Evaluation Working Paper

Sri Lanka Country Assistance Program Evaluation:

Evaluation of Policy-Based Lending in Sri Lanka

August 2007

Supplementary Appendix G

Operations Evaluation Department

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 27 April 2007)

Currency Unit — Sri Lanka rupee (SLR)

SLR1.00	=	$0.0092
$1.00	=	SLR109.27

ABBREVIATIONS

ADB	—	Asian Development Bank
GDP	—	gross domestic product
SLFP	—	Sri Lanka Freedom Party
SME	—	small and medium enterprise
SOE	—	state-owned enterprise
TA	—	technical assistance
UNP	—	United National Party

NOTE

In this report, "$" refers to US dollars.

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The guidelines formally adopted by the Operations Evaluation Department (OED) on avoiding conflict of interest in its independent evaluations were observed in the preparation of this report. To the knowledge of the management of OED, there were no conflicts of interest of the persons preparing, reviewing, or approving this report.

A. Scope and Purpose

1. This appendix is part of the Country Assistance Program Evaluation for Sri Lanka. This aims to (i) review the context of policy-based lending operations of the Asian Development Bank (ADB) in Sri Lanka, (ii) analyze the extent of the country's compliance with policy measures that it had agreed to, (iii) review key achievements of policy-based programs, and (iv) identify lessons.[1] By 31 December 2006, ADB had approved $569 million for 10 policy-based loans to Sri Lanka that accounted for 18% of ADB's total lending to the country in the past two decades (1986−2006). Table 1 lists the 10 policy loans that were reviewed in this evaluation.

Table 1: Policy-Based Program Loans to Sri Lanka by Sector, 1986−2006 (as of 31 December 2006)

Sector		Loan Title	Approval Date	Effectivity Date	Approved Amount ($ million)	Remarks
1. Agriculture and natural resources	(i)	Loan 820-SRI: Agricultural Inputs Program	16 Dec 1986	16 Jun 1987	29.0	Extended once; closed on 07 November 1989.
	(ii)	Loan 994-SRI: Agriculture Program Loan	28 Nov 1989	22 Dec 1989	80.0	Not extended; closed on 14 August 1991.
	(iii)	Loan 1127-SRI: Second Agriculture Program	26 Nov 1991	24 Feb 1992	60.0	Extended thrice. The second tranche release was cancelled. Closed on 31 December 1996.
2. Law, economic management, and public policy	(i)	Loan 1800-SRI: Private Sector Development Program (Subprogram I)	12 Dec 2000	25 Jan 2001	85.0	Extended thrice; closed on 24 November 2003.
	(ii)	Loan 2130-SRI: Fiscal Management Reform Program	14 Dec 2004	21 Dec 2004	45.0	Ongoing
3. Finance	(i)	Loan 1051-SRI: Financial Sector Program	20 Nov 1990	18 Dec 1990	80.0	Not extended; closed on 11 June 1993.
	(ii)	Loan 2040-SRI: Rural Finance Sector Development Program	11 Dec 2003	12 May 2004	50.0	Ongoing
	(iii)	Loan 2138-SRI: Financial Markets Program for Private Sector Development	15 Dec 2004	21 Mar 2005	60.0	Ongoing
4. Industry and Trade	(i)	Loan 1894-SRI: Small and Medium Enterprise Sector Development Program	20 Dec 2001	3 May 2002	20.0	Not extended; closed on 18 April 2005.
5. Power	(i)	Loan 1929-SRI: Power Sector Development Program	31 Oct 2002	28 Nov 2002	60.0	Extended once. The second tranche release was cancelled. Closed on 30 August 2006.

Source: Asian Development Bank database.

B. Phases of Reforms and Political Economy Context

2. **Major policy reforms began in late 1970s.** Sri Lanka had inward-looking and state interventionist policies in the 1950s, 1960s, and part of the 1970s. During this period, the

[1] ADB. 2006. *Guidelines for the Preparation of Country Assistance Program Evaluation Reports*. Manila. Available: http://www.adb.org/Documents/Guidelines/Country-Assistance-Program/default.asp

Government established public enterprises, nationalized private enterprises, and created state monopolies. By mid-1970s, Sri Lanka had become a state-dominated economy. It had loss-making state-owned enterprises (SOEs) overwhelmed with overstaffing, mismanagement, and pervasive government interventions. Over more than two decades, Sri Lanka had witnessed a series of economic policy shifts, largely shaped by changes in development thinking and the political economy of decision making.[2] Macroeconomic stabilization, economic liberalization, private sector development, financial sector reform, and fiscal management reform have been the major pillars of policy reforms. In the late 1970s, policy reforms occurred as partial reforms in trade liberalization, associated changes to the exchange rate regime, and subsidy removal.[3] A decade later, further reforms commenced and turned to privatization, labor market liberalization, the redesign of social security, and pro-poor growth initiatives to reduce poverty.

3. **Policy reforms in Sri Lanka tended to follow swings in the political pendulum.** Two major political parties have alternately governed the country: (i) the United National Party (UNP), and (ii) the Sri Lanka Freedom Party (SLFP). Both parties have supported state interventions in economic activity, and their differences have primarily been in the intensity of state intervention.[4]

4. **The first wave of economic reforms removed price controls and eased restrictions to foreign investment.** In 1977, UNP embarked on an economic liberalization program under President Junius R. Jayawardena. The first wave of reforms included dismantling currency controls and adopting a single exchange rate, eliminating price controls, lowering import tariffs, easing restrictions to foreign investment, and deregulating the financial sector. A majority (80%) in Parliament helped push the reforms forward, complemented by robust external conditions in the wake of rising international tea prices during 1976−1977. Resurgence in growth followed, fuelled by a public investment program. Gross domestic product (GDP) grew by 6% per annum between 1978 and 1983, compared to GDP growth of 2.9% per annum during 1971–1977**.**

5. **War broke out in 1983 and dampened economic growth**. When Sri Lanka's internal conflict escalated into civil war, private sector confidence plummeted, and the GDP growth fell to 3.4% per annum during 1984−1989. By late 1980s, Sri Lanka encountered major economic problems, compelling the UNP Government to call for new elections. After the general elections in 1989, UNP returned to power, but with a smaller majority. The Government subsequently pursued macroeconomic and sector adjustments with assistance from the International Monetary Fund. While the Government succeeded in quelling the Southern rebellion, the conflict in the North and East has remained intractable to date. The conflict directly and indirectly dampened economic growth in several ways. The conflict (i) resulted in destruction of human and capital assets and the displacement of people; (ii) discouraged foreign investment and tourism; (iii) diverted the Government's attention from its reform agenda; (iv) contributed to macroeconomic instability; and (v) created an adverse environment for private sector development and investments, particularly in the North and East. The lingering conflict has absorbed a significant portion of the attention of successive governments. On three occasions in the past, the Liberation Tigers of Tamil Eelam had agreed with the Government to a temporary cessation of hostilities. In February 2002, a Norwegian-brokered ceasefire agreement was reached between the Government and the Liberation Tigers of Tamil Eelam. The country faces

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[2] Political economy refers to interrelationships between political and economic institutions and processes, as they relate to policy decisions and reforms.

[3] Dunham, David. 2004. *Economic Liberalization and Institutional Reform*. In Saman Kelegama, editor, *Economic Policy in Sri Lanka: Issues and Debates*. Colombo: Institute of Policy Studies.

[4] Weerakoon, Dushni. 2004. *The Influence of Development Ideology in Macroeconomic Policy Reform Process*. In Saman Kelegama, editor, *Economic Policy in Sri Lanka: Issues and Debates*. Colombo: Institute of Policy Studies.

conflict resurgence after peace talks failed.[5] A report published by the International Crisis Group analyzed the conflict leading up to the unraveling of the peace process.[6]

6. **Privatization became a state policy a decade after the onset of economic liberalization.** Loss-making SOEs had become unsustainable with budgetary transfers to these entities averaging around 10% of GDP. Privatization began in 1987 and initially had a slow start due to the predominant use of SOEs as instruments of political patronage and employment protection. However, the sale of SOEs gained momentum after 1989. Privatization came in two waves: (i) the first wave (1989−1994), which divested 43 commercial SOEs, and (ii) the second wave (1995−thereafter), which divested and restructured several public utilities and services, including telecommunications and the national airline. Due to lack of transparency with the first privatization wave, the Public Enterprise Reform Commission was created in 1996 to effect privatization in a more transparent and structured environment.[7] The first wave of privatization occurred under President Ranasinghe Premadasa[8] (1989−1993) and the second wave, under President Chandrika Bandaranaike Kumaratunga (1994−2001). Coalition building was among the main concerns of President Premadasa, whose preoccupation with consolidating his support base partly shaped the reform process.[9] Further liberalization enhanced the incentives for exports, and the economy recovered.

7. **The People's Alliance formed a new government in 1994.** In late 1994, 17 years of UNP rule came to an end with the election of the People's Alliance, a coalition of SLFP, other parties, and splinter groups from UNP. This coalition did not reverse the economic liberalization process. The size of the state enterprise sector had diminished, and with it the scope to dispense employment and other sources of patronage.[10] This posed a challenge to the fragile political coalition under the incoming President Kumaratunga, which had a tenuous one-seat majority in parliament. The Government expanded ministerial posts and privileges to keep the coalition together. Consequently, the expansion of ministerial positions effectively made the executive presidency the central focus of national policymaking.

8. **A UNP-led government came to power in December 2001, ushering cohabitation with the country's President.** President Kumaratunga was reelected in 1999, and the People's Alliance won the general elections in 2000. A year later, several key members of the People's Alliance crossed over to UNP, which led the President to dissolve parliament and call for new elections. The United National Front won the parliamentary elections, and UNP returned to power under Prime Minister Ranil Wickremasinghe. This brought a difficult period of political cohabitation between UNP and President Kumaratunga who had been reelected. The UNP-led government renewed its commitment to economic policy reforms and private sector-led

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[5] The first truce was in 1987, brokered by the Indian Government and enforced by the Indian Peace Keeping Force. The second truce was in 1994, and the third (ceasefire agreement) was signed in 2002. Temporally, four distinct phases of armed conflict can be identified: 1983–1987, 1998–1994, 1995–2002, and 2006–now.

[6] International Crisis Group. 2006. Sri Lanka: *Failure of the Peace Process.* Brussels. Available: http://www.crisisgroup.org/home/index.cfm?id=4523&l=1

[7] Knight-John, Malathy and P.P.A. Wasantha Athukorala. 2005. *Rethinking Privatization in Sri Lanka: Distribution and Governance*. In John Nellis and Nancy Birdsall, editors, *Reality Check: The Distributional Impact of Privatization in Developing Countries*.

[8] President Ranasinghe Premadasa was assassinated in Colombo on 1 May 1993. He was replaced by Dingiri Banda Wijetunga who held the presidency until 1994.

[9] Dunham, D. and S. Kelegama. 1997. "Does Leadership Matter in the Economic Reform Process? Liberalization and Governance in Sri Lanka, 1989–93." *World Development* 25(2): 179–90.

[10] Durham, D. 2003. *States, Reforms, and Institutional Change: The Dynamics of Failure*. In Bertil Tungodden, Nicholas Stern, and Ivar Kolstad, editors, *Toward Pro-Poor Policies Aid, Institutions, and Globalization.* Annual World Bank Conference on Development Economics—Europe 2003.

growth.[11] The Government promoted second generation reforms to deepen economic liberalization by deregulation and further privatization, with macroeconomic policy aimed at stabilization and adjustment. In 2003, the Government and the International Monetary Fund signed an agreement on a poverty reduction and growth facility. The Government called for fiscal consolidation, and reductions of subsidies and welfare support programs.

9. **By late 2003, the cohabitation led to a political crisis, and a new SLFP-led government was formed after elections in April 2004.** A new government was formed by the United People's Freedom Alliance, a political coalition comprising SLFP, *Janatha Vimukthi Peramuna*, and other parties. Following the presidential election in November 2005, Mahinda Rajapaksa was sworn in as the fifth executive President of Sri Lanka. The political platform as reflected in the presidential manifesto (*Mahinda Chintana*)[12] set the development agenda of the Government. Much of the policy program in the *Mahinda Chintana* is a promise to promote social protection, small and medium enterprise (SME) development, and rural development. The Government has emphasized that (i) it would not pursue privatization as a way of improving the performance of SOEs, and (ii) efficiency improvement initiatives (rather than the change of ownership) would be used as a means to improve SOE performance.

10. **In October 2006, SLFP and UNP signed a memorandum of understanding to work together, but this cooperation was short-lived.** The memorandum of understanding focused on major national issues: (i) the conflict in the North and East, (ii) electoral reforms, (iii) governance, and (iv) social development. However, this bipartisan approach ended abruptly after several UNP members crossed over to the SLFP-led Government and accepted ministerial positions. Despite the crossover, UNP remains the largest opposition party. This crossover changed the political coalition of the Government. On 28 January 2007, a cabinet reshuffle took place with the appointments of 52 cabinet ministers, 33 non-cabinet ministers, and 19 deputy ministers. This represented the largest number of ministerial positions in the history of Sri Lanka, which is likely to pose challenges to budgeting and policymaking.

C. Design and Implementation of ADB Program Loans to Sri Lanka

1. Evolution and Scope of Policy-Based Lending

11. Box 1 summarizes the economic environment that prevailed in the last two decades during which ADB approved its policy-based loans. These policy-based loans were largely designed to promote sector development and performance through policy and institutional reforms. Major development constraints encompassed policy distortions and market impediments that required policy changes to promote sector growth. ADB's support for policy reforms primarily responded to government requests, policy dialogue, and macroeconomic conditions. ADB's assistance included sector studies, advisory technical assistance (TA), and capacity development assistance.[13]

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[11] Government of Sri Lanka. 2002. *Regaining Sri Lanka: Vision and Strategy for Accelerated Development.* Colombo.

[12] Available: http://www.mahindarajapaksa.com/MahindaChinthanaEnglish.pdf

[13] To name a few, ADB provided TA support for the design and/or implementation of some program loans: (i) agriculture (TA 1735-SRI: Study on the Impact of the First Agriculture Program Loan), (ii) private sector development (TA 3567-SRI: Governance and Institutional Support for Private Sector Development), (iii) SME development (TA 3822-SRI: Enabling SME Growth), and (iv) power sector (TA 3857-SRI: Restructuring Power Sector). Moreover, ADB has supported capacity development through project loans for the (i) institutional strengthening of fiscal management institutions (Loan 2131-SRI) and (ii) modernization of revenue administration (Loan 2132-SRI) in the case of the ongoing Fiscal Management Reform Program. It has also provided a TA loan for capacity development in the financial sector, which aims to strengthen the People's Bank and the Insurance

12. **When the country faced macroeconomic instability during 1986−1991, ADB approved four policy-based loans.** Sri Lanka faced growing budget deficits, distorted prices of agricultural inputs and products, lackluster agricultural performance, loss-making SOEs, and high financial intermediation costs. The macroeconomic instability required reforms to build on earlier liberalization to reduce the fiscal burden and remove obstacles to promote private sector development. ADB responded to government requests, and approved four policy-based loans of which three went to the agriculture sector and one to the finance sector. To help improve the country's balance of payments, ADB approved the Agricultural Inputs Program (Loan 820-SRI) in 1986 as a fertilizer import facility. It also sought to boost agricultural productivity by (i) removing price subsidies for fertilizer, (ii) reducing the number of mixed fertilizer products, (iii) enacting new fertilizer legislation, and (iv) promoting cost recovery from irrigation services to farmers. Subsequently, ADB approved the Agriculture Program Loans I and II (Loan 994-SRI and Loan 1127-SRI) in 1989 and 1991, respectively, to revitalize the agriculture sector and to focus on divestment of government interests in agriculture.[14] With the transfer of public sector assets and activities to the private sector, other concerns emerged, including capital market development and financial sector reform to support savings mobilization and resource allocation to encourage private sector development. ADB approved the Financial Sector Program (Loan 1051-SRI) in 1990, which aimed to (i) reduce financial intermediation costs, (ii) rationalize the interest rate structure, (iii) promote a secondary market for government securities and issues of private sector bonds, (iv) promote the use of equity financing for investment projects, and (v) accelerate the privatization program. The three aforementioned policy-based loans were in harmony with the government strategy and ADB's country strategy (1988−1992), which sought

Box 1: Economic Environment in Sri Lanka with Relevance to ADB Policy-Based Loans

1986−1991
- Unstable macroeconomic environment
- Persistent budget deficit
- Distorted pricing of agricultural inputs and products
- Lackluster agriculture sector performance
- Loss-making state-owned enterprises
- High financial intermediation costs in the financial sector

1992−1999
- During this period, there was no new ADB policy-based loan

2000–2004
- Initiatives to promote governance
- Efforts to improve public enterprise management
- Growing budget deficit and deteriorating fiscal performance
- Public debt exceeded 100% of gross domestic product from 2001 to 2004
- Efforts to improve policy and regulatory framework
- Efforts to improve institutional performance
- Underdeveloped rural financial markets
- Continuing labor market rigidities

2005 to Date
- Government emphasis on the role of the public sector
- Efficiency improvements of state-owned enterprises
- Government will not privatize state-owned entities

Board of Sri Lanka (Loan 2139-SRI) to complement the ongoing Financial Markets Program for Private Sector Development.

[14] The first set of policy measures focused on (i) fertilizer pricing, trade, and investments; (ii) crop production incentives and taxation; (iii) improved performance of the state plantation sector; (iv) irrigation cost recovery and improved water management; (v) rationalization of the Paddy Marketing Board; and (vi) rural credit. The second set built on previous efforts by pursuing reforms in (i) the phased reduction of agricultural export duties and ad valorem sales tax on tea, rubber, and coconut, and phasing out of agricultural export crop subsidies; (ii) rationalization of agriculture extension services; (iii) rationalization of sugar pricing and privatization of three state-owned sugar companies; (iv) rationalization of the fertilizer marketing system and privatization of state-owned fertilizer companies; (v) rationalization of the livestock subsector, including privatization of three state-owned livestock companies; (vi) restructuring of the Janatha Estates Development Board and the Sri Lanka State Plantations Corporation; and (vii) streamlining of the agricultural seeds subsector. Reforms to promote efficiency and productivity were essential for higher economic growth and poverty reduction.

to address structural issues by supporting a more diversified and export-oriented economy driven by the private sector. Privatizing commercially-oriented public enterprises and restructuring the agriculture sector were the focus of ADB assistance during this period.

13. **ADB did not approve policy-based loans to Sri Lanka from 1992 to 1999.** Notwithstanding continuing support for policy and institutional reforms by ADB's country strategy in Sri Lanka, no policy-based loan was approved by ADB from 1992 to 1999. The political dynamics were deemed not conducive to major policy reforms. ADB's country strategy at that time stated that preparatory work on sectoral and nationwide reform agenda should continue, and recognized that the timing for policy-based lending would have to depend on political developments.[15]

14. **ADB renewed its policy-based lending in late 2000.** A new round of policy-based lending by ADB commenced in late 2000. The economic environment was then characterized by inefficient public enterprise management, deteriorating fiscal performance, high public debt, underdeveloped rural financial markets, and labor market rigidities. In late 2001, the Government renewed its commitment to economic policy reforms and private sector-led growth. Part of the challenges lay in (i) promoting investment, employment, and services in the privatized sectors; (ii) carrying out institutional and regulatory reform for a more effective management of economic policy; and (iii) undertaking public enterprise reform for more responsive service delivery. Fiscal deficits largely reflected weakening revenue generation efforts, dependency of poorly performing SOEs on public spending (SOE transfers), and defense expenditures. Fiscal imperatives (raising revenues and promoting fiscal discipline) set the stage for fiscal reform.[16]

15. **During 2000−2003, ADB approved four policy-based loans.** These policy loans were designed to promote a private sector-driven growth, carry out public enterprise reform, improve access to rural finance, and support fiscal management reform. The Private Sector Development Program (Loan 1800-SRI), which was approved in 2000, sought to eliminate impediments to private sector involvement by developing an enabling environment for private sector participation, strengthening regulatory and institutional capacity, and improving the public-private interface. Moreover, strengthening the performance of SMEs was part of critical efforts to diversify the economy, improve competitiveness, and promote greater employment and economic growth. Consequently, ADB responded and approved the SME Sector Development Program (Loan 1894-SRI) in 2001 to improve the enabling environment for SMEs through (i) strengthening institutional capabilities to address strategic SME sector concerns, (ii) improving the regulatory framework for SMEs through deregulation, (iii) strengthening business capabilities of SMEs by improving their access to knowledge through the Internet, and (iv) developing the market for SME financing through legal reform, among others.

16. To assist rural finance institutions, which have suffered from weak governance, high transaction costs, and recurring losses that added to the fiscal burden, ADB approved the Rural Finance Sector Development Program (Loan 2040-SRI) in 2003. This program recognized that the creation of an effective and efficient rural finance system depends on the removal of systemic constraints and promotion of market-driven responses for providing appropriate

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[15] ADB. 1998. *Country Operational Strategy in Sri Lanka: 1998−2003*. Manila.

[16] In 2001, the economy posted public debt to GDP ratio of 103%, and an economic contraction of 1.5%—the first economic contraction since Sri Lanka's independence in 1948. This debt burden continued to rise to about 105% of GDP during 2002−2004, but subsequently declined to 93.0% in 2006. About one third of the privatization proceeds had been used to retire government debt since 1995.

products and services. Thus, it has aimed to establish an institutional framework for rural finance, with good governance and sustainability as core values.

17. In line with public enterprise reform and service delivery, ADB approved the Power Sector Development Program (Loan 1929-SRI) in 2002 to improve the sector's operating efficiencies, financial viability, and service quality. Its immediate objectives were to (i) support sector reform by establishing an independent regulator, developing an independent tariff-setting mechanism, rationalizing tariff, and functionally segregating the activities of the Ceylon Electricity Board and the Lanka Electricity Company (Private) Limited through unbundling of power generation, transmission, and distribution; (ii) enhance sector efficiency by introducing competition and commercialization; and (iii) encourage private sector participation by developing an enabling and transparent business environment.

18. **The elections in April 2004 changed the political landscape, and ADB approved two additional policy-based loans in December 2004.** A new SLFP-led government under the United People's Freedom Alliance came to power in April 2004. Complementing previous reforms in the financial sector in the 1990s, ADB approved Loans 2138/2139-SRI: Financial Markets for Private Sector Development, which followed in December 2004 to improve the private sector's access to finance and support the Government's public enterprise reform program in the banking industry. Its components have focused on developing financial markets and improving the operations of state-owned commercial banks, including the restructuring of the People's Bank, Sri Lanka's second largest bank. Without meaningful fiscal consolidation, a growing fiscal deficit and an impaired revenue administration would crowd out private investment and erode physical and social capital expenditures. In this context, ADB approved Loan 2130-SRI: Fiscal Management Reform Program in December 2004 to strengthen the management of public finances by improving tax administration effectiveness, improving the budget framework, strengthening public expenditure management and control systems, promoting fiscal discipline, and improving fiscal coordination. Since 2005, the policy environment has become more challenging. Structural reforms, in particular, have been limited largely due to the complexity and difficulty of decision making and consensus building within a political coalition that has diverse political agendas and development orientation.[17,18]

2. Performance of Policy-Based Lending Operations

19. Of the 7 completed (closed) policy loans, 4 loans were rated and 1 loan unrated by program completion reports, and 4 loans were rated by program performance audit reports.[19] As of 31 March 2007, completion reports had not yet been prepared for two policy loans. The program completion reports rated three policy loans "successful" and one "partly successful". The program performance audit reports subsequently downgraded the "successful" ratings of

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[17] The 2006 Asian Development Outlook noted that *"The election manifesto of the current Government included some departures from the past, but the extent and manner in which they will be implemented remains to be seen. Structural reforms may proceed in a diluted form or in some cases may even be reversed. Agreement on reforms may prove difficult and time-consuming: although the executive presidency is strong, the president's alliance spans a wide range of groupings with markedly different political agendas."* ADB. 2006. *Asian Development Outlook.* Manila. Available: http://www.adb.org/Documents/Books/ADO/2006/sri.asp

[18] Subsequently in 2007, the Asian Development Outlook highlighted that *"…although the private sector accounts for over 85% of GDP, the Government owns institutions that manage about 60% of all financial assets as well as all public utilities and some smaller enterprises. In key policy statements, it has announced that it would seek alternatives to privatization for bringing greater efficiency into the state-owned sector."* ADB. 2007. Asian Development Outlook. Manila. Available: http://www.adb.org/Documents/Books/ADO/2007/SRI.pdf

[19] In 2006, the Operations Evaluation Department renamed the program performance audit report as program/project performance evaluation report.

two policy loans for agriculture (Loans 820-SRI and 994-SRI). All of the program performance audit report-rated loans were assessed “partly successful”, mainly due to mixed outcomes, inconsistent government policies that negated earlier gains, and policy reversal (Table 2).

Table 2: Performance Ratings of Completed Policy Loans as of 31 March 2007

Loan Number	Title	PCR Rating	PPAR/PPER Rating	Remarks
0820	Agricultural Inputs Program	S	PS	After subsidy removal, higher fertilizer prices inadvertently encouraged adulteration of fertilizers by unscrupulous operators. Enforcement of the Fertilizer Act was weak. The number of officially approved mixtures of fertilizers did not decline as envisaged, but rose from 19 to 28.
0994	Agriculture Program Loan	S	PS	The program sought to revitalize the agriculture sector but fell short of producing an outstanding impact. The PPAR attributed this largely to inconsistent government policies that negated earlier gains, declining world prices of agricultural commodities, and political upheavals. For example, export taxes on tree crops were reduced but measures aimed at reducing the losses of state plantation companies were not achieved. The policy of increasing rural interest rates was ineffective due to the provision of subsidized term lending outside the program. A credit amnesty program offset gains from improved collection efficiency promoted by the program. Irrigation service fee collection was implemented but was not complemented by measures to penalize noncompliance. The fertilizer subsidy, which was removed under the previous Agricultural Inputs Program, was reintroduced. The PPAR also noted that a shortfall of the program was its failure to conduct a comprehensive analysis of macroeconomic policy and institutional constraints. Key policy constraints on efficient growth such as import licensing, uneven tariffs, and ill-defined rural property rights were not addressed.
1127	Second Agriculture Program	PS	PS	A major thrust of the program was to phase out government intervention in the agriculture sector. The PPAR noted that headway was made in privatizing plantation estates, which contributed to revitalizing the plantation crops subsector. Some progress was made in encouraging private sector participation in fertilizer marketing. Less progress was made in divesting the public sector role in the fertilizer, dairy, and sugar industries due to labor disputes and the reintroduction of the fertilizer subsidy. Sustained support was lacking in rationalizing the extension service, fostering private sector participation in the seeds sector, and providing livestock support services.
1051	Financial Sector Program	No rating	PS	The PPAR noted that the program contributed to positive results in promoting equity financing, accelerating the privatization program, and promoting the secondary market for Treasury bills, but no gains were seen in the operational efficiency and profitability of the National Savings Bank. In the post-PPAR period, however, the net profit of the National Savings Bank improved progressively from 1998 to 2004. Its return on average assets more than tripled from 0.6% to 2.2% over 2001−2004. Reducing financial intermediation costs in the financial sector continues to be a challenge. The interest rate spread (or average weighted lending rate less average weighted deposit rate) was about 9% in 2004 and 2005 for commercial banks, which did not differ from the pre-program level.

Loan Number	Title	PCR Rating	PPAR/PPER Rating	Remarks
1800	Private Sector Development Program	S	NA (no PPER yet)	The PCR noted that privatization and public enterprise reform led to the liberalization of telecommunications, insurance, and petroleum distribution industries. The state-owned enterprises have been implementing a corporate governance code. Improved processes are in place through the establishment of regulators to support competition and private sector development, including the establishment of the Insurance Board of Sri Lanka to handle independent regulation of insurance companies and the broadening of the jurisdiction of the Securities Exchange Commission over securities-related industries. Moreover, measures are being enforced to protect consumers by reducing cartel-like behavior in pricing consumer necessities. However, labor reforms have not been far reaching. To date, labor laws have continued to be restrictive and have not reduced disincentives to job creation in the formal sector.
1894	Small and Medium Enterprise Sector Development Program	No PCR yet	NA	The program sought to improve the enabling environment for development of SMEs. Key achievements included the deregulation of telecommunications, broadened opportunities for private sector initiatives and SME development, access by SMEs to business development services and knowledge through the Internet, and harmonized tax incentives through the amended Inland Revenue Act. This program was less ambitious than other programs in Sri Lanka and was embedded in the reform agenda of the Private Sector Development Program (Loan 1800-SRI).
1929	Power Sector Restructuring Program	No PCR yet	NA	Power sector reforms stalled after the change in government in April 2004 due to opposition from within the ruling political coalition and from the trade unions. Noncompliance with second tranche conditions for unbundling the power sector led to the cancellation of the loan in 2006.

NA = not applicable, PCR = program completion report, PPAR = program performance audit report, PPER = program performance evaluation report, PS = partly successful, S = successful, SME = small and medium enterprise.
Source: Asian Development Bank database.

20. **Policy Conditions.** Many policy conditions have been incorporated into the 10 policy-based programs for Sri Lanka. Overall, there have been 333 policy conditions, of which 191 conditions were part of the 7 completed programs and 142 conditions of the 3 ongoing programs. Of the 333 policy conditions in policy matrixes, 49 were non-tranche conditions: 36 in Loan 1127-SRI, 5 in Loan 1051-SRI, and 8 in Loan 1894-SRI.[20] The incorporation of many policy conditions in ADB-financed policy-based programs is not unique to Sri Lanka. These policy conditions were agreed to between ADB and the Government at the outset as part of the respective loan agreements.

21. **Compliance with policy conditions had been reasonably high.** Table 3 on compliance with policy conditions indicates that at the time of the program completion report or

[20] For example, non-tranche conditions dealt with (i) monitoring implementation of the SME program by the Task Force, (ii) presentation by the Deregulation Committee of an annual report and announcement of the implementation of deregulation recommendations, (iii) establishment of a business services support facility, (iv) completion of the legal framework review for banking and finance and recommendations for amending certain laws, (v) maintenance of the management autonomy of the National Savings Bank to determine deposit rates, and (vi) gradual reduction by the Central Bank of Sri Lanka of its purchases of Treasury bills on the primary market and shift to execution of open market operations on the secondary market, among others.

loan closing, 80% of the 191 conditions were complied, and 9% partly complied with. The others were either assessed as not complied with (9%) or amended (2%). Bottlenecks had occurred in enacting and implementing measures that called for restructuring enterprises/sectors and pension reforms, particularly when the reforms were politically sensitive. Enacting regulatory measures on finance, by contrast, proved easier to implement.[21] Box 2 illustrates policy conditions that were relatively difficult to fully comply with.

22. **A number of policy reversals occurred, mainly after program completion.** Policy reversals affected the following: (i) the elimination of the fertilizer subsidy, (ii) the reduction of the interest rate subsidy for the purchase of tea bagging machinery from 75% to 50%, and (iii) the elimination of the stamp duty. The fertilizer subsidy was eliminated in early 1990 but after program completion, the elected government led by the People's Alliance reintroduced it in 1994 as part of fulfilling its pledge to farmers. The reinstatement of the fertilizer subsidy was reasoned by the need to help farmers reduce the cost of rice production, given the cost-price squeeze from increasing fertilizer prices and declining output prices. The subsequent loan (Loan 1127-SRI) called attention to the policy condition on removing the fertilizer subsidy and incorporated it as a non-tranche measure. After program closing, partial compliance was achieved in October 1997 when the Government removed the subsidy on all fertilizers, except urea. In 2006, the Government commenced a fertilizer subsidy to smallholders who own less than 5 acres of tea, rubber, and coconut in line with the pronouncement of the *Mahinda Chintana.*[22] This was in addition to the fertilizer subsidy to rice and vegetable farmers. In the case of the purchase of new tea bagging machinery, the interest rate subsidy was reduced to 50% in 1994 as part of the policy measures of Loan 1127-SRI but reverted to its original level in less than a year. The Government eventually removed this subsidy in 1999. In relation to eliminating the stamp duty, compliance with this policy condition for the release of the second tranche ((Loan 1894-SRI) took place in 2002. A year after the loan closed, the Government reintroduced the stamp duty in 2006. Overall, instances of policy reversal affecting agriculture were related to trade policies and tariff rates such as (i) replacement of ad valorem duties with specific duties (i.e., the 35% ad valorem duty on potatoes was replaced with a specific duty of SLR20/kilo); (ii) imposition of import surcharges; (iii) *ad hoc* duty exemptions and adjustments; and (iv) the introduction of preferential tariffs under certain trade agreements.

[21] Legislation enacted in Parliament in compliance with conditions for the policy loans in the finance sector included (i) amendment to the Finance Companies Act to permit leasing companies to transfer assets to special purpose vehicle for securitization of assets, (ii) enactment of the anti-money laundering bill, (iii) amendment to the Inland Revenue Act to harmonize tax incentives, (iv) amendment to the Banking Act and Monetary Law, (v) enactment of the Insurance bill, (vi) establishment of the Insurance Board of Sri Lanka through the Regulation of Insurance Industry Act, (vii) amendment to the Securities and Exchange Commission Act to extend the jurisdiction of this commission, (viii) enactment of the Fiscal Management Responsibility Act, and (ix) amendment to the Stamp Duty Act. Outside of finance-related measures, Parliament also enacted the Consumer Affairs Authority bill and the amendment to the Termination of Employment of Workmen.

[22] Central Bank of Sri Lanka. 2006. *Recent Economic Developments: Highlights of 2006 and Prospects for 2007*. Colombo. Available: http://www.cbsl.lk/cbsl/RED2006/RED06_Chapter06.pdf

Table 3: Compliance with Policy Conditions of Program Loans Approved During 1986−2005[a]

Program Title	Total Policy Conditions							First Tranche				Second Tranche						Third Tranche						Fourth Tranche	
	Total Number	C	PC	NC	A	O	FC	Total Number	C	PC	NC	Total Number	C	PC	NC	A	O	Total Number	C	PC	NC	A	O	Total Number	FC
A. Completed Projects																									
1 Loan 820-SRI: Agricultural Inputs Program	6	5	0	1	0	0	0	---------- No tranche ----------																	
2 Loan 994-SRI: Agriculture Program Loan	24	20	2	2	0	0	0	19	15	2	2	5	5	0	0	0	0	0	0	0	0	0	0	0	0
3 Loan 1127-SRI: Second Agriculture Program[b]	53	38	8	7	0	0	0	5	5	0	0	12	11	1	0	0	0	36 [c]	22	7	7	0	0	0	0
4 Loan 1051-SRI: Financial Sector Program	35	27	5	3 [d]	0	0	0	7	7	0	0	23	19	3	1	0	0	5 [c]	1	2	2	0	0	0	0
5 Loan 1800-SRI: Private Sector Development Program	32	28	2	0	2	0	0	14	14	0	0	8	7	0	0	1	0	10	7	2	0	1	0	0	0
6 Loan 1894-SRI: Small and Medium Enterprise Sector Development Program	21	19	0	0	2	0	0	7	7	0	0	6	4	0	0	2	0	8 [c]	8	0	0	0	0	0	0
7 Loan 1929-SRI: Power Sector Development Program[b]	20	16	0	4	0	0	0	15	15	0	0	5	1	0	4	0	0	0	0	0	0	0	0	0	0
Total	**191**	**153**	**17**	**17**	**4**	**0**	**0**	**67**	**63**	**2**	**2**	**59**	**47**	**4**	**5**	**3**	**0**	**59**	**38**	**11**	**9**	**1**	**0**	**0**	**0**
Percent	**100**	**80**	**9**	**9**	**2**	**0**	**0**	**100**	**94**	**3**	**3**	**100**	**80**	**7**	**8**	**5**	**0**	**100**	**64**	**19**	**15**	**2**	**0**	**0**	**0**
B. Ongoing Projects																									
8 Loan 2040-SRI: Rural Finance Sector Development Program	65	28	3	0	3	14	17	15	13	2	0	17	13	1	0	3	0	16	2	0	0	0	14	17	17
9 Loan 2130-SRI: Fiscal Management Reform Program	50	37	2	0	0	11	0	18	18	0	0	21	19	2	0	0	0	11	0	0	0	0	11	0	0
10 Loan 2138-SRI: Financial Markets Program for Private Sector Development	27	14	0	0	0	13	0	8	8	0	0	11	4	0	0	0	7	8	2	0	0	0	6	0	0
Total	**142**	**79**	**5**	**0**	**3**	**38**	**17**	**41**	**39**	**2**	**0**	**49**	**36**	**3**	**0**	**3**	**7**	**35**	**4**	**0**	**0**	**0**	**31**	**17**	**17**
Percent	**100**	**56**	**4**	**0**	**2**	**27**	**12**	**100**	**95**	**5**	**0**	**100**	**73**	**6**	**0**	**6**	**14**	**100**	**11**	**0**	**0**	**0**	**89**	**100**	**100**

A = amended, C = complied with, FC = for compliance, NC = not complied with, O = ongoing, PC = partly complied with.

[a] Compliance with policy conditions was as of the Program Completion Report for completed programs, and 31 March 2007 for ongoing programs.

[b] The second tranche release was cancelled.

[c] These refer to non-tranche conditions during the program period, rather than to tranche conditions.

[d] Unclear compliance status.

Sources: (i) program completion reports, (ii) program performance audit reports, and (iii) progress reports (for ongoing programs).

Box 2: Illustrative Tranche Release Conditions That Were Difficult to Fully Comply With

2000−2006

- The Public Enterprise Reform Commission to submit to the Asian Development Bank plans for voluntary retirement of workers for each public enterprise to be divested. (The voluntary retirement scheme was too expensive to implement, given the budget deficit.)
- Introduce Superannuation Benefit Funds Regulatory Commission Bill to Parliament. (Due to the change in government in April 2004, Parliament did not approve the bill. After program completion, the Government explored alternatives to the state-owned provident funds, including merging the funds and increasing opportunities for the private sector to participate in pension management.)
- The Government to implement the unbundling of the Ceylon Electricity Board's generation, transmission, and distribution functions, and ensure the establishment and operation of the generation companies, the new transmission company, and the new distribution companies. (The reform process fell short of making the reforms effective due to political opposition and resistance from trade unions. These policy conditions were not complied with during program implementation.)
- The Government to reduce corporate income tax as a first step toward a uniform rate of 15% to be achieved over the medium term. (This condition was amended during program implementation. It was not feasible to reduce the corporate tax rate further to 15% due to the fiscal deficit and the need to raise tax revenue.)
- The People's Bank to enter into a collective agreement with trade unions. (The People's Bank management indicated in 2006 that the unions have resisted and hampered the pace of the bank reform.)
- Divest two Regional Development Banks. (In the 2007 Budget Speech, the Government proposed to merge the Regional Development Banks and the Small and Medium Enterprise Bank with the Lankaputra Development Bank. Thus, divestment is unlikely to be complied with.)

1986−1999

- The Government to remove all fertilizer subsidies. (The fertilizer subsidies were removed in 1990 but reintroduced after program completion.)
- Privatize Kantale Sugar Industries Limited by divesting at least 51% of its equity. (A court injunction was in force at the time of program completion. The program performance audit report noted in 2001 that this factory was not privatized due to labor disputes and was eventually slated for liquidation.)
- Privatize the Colombo Commercial Fertilizer Limited. (Labor disputes hampered privatization.)
- Privatize the Milk Industries of Lanka Company Limited. (After program completion, the Government repossessed this company, later known as Kiriya Milk Industries, due to labor disputes. In addition, the lack of institutional experience in preparing the company for privatization, selecting investors, and structuring an appropriate privatization arrangement contributed to the failure of privatizing this company.)

Source: Asian Development Bank. Various program completion reports, program performance audit reports, and progress reports.

23. **During the program implementation period, some policy conditions had become less appropriate.** This had affected several policy measures, for example, (i) the divestment of regional development banks due to the recent government proposal to merge the Regional Development Banks and the SME Bank with the Lankaputra Development Bank;[23] (ii) the establishment of a debt office independent from the Central Bank of Sri Lanka; and (iii) entry into a collective agreement with the trade unions on the People's Bank restructuring plan, because these unions preferred not to formally support the restructuring plan. This policy condition is now being addressed through alternative measures. At the time of the program completion report or loan closing, noncompliance with policy conditions included (i) divestment of sugar companies and fertilizer companies due to legal challenges and labor disputes; (ii) amendments to the Electricity Reform Act due to the anti-restructuring stance of the Ceylon

[23] Government of Sri Lanka. *Budget Speech 2007*. Colombo. Available: http://www.treasury.gov.lk/FPPFM/fpd/pdfdocs/budget2007/BUDGETSPEECH2007.pdf

Electricity Board unions; and (iii) the unbundling of Ceylon Electricity Board's power generation, transmission, and distribution functions and establishment of corresponding companies for the unbundled functions.

24. **Factors underlying performance.** Box 3 summarizes the enabling factors for the implementation of reform programs in the past two decades, as well as the deterrents to reforms. The enablers included a stable political environment that openly supported the reforms, effective policy dialogue, a clear grasp of reform objectives, and ownership of the reforms throughout program design and implementation. The deterrents have been numerous, which explain the predominance of partly successful ratings for the performance of policy-based lending operations. These include a combination of unfavorable macroeconomic conditions, unstable political and security situation, and changing government commitment to reform due to (i) coalitions with divergent views on the intensity and scope of state intervention in economic activities, and (ii) shortfalls in program design and implementation such as inflexible and partly unrealistic policy conditions and inadequate privatization arrangements (in the case of certain SOEs in agriculture). Many of the challenges encountered in Sri Lanka have also been encountered elsewhere in developing member countries where ADB has supported policy-based lending.[24] Based on evaluation lessons, there is a need to recognize the characteristics of successful programs.[25]

Box 3: Summary of Factors Affecting Policy-Based Lending Operations

What favored reforms?

- Stable political environment
- Clear understanding across stakeholders of the objectives of reform
- Shared commitment to reforms and ownership of the reform program from the design stage to the implementation stage
- Close involvement of the Government in policy dialogue
- Definition of the policy objectives according to the Government's development agenda

What deterred reforms?

- Complexity of the political economy of decision making
- Inadequate analysis of reform options and the feasibility of recommended actions
- Difficult macroeconomic environment
- Labor disputes and legal challenges to divestments
- Limited capacity of the Government to manage reform processes (change process and management of change)
- Shortfall of the executing agency in informing and educating political leaders, decision makers, and the general public on the objectives, costs/benefits, and expected results of policy reforms
- Lack of broad-based support for reforms involving sector restructuring/opposition from labor unions
- Inconsistencies in government policies, mainly in the agriculture sector
- Political and security instability

Source: Asian Development Bank. Various program completion reports and program performance audit reports.

25. While the problems traditionally encountered in policy-based lending are unlikely to be eliminated, their frequency and intensity can be reduced if the domestic political economy context is given more prominent recognition and accommodation in the design process for

[24] ADB. 2001. *Special Evaluation Study on Program Lending.* Manila
Available: http://www.adb.org/Documents/PERs/sst-stu-2001-16/ses-program-lending.asp

[25] ADB. 2007. *Evaluation Brief–Success Factors in Policy-Based Lending: Lessons from Evaluation.* Manila.

policy-based lending.[26] The political economy context affects policy formulation, timing, reform acceptance, and implementation. An ADB study on policy-based operations emphasized that full awareness is needed of the political environment, a country's policy priorities, trade-offs involved, and the stance of affected stakeholders.[27] This includes identifying the views of people who will gain from reforms, views of those who will lose from reforms, dynamics of vested interests, and proponents of the status quo.

26. Government ownership of the reforms is vital. The Fiscal Management Reform Program (Loan 2130-SRI), for example, was ready for approval under the UNP administration in 2003. Following the change of government in April 2004, it was redesigned to ensure effective ownership. At present, it is a flagship program of the Government. Working in tandem with the Fiscal Management Reform Program is the Financial Markets Program for Private Sector Development (Loan 2138-SRI), in recognition of spillovers across policy reforms that go beyond a sector intervention. These two policy-based programs recognize that addressing constraints in operations of state-owned banks is closely linked to the need for strengthening revenue collection to reduce the dependence of the Government on state-owned banks.

27. The agricultural sector in Sri Lanka experienced slippage of reforms due to inconsistent sector policies and divergent views on agricultural development, sharp price increases in agricultural inputs and food imports, public investment cutbacks, political instability, and security upheavals. In the finance sector, rigidities in interest rates and financial intermediation were stronger than expected during the implementation of the Financial Sector Program (Loan 1051-SRI) in the 1990s. The interest rate distortion was linked to the Government's interventions in the operations of state commercial banks and non-market based domestic finance. In the industry and trade sector, the economic downturn in 2001, fiscal imbalance, and the double-digit inflation rate intensified market and credit risks, and contributed to non-performing loans.

28. **Management of the reform process.** Managing the reform process in Sri Lanka has been difficult due, in part, to the complex political decision making dynamics and unrealistic deadlines and pace for carrying out the reforms. In the case of the first wave of privatization, an effective regulatory framework did not accompany the reform process. Two key factors contributed to this: (i) the Government decided to adopt a hands-off approach to regulation to attract private investment, particularly during 1977−1988; and (ii) the fast pace of asset sales precluded a proper sequencing of the reform process, where the establishment of regulatory structures would precede the divestment exercise. Consequently, privatization created opportunities for rent extraction among those who could benefit from it. For example, exclusivity provisions without adequate monitoring and regulatory arrangements in the divestment of telecommunications, gas, and airlines and underpricing of assets became part of the Government's privatization strategy.[28] With the establishment of the Public Enterprise Reform Commission in 1996, transparency and access to information improved through website posting of pertinent transaction details, press notices, and publication of annual reports.

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[26] Abonyi, George. 2002. *Toward a Political Economy Approach to Policy-Based Lending*. Economics and Research Department, Working Paper Series No. 14. Manila: ADB.

[27] Bolt, Richard, Manabu Fujimura, Cindy Houser, Franklin de Guzman, Frederick Nixson, and John Weiss. 2003. *Economic Analysis of Policy-Based Operations: Key Dimensions.* Economics and Research Department Special Study. Manila: ADB.

[28] Both the telecommunications and gas transactions were negotiated during a period of intensified conflicts and rampant terrorist attacks. It was not uncommon for multinational companies to drive a hard bargain with governments that face serious budget constraints. The telecommunications investor set out a choice of scenarios for the Government, with a 3-year monopoly and an immediate price hike, or a 5-year monopoly and a phased out price hike. Knight-John, Malathy. 2004. *Privatization and Regulation*. In Saman Kelegama, editor, *Economic Policy in Sri Lanka: Issues and Debates*. Colombo: Institute of Policy Studies.

29. The Government's ability to take resolute policy decisions is often undermined by the lack of majority in Parliament. Preserving the stability of the governing political coalition, in a country faced with a two-decade conflict, often took precedence over reforms. The odds against reforms were evident in power sector restructuring. The program carefully laid the essential building blocks for restructuring under an initially supportive political leadership, with advisory TA support. Although considerable effort had gone into the groundwork for power sector restructuring since 2002, the process fell short of making the reforms effective. The reforms began to stall after April 2004 when the ruling political party entered into a coalition with *Janatha Vimukthi Peramuna*, a nationalist Marxist party. [29] ADB cancelled $30 million from the total loan amount of $60 million due to noncompliance with the second tranche conditions, and closed the program loan in August 2006. Restructuring initiatives can encounter resistance to change because of their significant effects on organizations, employment, labor unions, and pensions.

D. Synthesis of Key Achievements

30. **ADB's policy-based lending operations in Sri Lanka to support private sector development have produced mixed outcomes.** Remarkable results have been achieved in the telecommunications industry (Box 4), where reforms have led to the issuance of external gateway licenses to independent operators, making this industry one of the most deregulated in Asia today. Over 2002−2006, the number of cellular phones per 100 persons rose dramatically from 4.9 to 27.3, while that of fixed lines more than doubled from 4.6 to 9.5. The growth momentum in telecommunications is likely to continue due to increased investment, expansion of coverage, and improvement of service quality. In the agriculture sector, privatization made headway in plantation estates in the 1990s, but not as much as in fertilizer, sugar, and dairy due largely to labor disputes and legal challenges. Privatization proceeds helped retire part of the government debt. Fiscal objectives and generation of sales revenues have been overriding considerations.[30] Fiscal imbalance would have been worse without the sales of state-owned assets through privatization.

31. Policy actions associated with amendments to the Termination of Employment of Workmen to facilitate labor market mobility were noteworthy, but the program completion report on the Private Sector Development Program (Loan 1800-SRI) noted that these were ambitious and did not lead to far-reaching labor reforms. Major changes in labor laws need to be introduced over a longer period to reduce disincentives to job creation. Restrictive labor laws, for example, make firms reluctant to take on staff to meet a big one-off purchase order because of the difficulty to lay off workers later. This curtails the flexibility of industries to respond to changing market conditions that require more flexible labor formation. Based on existing labor regulations, dismissal of workers in the formal sectors is costly and difficult. Sri Lanka is ranked fourth (along with Ghana and Zambia) as the most expensive country among 175 ranked countries in terms of costs (weeks of wages) of dismissing formal workers.[31] Sri Lanka requires a severance pay of 39 months of wages, making firms wary of hiring. Critics have argued that

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[29] *Janatha Vimukthi Peramuna* and its affiliated trade unions opposed the unbundling of Ceylon Electricity Board into separate companies for generation, transmission, and distribution. The unbundling was perceived as a precursor to privatization, although the restructuring did not specify privatization as an objective. The program was not able to conduct broad-based awareness campaigns and effective communication with external stakeholders as planned because the 2005 elections interrupted the process. In May 2006, the Ceylon Electricity Board unions threatened to cut off the supply of electricity nationwide, effectively hampering further efforts to carry the reforms forward to implementation stage. Political economy factors had been unfavorable.

[30] Knight-John, Malathy. 2004. *Privatization and Regulation*. In Saman Kelegama, editor, *Economic Policy in Sri Lanka: Issues and Debates*. Colombo: Institute of Policy Studies.

[31] World Bank. 2007. *Doing Business in South Asia.* Washington, DC. Available: http://www.doingbusiness.org/

rigid labor laws stifle the creation of jobs in the formal sector. More than 60% of jobs in Sri Lanka remain in the informal sector.

Box 4: Privatization of State-Owned Enterprises

Outcomes of Liberalizing the Telecommunications Industry

- Dismantled monopoly of the Sri Lanka Telecom Limited
- Wider coverage and higher telephone density. Over 2002−2006, the number of cellular phones per 100 persons rose dramatically from 4.9. to 27.3; that of fixed lines improved from 4.6 to 9.5.
- Shorter average waiting time for a fixed telephone line (from 7 years to less than a year)
- Access by enterprises and other users to the Internet
- Computerized billing system
- Doubling of the market capitalization of the Colombo Stock Exchange through the sale of the Sri Lanka Telecom Limited

Other Outcomes of Privatizing State-Owned Enterprises (SOEs)

- Partial retirement of the government debt due to the use of privatization proceeds: government debt as a percentage of the gross domestic product declined from 96.5% to 90.8% over 1990−1998, and then from 103.2% to 93.0% over 2001−2006.
- Mobilization of nearly SLR8.8 billion ($154.7 million) between 1993 and 1999 from the sale of SOEs under Loan 1127-SRI: Second Agriculture Program, of which SLR7.5 billion ($131.8 million) came from the sale of plantations. In addition, proceeds of SLR24.5 billion were gained from the sale of government shareholdings in SOEs covered by Loan 1800-SRI: Private Sector Development Program over 2000−2004 (telecommunications, insurance, petroleum distribution, and national airline, among others).
- Increased rent-seeking opportunities for the well-connected.
- Labor reforms were not far-reaching: major changes in labor laws are still needed to reduce disincentives to job creation.

Impacts

- The country's fiscal crisis would have been more severe without privatization.
- The overall fiscal deficit declined from 10.1% to 8.4% of gross domestic product over 1995−2006.

Source: Evaluation team's analysis.

32. **A code of corporate governance for SOEs is in place as well as regulatory measures for consumer and investor protection, insurance, and securities.** SOEs have started implementing a corporate governance code, which aims at enhancing the efficiency of public enterprises through improved accountability, transparency, and boardroom practices. Improved processes are likewise in place through the establishment and/or strengthening of regulators to support competition and private sector development. To protect investors and consumers from unfair competition, the Consumer Affairs Authority was created in 2003 to enforce measures to eliminate cartel-like behavior in pricing consumer necessities. The Government established the Insurance Board of Sri Lanka to handle independent regulation of insurance companies, and broadened the jurisdiction of the Securities Exchange Commission over securities-related industries (underwriters, margin providers, credit rating agencies, investment managers, and clearing houses).

33. **Economic liberalization has generally not succeeded in agriculture, which remains highly protected.** In general, agricultural reforms in the latter 1980s and early 1990s were aimed at boosting productivity in the agriculture by removing subsidies and market distortions, and encouraging private sector involvement in agriculture. Over the long term, a revitalized agriculture sector was expected to emerge as a policy impact. Except for plantation crops, there was no evidence that the policy-based programs had revitalized the sector as a whole. During 1996−2005, the agriculture sector posted a low average growth rate of 1% per year.

Inconsistent sector policies, underperforming research and development systems, limited use of improved seed and plant varieties, high transaction costs, poor market infrastructure, and structural barriers to agricultural performance (including state ownership of the land) have been among the underlying reasons. The unpredictability of government policies for production, trade, credit, licensing of imports, and pricing have deterred private sector participation.[32] The program performance audit report (2001) on Loan 1127-SRI: Second Agricultural Program, nonetheless, noted that the program made a positive contribution to rural poverty reduction. The elimination of plantation crop export taxes raised the gross returns of smallholder tea, coconut, and rubber cultivators by nearly 10% per year.

34. **Financial sector reforms have generated some results.** Availability of equity financing, an accelerated privatization program, and a secondary market for Treasury bills were among the outcomes associated with the Financial Sector Program, which was implemented from 1990 to 1993. At the institutional level, there were gains in operational efficiency and profitability of the National Development Bank, but little improvement occurred in the National Savings Bank, the Bank of Ceylon, and the People's Bank at the time of the program performance audit report (1997). Two other policy-based programs approved in the current decade are still ongoing: (i) Rural Finance Sector Development Program, and (ii) Financial Markets Program for Private Sector Development. At present, the financial, operational, and organizational restructuring of rural finance institutions is in process, and the capacity development support to these institutions is continuing. Over time, policy, legal, regulatory, and institutional reforms anchored on good governance, transparency, and fiscal discipline are anticipated to bring about a positive environment for rural finance. This improvement is contingent upon political commitments to support such reforms. Increased access to rural financial services is expected to facilitate growth and diversification of rural enterprises for both farm and non-farm sectors, and in the process, generate employment opportunities and reduce poverty.

35. **The high cost of financial intermediation continues to be an issue.**[33] While the high cost of lending is associated with the Government's crowding out of lending to the private sector, high margins are linked to the lack of competition into lower market segments, high adverse impacts of labor cost on bank cost structure, especially for the government-owned entities, and the need to absorb non-performing loans through provisions and write offs.[34] The ongoing Financial Markets Program for Private Sector Development represents a continuing effort to support reforms in the financial sector. Important measures have been implemented such as (i) drafting pertinent legislation on secured transactions, on permitting insurance companies to invest in securities, and on ensuring the commercial and political independence of People's Bank; (ii) amending the Finance Companies Act to permit leasing companies to transfer assets to a special purpose vehicle; (iii) providing additional powers to the Central Bank of Sri Lanka to take action against fraudulent schemes; and (iv) combating money laundering, among others. As a state-owned bank with a strong union presence, the restructuring of the People's Bank is inherently a challenging task. Several policy outcomes are expected from this ongoing program: (i) increased availability of financial products and services, (ii) enhanced corporate governance in the financial market, (iii) improved insurance industry regulation, (iv) improved governance of state-owned commercial banks, and (v) a restructured People's Bank.

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[32] ADB and World Bank. 2004. *Sri Lanka: Improving the Rural and Urban Investment Climate*. Washington, DC.

[33] Central Bank statistics indicated an average weighted lending rate of 14.8%−15.1% and an average weighted deposit rate of 5.3% to 6.2% over 2004−2005. Thus, the interest rate spread was about 9% during this period.

[34] ADB. 2005. *Sri Lanka: Financial Sector Assessment*. Manila.
Available: http://www.adb.org/documents/assessments/financial/SRI-financial-sector-assessment-2005.pdf

36. **Fiscal management reforms are in progress.** The Fiscal Management Reform Program is still ongoing, supported by TA for strengthening fiscal management institutions. Its comprehensive reform initiatives are built on a core of actions included in tax administration reforms and strengthening of decentralization arrangements. It develops criteria for intergovernmental transfers through the introduction of an incentive-based grant system that combines equalization objectives with rewards for fiscal efforts and fiscal discipline.[35] A reform of the budget process is ongoing to foster transparency and accountability. Key areas in which improvements have been carried out included the reorganization of revenue departments, creation of a taxpayer-friendly culture, enhancement of public awareness, and improvement of information technology facilities and audit systems.[36] Despite large deficits, fiscal headroom has been created to finance increased public investment against a rather unfavorable environment including (i) impact of tsunami (December 2004) and (ii) high oil prices. Over time, the Fiscal Management Reform Program is expected to bring about (i) a well-functioning, coordinated, and semi-autonomous revenue administration; (ii) streamlined budgeting procedures and expenditure control processes; and (iii) fiscal discipline through increasing transparency and accountability, results-based budgeting, and e-government. In the long run, the anticipated impacts include a reduced fiscal deficit and higher economic growth. The Inland Revenue Department improved revenue collection in the first year of program implementation (2005), providing encouragement for the Government to persevere with the reform agenda. The Government made a fresh start by reversing the steady decline in the ratio of revenue to GDP since 1999. Total revenues as a percentage of GDP, which declined from 17.7% in 1999 to 15.4% in 2004, improved to 16.1% in 2005, and subsequently to 17.0% in 2006. Government commitment to fiscal discipline was given legal status through enactment of the Fiscal Management Responsibility Act in late 2004.

37. **Restructuring reforms in the power sector have generated limited results.** Restructuring aimed to improve the operational and financial performance of SOEs. In the power sector, it called for a sequenced reform initiative that supported the establishment of an enabling and transparent business environment. Box 5 illustrates that the power sector restructuring reforms in Sri Lanka have not achieved the desired outcomes. Unbundling power sector enterprises into separate companies for generation, transmission, and distribution has not materialized due to political opposition.

Box 5: Outcomes of Power Sector Restructuring

- The independent regulator (Public Utilities Commission) is in place.
- The Electricity Reforms Act and the Public Utilities Act were passed by Parliament in 2002 but did not become effective.
- The unbundling of the power sector did not occur due to opposition from the *Janatha Vimukthi Peramuna*, a nationalist Marxist party, and from its affiliated trade unions.

Source: Key informant interviews by the evaluation team.

E. Identified Lessons

1. General Lessons

38. **Policy-based lending in Sri Lanka requires careful consideration of the reform environment.** Over the last two decades, ADB's policy-based lending in Sri Lanka has been partly successful with mixed results. The use of the policy-based lending instrument needs to be reassessed, taking into account the political economy of decision making, and the capacity and

[35] ADB. 2007. *A Comparative Assessment of the Asian Development Bank's Public Resource Management Reform Programs*. Manila.
[36] Central Bank of Sri Lanka. 2007. *Annual Report 2006*. Colombo. Available: http://www.cbsl.lk/publications.html

commitment of the Government to promote, direct, and manage reforms. Policymaking in Sri Lanka is often complicated by elections and the dynamics of political coalition. Certain calls for economic reforms may not be heeded, particularly during the rise to power of political coalitions that have differing agendas. A complex political and social structure, combined with civil strife, and a strong commitment to a welfare state, has made it difficult for many successive governments to push through unpopular but necessary decisions for structural change.[37]

39. **Policy and institutional reforms must have national ownership if these reforms are to be meaningful in terms of development.** Country ownership and political will for policy development and its associated reform agenda are requisites for which ADB assistance cannot serve as a substitute. Advancing policy and institutional changes in the country requires champions and coherent support from within the country. A country must draw up a reform agenda and strategy that suit its own political and social conditions. Pursuits of policy reforms that are built on an apolitical process and a lack of understanding of the country's history are bound to fail. A balance must be achieved between setting the pace of reforms and ensuring social and political stability. The political will to promote change is inevitably affected by resistance from vested groups that form the political support base. Thus, the vulnerability and sensitivity of policy reform need to be understood in program design and implementation. Alternative approaches to effect change and for change management must be sought, along with consideration of their costs and benefits. ADB needs to consider more flexible ways of formulating tranche release conditions since these conditions can be achieved in different ways.

40. **Policy reform is an art of making reform popular through civil participation and win-win outcomes for stakeholders.** Recent studies recognized that policy-based lending is not just a matter of packaging optimal market-based rules, and setting a tight schedule for their implementation. Policy reform is a process that requires a mechanism to accommodate the views of diverse interests and to make adjustments when necessary. Policy reform requires adaptation to accommodate changed circumstances. However, contingencies for changing circumstances are difficult to build into an ex-ante policy framework. There is a residual risk that the policy framework covers conditions that may not be met under a changed environment.

41. **Reforms involve change processes, and initiatives for change can face significant resistance from entrenched institutional structures and processes.** In Sri Lanka, many contesting value systems contributed to the pluralistic socioeconomic mix of state and market that has emerged from the liberal democratic tradition, socialism, to Marxism.[38] In this mix, many elements cannot easily form a consensus for defining approaches for service delivery and state functions, which include basic responsibility for social welfare.

42. **Reforms that involve major legislative changes can take more time to accomplish than is typically provided for in a program period of policy-based loans.** As in many countries, the amount of time to introduce legislative changes should be contextualized in program design. In a functioning democracy, the time required to effect changes to the legal environment should be carefully considered. There is a need to reconsider if legislative changes are absolutely necessary and if other options exist to achieve the desired reform objectives.

43. **Obtaining continued support from stakeholders for policy reforms is essential for sustaining the reform process.** While consultations are necessary during the formulation of a

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[37] ADB. 2006. *Asian Development Outlook: Sri Lanka.* Manila.

[38] Gunatilleke, Godfrey. 2004. *The Lessons of National Planning*. In Saman Kelegama, editor, *Economic Policy in Sri Lanka: Issues and Debates*. Colombo: Institute of Policy Studies.

policy reform program, such a program should also provide the resources for continued consultation and appropriate consideration of social cost to adjustment. Ensuring that safety nets and temporary measures are in place to cushion the effects of structural and institutional changes is important to fostering widespread support for the reform process.

44. **Policy-based programs remain a powerful tool to assure top level support for difficult reforms.** ADB generally evaluates the existence of top level support for reforms before approving program loans as evidenced and presented in development policy letters of the Government. However, there is the downside risk of policy reversal and variation of support for major policy reforms when there are changes in government and political coalition.

45. **The emphasis on approval undermines the continuation of a policy dialogue after program loans are disbursed and closed.** Non-tranche conditions, in particular, appear to be of lesser priority, and the overall monitoring of policy-based loans suffers after a program loan is fully disbursed. ADB should emphasize a continued policy dialogue and analysis of the effects of policy loans even after loans are disbursed.

46. **Perseverance to remain engaged in policy dialogue is critical.** ADB should be prepared to remain engaged in policy dialogue during times of policy reversal, when the implementation of ongoing programs is slow and may even stall, and when the prospects for further policy-based lending appear low. Resources are needed to continue the dialogue even when the prospects for new policy lending appear remote. The nature and scope of program loans requires continuity and involvement of experienced staff during program design and implementation. Frequent changes of staff can disrupt the continuity in policy dialogue.

47. **Policy conditions should not go beyond the Government's capacity to manage reforms, monitor change, and prepare the groundwork for future efforts.** Success in policy reforms partly depends on capacity development accompanying the reform initiatives. Well-targeted TA can support policy dialogue. However, government acceptance of TA and consulting services must not be taken for granted. General perception among senior government officials of the performance of TA and consultants influences government acceptance of external advice and TA.

48. **Program lending can be an effective instrument to induce reforms when a number of requisites are met.** Effectiveness is enhanced when (i) the program is based on a broadly supported set of reforms within national constituencies; (ii) the objectives are clearly defined and the reforms are prioritized and limited to manageable proportions; (iii) performance indicators of policy and institutional reforms are clearly defined; (iv) adequate flexibility is provided for adjustments to the program when warranted by changes in the external environment; (v) policy and institutional reform is understood to be a lengthy process through continuous review of options and consensus-building among decision-makers; (vi) the political leadership and the population at large are informed on the purpose and expected effects of reforms; and (vii) a sound macroeconomic environment and supportive macroeconomic policies are recognized as an essential complement to sector reform efforts.

2. Specific Lessons

49. **The basic causes of agricultural stagnation should be recognized.** Policy-based agriculture programs in the latter 1980s and in the 1990s, which aimed to revitalize the agriculture sector, have partly succeeded. Attempts at correcting distortions in the pricing of agricultural inputs and products and creating greater scope for private sector participation have

generated modest results. Along with efforts to enhance the private sector's role, greater attention should be given to structural barriers to agricultural performance including state ownership of land and practically all irrigation facilities, an underperforming research and development system, high-cost market infrastructure, and the agriculture protection regime. A thorough preparation of the policy base, which includes comprehensive sector work, is needed to pursue strategic and coherent choices.

50. **The rapid divestment in the past of government interests in SOEs within the short span of a program loan tended to sacrifice transparency.** Establishing realistic divestment targets, and encouraging the use of good practices for divestment, would have helped to achieve better results. Efforts to advance divestment should be accompanied by clear, well-defined subsector policies.

51. **Inadequate monitoring of the evolving incentive environment for private sector initiatives in agriculture contributed to a focus on simply implementing agreed reforms.** There was inadequate attention to mid-course adjustments to program measures. For example, monitoring the changes in the macroeconomic environment and in the agriculture sector would have alerted ADB and the Government to the need to make mid-course corrections in a number of the policy reforms.

52. **Resolution of labor issues requires significantly more time and more work that involves major restructuring than originally anticipated.** Government commitment is critical for major changes in labor legislation and the resulting costs to resolve these issues. Labor issues could be addressed as a separate program instead of implementing major changes concerning labor issues under a specific program to improve private sector development. This is due to significant issues around labor, including termination, unemployment insurance, and skills development for the unemployed. During program implementation, extensive efforts were carried out to find a window of opportunity and to bring together various groups (employers, unions, and the Government) to agree on a common course of action. However, extracting further concessions on reforms at that time was not possible.

53. **Proceeds from divestment of state assets and enterprises are dependent on the economic environment and market conditions.** The private sector development program had a mandatory program for privatization, with a quantified net asset value within a specified period to meet tranche release conditions. The Sri Lanka Telecom Limited and the Sri Lanka Insurance Corporation Limited, for example, were sold to meet tranche release conditions when the stock markets were plummeting worldwide and the Sri Lankan market was at a relatively low level.

54. **Policy conditions must be adaptable to changed circumstances.** Experience from the Small and Medium Enterprise Sector Development Program indicated that when including measures that have budgetary implications (such as a tax rate reduction), measures need to be fully consistent with fiscal consolidation efforts. For example, tax collection was much lower than anticipated, and the Government was not prepared to reduce the corporate income tax rate toward a uniform rate of 15%. This led to the amendment of the pertinent policy condition during program implementation. Consequently, the corporate tax rate was reduced from 35% to 30% for companies whose taxable income exceeds SLR5 million.

55. **Power sector restructuring is a dynamic and complex process with enormous challenges.** It requires a deep understanding of multifaceted dimensions: (i) the political economy; (ii) the historical background of reforms to provide an indicator of likely behavior; (iii) an assessment of local ownership; (iv) an assessment of institutions and their existing

capacity; (v) incentives and disincentives to reform; (vi) identified needs of the sector apart from restructuring; and (vii) changes required to achieve the reforms, taking into account the environment in which reforms are attempted. Where implementation progress is likely to be hindered by public and political resistance, provisions should be made for increasing public awareness of the reform agenda, building constituencies for reform, and reaching a consensus on the means for achieving reform objectives. Strategic measures are needed to knit reforms into a broader articulation of public interest.