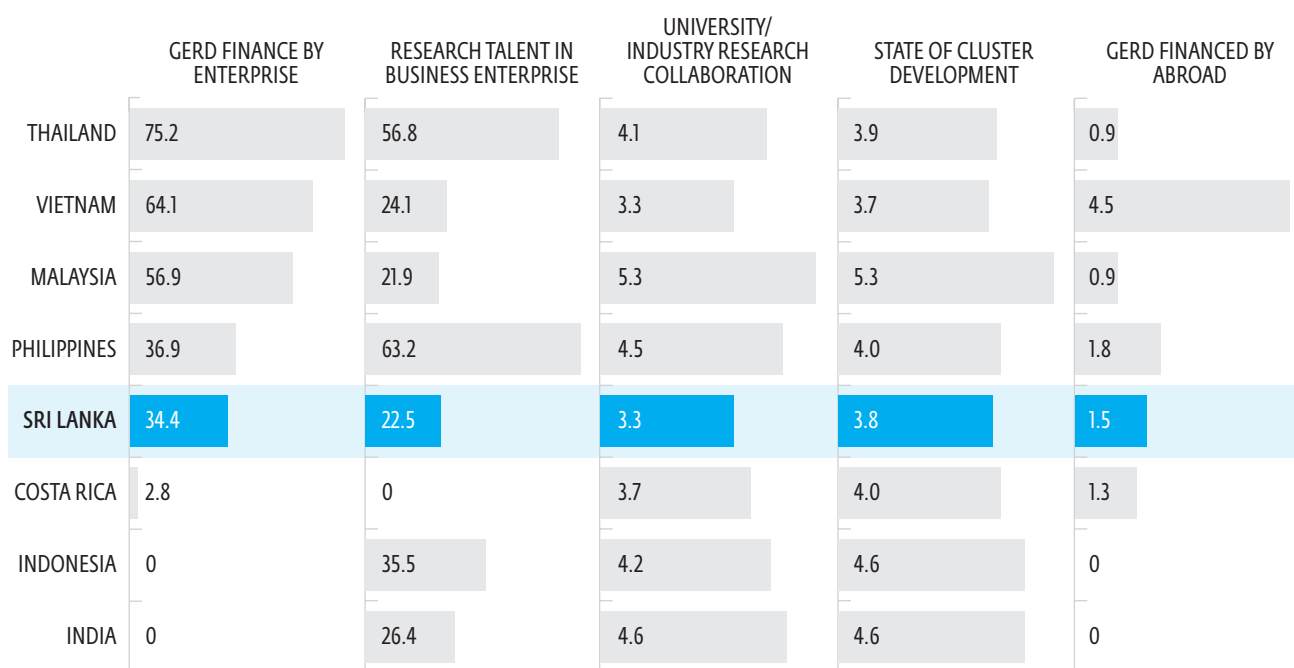
Note: \* 2015; \*\* 2018; BoP = balance of payments; ICT = information and communication technology.

Also, illustrative of a weaker innovation ecosystem are indicators of research and innovation that show that Sri Lankan firms use less R&D and fewer university advisory services and researchers than their peers. International innovation links also seemed relatively weak (far right column Figure 3.2). This correlates with low levels of FDI.

The relatively lower technological intensity of the economy is further reflected in low levels of investment into research: In 2018, Sri Lanka's investment in R&D was 0.13 percent of GDP—significantly lower than for other economies in the region, particularly in comparison with India (0.65 percent of GDP), Malaysia (1.0 percent of GDP), and Thailand (1.0 percent of GDP). Furthermore, the incidence of technology licensing and business R&D investment appears low compared with its peers, a problem that seemed to be even worse among SMEs in 2012 (World Bank, 2020). In addition, the allocation of this budget is not optimal (see constraints section). Sri Lanka's broader innovation ecosystem displays more gaps than its peers, with a low density of innovation staff (100 researchers per million against 216 in India, and 672 in Vietnam) and weak intellectual property protection. FDI-driven technology transfer is also weaker than its peers.



**FIGURE 3.2. SRI LANKAN FIRMS USE FEWER INNOVATION INPUTS**



Source: World Bank 2020a.

Note: GERD = gross domestic expenditure on research and development.

**Constraints and way forward**

**Skills gap.** Sri Lankan firms experience more challenges in finding qualified personnel than do firms in peer countries: The ICT industry estimates a gap of 15,000 specialists.<sup>67</sup> Interviews with innovative high-performing firms confirm that lack of access to qualified personnel slows their growth. For instance, a firm in the KPO sector servicing blue chip firms across the world mentioned that it could double its presence in Sri Lanka in about two years if only universities could produce more graduates. Several firms interviewed by the CPSD team have said they have established direct partnerships with leading universities such as Moratuwa, Sri Lanka Institute of Technology and Royal Institute of Colombo, to attract high-quality graduates but these are generally individual and ad hoc arrangements. Firms also highlight that universities produce graduates with skills that are not necessarily needed by the market and with the objective of serving in the public service. World Bank (2020) also notes that expenditure per student, tertiary enrollment, and inbound mobility in Sri Lanka remain lower than among peer countries.

**R&D spending.** A second important constraint relates to R&D spending. In Sri Lanka this is dominated by public spending, unlike developed economies where the private sector can account up to 50 percent. This suggests that incentives for the private sector to invest in innovation are not present. The amount and quality of government support for research and innovation is also lacking. The Innovation Diagnostic (World Bank 2016b), confirmed by the public expenditure review of R&D spending (World Bank 2020) finds the following shortcomings in Sri Lanka’s government interventions:



- The start-up environment is focused more on individual entrepreneurs and much less on accompanying growth (acceleration) of new firms (as discussed earlier in the section Financial Sector: Public Borrowing Crowds out SMEs).
- Support to R&D, which is overall low, is not demand driven and does not target firms. It also does not support firm innovation beyond R&D. Support to technology adoption and on promoting exports is weak.
- Fragmentation of efforts and lack of coordination remain despite considerable efforts in the past to improve coordination (through Ministry of Science and Technology). There are too many small programs across ministries, providing an opportunity to consolidate to create greater impact. Few resources are devoted to agencies' capacity building.
- Implementing the innovation and entrepreneurship strategy is slow. The National Innovation Agency, reporting to the president, was created in December 2019.<sup>68</sup> The agency will have the task of liaising with public and private institutions involved in innovation, monitoring and pursuing the development of the national innovation ecosystem, making recommendations to the government about national innovation programs, and broadly supporting the implementation of the innovation and entrepreneurship strategy.

**There are already many initiatives in Sri Lanka to support innovation and a strategy to go forward.** World Bank (2020) identifies 131 government programs related to innovation and entrepreneurship. A large share of the spending (68 percent) is concentrated on the top five programs which are: the Coordinating Secretariat for Science, Technology and Innovation, the Science and R&D division, the National Science Foundation, the National Enterprise Development Authority, and the National Research Council. While the programs are numerous, they are far from covering all bases, and thus there is scope to redirect some of the efforts toward experimenting with new approaches (World Bank 2020) to support direct financing (such as tax incentives or innovation vouchers) and reinforce the infrastructure and collaborative space for innovation involving the private sector (such as the Sri Lanka Institute for Nanotechnology, SLINTEC).

**Innovation is already seen as strategic in several leading industries in Sri Lanka**, often led by private sector efforts (John Keels, Dilmah, MAS Holdings, and so forth), as well as in public-private institutions (such as SLINTEC) and public ones (for example, Tea Research Institute, Coconut Research Institute, Rubber Research Institute).

**Some universities, like the University of Moratuwa (UOM) and the University of Colombo, despite the current constraints of the regulatory environment that limits faculty's ability to take part in private ventures (University Act and Circular 380) have managed to establish private sector-focused initiatives.** UOM's initiatives include UNI Consultancy Services, Electronic Research Laboratory (partnering with Zone 24\*7), SIL and UOM Rubber Products and Processes Development Incubator, and Dialog Mobile Communication Research Laboratory. Moreover, with support from the German government, the government initiated a University Business Linkages (UBL) program, now supported by the World Bank's Accelerating Higher Education Expansion and Development project (World Bank, 2017) targeting technology transfer for commercial applications with five universities (Moratuwa, Uva Wellasa, Southern Eastern, Eastern, and Jaffna). For instance, at the University of Jaffna, the UBL

program opens the use of university facilities (design, prototyping, manufacturing) to private firms. So far three companies have taken advantage of this new program: Swissranks, a Singapore company engineering solutions provider to the electronics and aviation industry; Senzmate, a Sri Lanka start-up offering IT based monitoring solutions to the agriculture and insurance sector; and BMI Holdings, a diversified business services provider.

**Fiscal challenges facing Sri Lanka going forward require a deep rethink of public support for research and innovation, starting with the implementation of the innovation strategy.** While raising the total spending on this important issue will be a challenge, fiscal consolidation may offer opportunities to redirect resources toward this crucial agenda. On the government policy level, the recommendations from World Bank (2016, 2020) suggest the following areas of focus:

- Promote the growth of private investment into R&D using instruments such as tax incentives, credit guarantees, and lending facilities that target innovative activities and sectors.
- Realign public policy to support more private innovation adoption and to focus less exclusively on R&D. Business advisory services such as in Colombia and technology extension services such as in India, as well as innovation vouchers and collaborative grants that encourage collaboration for innovation could be models.
- Realign public policy to reduce fragmentation and duplication of efforts. The newly created National Innovation Agency should be able to provide monitoring and evaluation of existing programs and advise on realignment if necessary, as well as advise about new public policies (discussed above).
- Build the capacity of innovation agencies to deliver programs more effectively. Coordination of agencies' work should also go toward building capacity.
- Support channels for better access of innovative firms to international markets, linking them to international sources of knowledge, but also to markets.

**At the sectoral level, initiatives and industry clusters following the SLINTEC model, with strong private sector involvement (linking also with local universities) and targeting industries where innovation adoption is critical and in which Sri Lanka has already developed capabilities (skills, successful firms) should be pursued to grow the national innovation ecosystem.** Sectors that could be targeted include IT (artificial intelligence, data science), the rubber derived products industry, and health and food products.

At the university level, solutions to strengthen links with the private sector concerning innovation could include the following initiatives (World Bank, 2016):

- New incentives for university–private sector collaboration using funding for joint university–private sector R&D projects and tax incentives for companies that contract education institutions for innovative projects
- Policies to encourage commercialization (international property rights, criteria for profit sharing, and revision of guidelines for undertaking R&D and consultancy work for university staff)
- Innovation spaces and incubators at the university level and resources (seed money, training) for universities to set up such spaces

## IT-Enabled Services

### Current sector performance

The IT-enabled services sector has grown by 120 percent over the past five years, thus recording one of the highest growth rates in the economy and becoming the fifth largest export segment. Network infrastructure levels are enough to meet existing demand levels and are considered better than many South Asian neighbors: Sri Lanka tends to outperform other Asian markets on connectivity (McKinsey, 2018). The national broadband network is continuing its expansion.

**Mobile network operations are dominated by several large and capable operators:** Dialog Axiata with 45.6 percent and Mobitel (Sri Lanka Telecom) with 25.1 percent, followed by Hutch (which merged with Etisalat) and Bharti Airtel with 19.8 percent and 9.6 percent respectively (FitchSolutions, 2019).<sup>69</sup> Lanka Bell, a wireless operator has also launched a 4G service. Sri Lanka has a maturing mobile market with the presence of several international investors (FitchSolutions, 2019), and all operators have launched 4G services. Mobile money is expected to take off. Mobile penetration in rural areas, however, could be improved.

**Leveraging an educated, English-speaking workforce, near universal connectivity and power supply, the ICT and business process outsourcing sector has seen an over 200 percent increase in export value from 2008 to 2017.** The industry currently employs 80,000 workers, with more than 300 IT companies. Exports amount to US\$1.2 billion. The industry's medium-term strategy envisages the sector becoming the top foreign exchange earner of the country by 2022, with US\$5 billion in revenue creating 200,000 direct jobs and 1,000 start-ups (Government of Sri Lanka, 2018c).

**The ICT-BPM (business process management) sector has been successful in leveraging Sri Lanka's (limited) pool of high-quality and low-cost software engineering talent; strong STEM skills; and technical expertise in legal, financial, and accountancy services.** Several Sri Lankan firms are leaders in IT and engineering services (Millenium IT, which provides software for the London Stock Exchange), analytics (Knowledge Process Outsourcing—Virtusa serves blue chip clients in the United States, such as Google, Amazon, and IBM) and BPM (WNS Global Services, serving clients such as Lloyds, M&T Bank, and IAG). BPM is the largest segment of the industry (an estimated 70 percent of total exports according to the government of Sri Lanka) and received investments from global providers of BPM services.<sup>70</sup> Leaders in the sector have expanded beyond Sri Lankan borders, seeking a global footprint and access to a pool of skilled labor in other countries to meet objectives of scale, complementarities in the offering of services (building on these markets' experience in specific segments of the business), or even language skills (such as Chinese).

**Even in sectors that are not traditionally IT focused, such as manufacturing, IT competencies are becoming a source of competitive advantage for some firms.** Some foreign investors in Sri Lanka are taking advantage of the quality of IT skills in the country to develop back-office services based in Sri Lanka for their international operations, thus contributing indirectly to the growth of IT services exports. In advanced manufacturing, IT-enabled manufacturing 4.0 is being adopted by firms in Sri Lanka (for instance in the textile and garment industry) and increases the demand on skilled STEM graduates in IT and engineering.

**A comprehensive export strategy for the ICT sector has been recently completed by the government (Government of Sri Lanka, 2018c).** It focuses on the following: a business-enabling (addressing issues such as labor and foreign exchange regulations), predictable, and transparent policy and regulatory framework (such as data and electronic transactions regulations); export growth through innovation and entrepreneurship (increase outreach to foreign markets); a supply of skilled professionals (improve linkages with universities and increase the presence of foreign universities); and a “champion builder program” (branding of Sri Lanka).

### **Constraints and way forward**

Robust growth has, however, been limited by several factors that prevent Sri Lanka from exploiting its full potential.

**The shortage of skilled professionals is the main constraint.**<sup>71</sup> All firms met with for this report confirmed this, and several of them declared that they could augment their capacity over the short term if they could find the relevant skilled professionals. For instance, a firm providing KPO services in the financial sector mentioned that it could probably double its Sri Lankan work force in the next two to three years if graduates were available. Sri Lanka Association for Software and Services companies SLASSCOM, the industry association, in its late 2018 survey, reported that the skills most in demand were artificial intelligence experts and data scientists. The demand for IT graduates is estimated at 15,000 per year when the government of Sri Lanka (2018c) reports that around 5,000 students graduate annually with IT diplomas, not counting graduates in technical and professional disciplines serving BPM industries (engineering, law, architecture). There are also some natural limits because of the size of Sri Lanka’s economy, which would tend to suggest that Sri Lanka’s comparative advantage should build on specialized IT business services that do not require significant scale to compete in the market.

**The regulatory environment has not been updated to follow the growth of the industry.** Firms have grown in some instances in a relative regulatory vacuum. A first area is the question of data protection and localization. Firms in Sri Lanka often operate with sensitive customer data. They have been able to do so by demonstrating to their clients that they could be trusted, but this cannot substitute for a strong regulatory environment. In addition, export markets may require compliance with local laws: for instance with the advent of the European Union’s General Data Protection Regulation, countries are starting to align their policies with the European Union’s—the government in Sri Lanka also started working on this. There is also an issue regarding the storage of data, for which firms in Sri Lanka generally use foreign servers—there is concern that a change in Sri Lankan laws on data localization may affect businesses. A second area where regulatory improvements are needed concerns laws governing digital transactions: the 2006 Electronic Transaction Act is not well implemented and needs to be updated. Finally, according to the government of Sri Lanka (2018c), the internet protocol regime is better than in neighboring countries and offers more security (firms interviewed for this report confirmed that they have no issues with the current regime), but registration is complicated, and firms are unaware of the protections it offers.

**Another regulatory issue affecting the sector is the question of access to backbone infrastructure and taxation.** SLT's position as the incumbent state-owned operator in the industry has given it a dominant role in the country's backbone network infrastructure. In 2016, the government chose SLT to be the infrastructure and service provider of the next phase of the Sri Lanka Government Network (SLGN 2.0). In June 2013, SLT was granted a formal license from the Telecommunication Regulatory Commission of Sri Lanka to build a national backbone network with wholesale access available equally to other operators in the country (World Bank 2020c; TeleGeography 2020): this gave SLT an implicit indication that it had an exclusive mandate to develop the country's fiber optic network. However, this is being challenged by Dialog, as the Telecommunication Regulatory Commission of Sri Lanka during their license renewal in 2014 allowed them last-mile access.<sup>72</sup> Moreover, the commission has not yet unbundled access to SLT's last-mile infrastructure, allowing the state-owned company to leverage its network to exclude value-added network services to competitors downstream in the value chain. Taxation of the sector is considered high and has substantially increased over the past decade. However, the telecommunication levy was reduced from 25 percent to 15 percent in 2018 and further reduced to 11.25 percent in 2020. Levies and charges on mobile telephony are an important source of fiscal revenue (GSMA 2018; TeleGeography 2020).

**Flexibility in contracting labor is an ongoing issue.** Sri Lanka's rigid labor laws are not in tune with IT-sector practices. Terminating a contract is difficult and requires prior notice. Laws also limit women from working after 10 pm. In addition, hiring expatriate labor is difficult because of complex procedures relating to workers' visas. The government of Sri Lanka (2018c) suggests adopting a specific visa regime such as the French Tech Visa. For short-term assignments it is often more expeditious for firms to ask foreign collaborators to come on a tourist visa. Participation in BOI programs offers a way to circumvent some of these rigidities.

**The business environment must be improved, particularly for start-ups.** Several laws contribute to a more costly business environment for start-ups (many being in the IT sector). Beyond the need for more incubation and especially acceleration (see section on finance), costs imposed by taxation (with issues of taxation for fledgling firms when they are not yet sustainable), foreign exchange regulations (which require setting up a foreign exchange account for earning and include rules regarding overseas share option programs when foreign investors invest in start-ups), and the absence of bankruptcy laws (which means that entrepreneurs are liable on their personal assets) are all issues that must be addressed.

**It is hard for the IT sector to find high-quality facilities.** Illustrative of the general challenge that investors face when in need of space to develop new activities, the IT sector is also subject to similar challenges as mentioned earlier. A recent example is HCL Technologies. It is an Indian company and global player now starting to operate in Sri Lanka and planning to create 1,500 jobs in the country. Initially HCL was looking for a space where it could develop a campus but had to temporally locate in offices before doing so.

**Industry-academic collaboration links need improvement.** As noted earlier in the broader context of education and innovation, the links between firms and universities need to be strengthened. Beyond nurturing and attracting top talent, this means that the education system needs to be more attuned to new demands of the IT growing industry and increasing the capacity to innovate and create value by strengthening links between research and commercialization will be central to the growth of the industry. These links should be improved as firms in Sri Lanka score only average in terms of digital maturity (De Bustis et al., 2018) and therefore there should also be positive spillovers for other sectors of the economy in deepening the IT ecosystem.

## Knowledge-Intensive and High-Quality Manufacturing and Agriculture

### Current sector performance

Globally competitive Sri Lanka-based firms have been highly successful in a set of niche products and markets. As mentioned earlier, the focus on specialized niche markets is directly related to the relatively small size of the Sri Lankan economy in general and its internal market.

Therefore, to counter these inherent limitations, Sri Lankan firms have focused on niche products and markets where they could achieve scale economies in local production and have generally relied on the openness of trade flows, both for access to external markets, as well as for access to inputs (often with support from facilities from the government). They have also invested abroad to achieve scale in production.

The niche sectors in Sri Lanka (see appendix B) include products in resourced-based sectors, (with varying degrees of value-addition, tea, rubber and coconut, cinnamon, and gems); complex apparel products and textile products with strong quality requirements (for the marine and aerospace sector); and electronic components with stringent quality requirements and customized solutions (sensors and cables for the auto and aerospace industries). Resource-led manufacturing activities in rubber and coconut products were initiated by national firms starting in the early 1970s, and foreign investors have followed in scaling up the sector. It should be noted, however, that foreign investment remains restricted in some agricultural sectors and coastal fishing (see the section “A Poor Investment Climate”). On the other hand, the large tea sector has focused on providing a single-origin high-quality loose-leaf black tea—with little value addition. In the apparel, textiles, and electronics manufacturing sectors, foreign investment has been critical, at least in the early development stages.

Factors of success common to all these sectors include Sri Lanka’s skilled and trainable workforce. In manufacturing and processing, these developments provide evidence of Sri Lanka succeeding in achieving scale in small-size products; meeting stringent quality standards; providing customized or small batch production; and tailoring “boutique” services for complex clients, new firms, small and medium firms, and clients that need continuous attention for constant innovation and upgrading. For this, niche sectors have relied on the following:

- An educated and comparatively cheap manufacturing labor force that is able to perform consistently to high standards, is English proficient, and learns well



- Educated managerial, technical, and professional talent (trained in Sri Lanka or abroad) that can adapt international practices to the unique circumstances of Sri Lanka or regional markets and liaise effectively with global counterparts
- Strong skills base in sectors such as accounting, law, and software development, supported by leading universities
- The ability to adopt and maintain production and services to international quality and customer standards (without necessarily government assistance)

Another factor of success is the ability to provide good operating conditions for foreign investors under BOI programs (including finding land) or more generally the willingness of government to facilitate the business environment for successful operators.

### **Resource-based manufacturing and high-value food products**

Sri Lanka's temperate climate, diverse topography, and rich biodiversity creates the basis for a potential comparative advantage in agriculture. The agribusiness sector consists of traditional plantation crops (tea, rubber, and coconut) geared toward exports, nontraditional export crops (spices, vegetables, nuts, fruits, oilseed), and fisheries. The large paddy sector is primarily for subsistence and domestic market purposes. The plantation sector has a mix of large companies and smallholders, whereas the rest of the sector is mostly smallholders. The sector has been characterized by a dualistic structure with high-quality exports and low-quality products catering to the local market.

The export agriculture and fisheries sectors boast high-value products, produced to high standards of quality, some of which have already generated a positive country brand image such as Ceylon tea and Ceylon cinnamon. Other products include pepper, cloves, cardamom, nutmeg, turmeric, areca nuts, crabs, lobsters, tuna, and sea cucumber (Johns Seafood, Jaysea Food Processing, Global Sea Foods). The country grows a range of bananas, but also exotic fruits such as pomegranates, mangos (Ellawala Horticulture), rambutans, avocados, and passion fruit on a small scale and currently not viable for export. However, when exporters have invested in certifications and good agricultural practices, the products have been successful and used by global firms (such as in the case of gherkins—pickled cucumbers—that are used by McDonalds). A recent success has been the export of strawberries mostly to India, but with some shipments to the Netherlands.

The sector also suffers from government restrictions on land availability for product diversification,<sup>73</sup> but also the government's dual role of supporting farmer income while protecting urban consumers from high prices. This has led to ad hoc protection, with tariff rates fluctuating during the year. There are also SOEs directly active in the sector (plantations and livestock). More important, the state is highly involved in distribution, being the sole importer of certain agricultural products.



### **Sophisticated manufacturing**

**Manufacturing in Sri Lanka accounted for 16 percent of GDP in 2018, with foods and beverages and textile and clothing representing about two-thirds of that value.** Sri Lankan manufacturing has witnessed several success stories in export markets and specialized manufacturing outside the traditional sectors, including for example, specialized rubber and tire products (Ansell, Global Rubber Industries), electric components (Orel), electronic components (TOS Lanka Co.), sensors for automobiles (Lanka Harness Co.), shipbuilding (Neil Fernando & Co.), textile-based products such as sails and harnesses (Amsafe Bridgeport, Future Fibres), and ceramics.<sup>74</sup>

**A common characteristic of the leaders in these industries is their high level of sophistication and product quality:** in the area of clothing, firms like Brandix, MAS (see Box 3.2), and Timex are major suppliers of specialized clothing; engineered textiles (parachutes) and harnesses for the aircraft industry and sensors for the automobile sector are produced to very high specification standards. Even in the food and consumer industries, which are more geared toward the domestic and regional markets, firms like Cargills, John Keells, and Hemas supply sophisticated products that are customized for the market.

**These successful pioneers offer a solid base upon which Sri Lanka's industry could build, targeting regional and new international markets.** While Sri Lanka offers affordable production costs, prices are not lower than competitors: across industries the value proposition of niche manufactured products relies on the ability to produce consistently at standard levels and maintain trust-based customer relations. An important factor in this success is the quality of the workforce, since many of these products require some degree of manual labor or human intervention. Niche pioneers have built on this comparative advantage and further invested in intangible assets and process innovation to be able to move into value-added segments of the supply chain. They have also benefited from favorable conditions provided by the government: duty-free access to inputs through special programs,<sup>75</sup> access to special economic zones (managed by the BOI) that have granted access to land and better-quality infrastructure, and accelerated procedures, such as border clearance (Box 3.2).

### **Constraints and way forward**

**If many of these successes illustrate Sri Lanka's capacity to compete globally, they also tend to be singular, the product of the vision of individual entrepreneurs and investors, rather than the outcome of an integrated growth strategy.** Most of these niche sectors have little in common and therefore there are few real industrial clusters in Sri Lanka, with the exception of perhaps the garment industry. To a lesser extent the natural resource-based sectors also exhibit cluster characteristics, but with seemingly relatively low economies of scope between them and no real ecosystem (including subcontractors, and so forth) around them. This is one aspect that the government has identified, with the new BOI strategy aiming to target five broad sectors<sup>76</sup> and supporting the emergence of industry clusters such as in the rubber and apparel sector,<sup>77</sup> while also addressing the challenges with availability of industrial land for new investors by seeking new special economic zone spaces. The extension of BOI zones is desirable in the short-term given the lack of space in current zones, their

concentration around Colombo, and the general difficulty in dealing with the business environment. However, without the development of clusters and the diffusion of good practices permitted under BOI programs, in the medium- to long-term, private sector successes will remain confined to relatively isolated examples. BOI-type enclaves cannot be scaled up forever and only fit relatively large investments—they do not benefit MSMEs and special regimes open the possibility of rent seeking.

**Innovation.** Successful niche firms share an ability to spur innovation in-house, but this does not generate much spillover for the rest of the economy or opportunities for additional investments. This is an area where the government innovation strategy could contribute to creating the condition for increased innovation capacity and diffusion.

**Standards and quality infrastructure.** While this report has already highlighted the importance of skills and labor as another fundamental pillar in the success of niche firms, a holistic approach to quality infrastructure systems at the national level should also contribute to the dissemination and scaling up of best practices observed in niche industries. An assessment of Sri Lanka’s national quality infrastructure (NQI) and whether it would need to be upgraded is beyond the scope of this report, but it seems apparent that NQI dimensions are not necessarily systematically considered alongside other elements behind the success of firms: innovation and quality of the labor force. The government developed a National Quality Infrastructure Strategy 2018–2022 (Government of Sri Lanka, 2018d), building on an assessment carried out by the World Bank (2017). The strategy foresees the creation of an apex body with a National Quality Council to address, among other items, coordination issues identified in the strategy and to focus on key priorities and sectors. Other policy issues include some regulatory gaps (outdated legislation), the lack of a centralized system to keep track of regulations and their implementation, and the need to implement regulatory impact analysis. The strategy also identifies the need to augment staff capacity in standards institutions and raise awareness of standard compliance with the private sector.

Among the operational objectives of the strategy is the establishment of standardization committees and units for key sectors—with respect to the niche sectors discussed here, these committees should also aim to build on and diffuse good practices achieved by leading firms, in close collaboration of course with the private sector, but also academia: there is strong evidence of sources of comparative advantage there for Sri Lanka.

While innovation is a critical component of export competitiveness, a successful export strategy needs to incorporate the entire value chain. Key new factors that have emerged are the required improvements in logistics and international market linkages.

**Logistics and internal transport infrastructure.** Innovative logistics have become an integral component of competitiveness of global firms, and the limitations of Sri Lanka’s transport and logistics infrastructure capabilities were made stark in the context of the COVID-19 pandemic. Warehousing, cold chain logistics, and highway development are vital not only for export development overall, but also for greater inclusion of the provinces in the benefits of international trade.

**Global marketing.** In the absence of FDI, establishing effective marketing channels and nurturing customer relations are vital. In traditional sectors like tea and cinnamon, firms need to move beyond reliance on government promotional activities on country brand image and build firm level branding, as in the case of Dilmah Tea. National level branding also needs to be more innovative, using the new tools of marketing such as bloggers, vloggers, product placement, and other innovative channels. Nurturing resilient cross-border business relationships may also involve setting up offices abroad. Further, high profit margins and greater customer orientation may be achieved through outward distribution (wholesale and retail) investments abroad.

**International linkages in the context of global and regional value chains.** An effective export strategy may involve both imports and outward FDI. To benefit from innovative strategies of global lead firms, Sri Lankan firms need to meet scale and scope requirements of global buyers. Once trust is established with international partners, they have proved to be a great source of product diversification. Thus, outward investment might be needed to meet such scale and scope requirements (as in the case of successful apparel exporters). Imports may also be needed to provide a variety of products to a global buyer—such as if buyers who trust the quality of Sri Lankan manufacturers want both rubber (latex) gloves and synthetic (nitrile) gloves.

# REFERENCES

---

Advocata Institute. 2019. *The State of State Enterprises in Sri Lanka—2019: Systemic Misgovernance: A Discussion*. Colombo, Sri Lanka: Advocata Institute.

Arrobbio, Alexandre, Saw Young Min, and Immanuel Steinhilper. 2017. *Corporate Governance of State-owned Enterprises in South Asia: A Regional Stocktaking*. Washington, DC: World Bank.

ADB (Asian Development Bank). 2017a. *The Sri Lankan Economy: Charting a New Course*, Manila: Asian Development Bank.

ADB (Asian Development Bank). 2017b. *Sri Lanka: Fostering Workforce Skills through Education* (Employment Diagnostic Study). Manila: Asian Development Bank.

Billar, D., and I. Nabi. 2013. *Investing in Infrastructure: Harnessing Its Potential for Growth in Sri Lanka*. Washington, DC: World Bank.

Central Bank of Sri Lanka. 2018. *Annual Report*.

Department of Census and Statistics. 2015. *Final Report for Formal Industries*. Department of Census and Statistics, Ministry of National Policies and Economic Affairs, Sri Lanka

De Bustis, A., V. Ganesan, and G. Heath, 2018. *Unlocking Sri Lanka's Digital Opportunity*, McKinsey & Company.

Dundar, H., B. Millot, M. Riboud, M. Shojo, H. Aturupane, S. Goyal, and D. Raju. 2017. *Sri Lanka Education Sector Assessment: Achievements, Challenges and Policy Options*. Directions in Development Series, Human Development. Washington, DC: World Bank.

FitchSolutions. 2019. *Sri Lanka Telecommunications Report: Q4 2019*.

Gajanayaka, H.R. and M.R.S. Mudunkotuwa. 2015. *A Study of Developing Colombo Port As a Major Multi Country Consolidation (MCC) Hub in South East Asia Region With the Help of Improving the Effectiveness of The MCC Activities*, Proceedings of 8th International Research Conference, KDU.

Government of Sri Lanka. 2018a. *National Export Strategy of Sri Lanka 2018–2022*.

Government of Sri Lanka. 2018b. *Innovation and Entrepreneurship Strategy of Sri Lanka 2018–2022: Building a Prosperous Sri Lanka Together: A Resilient and Innovative Economy with Export Competitiveness; and an Entrepreneurial Society with Better Jobs*.

Government of Sri Lanka. 2018c. *National Export Strategy: Information Technology Strategy 2018–2022*.

Government of Sri Lanka. 2018d. *National Quality Infrastructure Strategy of Sri Lanka 2018–2022*.

Government of Sri Lanka. 2018e. *National Export Strategy: Logistics Strategy 2018–2022*.

GSMA. 2018. *Reforming Mobile Sector Taxation in Sri Lanka: Promoting Growth in the Sri Lankan Mobile Sector and Wider Economy through a More Efficient Tax System*. London: GSMA Association.

IFC. (International Finance Corporation). 2018. *Sri Lanka: The Paradise Paradox: IFC Country Strategy 2017–2021*.

IFC (International Finance Corporation). 2019. *Creating Markets in Indonesia: Country Private Sector Diagnostic. Unlocking the Dynamism of the Private Sector*. Washington, DC: IFC.

IFC. International Finance Corporation). 2020. *Creating Markets in Myanmar: Country Private Sector Diagnostic. Building Markets for a Sustainable Economy*. Washington, DC: IFC.

IMF. 2018. 2018 Article IV Consultation and the Fourth Review Under the Extended Arrangement Under the Extended Fund Facility. Washington DC: IMF

ILO (International Labour Organization). 2015. “The Skills Gap in Four Industrial Sectors in Sri Lanka.” ILO, Geneva.

Japan External Trade Organization (JETRO). (2018). JETRO Survey on Business Conditions of Japanese Companies in Asia and Oceania

Kazmin, Amy. 2019. “Sri Lanka’s New Government Poised to Slash VAT Rate.” *Financial Times*, November 27. <https://www.ft.com/content/2848219a-1122-11ea-a7e6-62bf4f9e548a>.

Kathuria, S., and R. A. Yatawara. 2020. *Regional Investment Pioneers: The Payoff of Knowing Your Neighbors in South Asia*. Washington, DC, and Colombo, Sri Lanka: World Bank.

McKinsey. (2018). Unlocking Sri Lanka’s digital opportunity

Millennium Challenge Corporation. 2017. “Sri Lanka Constraints Analysis Report.” MCC, Washington, DC.

Noor S., T. O’Brien, and D. Stock. 2018. “Can Industrial Zones Address the Binding Constraints to Sri Lanka’s Growth?” Harvard Center for International Development, Cambridge, MA.

Organisation for Economic Co-operation and Development (OECD). (2017) *The Size and Sectoral Distribution of State-Owned Enterprises*, OECD Publishing, Paris,

Pitigala, N., and P. Singh. 2020. “Impact of Para-tariffs in Sri Lanka: The Case for Improved Transparency in Border Taxes.” Working paper.

TeleGeography. 2020. GlobalComms Database: Sri Lanka.

USAID (United States Agency for International Development. 2017. *Report on Sri Lanka's Current PPP Environment and Recommendations for Future PPP Strategy*. Report LPFM-16–038, prepared under the Leadership in Public Financial Management II (LPFM II). Washington, DC: USAID.

Wignaraja, G., D. Panditaratne, P. Kannangara, and D. Hundlani. 2020. "Chinese Investment and the BRI in Sri Lanka." Research paper, Chatham House, London.

World Bank. 2016a. *Sri Lanka, Ending Poverty and Promoting Shared Prosperity: A Systematic Country Diagnostic*. Washington, DC: World Bank.

World Bank. 2016b. *Sri Lanka Innovation and Entrepreneurship Diagnostic*. Washington, DC: World Bank.

World Bank. 2016c. *Sri Lanka PPP Diagnostic Note: Accelerating Infrastructure Investment through PPPs*. Washington, DC: World Bank.

World Bank. 2016d. *Democratic Socialist Republic of Sri Lanka Development of Domestic Airports—PPP: Options Study for Private Sector Participation in the Development of the Domestic Airport Sector in Sri Lanka*. Report ACS18616. Washington, DC: World Bank.

World Bank. 2016e. *Enhancing Competitiveness in Sri Lanka*. Washington, DC: World Bank.

World Bank. 2017. *Program Appraisal Document on a Proposed Loan in the Amount of US\$67 Million and Proposed Credit in the Amount of SDR 24.4 Million (US\$33 Million Equivalent) to the Democratic Socialist Republic of Sri Lanka for an Accelerating Higher Education Expansion And Development Operation*. Report PAD2183. Washington, DC: World Bank.

World Bank. 2017a. *Project Appraisal Document on a Proposed Credit in the Amount of SDR 55.4 Million (US\$75 Million Equivalent) to the Democratic Socialist Republic of Sri Lanka for a Sri Lanka Financial Sector Modernization Project*. Report PAD2082. Washington, DC: World Bank.

World Bank. 2017b. *Sri Lanka Education Sector Assessment Achievements, Challenges, and Policy Options*. Washington, DC: World Bank

World Bank. 2019a. *Sri Lanka Jobs Diagnostic*. Washington, DC: World Bank.

World Bank. 2019b. "Sri Lanka Human Capital Development: Realizing the Promise and Potential of Human Capital." World Bank, Washington, DC.

World Bank. 2019c. "South Asia Economic Focus, Spring 2019: Exports Wanted." World Bank, Washington, DC, April.

World Bank. 2019d. *Succeeding in Difficult Conditions: Lessons from National Champions*. Washington, DC: World Bank.

World Bank. 2019e. "Tourist Demand and Supply Assessment in Sri Lanka." World Bank, Washington, DC.

World Bank. 2019f. *Sri Lanka Energy InfraSAP: Final Report*. Report No: AUS0000803. Washington, DC: World Bank. <https://www.bioenergysrilanka.lk/wp-content/uploads/2020/01/Sri-Lanka-Energy-Infrastructure-Sector-Assessment-Program-Executive-Summary.pdf>.

World Bank. 2019g. "Framework Development and Infrastructure Financing to Support Public-Private Partnerships Projects." Project Appraisal Document Report 138145-LK, World Bank, Washington, DC.

World Bank. 2019h. *Program Appraisal Document on a Proposed Loan in the Amount of US\$25 Million to the Democratic Socialist Republic of Sri Lanka for a Public Sector Efficiency Strengthening project*. Report PAD2903. Washington, DC: World Bank.

World Bank. 2020a. "Sri Lanka Policy Expenditure Review on Business Innovation Programs, Australia-World Bank Partnership." World Bank, Washington, DC.

World Bank. 2020b. "Sri Lanka Logistics: Opportunities for Improved Resilience and Efficiency in the Domestic Supply Chain." Unpublished document. World Bank, Washington, DC.

World Bank. 2020c. "Integrated State-Owned Enterprises Framework iSOEF: Sri Lanka." Unpublished document. World Bank, Washington, DC.



# APPENDIX

## APPENDIX A. WORLD BANK LENDING AND IFC INVESTMENT PORTFOLIOS

### WORLD BANK PORTFOLIO AS OF OCTOBER 2020

ID	SHORT NAME	PRACTICE AREA (LEAD)	PRODUCT LINE	NET COMMITMENT (US\$, MILLIONS)	APPROVAL FY	CLOSING FY
<b>LENDING</b>						
P163742	Climate Smart Irrigated Agriculture	Agriculture and Food	IBRD/IDA	125.0	2019	2024
P156019	Agriculture Sector Modernization	Agriculture and Food	IBRD/IDA	125.0	2016	2022
P163714	General Education Modernization Project	Education	IBRD/IDA	100.0	2018	2024
P159995	Accelerate Higher Education Development	Education	IBRD/IDA	100.0	2017	2023
P151916	Early Childhood Development Project	Education	IBRD/IDA	50.0	2015	2021
P156021	Ecosystem Conservation and Management	Environment, Natural Resources & the Blue Economy	IBRD/IDA	45.0	2016	2021
P159303	Sri Lanka Financial Sector Modernization	Finance, Competitiveness and Innovation	IBRD/IDA	75.0	2017	2023
P174291	Sri Lanka COVID-19 Emergency Response AF	Health, Nutrition & Population	IBRD/IDA	87.2	2020	
P173867	Sri Lanka COVID-19 Emergency Response	Health, Nutrition & Population	IBRD/IDA	128.6	2020	2024
P163721	Sri Lanka: PSSP	Health, Nutrition & Population	IBRD/IDA	200.0	2018	2024
P156056	LK-Social Safety Nets Project	Social Protection & Jobs	IBRD/IDA	75.0	2017	2022
P172342	KMTT	Transport	IBRD/IDA	69.3	2020	2025
P132833	Transport Sector Project	Transport	IBRD/IDA	125.0	2016	2023
P160005	CRes MPA	Urban, Resilience and Land	IBRD/IDA	310.0	2019	2025

ID	SHORT NAME	PRACTICE AREA (LEAD)	PRODUCT LINE	NET COMMITMENT (US\$, MILLIONS)	APPROVAL FY	CLOSING FY
P163305	Local Development Support Project	Urban, Resilience and Land	IBRD/IDA	70.0	2019	2023
P157427	SCDP - Additional Financing	Urban, Resilience and Land	IBRD/IDA	55.0	2016	
P157392	Climate Resilience Additional Financing	Urban, Resilience and Land	IBRD/IDA	42.0	2016	
P130548	Sri Lanka Strategic Cities Dev Project	Urban, Resilience and Land	IBRD/IDA	147.0	2014	2022
P146314	Improving Climate Resilience	Urban, Resilience and Land	IBRD/IDA	110.0	2014	2021
P122735	LK: Metro Colombo Urban Development	Urban, Resilience and Land	IBRD/IDA	213.0	2012	2022
P166865	SL-IWWRMP	Water	IBRD/IDA	69.5	2020	2026
P147827	LK Water and Sanitation Improvement Proj	Water	IBRD/IDA	165.0	2015	2021
P148595	LK: AF Dam Safety WRP - Addl Fin.	Water	IBRD/IDA	83.0	2014	

## IFC PORTFOLIO AS OF OCTOBER 2020

CLIENT	COMMITTED EXPOSURE (US\$, MILLIONS)
<b>FIG</b>	
CBC	152.9
NTB SriLanka	36.4
NDB Sri Lanka	19.4
SANASA Development Bank PLC	11.1
Senkadagala Fina	7.9
Central Finance	7.9
NDB	6.0
Alliance Finance	2.0
<b>FIG: Trade Finance</b>	
CBC	25.2
Sampath Bank	16.3
NDB Sri Lanka	5.0
<b>MAS</b>	
John Keells Hold	125.0
RP Distributors	4.8
<b>CDF</b>	
Emerald SriLanka	8.5
PickMe	4.8
<b>INR</b>	
Fairway Waste Management	6.7
Senok WindEnergy	1.6
<b>Total</b>	<b>441.6</b>

## APPENDIX B—SOE PRESENCE IN THE ECONOMY, BY MARKET SHARE

SECTOR/MARKET	MAIN SOES	SOE MARKET SHARE	PRESENCE OF PRIVATE SECTOR	PRIVATE SECTOR POTENTIAL
<b>Petroleum supply and distribution</b>	Ceylon Petroleum Corporation	82% in fuel retailing	Y	Y
<b>LPG production, transmission, and distribution</b>	Litro Gas Lanka	70% of LPG downstream	Y	Y
<b>Electricity generation</b>	Ceylon Electricity Board	70%	Y	Y
<b>Port Infrastructure</b>	Sri Lanka Ports Authority	100%	Y	Y
<b>Air transport infrastructure</b>	Airport & Aviation Services	100%	N	Y
<b>Air transport passengers</b>	Sri Lankan Airlines	100% for international routes	N	Y
<b>Electricity transmission</b>	Ceylon Electricity Board	100%	N (legal monopoly)	Y
<b>Bulk supply water transmission and distribution</b>	National Water Supply & Drainage Board	100%	N (legal monopoly)	Y
<b>Mining—phosphate</b>	Lanka Phosphate	100%	N	Y
<b>Production of sugar</b>	Lanka Sugar Company	100%	N (production) Y (imports)	Y
<b>Electricity distribution</b>	Ceylon Electricity Board	88%	N	Y
	Lanka Electricity Company	12%		
<b>National lotteries</b>	National Lotteries Board	57%	N	Y
	Development Lotteries Board	43%		
<b>Bus transportation</b>	Sri Lanka Transport Board	40% in urban areas and 60% in rural areas	Y	Y
<b>Pharmaceutical manufacturing</b>	State Pharmaceuticals Manufacturing Corporation	40%–50%	Y	Y
<b>Telecommunications—fixed wired services</b>	Sri Lanka telecom group	44%	Y	Y
<b>Dairy processing</b>	Milk Industries of Lanka Company	40%	Y	Y

SECTOR/MARKET	MAIN SOES	SOE MARKET SHARE	PRESENCE OF PRIVATE SECTOR	PRIVATE SECTOR POTENTIAL
<b>Banking and finance</b>		39% (total share)	Y	Y
	Bank of Ceylon	16%		
	People's Bank	12%		
	National Savings Bank	8%		
<b>Insurance</b>		38% (total share)	Y	Y
	Sri Lanka Insurance Corporation	34%		
<b>Port operations</b>	Sri Lanka Ports Authority	37% at the Colombo port and 15% at the Hambantota port	Y	Y
<b>Telecommunications—mobile services</b>	Sri Lanka Telecom Group	25%	Y	Y
<b>Retail supermarket</b>	Sathosa	25% of modern retail trade	Y	Y
<b>Mining—graphite</b>	Kahatagaha graphite	15% of graphite mining	Y	Y
<b>Television broadcasting</b>	Independent Television Network	9%	Y	Y
	Sri Lanka Rupavahini Corporation	8%	Y	Y
<b>Radio broadcasting</b>	Sri Lanka Broadcasting Corporation	5%	Y	Y
<b>Mining—mineral sands</b>	Lanka Mineral Sands	N/A	Y	Y
<b>Construction</b>	State Engineering Corporation	N/A	Y	Y
	Central Engineering Consultancy	N/A		
<b>Hospitality</b>	Hotel Developers	N/A	Y	Y
	Canwill Holdings	N/A		
<b>Healthcare services</b>	Sri Jayawardenapura general hospital	N/A	Y	Y
<b>Education</b>	Post Graduate Institute of Management; National Institute of Business Management	N/A	Y	Y

Source: World Bank 2020c.

Note: N/A = not available; LPG = liquefied petroleum gas; N = no; SOE = state-owned enterprise; Y = yes.

## APPENDIX C—ISLANDS OF EXCELLENCE

KEY ICT SECTORS IN SRI LANKA <sup>a</sup>			
SEGMENT	STRENGTHS	EXAMPLES OF MARKET LEADERS IN SRI LANKA	MARKET SERVED
IT software R&D, application development, application management, IT solutions (including engineering) and consulting	Strong ICT trained workforce Pioneer universities (esp. University of Moratuwa)	Millenium IT bought by London Stock Exchange Group (LSEG) in 2009. SimCentric (battle training software developer) Cakelabs Codegen (travel software)	United States; United Kingdom; European Union; and regional emerging markets including Bangladesh, Cambodia, and Myanmar New: Australia, Japan, Scandinavia
Knowledge process outsourcing: big data, artificial intelligence, IT integration, legal process outsourcing, financial analytics, market intelligence	Strong STEM skills base and expatriate community English language	Virtusa WSO2 Acuity Knowledge Providers (former Moodys Analytics),	United Kingdom, United States, Hong Kong SAR, Australia, Singapore, Luxembourg, Ireland, Africa, Asia-Pacific New: Norway, New Zealand, Canada, Japan, Middle East
Business process management in banking, financial and other services	Largest number of trained accountants after United Kingdom. Educated workforce. Ability to handle complex tasks Ability to handle demanding clients/innovating clients. English language.	WNS Global Global anchor investors: Accenture, McKinsey, HSBC	United Kingdom, United States, Japan, Asia-Pacific New: Africa, Canada, New Zealand,

a. See <https://islandofingenuity.com/>.

RESOURCE- BASED INDUSTRIES			
SEGMENT	SECTOR	STRENGTHS	CONSTRAINTS
Solid rubber tires for heavy equipment	Rubber-based products	Natural rubber producer 25% of global production. Presence of global anchor investor: Camso-Loadstar (Michelin since 2019) Ability to produce to client specifications	Quantity of rubber (in part imported) Cost of finance Skills Small scale (mitigated by customization)
Surgical and household rubber gloves	Rubber-based products	Natural rubber producer Local pioneer Dipped Products (1973) Entry of global anchor investor Ansell* Lanka in 2014	Quantity of rubber
Industrial safety work gloves for example, construction	Rubber-apparel	Natural rubber/ apparel sector Presence of anchor investor, Ansell*	
Activated Carbon Used for air purification (personal masks and air filters) and water treatment.	Coconut-based products	Local pioneer -Haycarb (1976). Global anchor investor Jacobi Carbons (market leader) enters in 2007.	Coconut supply
Desiccated coconut and coconut water	Coconut-based products	Pioneer firms (Silver Mill) Third largest exporter after Philippines and Indonesia	Demand for coconut based products is growing (for example, coconut water) Demand for other coconut kernel products is diminishing (for example, coir)
Blue sapphires and semi-precious stones	Gems	Source of the world's largest blue sapphire Exports of gems have been growing fast since 2010 multiplied by more than 10 times and SL has been successful at partially integrating the value chain with cutting and polishing and has an emerging jewelry industry (with modest exports). Gem-mining -small players	Need to develop exploitation of new gem deposits Building on cutting and polishing skills.



HIGH-VALUE FOOD PRODUCTS			
SEGMENT	SECTOR	STRENGTHS	CONSTRAINTS
Single-origin Tea	Tea	<p>Second largest tea exporter in the world. Focus on high quality black tea-loose leaf. Mature country brand image “Ceylon Tea.”</p> <p>Orthodox methods like Darjeeling teas.</p> <p>Large private sector players in management and ownership.</p>	<p>Growth in tea blending and reduced demand for single estate teas.</p> <p>Increased global demand for lower quality tea and tea bags.</p> <p>Lack of value -added activities.</p>
Cinnamon	Spices	<p>World’s largest exporter of ‘true cinnamon’. Hand-crafted in rolls.</p> <p>Boosted by the establishment of a separate customs code 09061900 for Cinnamomum Zeylanicum, which differentiates it from cassia from China, Vietnam and Indonesia.</p> <p>Smallholders</p>	<p>Quality certification infrastructure</p> <p>Marketing and firm branding.</p> <p>Lack of labor with traditional knowledge</p>
Fisheries	Tuna, crab	<p>Exports of sushi-grade tuna to Japan and European markets.</p> <p>Strong customer relations.</p> <p>Sustainable practices including line fishing (tuna), meets MSC and other standards.</p> <p>Recent upgrading of regulatory practices in context of EU GSP+ preferences.</p> <p>Quality certification (HACPP, ISO)</p> <p>Diversification into new products (shrimp, seaweed)</p>	<p>Aging fleet.</p> <p>Incursions from Indian fisherfolk using unsustainable fishing methods into Sri Lanka waters.</p>

### COMPLEX APPARELS AND ENGINEERING TEXTILES WITH STRINGENT QUALITY REQUIREMENTS

NICHE PRODUCT	SECTOR	STRENGTHS	CONSTRAINTS
Complex garments for example, brassieres.	Apparel	<p>Produces about half of Victoria's Secret production.</p> <p>Deep relationships with Victoria's Secret, Triumph International</p> <p>Highly innovative—strong relationships with Nike</p> <p>Highly trainable workforce -'advanced' low skill</p> <p>Professionals with strong supply chain management skills (bras contain up to 50 components)</p> <p>High agility—switch to production of anti-viral cloth masks in COVID-19 context</p>	<p>Scale</p> <p>Skills in branding</p> <p>Research</p>
Sails, paraglider, parachutes; harnesses, cable braiding, carbon fiber masts (spars) related to sailing.	Engineering textiles and cables	<p>Highly trainable workforce. Adhere to stringent aerospace quality standards.</p> <p>Other inputs imported.</p> <p>Presence of global anchor investors: North Technology Group (Future Fibers, North Sails, South Spars)</p>	Smooth operations
Cargo pallet nets and transport handling products. Cables (HS560819)	Engineering textiles and cables	<p>Highly trainable workforce -medium skill</p> <p>Adhere to stringent quality standards (aviation)</p> <p>Presence of global anchor investor: Amsafe-Bridegport*-UK</p> <p>Inputs imported. No links to apparel</p>	Smooth operations -recently expanded

### HIGH-TECH ELECTRONIC COMPONENTS WITH STRINGENT QUALITY REQUIREMENTS

NICHE PRODUCT	SECTOR	STRENGTHS	CONSTRAINTS
Sensors for airbags and seat belts, precision weight measurement	Electronics Auto/ Aerospace/ precision	<p>Highly trainable workforce.</p> <p>First tier auto parts supplier for Toyota-Lanka Harness</p> <p>Aero Sense*UK/US- sensors for aerospace;</p> <p>Flintec*-sensors for precision weight technologies -Sweden</p>	Labor supply
Cable assemblies for industry, aviation and defense	Electronics	<p>Highly trainable workforce.</p> <p>Variosystems *Switzerland</p>	

Sources: CPSD interviews and industry scans; Government of Sri Lanka various export strategies from 2018.

# NOTES

---

- 1 Sri Lanka's credit rating was downgraded by S&P (to 'Selective Default') 'Fitch (to 'C') and Moody's (to 'Cd') after authorities announced suspension of interest and principle repayments in foreign currency.
- 2 The successive national lockdowns affected not only tourism but also domestic consumption.
- 3 The aspirational comparators chosen were Costa Rica, Malaysia, and Thailand. These upper-middle income countries have more diversified economies and have been able to upgrade to higher-value-added products. Additionally, some—such as Costa Rica, Malaysia, and Thailand—have a thriving tourism industry. They also share Sri Lanka's demographic challenges of a fast-aging population.
- 4 Central Bank of Sri Lanka, March 2020, [https://www.cbsl.gov.lk/sites/default/files/cbslweb\\_documents/statistics/mbt/Monthly\\_Bulletin\\_March\\_2020\\_e.pdf](https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/statistics/mbt/Monthly_Bulletin_March_2020_e.pdf) shekhar ai
- 5 Trade openness is the ratio of imports and exports of goods and services to GDP.
- 6 The Parliamentary Committee on Public Enterprises identifies six categories of institutions that fall under its oversight: regulatory bodies, promotional agencies, state-owned enterprises, educational agencies, development agencies and research institutions. Overall, there are 527 institutions that fall under this definition. Regular monitoring and reporting is carried out by the Ministry of Finance for 55 larger SOEs but in effect it is done only for a fraction of them (Advocata 2019).
- 7 OECD dataset on the size and composition of national state-owned enterprise sectors
- 8 Segments where medium firms dominate are food products, textiles, paper, printing, pharmaceuticals, basic metals, fabricated metal products, machinery, and motor vehicles.
- 9 Sri Lanka also suffered multiple credit ratings downgrade by global rating agencies in late 2021 / early 22 because of their assessment of the country's debt repayment capacity
- 10 Includes estimated current account and external debt and interest payments
- 11 See also Millennium Challenge Corporation (2017).
- 12 In 2002, Lanka Marine Services and in 2003 Sri Lanka Insurance Corporation were privatized with the government selling a majority stake. However, following a complaint by the Committee on Public Enterprises that the privatization process was carried out in a corrupt manner, these two transactions were investigated by the Supreme Court of Sri Lanka. Subsequently, between 2008 and 2009, the Supreme Court reversed both divestitures and ordered that the enterprises be reverted to state ownership. On the privatization of Lanka Marine Services, the judgment stated that it was "done without lawful authority" for the benefit of a private holding company (ADB 2017).
- 13 Millennium Challenge Corporation (2017) notes the overall success of special economic zones but also the fact that many are at capacity and not fulfilling the demand for streamlined environments.
- 14 For example, much of land is mandated to be used for rice production, even though Sri Lanka does not have a comparative advantage in the production of rice.
- 15 A recent study by Pitigala and Singh (2020), using partial and general equilibrium modeling, shows that the phased reduction of para-tariffs and unification with existing customs tariff structures could boost domestic production, promote exports, and raise employment and GDP, all while simplifying tariff administration.
- 16 "Vienna Tops Mercer's 21st Quality of Living Ranking," Mercer, March 13, 2019, <https://www.mercer.com/newsroom/2019-quality-of-living-survey.html>. In the quality of living index, Colombo ranks 32nd among cities in non-high-income economies, behind 20 other economies. The city ranks 138th among 231 cities globally.
- 17 An issue of trust stands in the way given the asymmetrical size of the partners. Sri Lanka points to the failure of India to adequately address issues that arose within the free trade agreement on goods and wants these issues addressed prior to engaging in a deeper agreement. India offers to address these goods trade-related issues within the new broader agreement. Issues of concern included discretionary behavior of customs officials in the judging of tariff concession claims, and non-tariff measures that involved testing on the Indian side with delays leading to 30–40 days for clearance. See S. Pohit and B. D. Pal, "What Ails India's Free Trade Agreements?," Financial Express, <https://www.bilaterals.org/?what-ails-india-s-free-trade> for details.
- 18 For domestic investors, the recent Inland Revenue Act No. 24 of 2017 provides an investment incentive regime granting a concessionary tax rate for selected sectors and investors and an enhanced capital allowance in addition to normal depreciation. While the standard rate of corporate tax is 28 %, a concessionary rate of 14 % applies for (a) MSMEs; (b) exporters of goods and services; and (c) the following sectors: agricultural business, education services, promotion of tourism, and IT services. Enhanced capital allowance provides additional capital allowance and an extended period for deducting these allowances for establishments in the Northern Province, for investments above US\$100 million and for SOEs. Specific provisions also provide additional allowances to the following sectors and activities: IT and R&D. In addition, Commercial Hub Regulation No 1, of 2013, offers specific provisions for entrepot trade and offshore logistics services, and the Strategic Development Project Act of 2008 provides additional tax incentives for large projects identified by the cabinet. Finally, the Colombo Port City project plans include the creation of separate regulatory authorities, including a separate investment authority. The government of Sri Lanka plans to designate the Port City as a special commercial zone, which will grant tax-free privileges for up to 50 years.

- 19 Of the 9 EPZs, Katunayake and Koggala are bonded areas under the commercial hub law; Mirijawila EPZ and Mattala Airport (near Hambantota) also offer bonded facilities.
- 20 See also Noor, O'Brien, and Stock (2018) for an earlier detail for each zone.
- 21 C. de Silva, "BOI to Boost FDIs via New Strategy," Daily FT, August 26, 2020, <http://www.ft.lk/business/BOI-to-boost-FDIs-via-new-strategy/34-705121>.
- 22 See for example, USAID 2017.
- 23 In 2014. Source: World Bank (2016).
- 24 President Rajapaksa recently instructed that deeds should be made more widely available, including for unutilized land owned by public enterprises.
- 25 See Department of Investment and Public Asset Management, [https://dipam.gov.lk/sites/default/files/Asset%20Monetisation%20Procedure%20and%20Mechanism\\_o.pdf](https://dipam.gov.lk/sites/default/files/Asset%20Monetisation%20Procedure%20and%20Mechanism_o.pdf).
- 26 See Department of Investment and Public Asset Management, [https://dipam.gov.lk/sites/default/files/Asset%20Monetisation%20Procedure%20and%20Mechanism\\_o.pdf](https://dipam.gov.lk/sites/default/files/Asset%20Monetisation%20Procedure%20and%20Mechanism_o.pdf).
- 27 Dundar et al. (2017)
- 28 2018 Sri Lanka Budget <https://www.parliament.lk/files/pdf/budget/2018/budget-speech-2018.pdf>
- 29 University Grants Commission, 2018 statistics, chap.1, [https://www.ugc.ac.lk/downloads/statistics/stat\\_2018/Chapter.pdf](https://www.ugc.ac.lk/downloads/statistics/stat_2018/Chapter.pdf).
- 30 University Grants Commission, 2018 statistics, chap. 4, [https://www.ugc.ac.lk/downloads/statistics/stat\\_2018/Chapter4.pdf](https://www.ugc.ac.lk/downloads/statistics/stat_2018/Chapter4.pdf).
- 31 The private provision of medical education has been met with widespread resistance. In 2017, Sri Lankan doctors, trained at state-run medical colleges, held a countrywide protest demanding the closure of the country's only private medical college. After a temporary admissions and registration blockade by the government, the Sri Lanka Supreme Court ruled in favor of allowing students of the private medical college to be registered as practicing medical professionals.
- 32 With total assets of US\$7.9 billion, the NBFIs sector has been growing at 20 % on average over the last five years. It has also maintained its overall capital level well above the minimum requirement during the last year, enhancing the resilience to any perceived adverse shocks.
- 33 Financial Sector Assessment Program Capital Market Development Technical Note, November 2015 (World Bank internal document).
- 34 National Financial Inclusion Survey 2018.
- 35 National Financial Inclusion Survey 2018.
- 36 National Financial Inclusion Survey 2018.
- 37 Sri Lanka Financial Sector Modernization Project.
- 38 IFC estimates.
- 39 Interviews during CPSD virtual mission.
- 40 IFC SME Finance Forum. <https://www.smefinanceforum.org/>
- 41 Sri Lanka Financial Sector Assessment Program (FSAP).
- 42 series A round is the second stage of startup financing and the first stage of venture capital financing.
- 43 Interviews during CPSD virtual mission.
- 44 Interviews during the CPSD virtual mission.
- 45 Sri Lanka FSAP.
- 46 The digital payments ecosystem lags peers. Sri Lanka has a well-developed payment and settlement infrastructure. The Sri Lanka inter-bank payment system, the Common Electronic Fund Transfer Switch and the Real Time Gross Settlement System are the main payment systems in Sri Lanka.
- 47 CPSD virtual mission Interviews.
- 48 In 2017, the government restructured the original loans with China and reached a 99-year concession agreement with China Merchants Port Holdings (CMPH) in exchange for a payment of US\$1.1 billion covering its debt.
- 49 Source: World Shipping Council. See also "Sri Lanka Container Throughput: Annual: Port of Colombo: Domestic," CEIC Data, <https://www.ceicdata.com/en/sri-lanka/port-statistics/container-throughput-annual-port-of-colombo-domestic>.
- 50 Sinopec, a Chinese company, was awarded fuel and trading operations at the port and started operating in 2020.
- 51 Source: Sri Lanka Civil Aviation Authority.
- 52 Covered in detail in section 3.1 on tourism.
- 53 IndiGo airline, Aeroflot, Edelweiss Airlines, Thai Air Asia, and Chongqing Airlines started operations in Sri Lanka in 2018.
- 54 Covered in detail in section 3.1 on tourism.
- 55 Covered in detail in section 3.1 on tourism.

- 56 Colombo and Hambantota ports; Mattala airport; and Katunayake, Koggala and Mirijawila EPZs.
- 57 The objective of the regulation is to promote entrepot trade. See World Bank (2020b) for more detail.
- 58 "Trade Boosting Project Launches in Sri Lanka," Global Alliance for Trade Facilitation, October 8, 2018, <https://www.tradefacilitation.org/article/trade-boosting-project-launches-sri-lanka/>.
- 59 Sri Lanka Trade Information Portal, <https://srilankatradeportal.gov.lk/>.
- 60 "Sri Lanka Tourism Vision 2025," <https://www.lovesrilanka.org/wp-content/uploads/2019/05/Sri-Lanka-Tourism-Vision-2025.pdf>.
- 61 United Nations, "Ministry of Tourism and Aviation, SLTDA and UNDP co-convene meeting with Development Partners on building a More Resilient Tourism Sector in Sri Lanka," news release, June 30, 2020, <https://lk.one.un.org/news/ministry-of-tourism-and-aviation-slt-da-and-undp-co-convene-meeting-with-development-partners-on-building-a-more-resilient-tourism-sector-in-sri-lanka/>.
- 62 The average per night price of a room in five-star graded establishments in Colombo exceeds US\$180 (with taxes), compared with similar accommodation units in Bangkok (US\$175), Kuala Lumpur (US\$165), Chennai (US\$130), and Mumbai (US\$168).
- 63 Sri Lanka Tourism Strategic Plan
- 64 Some positive actions in this direction have already been initiated by the Chairman of SLTDA
- 65 Tourism strategic plan.
- 66 MIT Atlas of Economic Complexity <https://atlas.cid.harvard.edu/rankings>
- 67 Interviews during CPSD virtual mission.
- 68 National Innovation Agency Act, <https://www.srilankalaw.lk/Volume-VI/national-innovation-agency-act.html>.
- 69 While the merger between Hutch and Etisalat reduced competition, the development is seen by the industry as potentially increasing the take up for broadband as the new entity will be able to compete with Dialog and SLT in terms of spectrum assets (Telegeography 2020).
- 70 Sri Lanka Export Development Board, <http://www.srilankabusiness.com/export-services>.
- 71 SLASSCOM, IT/BPM Industry Hot Skills Survey 2018, [https://students.nsbm.ac.lk/resources/Hot\\_Skills\\_Survey.pdf](https://students.nsbm.ac.lk/resources/Hot_Skills_Survey.pdf)
- 72 There is legal uncertainty over this as the decision was not ratified by the president.
- 73 For instance, efforts to support the growth of the spice sector by the Export Development Board were met with challenges to secure state-owned land allocated to other public agencies.
- 74 World Bank (2019c) offers an overview of several of these success stories.
- 75 An investment incentive provided to qualified firms registered with the BOI is the duty-free import facility for inputs and capital goods. Hence, BOI-affiliated exporters enjoy the facility of importing raw materials and capital goods at world prices, as they do not have to pay any customs duty, value-added tax, National Building Tax, or para-tariffs such as the Ports and Airports Development Levy.
- 76 Manufacturing (electronics and electrical, expanding value addition in apparel and pharmaceuticals); ICT (software development, business process management / knowledge process management, IT training/education, and emerging technologies); hospitality and tourism (MICE tourism, adventure tourism, wellness and ecotourism); agriculture and food processing (rubber, agri/processed foods and fisheries); and construction and infrastructure (rapid transit, ports, and airports).
- 77 C. de Silva, "BOI to Boost FDIs via New Strategy."

## IFC

2121 Pennsylvania Avenue, N.W.  
Washington, D.C. 20433 U.S.A.

## CONTACTS

**Jean-Christophe Maur**

[jmaur@worldbank.org](mailto:jmaur@worldbank.org)

**Volker Treichel**

[vtreichel@ifc.org](mailto:vtreichel@ifc.org)

[ifc.org](http://ifc.org)



**WORLD BANK GROUP**

THE WORLD BANK  
1818 - 18

**IFC**

International  
Finance Corporation