BOX 3

Sri Lanka's Economic Takeoff – The Need and The Readiness

Background

Sri Lanka was predominantly an agrarian economy with a somewhat higher per capita income compared to other developing countries, when it became a self governing nation in 1948. Subsequent governments that came to power adopted numerous policies aiming to stimulate growth and enhance welfare. Apart from policy swings, the internal conflict and youth uprisings caused severe damage to the economy, including loss of human capital and resources, while curtailing the fiscal space on investing in development projects, and preventing the economy from reaping expected benefits of various types of policy reforms introduced from time to time. With the end of the internal conflict in 2009, the economy started to unleash its potential along with large infrastructure development, recording above 8 per cent growth on average in the three years that followed, accompanied by rebounding investor confidence. Sri Lanka was progressing well towards graduating into an upper middle income country, but the progress slowed amidst subdued economic growth over the subsequent years (Figure B 3.1) due to various reasons.

While Sri Lanka is now classified as an upper middle income country, it is essential that the country adopts sound economic policies in order to avoid the "Middle Income Trap" and takeoff to become a high income nation with equitable and sustained growth.

Sri Lanka's Strengths

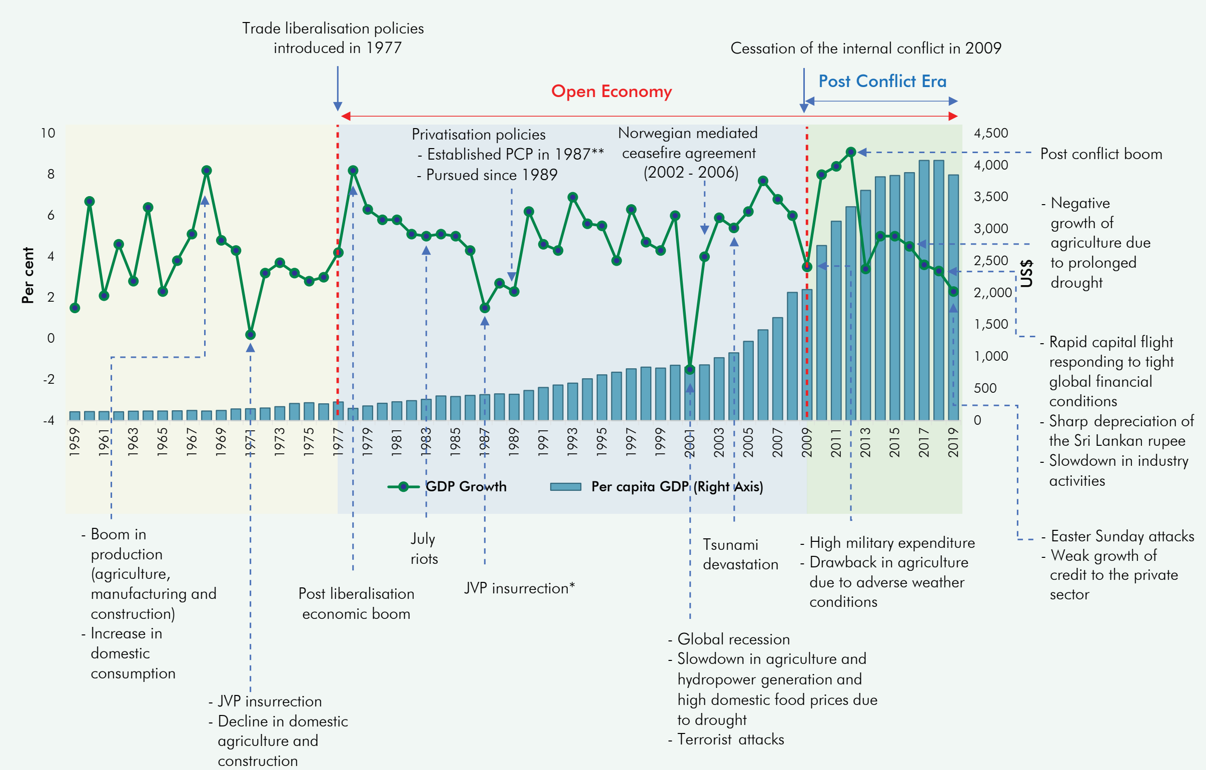
Sri Lanka stands way ahead of its regional peers in the human development track record, positioning itself among the high human development group, ranking 71 out of 189 countries. In terms of the literacy rates, Sri Lanka surpasses the regional and global averages with a rate of 92.5 per cent.[1] Further, Sri Lanka's social indicators rank among the highest in South Asia, with over 90 per cent households all over the island having access to safe drinking water and with even better records in the health sector backed by free universal healthcare facilities.[2] Extreme poverty is not common, and poverty, as measured by the Poverty Headcount Ratio (PHCR),

1 Based on provisional, Quarterly Labour Force Survey data by the Department of Census and Statistics (DCS) (2018)

2 See more on https://www.worldbank.org/en/country/srilanka/overview

Figure B 3.1

Growth Pattern of Sri Lanka



* Janatha Vimukthi Peramuna - JVP

** Presidential Commission on Privatisation

Sources: Lakshman, 1997
Central Bank of Sri Lanka, Annual Reports

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decreased significantly to reach 4.1 per cent by 2016 from 26.1 per cent recorded in 1996.[3] Further, the physical infrastructure development recorded significant growth in recent years with progress in various fronts, including becoming an almost fully electrified nation, remarkable levels of telecommunication connectivity, continuous additions to the country's expressway network connecting the commercial capital to regional capitals, and the completion of reclamation in relation to Colombo International Financial City. These developments are also reflected in increased ranking in the infrastructure sector of the 2019 Global Competitiveness Index by 4 positions to 61, endorsing Sri Lanka to become the most improved economy in the South Asian region in the overall index.[4] Exemplary diplomatic relationships garnered from the friendly, non aligned foreign policy followed by the nation since independence could be harnessed to attract Foreign Direct Investment (FDI) as well as to foster the country's international trade performance. Further, recent measures taken by the government to improve female participation in the active labour force could support inclusive economic growth.

An island privileged by its strategically important location, Sri Lanka is in the midst of the ancient maritime Silk Route and has been in the spotlight of Eastern and Western merchants throughout history. With growing trade between Asia and the rest of the World, Sri Lanka's geographic location has become even more important today, indicating its potential to evolve as an international maritime and logistics hub. Besides, vibrant aquatic and terrestrial ecosystems influenced by distinct geographic and climatic factors since prehistoric periods as well as inherited cultural values have blessed the nation with a large potential for ecotourism and wellness tourism. Moreover, proper and sustainable sourcing of substantial natural resources, including the mineral resources in the Eastern coast, would aid in boosting the development of the economy.

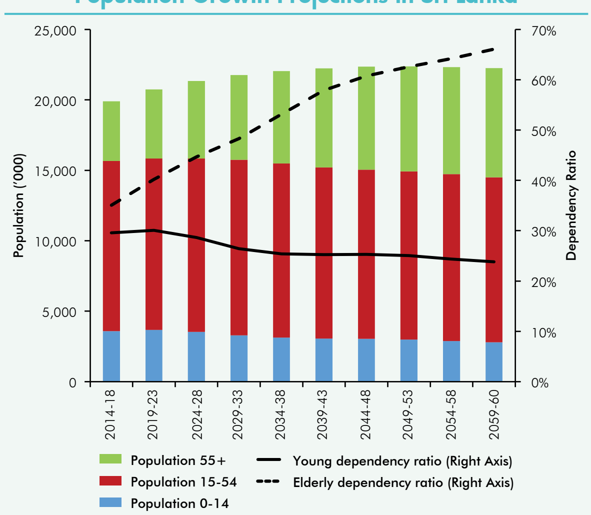
The Sri Lankan economy has been enjoying single digit inflation consecutively for over a decade as a result of proactive, forward looking monetary policy. Maintaining inflation at low and stable levels is considered to be an essential component to generate overall macroeconomic stability and support growth endeavours by facilitating the country's competitiveness, while helping to protect vulnerable segments of the population and boost employment creating production growth. This significant change in the structure of the Sri Lankan economy, which was once considered an economy with double digit inflation, will remain a catalyst in its efforts towards takeoff in the period ahead.

Issues and Challenges

Sri Lanka has not been able to maintain high growth over extended periods of time due to numerous reasons including high budget deficits, high trade and current account deficits, issues in land, labour and capital markets, traditional and bureaucratic institutions, cultural factors, weak governance structures, political instability and corruption, in addition to the factors mentioned at the outset.

It is worth noting that exports and FDI have been key drivers of growth in many successful economies in Asia. However, Sri Lanka's progress in terms of exports and FDI has been subpar compared to its regional counterparts. Sri Lanka has not been able to diversify exports and its share in global trade has declined over time, unlike its East Asian neighbours, and its exports structure has not evolved to the next level beyond apparel, tea and rubber products since the early 1990s. Anti export bias, lack of private domestic and foreign investment in the tradable, particularly industry sector, lack of innovation and research and development (R&D) have further deepened the woes of the exports sector. Meanwhile, the volatile economic and political climate together with the bureaucratic and restrictive investment climate have deterred foreign investment inflows to Sri Lanka. These developments have led to the widening of the external current account deficit forcing the country to increasingly rely on foreign borrowings to finance such deficits.

Figure B 3.2
Population Growth Projections in Sri Lanka



Source: UN population projections, medium fertility scenario (World Bank, 2015)

3 Household Income and Expenditure Survey conducted by the DCS, 2016

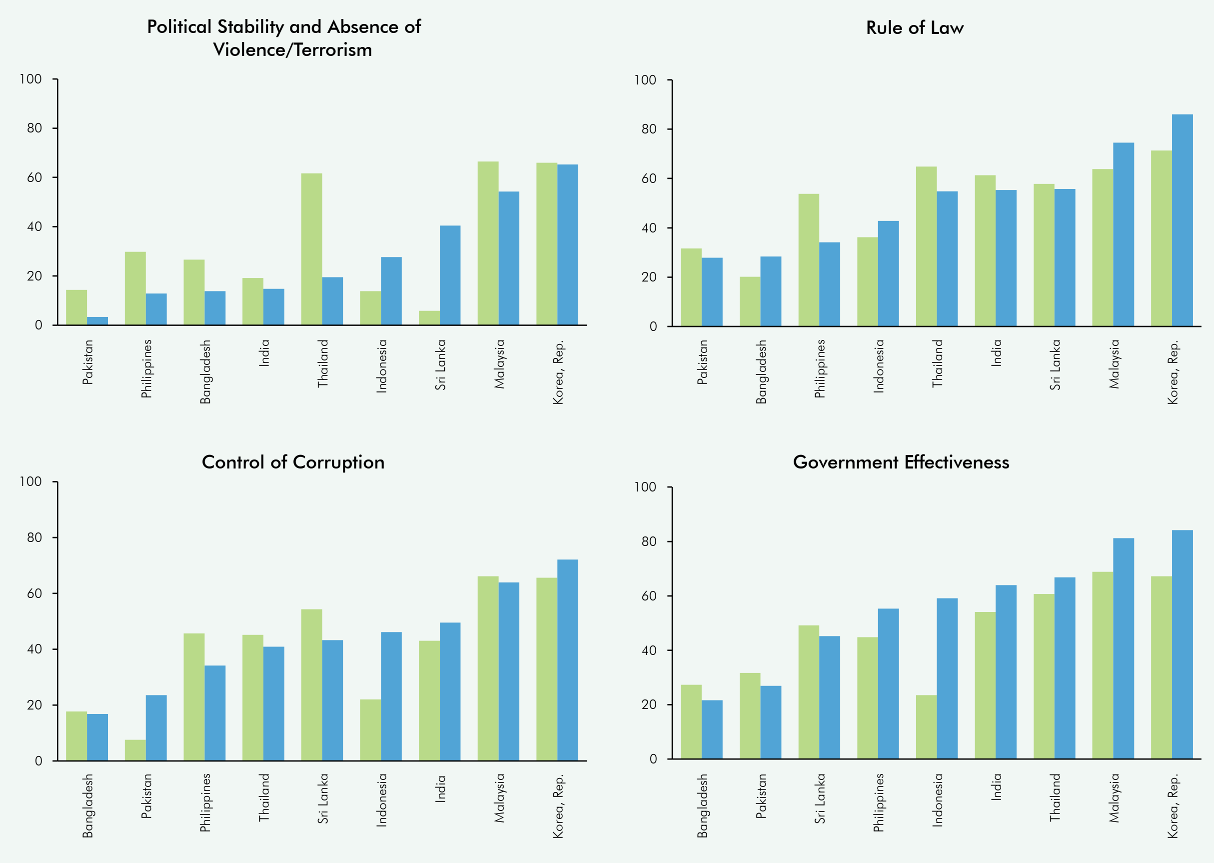
4 Sri Lanka ranks 84 out of 141 economies and has recorded a growth of 1.1 index points reaching a score of 57.1 in 2019 compared to the score of 56 in 2018

To achieve sustainable and inclusive growth, the workforce needs to be prepared for the challenges of the 21st century. Although Sri Lanka's performance in terms of human development has been commendable, high levels of educated youth unemployment and low levels of female labour participation have been observed compared to other emerging markets. Female labour force participation in Sri Lanka and in the region, has remained significantly lower than economies like China and those in the ASEAN region, and this is a serious concern for Sri Lanka given its large pool of highly educated females who are neither employed nor looking for work. In addition, inadequate exposure to STEM (Science, Technology, Engineering and Mathematics) education at secondary, higher education and university levels, has created a low skilled workforce that is unfit to serve the needs of present day employers and to create entrepreneurs.

Furthermore, Sri Lanka is undergoing a rapid ageing of its population, and has reached an advanced stage of this demographic transition compared to its peers. According to projections of the UN, between 2015 to 2060, the dependency ratio of the elderly is projected to rise sharply while that of the young would fall. In addition, Sri Lanka's population is projected to peak in the mid 2040s (Figure B 3.2). The share of the elderly is projected to increase to 25.7 per cent of the total population by 2050 compared to 13.4 per cent in 2015. This implies a contraction of the labour force, lower productivity, greater fiscal burden in the form of healthcare and elderly care, and high retirement benefit costs in the future. In fact, according to the World Social Protection Report (2017-2019), less than one third of the Sri Lankan population is covered by at least one social protection benefit scheme and only around 25 per cent of old age citizens are receiving a pension.

A key source of economic instability in Sri Lanka for many years has risen from misaligned fiscal operations. Compared to emerging market peers, Sri Lanka's fiscal deficits have remained high over time amidst declining government revenues and rising recurrent expenditure. Strikingly, the tax revenue to GDP ratio in Sri Lanka is

Figure B 3.3
Worldwide Governance Indicators - Percentile Ranks (a)



(a) Percentile rank indicates the country's rank among all countries covered by the aggregate indicator, with 0 corresponding to the lowest rank, and 100 to the highest rank.

Source: The World Bank

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one of the lowest by international standards. Moreover, government expenditure has continued to increase over the years in spite of the steps taken to rationalise expenditure. Reflecting the impact of sustained large budget deficits, debt levels in Sri Lanka have also remained high. Rising levels of external commercial debt have created a further drag on government finances, thus elevating risk and associated premiums, causing an increase in interest costs. Sri Lanka has little fiscal space to drive growth through large and continued fiscal stimulus and to pursue large infrastructure development projects, highlighting the need for intense fiscal reforms if the country is traverse a high growth trajectory.

Political instability and policy uncertainty create significant challenges for sustained economic growth since the associated uncertainties, negatively impact investment decisions and business confidence. Aisen and Veiga (2011) argue that political instability may shorten policy authorities' horizons, leading to sub optimal short term economic policies, and may also cause "a more frequent switch of policies, creating volatility and thus, negatively affecting macroeconomic performance". Political stability, presence of good governance, effectiveness of the government, rule of law, and eradication of corruption contribute positively to the sustained growth of an economy. Although Sri Lanka has remained a vibrant democracy resulting in frequent changes in governments, the absence of an independent civil service and the lack of national policies have led to inconsistent policies and affected Sri Lanka's image as a predictable destination for investment and other long term economic activities.

Strategies to Support Sri Lanka's Economic Takeoff

As discussed above, while several crucial conditions are already in place, there remain numerous hindrances that need to be addressed through policy reforms to support Sri Lanka's economic takeoff. Some examples of such reforms that could help Sri Lanka take the next leap forward towards becoming a high income economy over the next decade are outlined below.

A breakthrough in Sri Lanka's export strategy would serve as a springboard for the country to become a high income economy. Sri Lanka's merchandise export strategy needs to be revolutionised by diversifying to the export of medium to high technology products such as machinery and equipment, electronics, vehicles and pharmaceuticals, and value added mineral products, from the traditional low technology products such as garments and tea. Vietnam, a well known achiever in Asia, diversified its exports from agriculture and natural resources based products to apparel in the early 1990s and then to electronics in the late 2000s, and thus stands among the leading exporters in the global production network today.

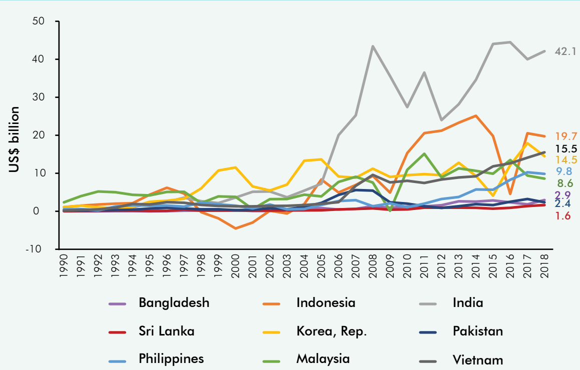
Sri Lanka should also look beyond its traditional export markets. Exports to the West have accounted for over half of its total exports, supported by preferential access to some extent. While GSP and GSP+ programmes have supported Sri Lanka in boosting its exports in the past, such benefits are shortlived, and will not be available for an upper middle income economy. Therefore, Sri Lanka should gradually shift its focus towards exporting to emerging Asia and other non traditional markets.

In addition to the diversification of merchandise exports, Sri Lanka needs to focus on further improving services exports. In addition to the already earmarked services sectors such as tourism and IT-BPO, measures should also be taken to improve exports of other important services such as logistics and financial services. The Colombo Commercial and Financial Hub, once ready for operation, would enable Sri Lanka to earn additional foreign exchange through the export of these services.

Sri Lanka needs to form strategic economic partnerships with other nations, particularly the regional countries, to promote its exports and maximise benefits from the movement of capital and human resources. Sri Lanka could, yet again, learn from the experience of Vietnam, which rose to become a leading emerging Asian economy driven by export growth. Since 1995, Vietnam actively signed multiple free trade agreements (FTAs), which resulted in the lowering of tariffs on Vietnamese exports, thereby paving way for the expansion of its exports sector as well as its economy. While taking measures to reap the most from the existing FTAs, measures should be taken to establish new trade pacts with other trading giants while preserving the country's sovereignty and independence. Such trade agreements would assist domestic exporters to integrate into global value chains (GVCs), thereby improving access to markets, while also promoting competition, improving efficiency and supporting innovation.

More crucially, Sri Lanka should also increasingly focus on attracting non debt creating financial flows to support reaching a higher growth trajectory through increased domestic production. Although inflows of FDI to Sri Lanka have gradually risen over the past decade, it remains well below the levels experienced by its regional peers. For instance, Vietnam, with the implementation of investor friendly policies and reforms over the years, has been successful in attracting substantially high FDI to productive and tradable sectors, and is now home to some of the world's leading electronic brands such as Intel, Samsung, Mitsubishi, GE, LG and Panasonic. Learning from this experience, Sri Lanka should also focus on attracting FDI towards infrastructure development as well as production that could promote the exchange of technology and expertise. Timely introduction of necessary legal, institutional and labour market reforms to address FDI deterrents would improve ranking of ease of doing business and enhance investor confidence in Sri Lanka. With increased FDI, producers would have enhanced access to GVCs, availing them of the opportunity to produce new products, and expand and diversify into new markets, while also leading to job creation, thus supporting the country's overall growth and development agenda. While supporting the stability of the exchange rate, higher FDI would also generate increased foreign revenue in the form of export earnings, thereby reducing the need for debt creating foreign funds to finance external current account deficits and improving government revenues in the long term.

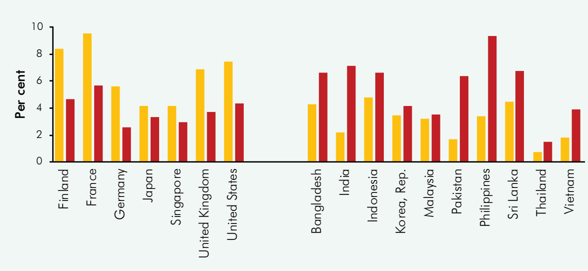
Figure B 3.4
Foreign Direct Investment, Net Inflows (BoP, current US$)



Source: World Development Indicators

As highlighted by authors such as Agénor, Canuto, and Jelenic (2012) and Agénor (2017), the lack of high quality human capital to meet the 21st century's labour market challenges is one of the reasons for the stagnation of countries at middle income levels, since it limits the benefits achievable with borrowed technologies from other countries and also the development of suitable technologies inhouse. Investment in high skilled education and labour market reforms are necessary to face this obstacle. When considering the composition of graduates of Sri Lanka, a majority seems to specialise in humanities and aesthetic studies. However, countries such as Singapore and South Korea, which have transitioned into the high income category from middle income levels, produce a higher proportion of graduates in science and technology related fields, thereby increasing their innovative capabilities. It is equally important to develop and support industries that require high skilled labour, so that the demand for such graduates would also be high. Therefore, in the context of Sri Lanka, the country needs to focus not only on the supply of experts by supporting science and technology related fields of higher education, but also needs to increase the demand for such experts. Experiences of the recent past highlight that many graduates migrate following the completion of their studies, leaving behind a heavy fiscal burden given the free education system in the country. Also, many graduates seem to favour government jobs over private sector employment preferring higher job security, despite the higher wage levels in the private sector, especially in sectors requiring higher skills. This phenomenon suggests an already existing shortage of such experts in the private sector, as highlighted by Nedelkoska, O'Brien and Stock (2018). Therefore, within the government's initiatives to broaden the university intake, further efforts are imperative to widen access to tertiary education to match the demands of the labour market. At the same time, studies including Delalibera and Ferreira (2019) have found evidence suggesting that the quality of early childhood education can contribute to increased levels of labour productivity, and Sri Lanka also needs to improve the quality of the primary and secondary layers of the education system. Improvements to the quality of the labour force achievable through such measures could also be beneficial in facing the country's emerging demographic challenges.

Figure B 3.5
Comparison of Unemployment Rates Among Educated Population – 2009-2016 Average (a)



(a) Data are not available for all countries for all periods. Only available periods are considered for the average in such instances.

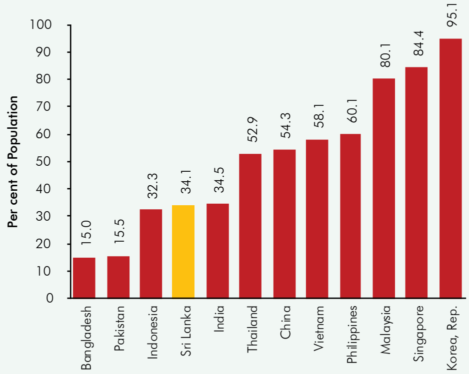
(b) Share of the labour force that is without work but available for and seeking employment. Definitions of labour force and unemployment differ by country.

(c) As a percentage of the labour force with advanced education. Advanced education comprises short-cycle tertiary education, a bachelor's degree or equivalent education level, a master's degree or equivalent education level, or doctoral degree or equivalent education level according to the International Standard Classification of Education 2011 (ISCED 2011).

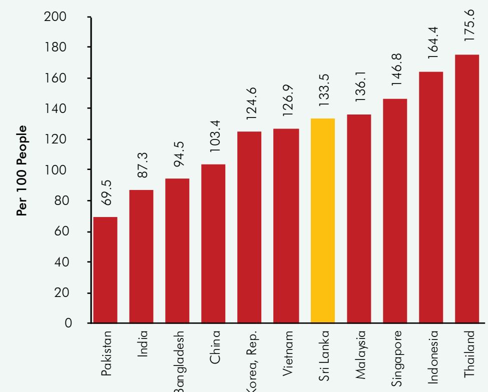
Source: The World Bank

Figure B 3.6
Internet and Mobile Penetration

Individuals using the Internet - 2017



Mobile Cellular Subscriptions - 2017



Source: The World Bank

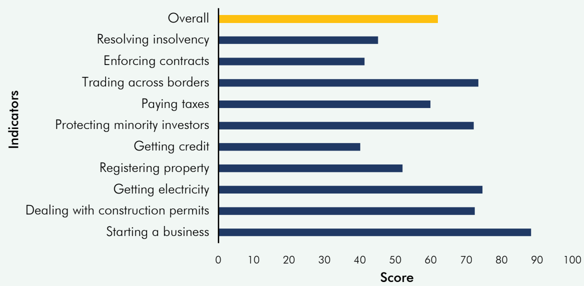
A common argument in literature on the middle income trap is that it occurs due to the inability to innovate. In many developing Asian countries, the importance given to intellectual property rights is low when compared to its Western counterparts. In the case of Sri Lanka, the existing laws and regulations are quite extensive in protecting intellectual property rights established by foreign entities, but attempts to establish intellectual property rights for local innovators and inventions are slow and involve tedious processes, thus discouraging innovation as it is difficult for inventors to obtain economic gains from their efforts. Thus, from a policy perspective, it is important to take measures to improve awareness of intellectual property rights and to ensure enforcement of such rules and regulations, while actively supporting local innovators to establish such rights domestically and abroad.

South East Asian success stories such as Singapore and South Korea suggest that improving access to advanced infrastructure, including telecommunication and broadband has contributed to sustained growth. Despite having made commendable progress in this regard, there is still ample space for improvement in Sri Lanka, as suggested by indicators such as a relatively high effective cost of broadband and a relatively low internet penetration rate (although the mobile phone penetration rate is at comparable levels) when compared with regional peers. With respect to transport infrastructure as well, the country could gain higher economic and social benefits by complementing the improvements to the road network by upgrading public transportation and the railway network.

Enhanced entrepreneurship paves way to generate higher levels of output and productivity of a country, increasing national income and income distribution through improved employment together with higher earnings. A well developed entrepreneurial culture of a country underpinned by a conducive environment to conduct business, enables the economy to move ahead in terms of attracting investments, thereby boosting overall economic activity. As per Doing Business 2020,[5] Sri Lanka holds the 99th position out of 190 economies for ease of doing business, remaining below its regional peers. India managed to raise its ranking through streamlining its reform strategies giving priority to the Doing Business indicators. Countries like Vietnam have upgraded their information technology infrastructure to make it easy to pay taxes. Recently, Sri Lanka too, made a few efforts to upgrade the information technology infrastructure by introducing online systems for filing taxes, processing constructions permits and business registration. With a view to facilitating and attracting foreign investments, the Board of Investment (BOI) has introduced an online application tracking system. The relatively poor score of Sri Lanka on the ease of doing business indicates that there is ample room for further improvement. In Sri Lanka, a lack of improvements can be observed in the areas of getting credit, enforcing contracts, especially in terms of the time and cost spent on resolving a commercial dispute and the quality of the judicial process as well as resolving insolvency considering the recovery rate and reinforcement of the legal framework for insolvency. Further developments can be achieved through government involvement in evolving the country's entrepreneurship by implementing broad minded, long term policies and programmes that offer opportunities for entrepreneurs.

5 Doing Business 2020 is the 17th series of an annual study of The World Bank which presents quantitative indicators on business regulations and the protection of property rights across 190 economies. The data are as of 1 May 2019.

Figure B 3.7
Doing Business Indicators - 2019 for Sri Lanka



Source: The World Bank

For decades, Sri Lanka, as a twin deficit country, has been relying on domestic and foreign borrowings for financing deficits. With a view to strengthening the fiscal position and maintaining government debt at a sustainable level, successive governments have pursued fiscal consolidation strategies, augmenting revenue by expanding the tax base, improving tax administration and compliance, while also rationalising expenditures. Recent tax reform initiatives including those aimed at improving tax administration, are expected to make the country's tax system simpler, while improving business confidence. As government expenditure also remains high, it is crucial for the government to increasingly focus on rationalising expenditure alongside fiscal consolidation measures with a proper monitoring process of government expenditure, without compromising essential public investment. These measures are important in the effort of moving toward becoming a high income country, as unsustainable levels of budget deficits and debt lead to macroeconomic instability, thereby hindering growth. In addition, the government needs to strengthen its efforts on reforming and restructuring State Owned Business Enterprises, thereby enhancing their financial viability and helping to reduce central government expenditure, while inculcating greater discipline in fiscal affairs.

It is widely accepted that political stability is a prerequisite for economic stability. However, consensus across political regimes on long term economic goals is even more important for sustainable growth. Experiences from Finland and Singapore, discussed by Foxley and Sossdorf (2011) and Chua (2011), respectively, suggest that social and political consensus on long term economic priorities can lead to many years of sustained growth. This has historically been a weak area in Sri Lanka as economic priorities have varied frequently when political regimes change. Thus, going forward, it is essential that the people of Sri Lanka demand for a consensus on long term economic goals of the country and persuade political authorities to collectively commit to implement consistent policies to achieve these goals, if the country is to progress towards high income levels with equitable and sustained growth.

Conclusion

Sri Lanka, once considered a promising emerging and developing economy and famously referred to as the "Wonder of Asia" with the dawn of peace in 2009, has to tread through rough waters over the past several years resulting in poor macroeconomic performance, particularly in terms of subpar growth and rising external and fiscal sector vulnerabilities. The absence of national economic policies, delayed implementation of the required structural reforms and the inability to build sufficient policy spaces have led the country to lose its steam as a fast growing economy in the region, amidst domestic political uncertainties, the Easter Sunday attacks, and frequent natural disasters. Moreover, uncertainties in the global front have also posed significant challenges to domestic economic activity. In spite of these drawbacks, Sri Lanka has managed to make steady progress in terms of reducing poverty, upgrading human capital, promoting good governance, fostering healthy international diplomatic and economic relations with key development partners, and maintaining single digit inflation for over a decade, to name a few. It is expected that these factors, together with the country's natural strengths and the implementation of appropriate policy reforms, particularly to address the deficiencies highlighted above, would set the stage for Sri Lanka to takeoff and reemerge as the economic miracle of Asia.

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