

CONCLUSIONS AND POLICY RECOMMENDATIONS

A good governance framework and a skilled labor force distinguish Sri Lanka among developing countries. In sharp contrast with neighboring countries, Sri Lanka has created a business environment that is relatively free from red tape and corruption. The economy is open, and trade reforms and other liberalization measures have helped transform the export and industrial base. The government has invested heavily in the health and education of the labor force. Yet despite these achievements, survey results show that the country fares poorly on many investment climate indicators. A low-intensity civil war, lasting from 1983 to 2001, discouraged international investors. It also restricted regional commerce and diverted scarce resources from productive economic uses. Moreover, there was little investment in infrastructure during the conflict period, undermining firms' productivity and the country's growth potential.

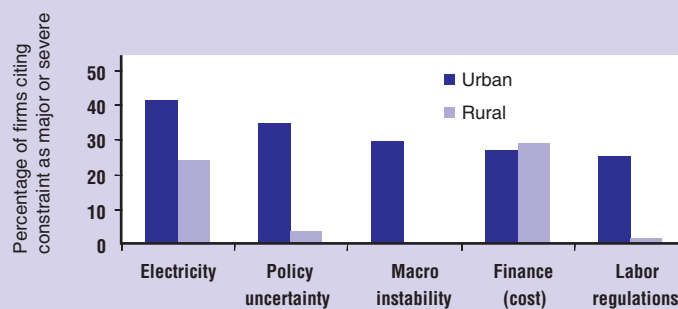
Accelerating economic growth and poverty reduction in today's global business environment will be no easy task. The growth prospects of Sri Lanka, as a small, open economy, depend on maintaining rapid export growth. That challenge is made more difficult by the country's strong export concentration in garments, especially with the imminent phasing out of the Multifibre Arrangement. Tackling the most important constraints in the investment climate will be crucial to maintain the competitiveness of the garment industry and foster greater diversification of exports.

As the Sri Lankan government develops a strategy for addressing investment climate constraints, it will be critical to pay greater attention to the differences between the rural and urban investment climates. A policy strategy recognizing the challenges facing rural entrepreneurs could do much to reduce the regional disparities and rural poverty in Sri Lanka.

5.1 A Policy Strategy Recognizing the Sharp Rural-Urban Differences

Rural and urban enterprises in Sri Lanka face dramatically different constraints. Rural firms reported being most constrained by transport, the cost of and access to finance,

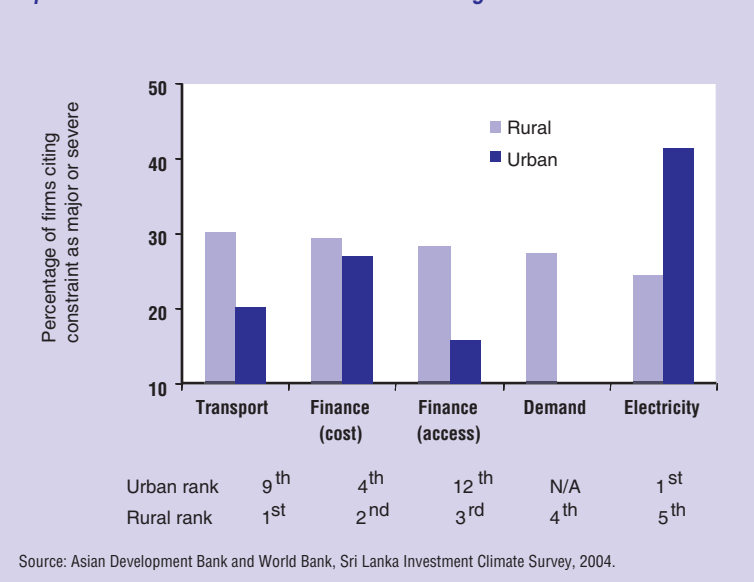
FIGURE 5.1
Top Five Urban Constraints and Their Rural Ratings



Urban rank	1 st	2 nd	3 rd	4 th	5 th
Rural rank	5 th	10 th	N/A	2 nd	15 th

Source: Asian Development Bank and World Bank, Sri Lanka Investment Climate Survey, 2004.

FIGURE 5.2
Top Five Rural Constraints and Their Urban Ratings



lack of demand for their goods, and electricity (figure 5.1). Urban firms ranked only two of these—electricity and the cost of finance—among their top five constraints, citing neither transport nor access to finance as major constraints (figure 5.2). But they also are troubled by issues that barely register as constraints in rural areas, such as economic and regulatory policy uncertainty, macroeconomic instability, and labor regulations.

Why is lack of market demand such a big challenge for rural entrepreneurs? There are several reasons. Most rural

enterprises are very small, with relatively inexperienced managers, and have few contacts or links with larger firms that can expose them to bigger and more diverse markets. Firms cater primarily to local demand in their community, which fluctuates with the agricultural cycle. Many rural nonfarm businesses were started as a survival strategy, to supplement modest incomes from agriculture, and their products and services tend to be of low quality and limited appeal. All these problems that rural enterprises confront in finding buyers for their products are exacerbated by their remoteness and the poor quality of roads, transport, and telecommunications.

As the government develops policies to improve the investment climate for all Sri Lankan firms, it is important that it take these marked differences between the rural and urban investment climates into account. Especially critical are new policies aimed at improving rural infrastructure and expanding access to markets for rural entrepreneurs. By improving rural employment and incomes, such policies would go a long way toward reducing the tremendous disparities between regions and thus addressing the widespread rural poverty in Sri Lanka.

5.2 Policy Recommendations

Achieving a permanent peace is undoubtedly the most important step that Sri Lanka can take toward improving its investment climate. The survey results outlined above also point to five other policy areas that warrant urgent attention, some of them specific to urban or rural firms and some of them shared:

- Improving access to and the quality of energy and transport (urban and rural firms).
- Reducing the cost of finance and improving access to it (urban and rural firms).
- Improving labor market flexibility (urban firms).
- Improving access to major markets (rural firms).
- Improving policy certainty and macroeconomic stability (urban firms).

Some of the policy recommendations that follow highlight new issues that the government has yet to address effectively. Others focus on issues that are neither new nor surprising, in areas where the government is already directing efforts. Even in these areas, however, results from the Investment Climate Survey provide the government with a concrete foundation for its policy direction and allow it to carefully weigh the potential costs and benefits associated with each possible course of action.

Recommendation 1: Improve access to and the quality of energy and transport (urban and rural firms)

As the survey results underline, the quality of infrastructure in Sri Lanka, especially its electricity supply and road network, is a key constraint to economic growth.

Improving Electricity Supply

The ability of both rural and urban firms to increase their productivity depends vitally on improving Sri Lanka's electricity supply. Failure to expand least-cost generation capacity has led to a reliance on emergency power purchases, huge financial losses, high tariffs, and frequent blackouts. The government faces a tremendous challenge in the electricity sector: it needs to expand coverage and improve the quality and reliability of supply while simultaneously reducing tariffs to efficient cost-of-supply levels to ensure that the country can continue to compete with its neighbors in the region.

The government is already undertaking several important reforms, including restructuring the Ceylon Electricity Board under the Electricity Reform Act of 2002 and establishing the Public Utilities Commission of Sri Lanka as the sector regulator. The new commission has made good progress in preparing licenses and regulations for the sector.

As the government moves forward with its energy reforms, it faces the following main policy priorities in the short term:

- Commercializing the sector and strengthening its financial and operational performance.
- Enabling the Public Utilities Commission of Sri Lanka to implement sector regulations, especially the tariff regulations aimed at achieving cost recovery.
- Minimizing delays in implementing a plan for expanding least-cost generation capacity.
- Preparing a policy to promote the development of small-scale distributed renewable energy in rural areas.

In the medium term the main policy priorities include these:

- Introducing transparent and efficient subsidy mechanisms to help expand access to electricity in rural areas.
- Investing in transmission and distribution systems to improve the quality and reliability of power supply.
- Phasing out capital and operation subsidies to reduce the sector's fiscal burden.
- Attracting private sector involvement in utility operations to help improve efficiency.
- Promoting renewable energy sources such as solar, hydro, biomass, and wind as part of the national energy strategy.

Improving Roads

Road transport poses the biggest obstacle for entrepreneurs in rural areas, with both poor access to roads and their poor quality continuing to impede regional development. Outside Western Province road density is low and the maintenance backlog so severe that many rural roads are impassable for much of the year. The situation is worst of all in North Eastern Province.

Lack of access to good-quality roads not only hampers existing businesses; it also makes it extremely difficult to start or participate in rural nonfarm enterprises. Moreover, the poor quality of the road network is not just a rural issue: more than 20 percent of urban enterprises consider transport to be a major or severe constraint. Improving the road network would go a long way toward promoting such key export sectors as tourism and would also help reintegrate North Eastern Province into the economy. The main policy priorities in the road sector include the following:

- Providing adequate funding for maintaining and rehabilitating roads, especially for addressing the maintenance backlog in the provinces.
- Selecting a core network of roads to be maintained.
- Developing an overall pricing policy for the sector.
- Strengthening the capacity of agencies responsible for formulating and implementing policies in the sector.

Recommendation 2: Reduce the cost of finance and improve access to it (urban and rural firms)

Reducing the cost of finance in Sri Lanka will require stabilizing the macroeconomic situation, reducing the deficit, and reforming the two state-owned commercial banks, the Bank of Ceylon and the People's Bank. The state banks are poorly run, and their large role in the financial sector means that they have far-reaching effects. Banks dominate the financial sector in Sri Lanka, and the Bank of Ceylon and the People's Bank together control almost half the banking assets. Both have high levels of nonperforming loans that have persisted despite repeated capitalizations and management improvements. Their inefficiencies lead to high intermediation costs reflected in large spreads. That in turn results in high costs of borrowing across the banking sector, since the more efficient private banks have chosen to charge similarly high lending rates for the sake of high profits.

Expanding financial services to enterprises, especially small and medium-size enterprises, will require further refining the regulatory and judicial framework. Parate powers of debt recovery (allowing foreclosure on collateral without court intervention) should be granted to all licensed institutions—banks as well as finance, leasing, and factoring companies. The Credit Information Bureau should be expanded to allow access to factoring companies and other nonbank and nonfinancial providers of credit. In addition, the bureau should incorporate information from the registrar of companies and court judgments and could develop a credit scoring model to offer its members as a risk management tool. Financial institutions could use international assistance to develop new financial products better tailored to small and medium-size enterprises. Assuring secure property rights and improving the functioning of the land administration system would also improve access to credit, particularly for rural entrepreneurs.

In rural areas the widespread growth of microfinance institutions and credit cooperatives has expanded the availability of financial services, but access to finance, especially long-term finance, remains an important obstacle for rural enterprises. Moreover, performance varies widely among

different types of microfinance providers, with the most successful those that apply modern principles of microfinance, including market interest rates. Another concern is the supervisory vacuum in which these institutions operate. One way to improve their safety while avoiding overregulation would be to sponsor the creation of national associations or an apex institution that would monitor operations and possibly provide risk management and liquidity services. Formal state financial institutions should apply market interest rates and better credit and recovery practices in their rural portfolio. Debt forgiveness programs should be avoided, since they distort rural credit markets and discourage entry by formal financial institutions.

Reforming the contractual savings system could help develop new sources of long-term finance for the private sector, particularly for large enterprises and commercial banks. In turn the banks could expand long-term finance for small and medium-size enterprises.

The key policy priorities in the finance sector are thus as follows:

- Restructuring state banks.
- Enhancing debt recovery mechanisms.
- Expanding and upgrading the capacity of the Credit Information Bureau.
- Improving the regulatory framework for microfinance institutions.
- Reforming the contractual savings system.

Recommendation 3: Improve labor market flexibility (urban firms)

Labor regulations rank as the fifth most important obstacle to doing business, cited as a major or severe constraint by more than a quarter of urban firms. Indeed, Sri Lanka's labor regulations are restrictive, and firms cope by hiring temporary workers, which reduces productivity. They are also rigid, which discourages investment and results in higher unemployment, especially among the educated youth. And they are discretionary, creating great uncertainty about the cost of hiring and firing workers. These effects put Sri Lanka at a competitive disadvantage in attracting foreign direct investment, even in comparison with other destinations in South Asia. As the Multifibre Arrangement is phased out, restrictive labor regulations will prevent the restructuring of the garment sector needed to respond to a more competitive market environment.

Reform of labor laws has traditionally met with strong opposition from trade unions. In 2003, however, the government moved to reform labor regulations. While the details of the proposed reforms remain under discussion, they include introducing a formula for employee severance payments, imposing strict limits on the duration of labor tribunal cases, and establishing an unemployment benefit system.

To encourage foreign direct investment, foster the efficient reallocation of labor, and promote employment in the formal sector, Sri Lanka needs to transform its discretionary and costly severance payment into modern, affordable, and equitable income support for the unemployed. This support need not take the form of unemployment insurance, however, since current conditions may not favor the effective operation of such a system. One way to proceed is to reform the severance system alone. Alternatively, if the country introduces an unemployment insurance system, it should accompany this step with radical reforms to the costly severance payment system, including ending the requirement for approval of retrenchment applications by the labor commissioner and other discretionary practices. The unemployment insurance system would need to be adapted to the country's circumstances to minimize adverse effects on employment, ensure affordability, and reduce

administrative costs. Administration of the system should be kept simple, with no individual monitoring of beneficiaries, and its financing limited to employer and employee contributions.

Other initiatives could also help improve the functioning of the labor market. Expanded further, the employment clearinghouse Jobsnet could provide a useful forum for those wishing to start their own business and a source of information on training and opportunities for developing new skills.

Recommendation 4: Improve access to major markets (rural firms)

While rural entrepreneurs identified lack of market demand as a major constraint, less than 10 percent believed that they needed marketing assistance and less than 2 percent used any such assistance. These results reflect a lack of awareness of its potential benefits. So while improving the coverage and quality of rural infrastructure must form a big part of any strategy for increasing access to markets for rural firms, initiatives to extend marketing assistance are also important. There are several possible ways to provide such assistance to rural entrepreneurs (Vijverberg 2002; GTZ 2003). Business organizations and local chambers of commerce could strengthen marketing channels by helping to develop business directories and by holding product fairs to expose local producers to buying habits and consumer behavior in different markets. They could also share information on prices, quality standards, and ways to obtain technical, financial, and organizational services for greater value addition. In addition, supporting group marketing (through associations and cooperatives, for example) and business clusters would help rural enterprises take advantage of scale economies, perhaps allowing them to purchase inputs at lower prices, access larger markets, and share equipment and infrastructure.

Recommendation 5: Improve policy certainty and macroeconomic stability (urban firms)

As the survey revealed, policy uncertainty and macroeconomic instability-ranked by urban enterprises as the second and third most important constraints-have a tremendously adverse effect on firms. To be effective, firms must be able to plan for the future. To feel secure about committing to investments, they need to be able to count on low inflation and interest rates, a steady exchange rate to support international trade, and some assurance of continuity in business-related policies.

In Sri Lanka, where the political system leads to frequent changes of government, businesses have difficulty in planning for the future. The past four years have seen three general elections, each accompanied by changes in political outlook and appetite for reform. Every election imposes large direct costs on the economy-elections are not cheap. But the indirect costs dwarf the direct costs-witness the large number of international companies that pulled out of potential investments in Sri Lanka late in 2003.

A policy framework geared to improving policy certainty and macroeconomic stability would include the following measures:¹

- Reducing the deficit and public debt to the targets set in the Fiscal Management (Responsibility) Act-for the deficit, 5 percent of GDP (from 8 percent), and for public debt, 85 percent of GDP (from 101 percent)-by 2006.
- Strengthening revenue collection through better tax administration.
- Reforming the civil service and reducing the wage bill.
- Reducing the losses of state-owned enterprises.

- Committing all parties to reducing public sector interference in the economy, including maintaining the independence of the Central Bank and ensuring independent economic regulation.

Notes

1. See World Bank (2004a) for a more detailed discussion of structural issues affecting macroeconomic stability.