

BTI 2008 | Sri Lanka Country Report

Status Index	1-10	6.61	# 37 of 125	
Democracy	1-10	6.30	# 57 of 125	➔
Market Economy	1-10	6.93	# 31 of 125	➔
Management Index	1-10	5.40	# 51 of 125	

scale: 1 (lowest) to 10 (highest) score rank trend

This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	19.6	HDI	0.76	GDP p.c.	\$	4,088
Pop. growth ¹	% p.a.	0.8	HDI rank of 177	93	Gini Index		40.2
Life expectancy	years	75	UN Education Index	0.81	Poverty ³	%	41.6
Urban population	%	15.1	Gender equality ²	0.37	Aid per capita	\$	60.9

Sources: UNDP, Human Development Report 2006 | The World Bank, World Development Indicators 2007 | OECD Development Assistance Committee 2006. Footnotes: (1) Average annual growth rate 1990-2005. (2) Gender Empowerment Measure (GEM). (3) Percentage of population living on less than \$2 a day.

Executive Summary

Sri Lanka's trajectory during the past two years has been marked by continuing economic development amidst political conflict. Increased foreign remittances, continuing direct foreign investment and rising exports have enabled the buildup of foreign exchange reserves despite a commodity trade deficit. Foreign trade is mostly deregulated, policies are market-friendly and the tax regime is liberal. The education level of the workforce is high. Educational opportunities for women are excellent though there are considerable gender barriers to engagement in society and the economy. Private property is relatively well-protected. One of the biggest complaints among absentee landlords is the manner in which squatters take over their property or neighbors build over sections of property. Trying to get such people to reverse course can take years of litigation in the Sri Lankan court system. On the other hand, the 2004 elections have been followed by some troubling signs, such as increased overstaffing of the public sector and continued illegal siphoning of funds from state ventures. The budget deficit continues to be excessive and inflation has begun to reach double digits. The privatization of state enterprises has halted.

The political picture is mixed. The cease-fire between the state and the separatist Liberation Tigers of Tamil Eelam (LTTE), which had been fragile since 2004, collapsed in mid-2006, resulting in open fighting with many casualties. Continued conflict has had adverse implications for human rights, where both the state and the LTTE have poor records. While state forces seem to have gained some victories in the fighting, separatist forces control extensive areas of territory in which they run a parallel administration. On the other hand, in most of the country outside the areas of conflict, democratic processes have continued to operate with extensive political participation and freedom of association. Despite some violence and the influence of state-run media, opposition news outlets are numerous. While there are flaws in the

independence of the judiciary, the Supreme Court has delivered some judgments that have posed political challenges to the executive. Fundamentally, there is strong public support for the democratic process, and democratic institutions such as the fragmented and slightly polarized party system seem stable.

There are considerable impediments to political transformation because of the difficulty in finding common ground between the state and the separatist forces and because political rewards do not seem to flow to moderates. Currently, the forces advocating a compromise settlement are weaker than they were two years ago. The government has shown remarkable steering capacity in economic matters and has made a concerted attempt to assist the poor during the period under review.

History and Characteristics of Transformation

Sri Lanka held its first democratic elections based on universal suffrage in 1931. By the end of British colonial rule in 1948, the country's elite had been socialized into accepting a British-style parliamentary system, which survived several power transfers in the wake of successive defeats of the ruling party in the 1950s and 1960s. A party system developed with the United National Party (UNP) and the Sri Lanka Freedom Party (SLFP) as its two major parties. During the second half of the twentieth century, the two parties combined won a steady 80% of votes and seats.

However, political parties were elite-dominated with minimal internal democratization. Ethnic tensions escalated, principally between the majority Sinhalese and minority Sri Lankan Tamils of the north and east. Sinhalese politicians implemented a number of policies that alienated many Sri Lankan Tamils, including the exclusion of most Tamil plantation workers in the central part of the country ("Up-Country Tamils") from citizenship in 1948, making Sinhala the only official language in 1956 and giving special constitutional recognition to Buddhism – the religion of most Sinhalese in 1972. The largely Hindu Sri Lankan Tamils were further aggrieved by diminishing opportunities for state employment in the 1960s and schemes intended to limit their access to some areas of university education in the 1970s. During the 1950s, Sri Lankan Tamil politicians began to demand a federal system and in the 1970s eventually opted for a separate state.

In the late 1970s, the more radicalized Tamil youth moved toward armed struggle. Faced with these challenges, as well as a short-lived insurgency among the Sinhalese youth in 1971, the state began to continually invoke a state of emergency, exerting greater control over the media and expanding the military forces. A new constitution in 1978 established a French-style presidential system and new anti-terrorist laws were enacted. Increasing attacks on state institutions and on the armed forces by Tamil

militant groups in the 1980s and a pogrom against Tamil civilians in 1983 made matters worse. An offer of a quasi-federal system following Indian armed intervention in 1987 failed to resolve the issue. By the late 1980s, the state faced twin armed insurrections, one by Tamil separatist groups and another by Sinhalese Marxists. It was able to crush the latter, but the Liberation Tigers of Tamil Eelam (LTTE), which emerged as the dominant Tamil rebel group, defeated its rivals and established control over some territory in the northeast.

A federal solution was and continues to be opposed by significant numbers of Sinhalese and military efforts to eliminate the LTTE have not met with much success. In February 2002, Sri Lanka and the LTTE agreed to yet another cease-fire but this time with Norwegian mediation and with a task-force on the ground to monitor the cease-fire. However, peace talks stalled after April 2004, and there has been extensive fighting since mid-2006.

Meanwhile, reforms permitted most Up-Country Tamils to gain citizenship rights in the 1980s and Up-Country Tamil political parties currently participate in mainstream politics. At the same time, Muslim political parties emerging in the last twenty years have begun advocating a separate Muslim province.

The British left Sri Lanka with a colonial economy in which the state depended on the plantation sector for much of its revenue. Sri Lankan politicians maintained the well-developed health care system that they inherited from colonial rule and they vastly expanded secondary education. They also subsidized the price of rice, a staple in Sri Lanka. On the other hand, they also inherited a weak industrial sector, requiring heavy investment in agriculture to reduce the country's dependence on food imports. A somewhat costly strategy of import substitution and of economic development through public sector companies was attempted up until 1977. From then on, market-oriented reforms were gradually adopted. Successive governments of different political hues have pursued privatization, public sector reforms and the liberalization of trade and capital movements, although populist opposition to some of these changes continues.

Transformation Status

I. Democracy

1 | Stateness

Sri Lanka as a state has wide recognition internationally, but it has been unable to control significant areas in six of its twenty two districts. There are approximately 500,000 people living in these areas, in which the LTTE runs a parallel administration with its own police, tax collectors and justice system. Since a period of relative stability from late 2001 to mid-2006, clashes between the LTTE and the state have led to over 3500 deaths and the displacement of 250,000. State forces have control throughout the rest of the country.

Monopoly on the use of force

Since the removal in the 1980s of obstacles that prevented Up-Country Tamils from gaining citizenship, all groups in Sri Lanka have legal access to political rights. On the other hand, considerable numbers of ethnic Tamils do not accept the current Sri Lankan state as legitimate and in 2005, the LTTE enforced a boycott of the presidential election.

State identity

The state supports all major religions in Sri Lanka, with a deputy minister for religious affairs, and state departments supporting Buddhism, Hinduism, Islam and Christianity. In effect, however, the Buddhist lobbies have extensive influence and Article 9 of the constitution specifies that “The Republic of Sri Lanka shall give to Buddhism the foremost place,” although Articles 10 and 14 safeguard freedom to have or adopt a religion of one’s choice and the freedom to teach and practice one’s religion in public or private. The last two years have seen attacks on some churches, due to suspicions of evangelization with the help of foreign funds after the tsunami disaster. However, Buddhist efforts to legally prohibit the use of inducements for conversion have failed.

No interference of religious dogmas

Sri Lanka has an effective administrative structure that provides basic health and educational facilities to all areas. Central and provincial agencies provide power, water, housing and other basic facilities, and implement state policies such as those relating to fertilizer subsidies. In the north and east, civil war has led to the attenuation of the administrative structure, although schools, hospitals and other

Basic administration

state agencies, maintained by state funds but under effective LTTE political control, have continued to operate when there is a lull in violence. The level of corruption in state administration has shown no improvement in the past few years. Political interference in the operation of the administration is routine and recruitment to state agencies (except in the case of professionals such as doctors) is carried out almost entirely through political recommendation.

2 | Political Participation

Recent elections at the national and local levels in 2005 and 2006 respectively, have been generally free and fair. The margin of victory in the presidential election of 2005 was less than 2%. On the other hand, the party in power controls significant portions of the news media including major newspapers and state TV. Ministers use state resources, including the police, during political campaigns. Therefore, particularly in local and provincial elections, where the outcome would not materially affect the power structure, the ruling party has a distinct advantage. Areas in the northeast under LTTE control do not have free elections.

Free and fair elections

Democratically elected officials have been able to implement their policies. The president is the commander-in-chief of the armed forces and has been able to appoint his choices of chiefs for the army, navy, air force and police without precipitating a crisis. Administrative officers are transferable and subject to political will. Legislators wield extensive influence with administrators in their constituency. However, local and provincially elected officials in the opposition are not assured of cooperation from state agencies in enforcing their policies and regulations; only prominent political supporters of the government are guaranteed cooperation.

Effective power to govern

Under the laws relating to public security, the state can restrict public meetings of groups, although this is rarely done. However, gangs attached to individual politicians intimidate voters and opposition politicians participate in politics at some personal risk. In areas under LTTE control, there is virtually no room for dissent.

Association / assembly rights

The state controls significant portions of the news media, including major newspapers and state TV. However, there are independent media outlets critical of the government, and they provide for a plurality of opinions – political, ethnic and religious – especially if weekly newsheets are taken into consideration. At the same time, several journalists and their families have been attacked and killed during the observation period, and freedom of expression is severely restricted in the northern and eastern areas due to the civil war.

Freedom of expression

3 | Rule of Law

The advent of the presidential system in 1978, combined with the president's party long-term majority in the legislature, curbed the legislature's power for several years. However, more recently (2001–2004), the president's party has lost its control of the legislature, leading to a more balanced system. After narrowly winning the 2004 election, the ruling coalition has had to make compromises to build support in the legislature. The exit of an important coalition partner in June 2006 forced the president to rely on opposition support to secure his legislative program. The president has used his powers of patronage (there are 104 ministers in a legislature of 225 members) to wean legislators from opposition parties.

Separation of powers

Judges of the Supreme Court and of the Court of Appeal are appointed by the president and cannot be removed from office except with majority support in the legislature for proven misbehavior or incapacity. No judge has ever been removed under this provision. In recent times, the Supreme Court has occasionally asserted its independence, ruling unconstitutional both the proposed arrangement for the distribution of tsunami aid in 2005 and the 1987 executive order merging the Northern and Eastern Provinces in 2006. There is a well-organized legal system with a system of appellate courts and an influential lawyers' association. However, political appointments to the bench (in all courts) and the intimidation and transfer of judges (mostly in the lower courts) have diminished the judiciary's independence. Corruption and political influence have undermined confidence in the judiciary. The judiciary is not empowered to rule on the constitutionality of legislation after it is enacted, though bills can be challenged before they become law.

Independent judiciary

Inefficiency, anomie and corruption are widespread at all levels of government as is the impunity with which such practices and human rights violations are perpetrated. The latter especially has ascended to new heights under the Mahinda Rajapaksa government. Recent reports suggest that President Mahinda Rajapaksa's brothers may be involved in questionable practices as well, and some reports in Sri Lanka have been referring to one brother as "Mr. 10%." No high-ranking politician or public servant has been prosecuted for abuse of power while in office despite evidence that seemed to warrant *prima facie* cases. Successful prosecutions after political defeat are extremely rare. There is no practice relating to disclosure of financial interests while in office.

Prosecution of office abuse

The civil war has led to militarization, human rights violations, torture and disappearances, particularly, but not exclusively, in the northeast. There are instances of torture, rape and abuse at the hands of the state security forces. In areas under LTTE control, there have been numerous abductions and the recruitment of child soldiers is extensive, as is a system of summary justice.

Civil rights

4 | Stability of Democratic Institutions

In the past year, the elected president has been able to negotiate for support within the legislature and is in control of the administration and armed forces. Thus, for instance, despite charges of favoritism and corruption, tsunami relief reached most victims in the areas under state control. In areas under LTTE control however, policy is dictated by unelected leaders.

Performance of democratic institutions

Democratic procedures are widely regarded as the only means conferring legitimacy. They are not questioned by any party or group, though sometimes subverted in practice. A recent survey reported that support for democracy in South Asia was highest in Sri Lanka. Voter participation is high and voters sometimes accept personal risks in order to cast votes.

Commitment to democratic institutions

5 | Political and Social Integration

The party system is moderately fragmented in terms of the effective number of parties, and voter party loyalties appear to be fairly stable. The two largest parties, the United National Party (UNP) and the ruling Sri Lanka Freedom Party (SLFP), dominated by Sinhalese Buddhists and middle-upper class interests, have historically been able to absorb adherents of smaller parties, including those who had supported Marxist groups. The last two legislative elections seem to indicate that at least 10% of the vote goes to fragmented ethnic parties. The Marxist JVP gained 39 seats (out of a total of 225) in coalition with the SLFP in 2004 but was able to gain only 10% of the votes in the local government elections of 2006. The two major parties agree on broad economic and social policies. Individual politicians seem comfortable in changing allegiance from one major party to the other. Nevertheless, there is considerable polarization between the two major parties on the one hand and the minority ethnic parties on the other. Party organization is undemocratic. Party branches become active only at election time and act mostly to mobilize voters.

Party system

Religious interests such as groups of Buddhist monks and the Catholic Church are vocal, with Islamic and Hindu groups being less active. With the rise of the service sector and the growth of industry in free trade zones, trade union membership has continued to drop and currently includes only about 40% of workers in the organized sector (most union members are plantation workers). Trade unions are organized at the company level, affiliated with political parties and their strength varies with party fortunes. Employers federations are influential in terms of pushing economic reforms. There are many NGOs actively engaged in supporting poorer sections of society and in the creation of ethnic harmony, but the leadership is thin and NGOs dependent on foreign grants have come under increasing attack as “foreign agents.”

Interest groups

The 2005 survey on the State of Democracy in South Asia, concluded that support for democracy in Sri Lanka was higher than in any other country in the region. This support is stronger among the majority Sinhalese than among ethnic minorities. Participation in elections has been very high with over 73% in the presidential election of 2005. Violence during elections has decreased and changes of government have been frequent.

Consent to
democratic
norms

There is no reliable survey data on inter-personal trust but extensive social networks exist in Sri Lanka. Many of them are based on religious affiliations and center on a temple, mosque or church and often organize pilgrimages. Social organizations in rural areas tend to concentrate on helping neighbors facing a crisis. In urban areas, the upper-middle class participates in organizations such as the Lions Club, Jaycees and the Rotary Club. The poorer sections of urban society continue to work with religious leaders, often replicating rural patterns of organization.

Associational
activities

II. Market Economy

6 | Level of Socioeconomic Development

Sri Lanka is a middle-income country that performs much better than comparable economies in terms of the Human Development Index. Nationally, absolute poverty has declined gradually to less than 24% of the population. The 2006 UNDP's Gender-related Development Index for Sri Lanka is 99.2% of its Human Development Index due to a high life expectancy, low child mortality and high education levels for women. However, men hold over 60% of employment in the organized sector. Safe drinking water is available to 75.4% of the population and satisfactory sanitation to 72.6%, but only to 24.8% and 35.5%, respectively, of the workers living on plantations. Scenes of open conflict in parts of the north and east, have remained largely excluded from economic growth in Sri Lanka. These provinces contain almost 12% of the population of the country but account for only 3% of the economy. The people in these regions are largely Tamil or Muslim, though they include some Sinhalese. Some of these areas were hard hit by the tsunami of 2004 but have seen only limited assistance. Government-imposed limitations on fishing and the LTTE's financial exactions have proved burdensome. Education is disrupted; children are abducted to serve in militias. Shortages of food and other necessities accompany clashes between the state and the LTTE.

Socioeconomic
barriers

Economic indicators		2002	2003	2004	2005
GDP	\$ mn.	16,536	18,246	20,055	23,479
Growth of GDP	%	4.0	6.0	5.4	5.3
Inflation (CPI)	%	9.6	6.3	7.6	11.6
Unemployment	%	8.7	9.2	8.5	-
Foreign direct investment	% of GDP	1.2	1.3	1.2	1.2
Export growth	%	6.3	5.4	7.8	7.5
Import growth	%	11.2	10.2	9.3	8.7
Current account balance	\$ mn.	-236.3	-70.7	-647.6	-647.3
Public debt	\$ mn.	8,400.4	9,158.8	9,847.5	9,811.6
External debt	\$ mn.	9,739.6	10,441.2	11,085.1	11,443.9
External debt service	% of GNI	4.4	3.3	4	1.9
Cash surplus or deficit	% of GDP	-7.6	-7.1	-7.6	-7.3
Tax Revenue	% of GDP	14	13.2	13.9	14.3
Government consumption	% of GDP	8.8	7.9	8.1	8.5
Public expnd. on edu.	% of GDP	-	-	-	-
Public expnd. on health	% of GDP	1.7	1.7	2.0	-
R&D expenditure	% of GDP	-	-	-	-
Military expenditure	% of GDP	3.1	2.7	2.8	2.0

Sources: The World Bank, World Development Indicators 2007 | UNESCO Institute for Statistics | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security

7 | Organization of the Market and Competition

Market competition in Sri Lanka is stable. Discrimination against foreign investors is very low with investment up to 100% allowed in many sectors. However, (with some exceptions) foreign investment under \$1 million is prohibited in areas of retail trading and non-bank lending, and in some sectors, foreign investment exceeding 40% is subject to screening and approval. Outward investment needs state approval. The labor market has become more flexible since the reforms of 2003, though the state controls some wages and prices,

Market-based
competition

including the prices of petroleum, water, power, bus and rail fares, and bread. The top income tax rate is low at 30% and the top corporate tax rate 32.5% (including a 2.5% surcharge).

The only monopolies that exist are state-owned (e.g., electricity) and the state fixes the prices of some commodities such as bread. There are no specific anti-cartel laws but market competition has prevented the growth of monopolies or cartels.

Anti-monopoly
policy

Foreign trade is deregulated and according to the World Bank, Sri Lanka's weighted tariff rate for 2004 was 6.8%. Free trade agreements with India and Pakistan allow tariff free imports of many items.

Liberalization of
foreign trade

The banking sector has continued to improve. Foreign banks need the central bank's approval before opening branches. There are 23 commercial banks, of which 13 are foreign-owned and two state-owned. There are also 16 specialized banks, and 10 merchant and investment banks. The two state-owned commercial banks hold almost 50% of banking sector assets, but their share of non-performing loans fell from 18% in 2003 to 8% in mid-2006, and their profitability has improved. Overall, the percentage of non-performing loans fell from 7% in 2005 to 6.3% in 2006. Banking practices including liquidity requirements and calculation of assets conform to international standards. As of early 2007, the Colombo Stock Exchange has 249 listed companies and the All Share Price Index rose from 1507 in 2004 to 2384 in 2006, one of the best performers in the region. The average P/E ratio of 12 is comparable to those in Bangladesh and Pakistan, but lower than in India.

Banking system

8 | Currency and Price Stability

Fiscal policies have not contained inflation caused by increases in domestic fuel prices, higher import prices, mandated wage increases for state workers and an increase in the money supply. Thus, inflation, as measured by the Colombo Consumer Price Index, was 7.6% in 2004, rose to 11.6% in 2005, and could exceed 14% for 2006. The central bank raised interest rates four times in 2006 and in early 2007, both inflation and interest rates were at a ten-year high. With the state budget deficit at 8.7% of the GDP in 2006 and an increased military expenditure predicted for 2007, it will be difficult to contain inflation. The Sri Lankan rupee, which had held steady around 100 per one U.S. dollar in 2004—virtually unchanged from 2003—began to slide to 106 per U.S. dollar by October and was expected to depreciate to 108 per U.S. dollar by 2007.

Anti-inflation /
forex policy

International reserves continued to grow in 2005 and 2006, despite deficits in the current accounts balance which rose from \$652 million in 2005 to over \$1400

Macrostability

million in 2006. This was largely due to increased foreign remittances from Sri Lankans overseas, which rose from the previous record of \$1350 million in 2004 to \$1735 million in 2005 and over \$2100 million in 2006.

9 | Private Property

Property rights and acquisition are adequately secured in the industrial and service sectors. Land ownership and sale is safeguarded, although land registration procedures are cumbersome. In parts of the country where state land is granted free to agricultural settlers, it is held in leasehold and is not legally disposable. While this measure was established to prevent forfeiture of land for debt, it has led to limited mobility for some farmers.

Property rights

Privatization of state enterprises has continued, with the major state insurance corporation privatized in 2005. However, there is resistance to privatization of power by trade unions and it is expected that the pace of privatization will slow under the new president.

Private enterprise

10 | Welfare Regime

Sri Lanka's Human Development Index in 2004 was considerably above that of many countries with higher per capita GDP because of long-standing and comprehensive welfare programs. Free health care implemented for over half a century continues, but is challenged by financial constraints, the high incidence of malnutrition among children, the re-emergence of communicable diseases such as malaria and dengue fever, and a demographic transition that has led to greater demand for care of the elderly. One in five Sri Lankans does not have access to a safe water supply. Basic provision of education is comprehensive, with state or state-assisted schools providing education free from grade 1 to grade 12, but there is a shortage of teachers in foreign languages and in technical subjects, and tertiary education is not well-funded. The rural population and most in the urban sector have no insurance coverage for natural disasters, disability and old age.

Social safety nets

Access to public services is open by law. There are however, inequalities in practice. There is no gender gap in educational enrollment or achievement, but men dominate the more lucrative levels of employment in both the public and private sectors. There are regional and urban-rural disparities in the quality of the education system. Access to financial resources is limited for the poorer sectors of society, despite the state's encouragement of micro-lending. In 2006, banks were instructed to devote 10% of their lending portfolio from 2007 to 2010 to agriculture. Access to opportunity has been severely limited in areas of conflict of the north and east, which has affected large numbers of minority Tamils and Muslims and some Sinhalese.

Equal opportunity

11 | Economic Performance

The overall economy has grown at an impressive rate. Despite the impact of the 2004 tsunami, the GDP growth rate was at 6% in 2005, and had reached 7% in 2006, despite the rise in petroleum prices. Thus, government debt as a percentage of GDP was 91.5% in December 2006, a slight decline from the 94% at the end of 2005. Unemployment has fallen from 8% in 2004 to 6.7% in 2006. Agricultural and industrial production continues to grow and the rising commodity trade deficit is compensated for by a continuing inflow of private remittances (now the primary foreign exchange earner for Sri Lanka). The investment-to-GDP ratio rose to 29% in 2006, and private investment accounts accounted for 87% of total investment. However, inflation has risen to over 14% and the terms of trade declined by another 3% in 2006. The overall budget deficit in 2006 was 8.7% of GDP, and military expenses for 2007 are projected to reach a record \$1.3 billion. The 2006 surge in hostilities between the state and the LTTE acts as a major deterrent to the growth of foreign investment and tourism. Sri Lanka's first international credit rating by Fitch (BB-) in December 2005, placed it on par with Vietnam, Indonesia, Brazil and Turkey, but renewed fighting in 2006 made Fitch revise the outlook from stable to negative.

Output strength

12 | Sustainability

The encroachment of natural reserves and continued deforestation, despite logging restrictions imposed in 1999, have resulted in soil erosion and other adverse effects on biodiversity. The provision of free water for agriculture has contributed to high usage. Air and water pollution has worsened in urban areas and development pressures have also led to the reclamation of estuarial, lagoon and marsh waters, and the unrestricted disposal of untreated sewage, leading to major pollution problems. Environmental concerns, however, tend to take a back seat to growth considerations. Ecologically sustainable growth gets only scant attention and is not reflected in the institutional framework.

Environmental policy

The existing system of education at the primary and secondary levels is comprehensive, but tertiary education continues to fall behind in quality. The law provides for a state monopoly on university education, but private tertiary educational institutions provide post-secondary diplomas and link programs with foreign universities. State universities and R&D facilities are poorly funded. Modern infrastructure does not extend nationwide, but is limited to certain segments and enclaves such as major cities and modernized economic sectors.

Education policy / R&D

Transformation Management

I. Level of Difficulty

The geographical concentration of Tamils in the north and parts of the east has reinforced demands for a separate state. Until 2004, the opposing party's presidency blocked peace efforts initiated by the government, regarding the settlement as too conciliatory. The dispute ended with the victory of a coalition led by the president's party, but the government depends on the support of Sinhalese nationalist groups, some of whom oppose movement toward a federal system. The LTTE's boycott of the 2005 presidential election, which ensured the victory of the less conciliatory candidate, Mahinda Rajapaksha, and the LTTE's policy of assassinating political opponents has exacerbated the situation. Since the acceptance of the LTTE's separatist demands would spell political suicide for the government, there is no solution in sight. Government attacks on LTTE strongholds in late 2006 have made matters worse. In terms of economic development, the challenges are less daunting. Sri Lanka does not have exploitable oil or coal resources. There are also problems of continuing poverty with considerable sections of the poor feeling excluded from the benefits of economic growth. On the other hand, Sri Lanka has a good geographic location, an educated labor force and a basic (though inadequate) system of internal transport. Much of the needed economic structural reform has already been accomplished, with relatively broad consensus.

Structural
constraints

There are numerous NGOs in Sri Lanka concentrating mostly on poverty alleviation and ethnic reconciliation. While there is faith in democracy, patron-client ties are strong, and trust in state institutions is limited among the poor and ethnic minorities.

Civil society
traditions

Civil war between the separatist LTTE and the state is the major conflict. Although the cease-fire of February 2002 reduced armed clashes between the two sides, since 2004, both have moved toward increased military conflict. The LTTE was aware that their boycott of the 2005 presidential election would result in the defeat of the more conciliatory UNP candidate and a likely return to war, but made that choice anyway. Most Sinhalese voters clearly preferred the more belligerent United Peoples Front Alliance (UPFA) – consisting of the SLFP and

Conflict intensity

the JVP and other leftist parties – to the UNP. Although the president, after winning the election, adopted a more conciliatory stance and broke with the JVP in June 2006, open clashes in the second half of 2006 led to over 3000 deaths, including 650 in state forces and over 800 LTTE cadres. A key factor in the renewed conflict was the state's refusal to disarm a pro-state Tamil militia that had broken away from the LTTE. Despite the recent measures to increase public servants' wages, subsidize fertilizers to help farmers and alleviate poverty, there is resentment over corruption and the excessive wealth enjoyed by a few. The most developed area, the Western Province, produces 50% of the GDP and less than 15% of households are below the poverty line, while about 30% of households in the other provinces live in poverty.

II. Management Performance

14 | Steering Capability

The current president's victory in 2005, which was based on a populist platform, raised fears that some of the recent economic reforms would unravel. This did not happen, however, as the leftist JVP departed from government. In fact, controlled prices for goods such as petroleum and services such as bus and rail, were raised in mid-2006. Although there were efforts to control inflation by raising interest rates, and the budget deficit for 2006 was controlled, increased military expenses, the continuation of subsidies and increased overstaffing of the public sector will likely hurt long-term economic development. The government in power (SLFP and its allies), which is challenged from both the left and the right, sees a need to balance measures to retain popular support for long-term economic objectives. This dilemma is also clear from a political perspective. In December 2006, the state decided to separate the Northern Province from the Eastern Province. Earlier in the year, the Supreme Court, in response to a petition sponsored by the JVP, had ruled that the executive order of 1987, decreeing the union of the two provinces, had been unconstitutional. The de-linking was supported by many Sinhalese who saw the merger as a means to submerge the Sinhalese in the Eastern Province in a Tamil majority in the combined Northeastern Province. However, most Tamil groups condemned the move as counterproductive and a new obstacle to peace.

Prioritization

The government's majority in the legislature depends on a coalition of assorted parties and survives because the opposition is fractured and not confident about

Implementation

winning an election. However, this constellation inhibits innovative reform and risk-taking. The threat of trade union action also prevents the introduction of some economic reforms. For instance, the threat of a strike has kept the power supply, which is currently the monopoly of a state agency operating under huge financial loss, from undergoing privatization or restructuring.

In terms of the ethnic conflict, despite wide recognition of the costs of conflict, the state and the LTTE remain relatively inflexible in terms of the cognitive frameworks through which they view the issue. The LTTE and some other Tamil organizations view Tamils as an oppressed nation and themselves as liberation organizations. The Sinhalese majority who dominate the state view the LTTE as a terrorist organization and the Tamils of the north and east as making excessive demands on the state. Both sides harbor hopes of a military victory and are emotionally invested in their positions. There is an immense lack of trust. The reluctance to embrace more moderate policies could be interpreted not as the inability to learn from errors, but rather as the propensity to recognize that moderation in ethnic politics does not pay political dividends in a divided society. In terms of economic policy, the leadership has shown great pragmatism and both major parties accept the principles of a market economy.

Policy learning

15 | Resource Efficiency

The public sector is overstaffed and the appointment of new public officials is politicized except for a minority of specialized professionals such as doctors. Once appointed, public officials are protected in their positions, though they can be subject to transfers to undesirable locations. The state debt as a percentage of GDP is manageable, and the state budget deficit for 2006 was 8.7% of GDP. Auditing of state agencies is routine. However, the Parliamentary Committee on Public Enterprises reported in 2006 that about one billion U.S. dollars had been siphoned off from state funds over the past few years. Elected local and provincial assemblies have legally defined spheres of activity but do not have adequate financial resources.

Efficient use of assets

Policy coordination through the administration is well-established; many central ministries have branches at the provincial level with coordination provided for by civil servants. On the other hand, although the political decision makers at the national level recognize that civil war-related policies have economic impacts, there is a tendency, within the administration, to believe that Sri Lanka can afford guns and butter policies at the same time.

Policy coordination

There is no prosecution of corrupt politicians in power. Public procurement systems are notoriously open to bribery and there is virtually no accountability of officeholders in terms of asset declarations and conflict of interest rules. State

Anti-corruption policy

spending is audited, but party financing is not regulated. The media occasionally highlights glaring instances of questionable decisions. For instance, publicity surrounding the grant of some valuable state land to former president Kumaratunga led to her decision not to accept the land.

16 | Consensus-Building

The two major parties (SLFP and UNP) agree on the long-term strategic goals of a market-based democracy. The party in power, the SLFP, has placed greater emphasis on poverty eradication – but within the framework of a market-based economy. The Marxist JVP advocates state intervention in the economy, but their effort to contest independently in the local government elections of 2006 revealed that a support base of less than 15% of the electorate. The LTTE has not voiced a coherent policy in relation to a market economy or democracy, but it clearly acts in undemocratic ways.

Consensus on goals

The major veto actor is the LTTE, which can and has prevented participation in elections when it so wishes. The military has not interfered in economic and political policy-making, though it has influence over policies relating to state forces. Trade unions can influence policy in a few sectors where they are strong (e.g., power, transport, tea production).

Anti-democratic veto actors

There is broad consensus on a market-oriented growth policy combined with poverty eradication. In late 2006, the government and the main opposition party (UNP) signed a Memorandum of Understanding on five key policy areas (the ethnic conflict, electoral reform, good governance, social development and a structure for collaboration) to facilitate consensus-building. But this agreement seems to be in tatters after some UNP legislators defected to the government. Ethnic cleavages are significant. Apart from the LTTE's demand for a separate state in the northeast, the Up-Country Tamils in the central part of Sri Lanka see themselves as an economically oppressed group. Muslims, who make up almost 8% of the population, are influenced by external events and have become more conscious of their identity and interests.

Cleavage / conflict management

The political leadership does not make specific efforts to encourage the participation of civil society in the political process, but does aim to manage civilian groups who seek to intervene in politics. Several journalists have been killed during the review period. However, the press enables public debate on policy. Intellectuals who criticize state policies find outlets in the media but also find themselves under attack. Professional associations and interest groups are able to influence the state in certain narrow areas.

Civil society participation

Both the majority Sinhalese and the minority Tamils see themselves as victims of historical acts of injustice, the former during colonial times and the latter in the period since independence. The continuing ethnic divide (which extends to a lesser extent to the Muslims) hinders progress toward reform goals. There is urgent need to recognize and acknowledge more recent acts of injustice by state agencies towards the minorities and the powerless (women and the poor).

Reconciliation

17 | International Cooperation

The state has worked successfully with the IMF and World Bank in the past decade and continues to do so. International actors have influenced state direction in economic policy, moderating populist influences in the last two years. However, large commitments of foreign donors for post-tsunami reconstruction have stalled with the inability of the LTTE and the state to agree on a mechanism to manage reconstruction. In December 2006, Germany suspended tsunami aid to Sri Lanka until progress was made on peace talks and announced the transfer of \$25 million in aid to Indonesia. However, other development grants and loans continue. For instance, as of September 2006 there were sixteen World Bank projects in Sri Lanka, with a total value of \$806.6 million and an undisbursed balance of \$519.7 million.

Effective use of support

Sri Lanka has followed through in terms of reform policies and economic commitments. It has been less successful in keeping its commitments to resolve armed conflicts and reduce human rights abuses. A recent Supreme Court decision that places Sri Lankan law above international norms of justice has led to criticism.

Credibility

Sri Lanka has excellent relations with its neighbors, despite some disquiet in India relating to state policy toward the Tamils. Free trade agreements with India and Pakistan have significantly lowered tariff barriers and encouraged trade. Sri Lanka is a member of the regional body SAARC.

Regional cooperation

Strategic Outlook

There are five areas in which a change in policy is recommended:

Civil war: Bringing an end to the civil war is crucial if Sri Lanka is to attain the twin objectives of democracy and a market-based economy. The continuing conflict is militarizing and brutalizing society while draining resources and discouraging foreign investment. The conflict has been escalating in recent months; in terms of objectives, the two sides are as far apart as ever. President Rajapaksha has sought to build a consensus on the state approach to separatism and has grown more flexible in his approach since being elected, but he clearly fears being outflanked by his political adversaries. The Liberation Tigers of Tamil Eelam (LTTE), for its part, insists on being regarded as the only legitimate representative of the Tamils. The two sides will continue fighting as long as each perceives military victory to be in reach. Improving control over the flow of funds to the LTTE and tying international aid to progress made in peace talks are good first steps. Providing support for emerging peace movements within Sri Lanka will prove more difficult, and even more so in LTTE-dominated areas.

There are excellent prospects for continued progress toward a market economy. The Sri Lankan economy has demonstrated the ability to deal with adverse shocks. However, inflationary pressures are increasing and the external current account is widening. The rising debt service burden makes the economy vulnerable to external shocks. Further monetary tightening may be needed to control credit growth and to keep inflation in check.

Transparency and accountability in Sri Lankan state expenditure and procurement practices are important in terms of checking corruption and in developing public trust. Transparency and efficiency in the legal and administrative framework will reduce the transaction costs of business enterprises and promote investment. Steps that might be taken include greater legal public access to information, publication of annual accounts of state enterprises and strengthening auditing and reporting procedures.

Sustainable development will require that political stability and economic growth be combined with both a vision for the transformation of Sri Lankan society and greater attention paid to social justice. The emphasis on reducing rural poverty is a good start. Improving law and order, and ensuring better access to the judicial system should be part of the aforementioned vision, as it is needed to improve public trust. Of equal importance is the improvement of

education quality and access. Having recognized this fact, the state is using external assistance to improve the existing education infrastructure, but R&D expenditures remain low (less than 2% of GDP). Sustainable development also involves upgrading material infrastructure facilities such as highways, ports, safe drinking water and power. The government aims to provide 100% of the urban population with a piped water supply by 2010 and has implemented a road rehabilitation program called “Maga Naguma”.

Environmental issues should be linked to sustainable development. The government needs to engage the private sector, NGOs, civil society and other stakeholders in extensive talks to build a development policy consensus that pays greater attention to environmental concerns. Sixteen of Sri Lanka’s coastal lagoons that make up half of the country’s wetlands are classified as threatened. This is mostly due to development for tourism and recreational purposes, fisheries, fish farming, industrial development, unrestricted disposal of untreated sewage, large-scale sand mining and housing. Growing population pressure and some cultivation and clearing practices have led to enhanced vulnerability to natural disasters such as landslides and floods. Existing legal instruments, such as the Environmental Impact Assessment (EIA) and Environment Protection Licence (EPL) need to be fully utilized and strengthened.