

SRI LANKA

COUNTRY ASSISTANCE STRATEGY

2009-2012



THE WORLD BANK



THE WORLD BANK GROUP

SRI LANKA



COUNTRY ASSISTANCE STRATEGY



**For the
DEMOCRATIC SOCIALIST REPUBLIC OF
Sri Lanka**

2009-2012

July 24, 2008

PUBLIC LIBRARY
JAFFNA
SPECIAL COLLECTION



The World Bank
South Asia Region

The International Finance Corporation
South Asia Department

Sri Lanka Country Office

Digitized by Noolaham Foundation.
noolaham.org | noolaham.media

5082(P)CC



Fishing has resumed and normalcy is returning to the Ampara coastal villages in the east of Sri Lanka. 78 percent of the coastal population in Ampara was affected by the 2004 tsunami. About 100,000 families benefitted from the World Bank funded livelihood support cash grants program that eased income losses through four rounds of cash grants of Rs. 5,000 [US\$50] per family transferred directly to the beneficiaries' passbook bank accounts.





THE WORLD BANK

© 2008 The International Bank for Reconstruction and Development/ THE WORLD BANK

1818 H Street, N.W.

Washington, D.C. 20433, USA

The material in this work is copyrighted. No part of this work may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or inclusion in any information storage and retrieval system, without the prior written permission of the World Bank. The World Bank encourages dissemination of its work and will normally grant permission promptly.

For permission to photocopy or reprint, please send a request with complete information to the Copyright Clearance Center, Inc, 222 Rosewood Drive, Danvers, MA 01923, USA
Telephone 978-750-8400, Fax 978-750-4470, www.copyright.com

All other queries on rights and licenses, including subsidiary rights, should be addressed to the Office of the Publisher,

The World Bank

1818 H Street NW, Washington, DC 20433, USA,

Fax 202-522-2422, e-mail pubrights@worldbank.org

ISBN: 978-955-8908-30-3

Photography

Shahidul Alam/Drik/Majority World

Lakruwan Wanniarachchi (*Page 29*)

Chulie de Silva (*Pages 4, 10, 27, 57, 68, 72-73*)

Design

Mahbub/Drik, Bangladesh (www.drik.net)

Printer

Ari Investments Limited

19, St. Joseph Road, Nugegoda, Sri Lanka.

(Cover Photo)

7 year old Amanda Sewmini Bandara wants to be a doctor when she grows up. She has a good chance of doing that from the Sewamuktha Kandawura MahaVidyalaya, a Primary and Secondary School in Polonnaruwa. The World Bank's **Education Sector Development Project** is supporting school activities to improve learning outcomes.

(Back Page Cover)

Jawfar Jeskiya (22), Mohamed Akbar Asana Umma (12), Hairulla Rizmiya (16), Jwafar Pasila Umma (19) and Nazoor Hafiza (20) deftly carry water much needed for their households. All are students of Wathtakkandal Muslim School in Puttalam. Asana Umma the youngest is still at school and the two twenty year old are married. **Puttalam Housing Project.**


SRI LANKA  **COUNTRY ASSISTANCE STRATEGY**

The last Country Assistance Strategy for Sri Lanka [Report No: 34054-LK] was discussed by the Board on April 1, 2003

Currency & Equivalents
Currency Unit = Sri Lanka Rupee (Rs)
US\$ 1= Rs 107.3 (as of May 2, 2008)

Fiscal Year
January 1 - December 31

	IDA	IFC
Vice President	Isabel M. Guerrero	Paolo M. Martelli
Country Director/Manager	Naoko Ishii	Gilles Jacques Galludec
Task Team Leader	Claus Pram Astrup	Paul Antony Barbour

A close-up photograph of a woman with dark hair, smiling warmly as she cradles a baby. The woman is looking down at the baby with a gentle expression. The baby is wearing a green patterned shirt and is being held in the woman's arms. The background is blurred, showing other people in a clinical or community setting. A yellow square is visible in the upper right corner of the image.

R.M. Leelawathi playfully cradles her 10 month old grandson R.M. Thushan at the Well Baby clinic Mahiyangana Base Hospital. Health Sector Development Project

ABBREVIATIONS & ACRONYMS

AAA	Analytic and Advisory Activities	LTTE	Liberation Tigers of Tamil Eelam
ADB	Asian Development Bank	M&E	Monitoring and Evaluation
APRC	All Party Representative Committee	MC	Mahinda Chintana
BMI	Body Mass Index	MDG	Millennium Development Goal
BOP	Balance of Payments	MF	Macro Framework
CAS	Country Assistance Strategy	MIGA	Multilateral Investment Guarantee Agency
CAS CR	Country Assistance Strategy Completion Report	MPR	Monetary Policy Roadmap
CAT	Core Accountability and Transparency	MPs	Members of Parliament
CBSL	Central Bank of Sri Lanka	NCDs	Non Communicable Diseases
CDD	Community Driven Development	NEHRP	North East Housing Reconstruction Project
CFA	Ceasefire Agreement	NGOs	Non Governmental Organizations
CFAA	Country Financial Accountability Assessment	NPA	National Procurement Agency
CLCA	Community Livelihood in Conflict Affected Areas	PCN	Project Concept Note
COPE	Commission on Public Enterprises	PEOET	Public Expenditure of Education Tracking
CPI	Consumer Price Index	PER	Public Expenditure Review
CPIA	Country Policy and Institutional Assessment	PFM	Public Financial Management
DCS	Department of Census and Statistics	PHP	Puttalam Housing Project
DHS	Demographic and Health Survey	PPPs	Public Private Partnerships
DIR	Detailed Implementation Review	PRS	Poverty Reduction Strategy
ERP	Emergency Recovery Project	PSI	Program for School Improvement
ESDP	Education Sector Development Program	P-TOMS	Post Tsunami Operational Management Structure
ESW	Economic and Sector Work	QAG	Quality Assurance Group
EU	European Union	QER	Quality Enhancement Review
FDI	Foreign Direct Investment	RADA	Reconstruction and Development Agency
FMRA	Fiscal Management Responsibility Act	ROSC	Report on the Observance of Standards and Codes
FSAP	Financial Sector Assessment Program	SDR	Special Drawing Rights
GDP	Gross Domestic Product	SEDF	South-East Asia Development Facility
GSP	Generalized System of Preferences	SIP	Small Investment Program
HIES	Household Income and Expenditure Survey	SLFP	Sri Lanka Freedom Party
IBRD	International Bank for Reconstruction and Development	SLMM	Sri Lanka Monitoring Mission
ICA	Investment Climate Assessment	SMEs	Small and Medium-sized Enterprises
ICR	Implementation Completion Report	SOEs	State Owned Enterprises
ICT	Information Communication Technology	SWAP	Sector Wide Approach
IDA	International Development Authority	TA	Technical Assistance
IDPs	Internally Displaced Persons	TAFREN	Task Force for Rebuilding the Nation
IEG	Independent Evaluation Group	TERP	Tsunami Emergency Reconstruction Program
IFC	International Finance Corporation	TNA	Tamil National Alliance
IFRC	International Federation of Red Cross	UNF	United National Front
IMF	International Monetary Fund	UNP	United National Party
JBIC	Japan Bank for International Cooperation	UPFA	United People's Freedom Alliance
JSAN	Joint Staff Advisory Note	WBI	World Bank Institute
JVP	Janatha Vimukthi Peramuna	WTO	World Trade Organization

TABLE OF CONTENTS

i. EXECUTIVE SUMMARY	i	
1. COUNTRY CONTEXT	1	
A. RECENT POLITICAL DEVELOPMENTS		2
B. THE ECONOMY		5
C. POVERTY REDUCTION		10
2. DEVELOPMENT CHALLENGES	19	
A. GOVERNMENT PRIORITIES-THE MAHINDA CHINTANA		20
B. MEDIUM TERM ECONOMIC OUTLOOK		26
3. LESSONS FROM THE LAST CAS AND PUBLIC CONSULTATIONS	33	
A. IMPLEMENTATION LESSONS		34
B. MESSAGES FROM PUBLIC CONSULTATIONS		38
4. BANK GROUP ASSISTANCE STRATEGY	43	
A. SUPPORTING GROWTH AND POVERTY REDUCTION		44
Strategic Objective 1 - Expanding Economic Opportunities in Lagging Regions		44
Strategic Objective 2-Improving the Investment Climate and Competitiveness		47
Strategic Objective 3- Enhancing Quality Services and Accountability		50
B. ADDRESSING CAUSES AND CONSEQUENCES OF CONFLICT		55
C. STRENGTHENING TRANSPARENCY AND ACCOUNTABILITY		59
5. PARAMETERS AND INSTRUMENTS FOR THE BANK GROUP'S ENGAGEMENT	65	
A. COUNTRY DEVELOPMENTS AND THE BANK'S PROGRAM		66
B. ENHANCING THE CONFLICT-SENSITIVITY OF BANK ASSISTANCE		69
C. IFC INSTRUMENTS		71
D. PARTNERSHIPS AND DIALOGUE		72
E. PORTFOLIO MANAGEMENT		75
6. MANAGING RISKS	79	
A. DEVELOPMENT EFFECTIVENESS RISKS		80
B. THE BANK'S REPUTATIONAL RISKS		81
C. FIDUCIARY RISKS TO BANK-FINANCED ACTIVITIES		83



LIST OF BOXES

BOX 1. AVAILABILITY OF HOUSEHOLD DATA FOR THE CONFLICT-AFFECTED NORTH AND EAST	11
BOX 2. LESSONS FROM TSUNAMI RECONSTRUCTION	35
BOX 3. EXAMPLES OF HOW EXISTING PROJECTS ADDRESS CAUSES AND CONSEQUENCES OF CONFLICT	58
BOX 4. CONFLICT FILTER TO ENHANCE EFFECTIVENESS AND REDUCE REPUTATIONAL RISKS	70
BOX 5. PROJECTS AT RISK AND MITIGATING ACTIONS	76

LIST OF TABLES

TABLE 1. GROWTH AND POVERTY IN THE WESTERN PROVINCE COMPARED TO THE REST OF THE COUNTRY	15
TABLE 2. SRI LANKA'S ACHIEVEMENT OF THE MDGS-STATUS OF SELECTED INDICATORS	16

LIST OF FIGURES

FIGURE 1. QUARTERLY REAL GDP GROWTH	7
FIGURE 2. CONSUMER PRICE INFLATION	7
FIGURE 3. FOOD PRICES, WORLD AND SRI LANKA. 2002=100	7
FIGURE 4. GROWTH IN BROAD MONEY AND NOMINAL GDP	8
FIGURE 5. CENTRAL GOVERNMENT BUDGET DEFICIT	8
FIGURE 6. REAL EFFECTIVE EXCHANGE RATE, JAN 2004=100	9

LIST OF CAS ANNEXES

ANNEX 1. RESULTS MATRIX	90
ANNEX 2. SUMMARY OF CAS CONSULTATIONS	97
ANNEX 3. DONOR COMMITMENTS ACROSS SECTORS	102
ANNEX 4. THE GOVERNMENT'S MEDIUM TERM MACROECONOMIC FRAMEWORK	104
ANNEX 5. A NOTE ON THE SIZE AND SUSTAINABILITY OF PUBLIC DEBT	105
ANNEX 6. CAS COMPLETION REPORT	109

LIST OF ANNEX TABLES

ANNEX A2. COUNTRY AT A GLANCE	140
ANNEX B2. SELECTED INDICATORS OF BANK PORTFOLIO PERFORMANCE AND MANAGEMENT	144
ANNEX B3. IBRD/IDA PROGRAM SUMMARY	145
ANNEX B3. IFC AND MIGA INVESTMENT OPERATIONS PROGRAM	146
ANNEX B4. SUMMARY OF NON-LENDING SERVICES	147
ANNEX B6. KEY ECONOMIC INDICATORS	148
ANNEX B7. KEY EXPOSURE INDICATORS	153
ANNEX B8. IFC INVESTMENT PORTFOLIO	154
ANNEX B8. IBRD/IDA OPERATIONS PORTFOLIO	155

Paddy farmer in Ampara.
**Community Livelihoods in
Conflict Affected Areas Project,**
Sambunagar, Ampara.





EXECUTIVE SUMMARY

A CHANGED CONTEXT

This Country Assistance Strategy (CAS) is being presented to the Board at a challenging time for Sri Lanka, in circumstances that are significantly different from those in 2003 when the last CAS was presented. Echoing the broad-based sense of optimism at that time, the previous CAS was aligned to support the goals of peace, economic growth and equity.

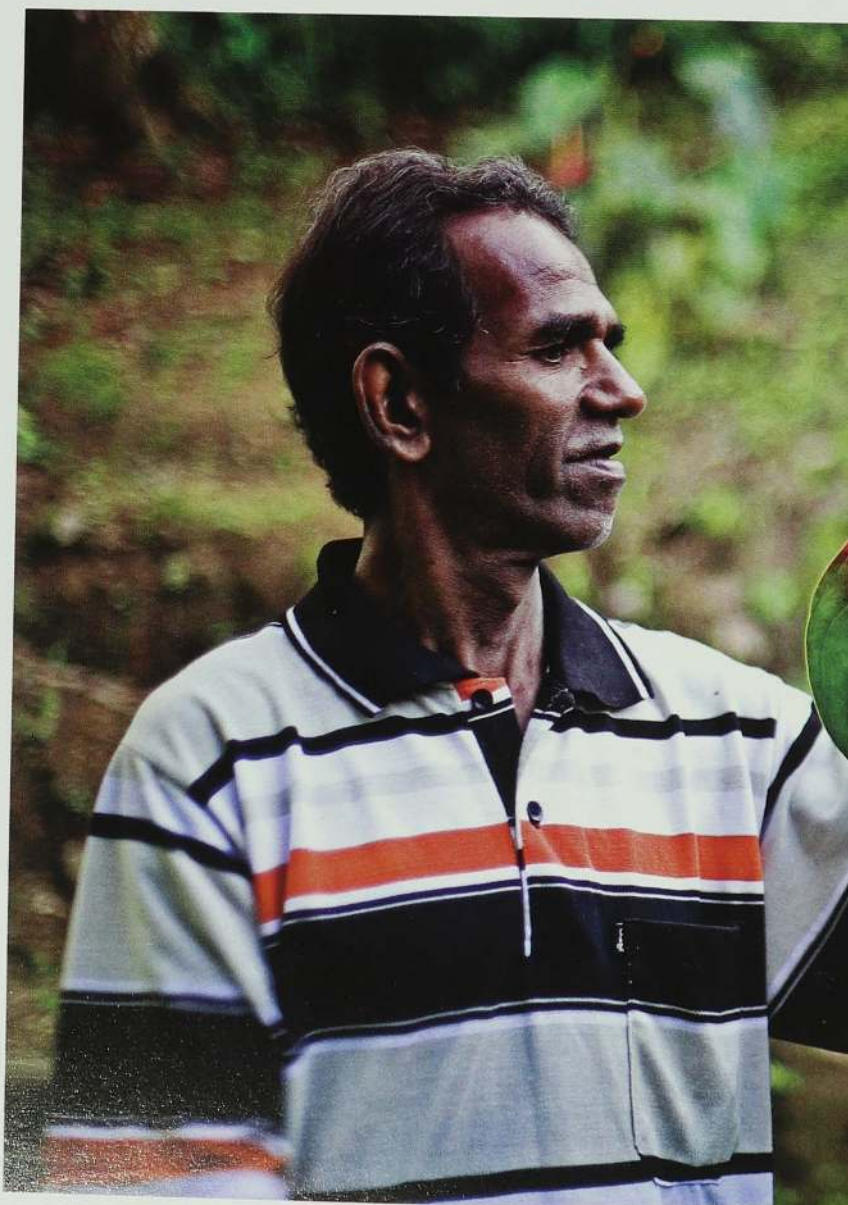
In terms of peace, developments during the last five years have been sobering. After a temporary slowdown in armed confrontation following the 2002 ceasefire agreement (CFA), violence reemerged in 2005, resulting in renewed and major human suffering. The Rajapakse Government has made it clear that while it is pursuing military operations to eradicate terrorism, it is also fully committed to finding a political solution to address the legitimate grievances of Sri Lanka's minority communities. Although local government elections for the East were held in the spring of 2008, the political process towards increased devolution and local self-determination, spearheaded by the All Party Representative Committee, still has a considerable way to go.

Despite the escalating conflict, economic growth has been strong since 2003—averaging 6.3 percent per annum. But macroeconomic imbalances, particularly high inflation and persistent budget deficits, are emerging as serious concerns.

Despite aggregate economic growth, increasing inequality held back poverty reduction during the 1990s. While the latest Household Survey indicates that the last decade's seemingly unstoppable increase in inequality is finally abating, at least in the non-conflict areas, the challenge of accelerating and sustaining growth outside the Western Province remains.

Besides the three goals of peace, growth, and equity, the previous CAS also had to respond rapidly to the devastating tsunami that hit Sri Lanka in late 2004.

In light of this complex and challenging environment, the new CAS adopts a more focused approach to the areas of engagement and a more flexible approach to the nature of the Bank's engagement in Sri Lanka. The design of the CAS has been informed by extensive consultations not only



with the Government but also with a broad cross-section of Sri Lankan society across many parts of the country. The consultations and the experiences from implementing the previous CAS have shaped the Bank's thinking, both about what the Bank should be focusing on in terms of its assistance and how best to deliver that assistance.

THE 'WHAT' OF BANK ASSISTANCE

The Bank will support the overall objectives of the

Hearing and speech impaired P.Dharmadasa grows varieties of exotic anthurium flowers for a living with support from the **Gemi Diriya Project**



Government's vision for economic development laid out in the 'Mahinda Chintana-10-year Development Framework'. The *Mahinda Chintana* aims at accelerating growth, with particular emphasis on the achievement of equitable development, recognizing that there has been a "perpetuation of income disparities, both among income earners and geographic regions". The *Mahinda Chintana* focuses on three main areas: (i) achieving more equitable development through accelerated rural development; (ii) accelerating growth through increased investment in infrastructure; and (iii) strengthening public service delivery. These objectives were validated during the CAS consultations and serve as our overarching objectives.

In order to maximize impact and mitigate risks, the Bank has designed a cautious program of interventions that can deliver positive development outcomes in poor and underserved areas, even in Sri Lanka's changed circumstances. The proposed lending program is based on a series of narrowly-scoped investment projects. The program strongly emphasizes community-focused projects and projects delivered through local and provincial governments. These projects aim to provide infrastructure, public services and livelihoods at the local level. In line with the Government's priorities and the inputs the Bank received during its public consultations for this CAS, particular emphasis will be laid on improving connectivity and market access through rehabilitation and enhancement of the road network. The program will also prioritize assistance for reconstruction and service delivery in conflict-affected areas, including support for nascent local government institutions in the East.

The Bank will systematically seek to build domestic constituencies for policy reform and facilitate the sharing of international best practices. The Bank's



President of the Pallikudiruppu village Farmer A.L.M. Farook, Ampara. **Community Livelihoods in Conflict Affected Areas Project.**

experience from the last CAS shows that while it may not always be feasible to pursue grand reforms, it is nonetheless productive to pursue incremental improvements whenever possible. The Bank must be agile in exploiting openings for policy reforms if and when they appear, and carry out continuous consultations to build constituencies for policy and institutional changes. This was echoed during the CAS consultations which revealed a strong demand for the Bank to more systematically engage diverse audiences, including through partnerships with local think-tanks and civil society organizations, to more proactively facilitate the sharing of international best practices and expertise with Sri Lankan audiences, and to nurture public policy discussions.

The IFC will further strengthen its rapidly scaled up engagement in Sri Lanka. On the investment side, IFC provides additionality by offering longer-term capital than is otherwise available in the Sri Lankan market. The IFC will increasingly reach out to second-tier, smaller clients and help develop the domestic financial market. On the advisory side, the IFC will continue to provide services through the South-East Asia Enterprise Development Facility, a five-year, multi-donor trust

fund established especially for this purpose. The IFC and the Bank will further enhance collaboration to leverage their joint impact, as successfully done, for example, with the ongoing Bank Group support for rural electrification.

THE 'HOW' OF BANK ASSISTANCE

The Bank's experience from the last CAS shows that it has the ability to implement projects even under highly adverse conditions. There is no denying that maintaining the quality of the Bank portfolio in Sri Lanka's volatile operating environment is a challenge. Several projects have faced implementation difficulties on account of the escalating conflict. But through robust project design and strong field-based supervision, the Bank has demonstrated its ability to deliver relevant development outcomes on the ground and rapidly adapt to changing circumstances when it must—as evidenced, for example, by the change in focus from infrastructure to livelihoods in community driven development in conflict-affected areas. The Bank will aim high in project implementation with the support of its broad network among civil society organizations.

As the conflict looms large over Sri Lanka, it is critical that the Bank's engagement be highly conflict-sensitive. Our work in Sri Lanka needs to minimize the risk of Bank activities inadvertently fueling ethnic tensions and further straining Sri Lanka's social fabric. Furthermore, we need to manage the reputational risk of being perceived as a partial or biased actor on the development scene. At the program level, the Bank will not allow resources committed for the North and East to be reprogrammed to other parts of the country, even if a deteriorating

Geethika (7) clutches close to her the North East Housing Reconstruction Project beneficiary accounts book. With her are siblings Abhinaya (2) and Kiruplani (9) in their nearly finished house in the village of Vallathapitiya, in Ampara. 22,444 houses were rebuilt by June 2008 out of the targeted caseload of 34,784 houses under this project.



situation on the ground renders it impossible to implement activities in the North and East. At the project level, greater conflict-sensitivity in design, implementation, and monitoring and evaluation will be achieved by subjecting all lending operations to a 'conflict filter'. The conflict filter will require projects to show that benefits are transparently distributed and potential tensions are mitigated through broad-based consultations and credible redress mechanisms.

The Bank will systematically seek opportunities to address the causes and consequences of the conflict. The North and East of the country have been most severely affected by the last 25 years of fighting and displacements. Against this background, the Bank will emphasize efforts to improve access to public services and enhance livelihood opportunities in conflict-affected areas, with a particular focus on rehabilitation of roads, irrigation networks and water supply. The Bank would also provide assistance to address traumatized people's needs in the conflict-affected areas. In addition, the Bank will seek to enhance inter-ethnic awareness by helping to expand the social space for people belonging to different communities. This would be done, for example, in education programs, by supporting English as a link language, working towards mixed Tamil-Sinhalese schooling and teachers' education, and encouraging members of different ethnic groups to work together around common goals in community driven development initiatives.

MANAGING RISKS

The CAS responds to the country's current needs and emerging opportunities while taking into consideration ongoing uncertainties and risks. Despite careful selection and design, the proposed program remains

vulnerable to further deterioration because of the conflict and requires careful implementation and adaptation. Deepening the Bank's existing networks of civil society organizations and development partners will help the Bank to monitor and assess these risks. The enhanced emphasis on conflict sensitivity will help mitigate the Bank's reputational risks. Managing the significant macroeconomic risks arising from persistently high fiscal deficits, high inflation and Sri Lanka's vulnerability to external shocks, requires strong corrective measures by the Government—a point emphasized in our ongoing policy dialogue. Finally, the Bank faces considerable fiduciary risks, in particular in the North and East, where the situation is especially volatile and where intensive supervision is most challenging.

At the same time, we believe that there are substantial benefits to the Bank's engagement in Sri Lanka, both in assisting the Government in fulfilling its long-term vision of accelerating growth and reducing poverty, and in proactively addressing the causes and consequences of the conflict. These would be lost if the Bank were to disengage. In this sense, there are also significant development and reputational risks to the Bank from not remaining substantially engaged in Sri Lanka. This CAS strikes a balance between the development and reputational risks of remaining engaged as Sri Lanka's long-standing development partner in this fluid and complex situation, against the development and reputational risks of disengagement.

ISSUES FOR THE EXECUTIVE DIRECTORS

- 1) *Is the proposed Country Assistance Strategy—including its conflict-sensitive approach—likely to be robust and flexible enough to mitigate the development and reputational risks of the Bank's engagement in Sri Lanka?*
- 2) *Is the proposed program of activities and choice of instruments appropriate, considering the country circumstances and the Bank's comparative advantages?*

Over 500 families in Wegela in the Kandy District will benefit from this Second Community Water Supply and Sanitation Project. The raw water is first pumped into these two tanks, and then to one roughing filter tank and to two slow sand filters. The two treated water reservoirs below these can each hold 60,000 litres.





11

Sri Lanka provides specialist pediatric health services also in rural areas, Well Baby clinic. Mahiyangana Base Hospital. Health Sector Development Project.

COUNTRY CONTEXT

The armed conflict is an important stumbling block to long-term development and poverty alleviation in Sri Lanka. The conflict has deep historical roots, and involves multiple issues such as ethnicity and access to economic opportunities. Recently, the Government has gained control of the Eastern Province but battles still continue in the North. Despite the conflict, economic growth has averaged 4.9 percent annually since 1977. Growth was bolstered by broad-based liberalization initiated more than three decades ago, well ahead of other countries in the region. In the last couple of years, growth has averaged more than 7 percent per annum, but high inflation and a widening current account deficit are emerging areas of concern.

RECENT POLITICAL DEVELOPMENTS

1. The political landscape has changed significantly since the last CAS. At the time of the previous CAS, the incumbent Sri Lankan Government was an uneasy cohabitation between President Chandrika Kumaratunge of the Sri Lanka Freedom Party (SLFP) and Prime Minister Ranil Wickremasinghe of the United National Front (UNF). This arrangement ended in early 2004. The President dissolved the Parliament and called for elections. At the elections held in April 2004, the United People's Freedom Alliance (UPFA)-a coalition led by the SLFP under President Kumaratunge's leadership-captured Parliamentary power. The coalition consisted of a few political groups, including the nationalistic left-wing party *Janatha Vimukthi Peramuna* (JVP). In mid-2005, the JVP left the Government due to conflicts within the governing coalition. The immediate issue which led to the break-up of the coalition was the proposed tsunami aid sharing agreement (P-TOMS) that the President proposed to sign with the LTTE (Liberation Tigers of Tamil Eelam). (P-TOMS was later declared unconstitutional by the Supreme Court). In November 2005, Mahinda Rajapakse, who had been Prime Minister since 2004, won the presidential election. He continues to be supported by a coalition of political parties in the Parliament, including a number of MPs (Members of Parliament) belonging to the United National Party (UNP) who 'crossed over' and joined his Government in 2006. His Government currently holds 123 seats in the 225-seat strong Parliament.

2. The Sri Lankan conflict has deep historical roots. Some trace the origins of the Sri Lankan ethnic conflict to the 'divide and rule policies' of the British whose colonial rule ended with the country's independence in 1948; others trace it much further back. Several post-independence events accentuated the existing problems. One such widely cited event is

the Sinhala Only Act of 1956 which gave official status only to the language of the majority Sinhala community that makes up around 75 percent of the population. Though the Tamil language was given official recognition later, political confrontations between the Sinhalese and the Tamils continued. The armed separatist conflict emerged in the mid-1980s, at a time when the economy was simultaneously moving forward with a major reform program following economic liberalization in the late 1970s. In spite of various attempts at peacemaking, this conflict continues to lead to substantial loss of life and property. Though the ceasefire agreement (CFA) of 2002 was aimed at creating the necessary space for a lasting peace settlement, six rounds of peace talks in 2002 and 2003 failed to produce tangible progress, with the two sides blaming each other for the failure of negotiations. After a temporary slowdown in armed confrontations following the CFA, violence reemerged, including the assassination of the Foreign Minister by the LTTE in August 2005.

3. According to the Rajapakse Government, Sri Lanka's ethnic problem has two elements-a 'terrorist' element attributed to the LTTE and a 'genuine grievances' element felt by the minority communities. On this basis, the Government views the solutions as falling into two components-military operations to 'eradicate terrorism' and a political solution to address the genuine ethnic element of the conflict. In February 2006, there were attempts to revive the peace talks when the parties met in Geneva, but no noticeable progress was achieved. As a part of its effort towards finding a political solution, the Government, in September 2006, initiated an All Party Representative Committee (APRC) process to build a 'Southern' consensus in Parliament about constitutional amendments. In particular, this process was expected

Pakeer Mohideen Jannath Beevi (66), her widowed daughter Abdul Rahman Mahmootha (40) and two year old Ajwas Asfa are outside Beevi's house which is being built under the US\$ 32 million Puttalam Housing Project. Beevi, a mother of eleven, arrived in the Mujahidiepuram, Puttalam IDP camp with Mahmootha in 1990, but grand niece Asfa belongs to the generation born in the camp.



to help with the devolution of power to sub-national authorities and pave the way for a negotiated solution. In parallel, arguing that elimination of terrorism is essential for a sustainable political solution, the Government stepped up military activities against the LTTE following several violent incidents, and used the military to reopen an irrigation canal that the LTTE had forcibly closed.

4. In July 2007, after intense armed confrontations, the Government restored its authority over the LTTE-held areas in the Eastern Province. During the one-year period of confrontations, about 5,000 lives were lost and over 300,000 people displaced. This period also witnessed an increase in allegations of human rights violations by all parties involved in the armed conflict. The Government established a Ministry of Human Rights, created a presidential commission to inquire into these allegations, and initiated a witness protection program. These initiatives appear to need more time to have a significant impact on the ground. In the Eastern Province, where 153,000 Internally Displaced Persons (IDPs) have moved back to their home villages¹, security-related restrictions on civilian movement still prevail. The presence of paramilitary groups, which are torn by internal rivalries, is said to be an impediment to the restoration of civilian life. In a move to restore normalcy in the East, local government elections for the predominantly Tamil Batticaloa District were held on March 10, 2008. The elections were free of violence but the non-participation of the UNP and the TNA (Tamil National Alliance) was, however, perceived by some to reduce the fairness of the election. Elections for the Eastern

Morning chat at the Nadukudiyiruppu village, Vakarai where 65 houses are being reconstructed. **North East Housing Reconstruction Project.**



Provincial Council have been announced for May 10, 2008. All political parties with a vote base in the Province are likely to contest.

5. On January 2, 2008, the Government announced its intention to unilaterally abrogate the CFA. The abrogation can, to some extent, be viewed as a 'formalization' of the situation on the ground that has prevailed since 2006, although the international community and other stakeholders are concerned that this would further intensify armed confrontations. The abrogation also implies that the Sri Lanka Monitoring Mission (SLMM), tasked with monitoring ceasefire violations by the two sides, has been disbanded. The Government has argued that the abrogation of the CFA would increase the political space and opportunity for finding a political solution. In the meantime, armed confrontations and consequent displacements have shifted to the North.

6. On January 23, 2008, the APRC issued an 'Interim Report' on its proposed political solution, while stating that it would continue to work on a final

¹ United Nations High Commissioner for Refugees (UNHCR), Sri Lanka Statistical Summary, 2007.

report. The APRC's recommendations focus mainly on the rapid implementation of the 13th Amendment to the Constitution which has not been fully implemented since its introduction as part of the 1987 Indo-Lanka agreement². Although there is criticism that this is not sufficient to gain the support of the Tamil community, the Government says it has given precedence to finding a practicable rather than the ideal solution. According to the Government, past experience shows that any constitutional change is rendered impractical within the present constitutional framework, electoral system, and fragmented political party system. The Government considers it more feasible to pursue maximum devolution within the existing legislation rather than seek new constitutional amendments. Decisive moves towards full implementation of the APRC recommendations, however, remain to be seen.

B THE ECONOMY

7. Sri Lanka has achieved three decades of sustained growth, averaging 4.9 percent annually since 1977. In conjunction with modest population growth, this has resulted in a doubling of per capita incomes over the past three decades-to over US\$ 1,600 in 2007. Well-ahead of other countries in the region, Sri Lanka initiated broad-based liberalization and deregulation in 1977, with a gradual reduction in license controls on foreign trade. The process continued with other initiatives-for example, membership of WTO in 1995, signing of the Indo-Lanka Free Trade Agreement in 1998 (from which the tariff phase-out is expected to be completed this year),

floating of the exchange rate in 2001, and implementation of the South Asian Free Trade Agreement in 2006. In the domestic economy there were parallel reforms, in particular in the areas of reforming public enterprises through privatization, and facilitating private sector participation in the telecommunications, gas and power, port, aviation, insurance, and finance sectors. These policy decisions have served the country well-by laying the foundations for today's strong export sector and rapidly expanding telecom sector, and the gradual shift from reliance on primary sectors to industry and services. They have helped transform the Sri Lankan economy from an inward-looking economy focused on self-sufficiency to a competitive export-oriented economy. The results are impressive: the share of exports to GDP in 2007 had increased to 29.2 percent, compared to less than 5 percent in the 1970s, and the export base had been diversified away from the traditional tea and rubber exports to include, notably, large exports of garments. Sri Lanka, however, is still underperforming relative to several of its East Asian neighbors and particularly, in recent years, vis-à-vis India, suggesting that Sri Lanka is not fully exploiting its potential, in part due to the ongoing conflict.

PUBLIC LIBRARY
JAFF
SPECIAL COLLECTION

² The 13th Amendment to the Constitution devolved responsibility for certain public services from the Central Government to the newly created Provincial Councils.

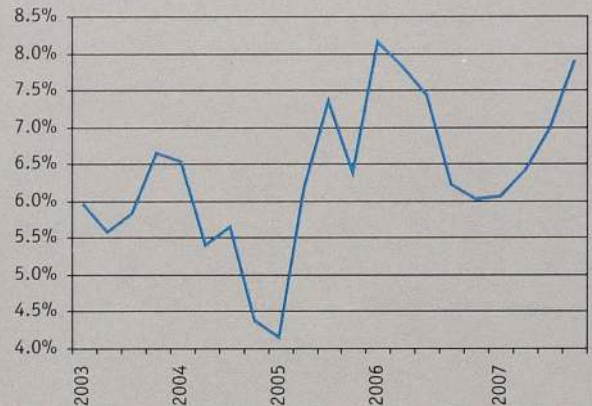


Mathematics, Environment and Sinhala language are the favorite subjects of this 10 year old schoolboy. Increasing learning competencies of school children is a key objective of the **Education Sector Development Project**.

8. In the past two years, economic growth in Sri Lanka has been quite strong Growth accelerated in 2006 to 7.7 percent. A robust growth momentum was sustained in 2007, though with somewhat lower 6.8 percent growth. Growth has been primarily driven by domestic demand-both consumption and investment-but exports have also been buoyant; there are signs that consumption and investment growth decelerated in 2007. The gradual recovery from the tsunami, coupled with the substantial inflow of foreign remittances and increased affordability of services such as telecommunications, have all contributed to the robust economy. Significant inflows of remittances from the large Sri Lankan workforce abroad, amounting to 7.2 percent of GDP in 2007, are another source of resilience of the Sri Lankan economy. In this growth environment, the official unemployment rate (excluding the North and East) declined from 8.1 percent in 2004 to 5.5 percent in the fourth quarter of 2007.

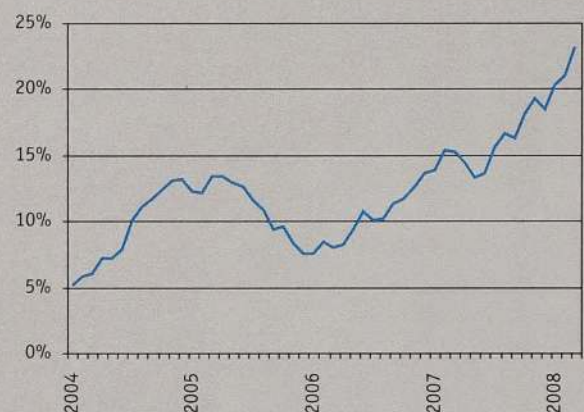
9. Inflation has been accelerating since early 2006, partly as a result of rising world market prices of food and oil. Inflation reached 25.0 percent in April 2008 (year on year) (16.0 percent on a year-average basis), and has yet to show signs of abating. Domestic food prices, which make up about 46 percent of the basket in the Sri Lankan Consumer Price Index (CPI), have increased in line with international trends and are the item predominantly responsible for the rise in the overall CPI. Moreover, since the Government re-introduced periodic revisions to domestic fuel prices in April 2006, rising prices of fuel-in line with international trends-have further contributed to inflation. Since April 2006, the retail prices of petroleum and diesel have increased by about 60 percent. Since May 2007, the Government has allowed the price of kerosene (mostly used by the poor) to increase by about 40 percent.

Figure 1. Quarterly Real GDP Growth



Source: Department of Census and Statistics

Figure 2. Consumer Price Inflation



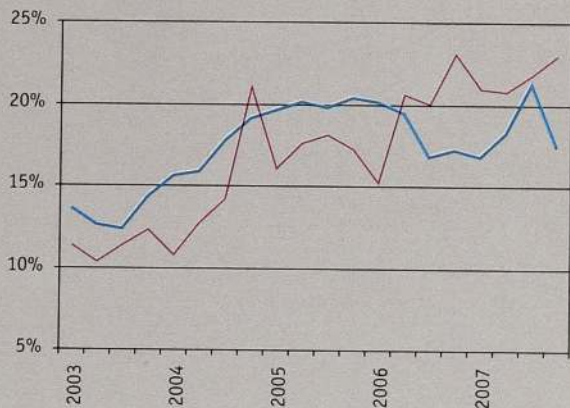
Source: Department of Census and Statistics

Figure 3. Food Prices, World and Sri Lanka. 2002=100



Source: Department of Census and Statistics and World Bank data.

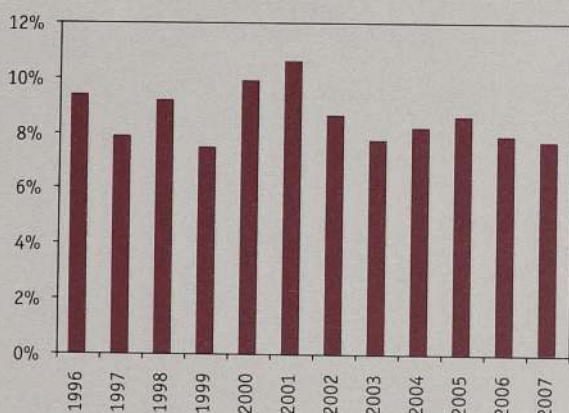
Figure 4. Growth in Broad Money and Nominal GDP



Source: Department of Census and Statistics

10. Monetary growth has fueled inflation, although the growth in monetary aggregates has declined in recent months. Although the nominal interest rate on Government securities increased sharply during 2007 (approximately 700 basis points for Treasury bills), real interest rates have been low or even negative for significant parts of the past two years, which has made borrowing exceedingly attractive. Monetary growth has also, at times, been fueled by bank financing of the fiscal deficit. In 2006, the Central Bank's net financing of the Government deficit was equivalent to 1.3 percent of GDP, while it was equivalent to -0.3 of the GDP in 2007. There is a risk that continued high inflation will entrench inflationary expectations and make future attempts to curb inflation considerably more difficult.

Figure 5. Central Government Budget Deficit



Source: Department of Census and Statistics

11. The fiscal deficit remains high despite recent consolidation efforts and is a source of macroeconomic instability. Sri Lanka has had historically high fiscal deficits of about 8 percent of GDP during the past decade, and deficits have persisted despite the introduction of the Fiscal Management Responsibility Act (2003) and commendable progress in tax collection during the past few years due to administrative and organizational measures. The revenue to GDP ratio increased from 13.7 percent in 2003 to 15.8 percent in 2007, as tax loopholes were closed and collection efforts intensified. However, the revenue-to-GDP ratio in 2007 was 0.5 percentage points lower than in 2006; the decline was in part due to reduced import duties on essential food items. On the expenditure side, the ratio of recurrent expenditures to GDP has hovered around 18 percent during the past five years, but declined to 17.4 percent of GDP in 2007 from 18.6 percent in 2006. In 2007, interest payments accounted for 27 percent of total recurrent expenditures (4.8 percent of GDP). The public sector wage bill (including for defense) accounted for another 34

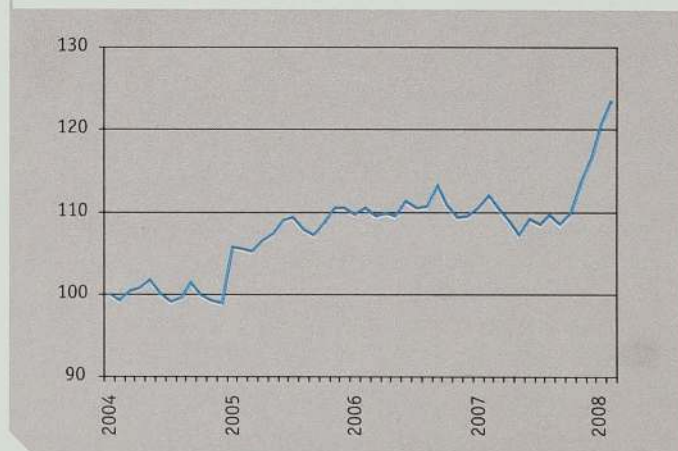
percent (6 percent of GDP). Various subsidies (for example petroleum, electricity, railways, fertilizers, etc.) have also traditionally been a considerable drain on public finances but aggressive pricing reforms of fuel and electricity have reduced this recently. The Government maintains that it is committed to adhering to the Fiscal Management Responsibility Act (FMRA) which stipulates a maximum allowable deficit of 5 percent of GDP, but its target year has been shifted from the initial 2006 to 2010. High and persistent fiscal deficits have resulted in high public debt. At the end of 2007, total public sector debt amounted to 86 percent of GDP, of which about half was foreign-currency denominated. This, however, is an improvement from the situation nearly three years ago when the public debt was over 100 percent of GDP. The reduction in debt over the years is mostly attributable to faster growth in nominal GDP relative to the debt stock, although exchange rate movements have also had some impact on the debt to GDP ratio.

12. Appreciation in the real effective exchange rate is jeopardizing export competitiveness. The basket-based real effective exchange rate has appreciated by 25 percent since early 2004, eroding price competitiveness, as depreciations in the nominal exchange rate have not kept pace with excess inflation in Sri Lanka compared to its trade partners. In parallel, the current account deficit has widened since 2003, providing further evidence that domestic demand is outpacing supply. An increasing import bill, on account of higher oil prices, also has been a contributing factor. The current account deficit reached 4.2 percent of GDP in 2007 which, however, is a decline compared to 2006 when it was 5.9 percent of GDP. The widening trade deficit (12 percent of GDP in 2007 compared to 8.4 percent of GDP in 2003) has been partially offset by increased remittance transfers from the large pool of Sri Lankan workers abroad-net private

"Will I see this thing called electricity before I die" asked R. G. Ariyawathie (70) six years ago. She has lived to see her village lit under the Renewable Energy for Rural Economic Development Project.



Figure 6. Real Effective Exchange Rate, Jan 2004=100



Source: Central Bank of Sri Lanka



A resettled conflict affected mother now runs the village grocery shop. **North East Irrigated Agriculture Project.**

transfers reached 9 percent of GDP in 2007, up from 6.6 percent in 2003. Since the time the Rupee was floated (2001), with the exception of 2004, the country has recorded surpluses in the overall balance of payments (BOP) despite the current account being continuously negative. The main sources of BOP support are increased foreign direct investment (FDI) inflows (although still relatively low by international standards) and the increased debt capital inflows, following the 'measured' opening up of the capital account where the authorities opened up a limited portion of Sri Lanka's Treasury bond market to foreigners. In addition, the Government, in October 2007, floated its first sovereign bond issue. As a result, foreign reserves have strengthened and the reserve cover stood at about 3.6 months of imports by end-February 2008.

C POVERTY REDUCTION

13. Poverty has declined rapidly in the past five years recent years, on account of strong economic growth with little change in inequality of consumption between people and regions. The Department of Census and Statistics has just reported that the national poverty headcount, as measured by the Household Income and Expenditure Survey (HIES) 2006/07, is 15 percent, which is a sharp decline from the 23 percent headcount reported in 2002. This positive development is coupled with the good news that most of the reported decline occurred in regions outside the Western Province (WP), reducing the large gaps seen in 2002 between WP and the rest of the country. For example, the Southern Province halved its

poverty from 28 percent in 2002 to 14 percent in 2006/7, which brings it much closer to the poverty rate of WP (11 percent in 2002 and 8 percent in 2006/07). In parallel, interpersonal inequality appears to have stabilized after rising through the 1990s. The Gini coefficient of per capita consumption was 0.40 in 2006/07, unchanged from the 2002 level. No worsening in interpersonal inequality, coupled with significant poverty reduction in lagging regions, suggests that economic growth between 2002 and 2006/07 was equitably distributed among the rich and poor and different regions of the country. More detailed diagnostic work, which has not been conducted with the 2006/07 data yet, would however be necessary to identify the underlying factors that explain the recent trends.

14. The poverty and inequality changes since 2002 are in sharp contrast to the period between 1990/91 and 2002 when overall poverty declined by only 3 percentage points (from 26 to 23 percent)—mainly due to increasing interpersonal and regional inequality. The Gini coefficient increased from 0.32 in 1990/91 to 0.40 in 2002, considerably more than in other countries in South Asia. Gaps between WP and the rest of the country widened and estate poverty increased sharply during this period. Simulations based on these trends had suggested that Sri Lanka would fall short of the Millennium Development Goal (MDG) of halving poverty by 2015 from the 1991 level. But, given the reduction between 2002 and 2006/07, the country can be expected to reach its poverty MDG target well before 2015—if the recent trend is sustained.

15. The poverty and inequality trends reported above largely exclude the North and East. These regions were not covered by the 1990/91 and 2002 HIES due to security concerns; but the 2006/07

Box 1. Availability of Household Data for the Conflict-affected North and East

None of the HIES surveys from 1990/91 to 2002 could cover the North and East due to the security situation that prevailed at the time the surveys were being fielded. While an attempt was made in 2002 to take advantage of the ceasefire at that time, the worsening security situation made it impossible to collect year-round data on a sample that was representative enough. The 2006/07 survey covered a large part of the Eastern Province but excluded the Trincomalee district and some of the remote areas of the Batticaloa and Ampara districts. The HIES in Sri Lanka does not provide information on education, health and other social sector indicators. Surveys that typically do so—namely the Consumer Finance and Socio Economic Survey (2003-04), Labor Force Survey (various rounds), and the Demographic and Health Surveys (DHS; various rounds, latest in 2004)—include parts of the North and East but exclude large areas. None of these sources is appropriate for estimating consumption poverty and inequality; while they provide some indication of the non-income dimensions of welfare in the North and East, these indicators may not accurately reflect the conditions in the two provinces due to the surveys' inability to cover many areas.

estimates include parts of the Eastern Province. While a few other surveys have covered the North and East partially in recent years, none of them yield consumption poverty estimates and all of them were



A single lamp gives light generated by a micro hydro project to Duminda as he plays “shop” outside his house in the remote village of Heeloya. His mother, Bisomenike grows coffee, pepper, cardamoms, cashews and cloves in her little garden to earn a living. Renewable Energy for Rural Economic Development Project.



unable to field adequate samples (see Box 1). The absence of conflict-affected areas in HIES data also implies that the rest of the country, mentioned above, refers to provinces not directly affected by conflict.

16. In spite of the broad-based poverty reduction from 2002 to 2006/07, some of the concerns about poverty and inequality which were highlighted in earlier data continue to be valid. *Firstly*, the improvements from 2002 to 2006/07 did not include the estates, where the poverty rate has increased from 30 to 32 percent. *Secondly*, while the differences in poverty and incomes between the WP and the rest of the country have declined, the gaps are still very large. The poverty rate for WP, at 8 percent, is almost half the national average while for Uva and Sabaragamuwa, it remains high at about 10 percentage points above the national average. Annual per capita income in the WP exceeded US\$ 2,000 in 2006, compared to US\$ 800 for the rest of the country (Table 1). While WP has sustained annual average growth of more than 6 percent per annum since 1997, the rest of the country has grown by only about 3 percent per annum during the same period. *Thirdly*, although interpersonal inequality did not worsen from 2002 to 2006/07, the Gini coefficient of consumption was still the highest among all South Asian countries. Given these disparities, the Government's emphasis in its 10-year development framework on equitable growth, with particular focus on lagging regions, continues to be relevant.

17. While detailed diagnostic work with HIES 2006/07 data is still awaited, analysis with 2002 HIES data has shown that a range of factors limit economic opportunities for poor households in Sri Lanka. Poverty is most significantly associated with a higher number of dependents in the household,

employment of household heads in the informal sector, lack of assets, and deficiencies in human capital. Although primary enrollment and literacy are near-universal in Sri Lanka, low education attainment is prevalent among the poor. In 2002, over 30 percent of households where the heads of the households had schooling up to grade 5, were poor, compared with less than 10 percent where household heads had completed at least grade 9. Net enrollment among children for grades 10-13 among the lowest income quintile is only half that of the richest quintile. Rich-poor differences also occur in birth-weight, malnutrition among preschool children, and nutritional status of adult women. Demographic and Health Survey (DHS) data shows that 47 percent of children (between age 3 months and 5 years) in the poorest quintile were underweight compared to 11 percent in the richest quintile, and 37 percent of women in the poorest quintile had low BMI (body mass index) compared to 10 percent in the richest.

18. Poverty is also associated with isolation from markets and poor access to infrastructure facilities like electricity.

Lack of connectivity to markets appears to be a particularly common characteristic of poor areas in Sri Lanka and, consistent with this, is identified by rural non-farm enterprises as a critical constraint they face along with other factors like poor access to and quality of electricity, and limited access to finance. Improving connectivity and access to infrastructure is therefore likely to bring significant benefits to lagging regions. In this context, the Government's focus on investing in infrastructure development seems consistent with the needs of the poor in the lagging regions in particular.

19. The sharp rise in poverty in estates during the past decade is a cause for serious concern.

While

the national poverty rate declined by 11 percentage points from 1990/91 to 2006/07, the estate poverty rate increased by 12 percentage points-this makes the estate poverty rate in 2006/07 more than double the national average. Analysis of HIES data up to 2002, as well as non-HIES data sources, suggests a number of key features of estate poverty. *Firstly*, movements in the poverty headcount rate can overstate the welfare changes in the estates-a high degree of clustering of the estate population around the poverty line implies that even small shocks can produce a large increase in the poverty rate. *Secondly*, rising poverty in the estates is partly explained by a fall in the average number of income-earners in estate households between 1990/01 and 2002, and can also be linked to growing unwillingness among the estate youth to work on the estates, even though work opportunities outside remain limited. *Thirdly*, many of the factors that limit the opportunities of the poor in remote, rural areas also apply to the estate poor. But the estate poor are especially disadvantaged in terms of mobility and economic opportunities on account of isolation. For example, lack of access to all-weather roads connecting estates to towns and the resident labor structure prevalent in most estates, contribute to their social isolation from the mainstream. This is evidenced, for example, by the high share of estate workers who do not have National Identity Cards.

20. Most non-income indicators among estate residents have improved over the last decade but still lag significantly behind those for even rural (non-estate) Sri Lankans. For example, in 2000, 37 percent of estate children were stunted compared with 14 percent of rural children, and 48 percent of estate mothers had low BMI compared with 23 percent of rural mothers. Other than higher income poverty in the estates that tends to depress human development

Table 1. Growth and Poverty in the Western Province Compared to the Rest of the Country

	<i>Western Province</i>	<i>Rest of the Country</i>
1. Share of National Economy	50 percent of production, 28 percent of population (2006) <ul style="list-style-type: none"> Nearly 2/3 of the economy in services 	Balance 50 percent shared by other eight provinces with no one province having more than 10 percent share of production <ul style="list-style-type: none"> Over 1/3 of the economy still in agriculture
2. Economic Growth	<ul style="list-style-type: none"> 6.3 percent (1997-2006) <u>Annual Per Capita Income</u> <ul style="list-style-type: none"> 1996 : \$ 1,167 2006 : \$ 2,118 Growth: 6.1 percent (1997-2006) A middle income country 	<ul style="list-style-type: none"> 3.6 percent (1997-2006) <u>Annual Per Capita Income</u> <ul style="list-style-type: none"> 1996 : \$ 520 2006 : \$ 838 Growth 4.9 percent (1997-2006) Still a low income country
3. Equity of Growth	<ul style="list-style-type: none"> Poverty incidence declined from 19 percent in 1990 to 8 percent in 2006/07 Gini quite high (0.41 in 2006/07) , but stable over time Per capita expenditure growth > 40 percent from 1990 to 2002 	<ul style="list-style-type: none"> Poverty incidence in 2006 at 18.4 percent, more than double that of Western Province Gini lower than Western Province, but significant increases in most provinces since 1990 Per capita expenditure growth ≤ 20 percent for other provinces from 1990 to 2002
4. Unemployment	5.7 percent [2006]	6.9 percent [2006]

Sources: Department of Census and Statistics, Central Bank of Sri Lanka and World Bank staff calculations.

indicators, the quality of certain critical services, including health and education, is also usually poor in the estates compared with the rest of Sri Lanka.

21. Sri Lanka is on track to achieve most MDG targets, including reducing poverty by half, but now faces the challenges of achieving quality, relevance and sustainability in key public services (Table 2).

Sri Lanka is poised to reach universal primary education enrollment, although there remain pockets of children of marginalized groups that either never

attend or drop out of the schooling system (for example, street children, orphans, the disabled, and those displaced due to the conflict in the Northern and Eastern provinces). Sri Lanka's impressive education indicators also mask serious deficiencies in the quality and efficiency of education. Sri Lanka has a strong track record in promoting gender equality and empowering women, reducing child mortality and improving maternal health-child and maternal mortality rates have been reduced to levels comparable with those of more developed countries and are the

Table 2. Sri Lanka's Achievement of the MDGs—Status of Selected Indicators

	1990	Current 1/	2015	Comments/issues
<i>Goal 1: Eradicate Extreme Poverty and Hunger</i>				
Proportion of population below National Poverty Line ³	26.1%	15.2%	13.1%	On track, but inequality is a concern
<i>Goal 2: Achieve Universal Primary Education</i>				
Net enrolment ratio in primary school	91.7%	97.5%	100%	On track, but questions remain about the quality of education
<i>Goal 3: Promote Gender Equality and Empower Women</i>				
Ratio of girls to boys in primary education	94.2%	99.0% 2/	100%	On track
<i>Goal 4: Reduce Child Mortality</i>				
Under-5 mortality rate for girls (per 1,000)	20.0	12.0	12.0	On track, but child malnutrition still a concern
<i>Goal 5: Improve Maternal Health</i>				
Maternal mortality ratio (per 1,000)	42.3	27.5	10.6	On track
<i>Goal 6: Combat HIV/AIDS, Malaria and Other Diseases</i>				
Incidence of Malaria/100,000	1520	350	–	On track; HIV/AIDS prevalence also low, but little progress on TB
<i>Goal 7: Ensure Environmental Sustainability</i>				
Share of population with access to improved water sources	72%	84.7%	86%	On track, but significant challenges with regard to soil erosion and solid waste management


Source: UNDP (2005); Department of Census and Statistics (2006).

1/ 2006 if not otherwise indicated. 2/ The ratio in secondary school is 105.7.

lowest among South Asian countries. At the same time, Sri Lankan women have yet some way to go in terms of gender parity in employment and wages. Women are also markedly under-represented in jobs with any degree of decision-making authority—even in job sectors where female workers are the vast majority, such as the garment industry and estate sector. In terms of combating HIV/AIDS and other diseases, Sri Lanka has performed relatively well with a low HIV/AIDS prevalence rate and high immunization rates.

Finally, in terms of ensuring environmental sustainability, Sri Lanka is making strides towards increasing the coverage of sanitation and access to safe water, but there remains a large unfinished environmental agenda, including curbing soil erosion and strengthening solid waste management.

³ The National Poverty Line has been used since the US\$ 1 per day goal is unrealistic in the context of Sri Lanka.

A woman with a warm smile, wearing a vibrant red sari with a gold border and a blue short-sleeved top. She is standing in front of a light blue wall. Her hands are clasped in front of her, holding a small, woven basket. The background is a simple, slightly textured wall.

The caretaker at the Pre-school
Mujahidiepuram, Puttalam IDP camp.
Puttalam Housing Project.

More than 600 km of national and rural roads are scheduled to be completed by 2011 under the Country Assistance Strategy. **The Road sector Assistance Project.**



DEVELOPMENT CHALLENGES

Sri Lanka's main development challenges, as emphasized in the Government's 10-year Development Framework, are to accelerate growth through increased investment in infrastructure, to achieve a more equitable development through assistance to the lagging regions, and to strengthen public service delivery to ensure quality and performance of services to meet modern development needs. There is also a significant need for developing the North and the East which have suffered disproportionately from the conflict and lack of investments. At the same time, the Government faces the challenge of stabilizing the economy by reducing inflation and the fiscal deficit, while aiming at higher growth for a sustained period.

A GOVERNMENT PRIORITIES-THE MAHINDA CHINTANA

22. The Government's 10-year Development Framework, Mahinda Chintana (MC)-Vision for a New Sri Lanka, is built on President Rajapakse's election manifesto. In November 2006, the Government presented a draft of the MC to the public, including donors who discussed it at the Development Forum in Galle in January 2007. As noted in the Joint Staff Advisory Note (JSAN), the draft has high Government ownership. It was prepared by the Ministry of Finance, in extensive discussion with sector ministries and provincial councils, although broader public consultation was more limited.

23. The MC aims to accelerate growth from its historical average of about 5 percent to over 8 percent by the year 2010, and adequately identifies Sri Lanka's main development challenges. The Government expects this growth to cut poverty by half to 12 percent over the next 10 years: "*Sri Lanka needs a [higher] growth rate...to ensure that the economy is capable of providing better livelihood for all citizens, including those who are in abject poverty*". The MC places particular emphasis on the achievement of equitable growth, recognizing that there has been a "*perpetuation of income disparities, both among income earners and geographic regions*". To achieve this ultimate goal, the MC has been built on previous efforts and provided a pragmatic approach. The MC focuses on three main areas: (i) accelerating growth through increased investment in infrastructure; (ii) achieving more equitable development through accelerated rural development; and (iii) strengthening public service delivery, in particular in health and education.

24. As noted in the JSAN, a critical thrust of the Government's strategy is to accelerate growth

through increased investment in infrastructure. The Government takes the view that investment in infrastructure has been neglected for decades and has become a binding constraint to growth and poverty reduction in Sri Lanka. The Government's strategy focuses, in particular, on large-scale projects in power, roads, ports, water supply, and sanitation. The total value of the envisaged investment program in 'major' infrastructure projects from 2006-2011 (the 'Mahinda Randora') amounts to almost US\$1 billion annually, equivalent to about 3 percent of the GDP. The total capital investment budget is expected to amount to about 8 percent of GDP in the medium-term. As noted in the JSAN, the envisaged infrastructure program may be too optimistic in terms of the available resources. The JSAN also points to the need for improved coordination and clarification of roles and responsibilities in infrastructure provision. The fact that capital spending has fallen short of budgeted amounts in recent years may also point to constraints in the capacity of Government agencies to accelerate investments. More broadly, pursuit of this program may also add to existing bottlenecks in the labor market as unemployment is already at its lowest recorded level ever.

25. Another key objective of the MC is to achieve more equitable development through accelerated rural development. To implement the Government's rural development strategy, the *Gama Neguma* ('Village Uplifting') program has been launched. The objective of the *Gama Neguma* is to convert villages and towns into small centers of growth by promoting a holistic approach to infrastructure planning. As noted in the JSAN, to avoid duplication and ensure coordination, especially in service delivery mechanisms, the *Gama Neguma* will bring together a number of different

Children are back at school in Batticaloa. Resources are being made available to restore education facilities and improve the quality of education in the Northern and Eastern Provinces. Schools located in poor areas are the main focus of assistance. Education Sector Development Project.



Training for teachers on the modernized curriculum will be carried out under the **Education Sector Development Project**.



programs and will seek to foster the people's participation in planning and prioritization of projects. The proposed model reflects lessons learned through the Bank-supported Gemi Diriya project. Complementary approaches may need to be devised by combining the implementation of village level rural livelihood interventions with small infrastructure and inter-village connectivity and rural infrastructure development. The MC emphasizes that increasing agricultural productivity is critical to raising rural incomes. It rightly places considerable importance on diversification to higher value products (for example, fruits, vegetables, livestock, and fisheries) for the

domestic and export markets as a means of raising farm incomes and fostering growth. The MC also puts forward a strong role for the public sector in implementing the strategy. As noted in the JSAN, this includes areas where the private sector could potentially be more appropriate and efficient, including, for example, research and extension, where past public-driven interventions have had only mixed success.

26. The MC emphasizes strengthening public service delivery, noting that the current quality and performance of services does not adequately meet modern development needs. As noted in the JSAN, the MC adequately identifies the challenges and achievements in key social services. In health, the Vision notes a number of outstanding challenges, including insufficient implementation of decentralization, the very high occupancy rate in some of the large hospitals, very low occupancy in more peripheral district hospitals, and the uncertain positioning of private providers. A key challenge for the Government would be to prioritize and operationalize an appropriate policy response to remedy these deficiencies. In education, the MC aims to promote equal access and improve the quality of basic and secondary education. In terms of social protection, the MC emphasizes the need to move from passive receipt of assistance to active participation in the economy. The MC explicitly notes the need to improve the targeting of the Samurdhi program, the largest cash transfer and social assistance program in the country: *"The Samurdhi program is now in the reform process, with particular attention being given to the introduction of efficient entry and exit mechanisms"*.

27. The MC notes the need for developing the North and East which have suffered disproportionately from the conflict and lack of investments.

The MC recognizes that the ongoing conflict has imposed a heavy economic cost on the North and East and that the poverty situation there is more serious than in other parts of the country. The Government's framework for interventions in the North and East has three pillars: (i) reintegrating-including assisting with income generating activities-those displaced or affected by the conflict; (ii) resuming service delivery, including through investments in physical infrastructure; and (iii) strengthening the role of local governments/administrations. The Government has recently prepared a US\$ 2 billion Reconstruction Plan for the East. While the Plan is somewhat lacking in clear priorities and is not likely to be fully financed or implemented within its current three-year horizon, it distinctly points to the large needs of the Eastern Province. As noted in the JSAN, the Government's strategy for the North and East is based on the assumption that the armed conflict will subside in the near future.

28. The MC intends to facilitate private investments by continuing with the fairly liberal and open economic regime that Sri Lanka has had for the past 30 years.

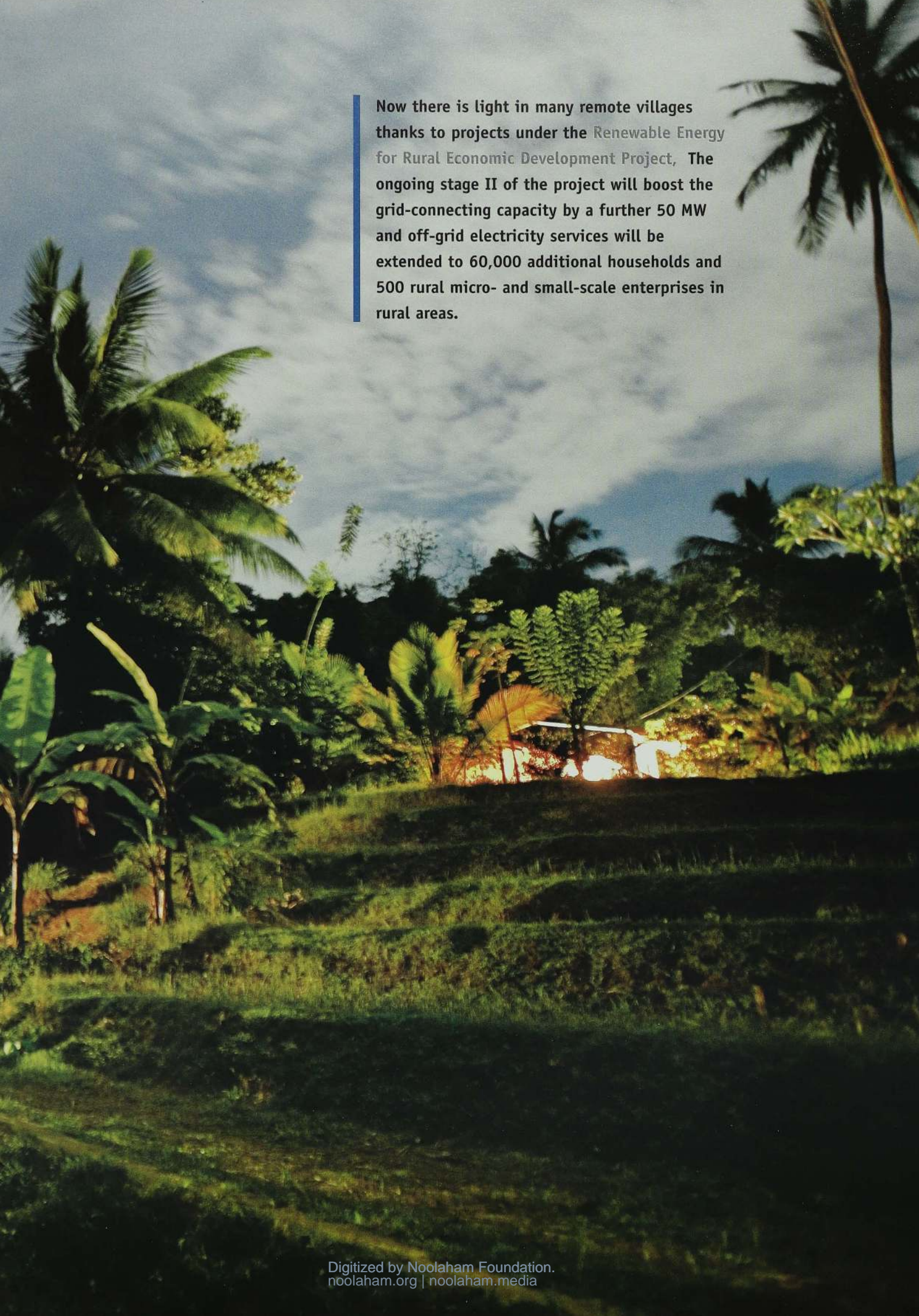
The export sector would continue to be supported through a conducive tax regime, a flexible exchange rate, market access via multilateral and bilateral trading arrangements, incentives for value addition by access to duty free inputs, and a liberal investment regime. The MC also states that the Government is committed to strengthening both product and factor markets-including land, labor and financial markets-to ensure the efficiency and competitiveness of the economy. Improvements in state-owned enterprises (SOEs) would be pursued

through strategic reforms (privatization is explicitly ruled out) but, as noted in the JSAN, progress in structural reforms of SOEs has so far been limited. The MC is also vague about the Government's policy stance in other areas. For example, the MC notes the importance of having a sound regulatory framework for public-private partnerships (PPPs), the need to modernize rigid labor laws and increased private sector participation in higher education, but is often ambiguous in its discussion of the policy measures that will be taken, how they will be implemented, and their relative importance.

29. The Government has made several notable policy decisions during the last two years.

The most decisive actions taken include moves to eliminate fuel subsidies, a comprehensive overhaul of electricity pricing with the objective of achieving full cost-recovery, and the long-awaited effort towards better targeting of the *Samurdhi* (welfare) program. Other notable accomplishments include strengthening the tax administration (including customs), establishing-with support from the Bank-a road maintenance fund, and some progress in land-titling reform. The Government has also introduced a number of much-anticipated laws and regulations, such as the Companies Act (2007), Payment Devices Frauds Act, Finance Leasing Act, Prevention of Money Laundering Act, Financial Transaction Reporting Act (all in 2006), as well as Corporate Governance for Licensed Commercial Banks in Sri Lanka (2007). On the investment front, several large scale infrastructure investments, including for the Colombo port and power plant, have commenced after many years delay. In parallel, the Government has managed to break the deadlock on several large-scale infrastructure projects (for example, in the power sector) that were stalled for many years.





Now there is light in many remote villages thanks to projects under the Renewable Energy for Rural Economic Development Project. The ongoing stage II of the project will boost the grid-connecting capacity by a further 50 MW and off-grid electricity services will be extended to 60,000 additional households and 500 rural micro- and small-scale enterprises in rural areas.

B MEDIUM TERM ECONOMIC OUTLOOK

30. The MC sets out ambitious targets for medium-term economic growth. According to the MC's associated macro-framework (MF), real GDP growth is projected to accelerate from its historical level of around 5 percent to over 8 percent from the year 2010 onwards⁴. Such growth would raise per capita GDP from US\$ 1,610 in 2007 to around US\$ 3,000 by 2012, equivalent to an almost two-fold increase of incomes in Sri Lanka in the coming five years. The main driver of growth is expected to be a sharp increase in both public and private investments which-in conjunction with the implementation of a number of structural policy measures-is assumed will lead to higher total factor productivity in the longer term. Underpinning this growth scenario is the assumption that the policy environment will be favorable and will include: (i) a conducive external environment, including an external trade policy aimed at securing markets for Sri Lankan products through preferential trade agreements; (ii) a reduction in inflation (measured by the GDP deflator) to 8.5 percent by 2010 through the implementation of a prudent monetary policy; (iii) a reduction in the fiscal deficit to 5 percent by 2010 by continued increases in tax collection, expenditure restraint and prudent debt management; and (iv) a reduction in the public debt to GDP ratio to 77 percent by 2010.

31. The MF clearly recognizes the importance of global developments for Sri Lanka. In line with the most recent World Economic Outlook projections, the MF anticipates the global economy to grow by about 4 percent in the next few years. Emerging market economies in the South and East Asia regions are expected to grow well above the global average, while advanced economies are expected to avoid an outright recession brought on by the recent turbulence in international financial markets. Moreover, Sri Lanka expects to positively benefit from greater regional

integration through expansion of multilateral, regional and bilateral trade arrangements, and a continuation of its open market economic policies. Against this background, exports are projected to grow (in US\$-terms) at around 10-11 percent per annum to reach US\$ 11.4 billion in the year 2011. Imports are expected to grow roughly at the same rate and the trade deficit is likely to hover around 9-10 percent of GDP through 2011.

32. The downside risks from the external environment are considerable and recent deterioration in the external outlook could have significant negative effects on Sri Lanka. First, as noted in the MF, a slowdown in advanced economies could threaten Sri Lankan exports in particular. Moreover, as also noted in the MF, higher than expected oil prices (and other commodity prices) in international markets could threaten macroeconomic stability and growth targets and, in this respect, Sri Lanka's weak fiscal and external position would not leave the Government with much room to maneuver and cushion the shocks. But there are several other risks. First, the important Sri Lankan garment industry will face renewed international competition in the US market when the quota on Chinese exports to the US expires in 2008. Second, Sri Lanka's continued eligibility for participation in the EU's GSP+ scheme (which is determined, inter alia, by the country's adherence to minimum labor standards and its human rights record) that ensures duty free access to the EU

⁴ In the original MF, accompanying the MC which was developed in late 2006, real GDP growth was expected to reach 8 percent in 2008 and 8.5 percent in 2010. In view of the lower than expected growth in 2007, the updated MF provided by the Government for this JSAN, and published in the Central Bank's 2008 Annual Report, projects that growth will reach 8 percent only in 2010, that is, two years later than originally projected. It should also be noted that while the original MF in the MC was extrapolated to 2016, the updated MF is only extrapolated to 2011 (see Annex 4).

for a large share of Sri Lanka's exports, is also up for review in 2008. Third, the 25 percent appreciation in the real effective exchange rate that has taken place during the past four years would be expected to make a noticeable dent in export competitiveness. Finally, as noted in the JSAN, the worsening security situation and the recent downgrading of Sri Lanka by international credit rating agencies, would also seem to pose additional risks for tourism receipts, FDI inflow and the Government's access to international capital markets.

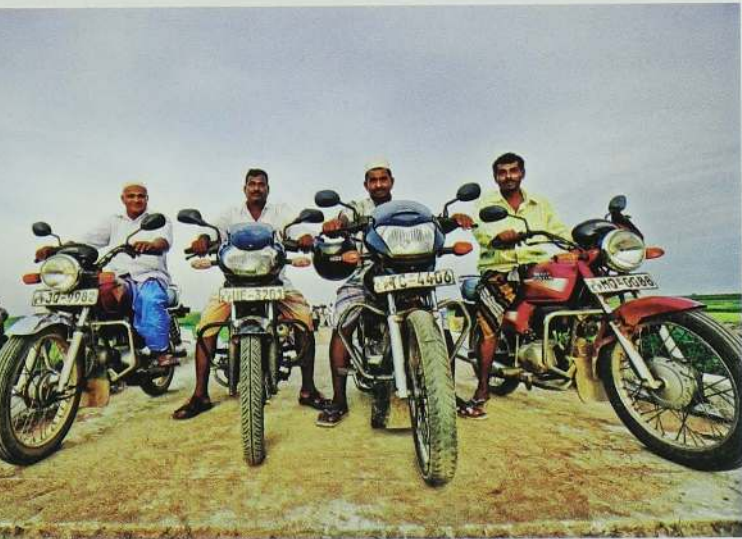
33. The MF envisages a gradual reduction in inflation which has been a perennial source of macroeconomic instability in Sri Lanka. In a welcome attempt to strengthen predictability and

credibility of monetary policy, the Central Bank of Sri Lanka (CBSL) in 2007 adopted a Monetary Policy Roadmap (MPR) in which explicit targets for growth of reserve and broad money were set. In parallel, an improved internal monitoring mechanism was introduced by the CBSL in 2007, with a view to identifying deviations from the targets as early as possible and facilitating timely corrective action. For 2008, the CBSL has adopted a somewhat less ambitious end-year inflation target in the range of 10-11 percent. Also, as noted in the JSAN, sustainable reductions in inflation would require both decisive monetary policy action and considerable progress in fiscal consolidation to reduce demand-push factors of inflation.



The restored Mahadangasweva water tank provides water for paddy cultivation, vegetable gardening and for bathing and washing to a village that has no electricity. **North East Irrigated Agriculture Project.**

Farmer Bikers of Akkaraipattu, Ampara. **Community Livelihoods in Conflict Affected Areas Project.**



34. Fiscal consolidation is a key element in the MF's objective to enhance macroeconomic stability.

According to the MF, the budget deficit will be reduced to around 5 percent of GDP by 2010. This would bring the deficit in line with the targets stipulated in the FMRA, albeit with a lag of six years. On the *revenue side*, total revenue-to-GDP is expected to increase by about 3 percentage points to 18.5 percent by 2010, mainly through further strengthening of the tax administration and continued expansions in the tax base (for example, by reducing tax privileges for companies registered under the Board of Investment scheme). On the *expenditure side*, consolidation is expected to take place entirely by keeping recurrent expenditures in check. In particular, improvements are expected to be achieved by phasing out budgetary transfers to SOEs. The Government has taken several commendable steps in this regard, in particular by allowing increases in domestic fuel prices and by raising electricity tariffs (albeit by using a highly progressive scale) with a view to eliminating the quasi-fiscal losses of the Ceylon Electricity Board. The MF also notes efforts to establish a 'cost effective public expenditure management system', with public

expenditures being programmed within a medium-term and sectoral budget framework to improve efficiency and productivity. Overall, recurrent expenditures are expected to be reduced to 16.0 percent of GDP by 2010, compared to 17.4 percent of GDP in 2007. Such improvements on the revenue and recurrent expenditure side would make room for an increase in public investments from 6.1 percent of GDP in 2007 to almost 8 percent of GDP from 2008 onwards, while still achieving the desired deficit targets.

35. The envisaged fiscal consolidation is necessary, but highly ambitious.

On the revenue side, considerable progress has been achieved since the revenue-to-GDP ratio reached a low of 14.9 percent in 2004. In 2007, the revenue-to-GDP ratio declined to 15.8 percent from 16.3 percent in 2006. As emphasized in the JSAN, this raises serious concerns about the Government's ability to achieve the sharp increase in revenues that is a key part of the envisaged fiscal consolidation. Increased revenue collection and strong tax reform measures, including further broadening of the VAT-base, would be required. However, recent changes in tax policy have instead mainly focused on increasing excise⁵ and imposing cesses on approximately 600 imported items. On the expenditure side, consolidation remains a challenge as over 60 percent of public expenditure is allocated to salaries, interest payments and defense. As noted in the JSAN, with respect to the Government's intention of reducing losses of SOEs, the focus on pricing reforms, while welcome, has not been accompanied by similar strong efforts to improve operational efficiencies of SOEs. The Government has also recently

⁵ Largely covering 'deemed' non-essentials such as motor vehicles, tobacco and spirits.

created a number of new SOEs-for example, a government-run import agency to keep consumer prices of 'essential' goods down, and a budget airline.

36. The MF projects a continued reduction in the public debt-to-GDP ratio. However, in the medium-term, the public debt-to-GDP ratio remains a concern. Sri Lanka's public debt reached 86 percent of GDP in 2007, a reduction from nearly 90 percent in 2006, mainly due to the faster growth in nominal GDP compared to debt stock. The share of foreign debt in total debt has remained relatively stable at around 44 percent, of which about 80 percent is concessional. In the past two years, there has been an increase in

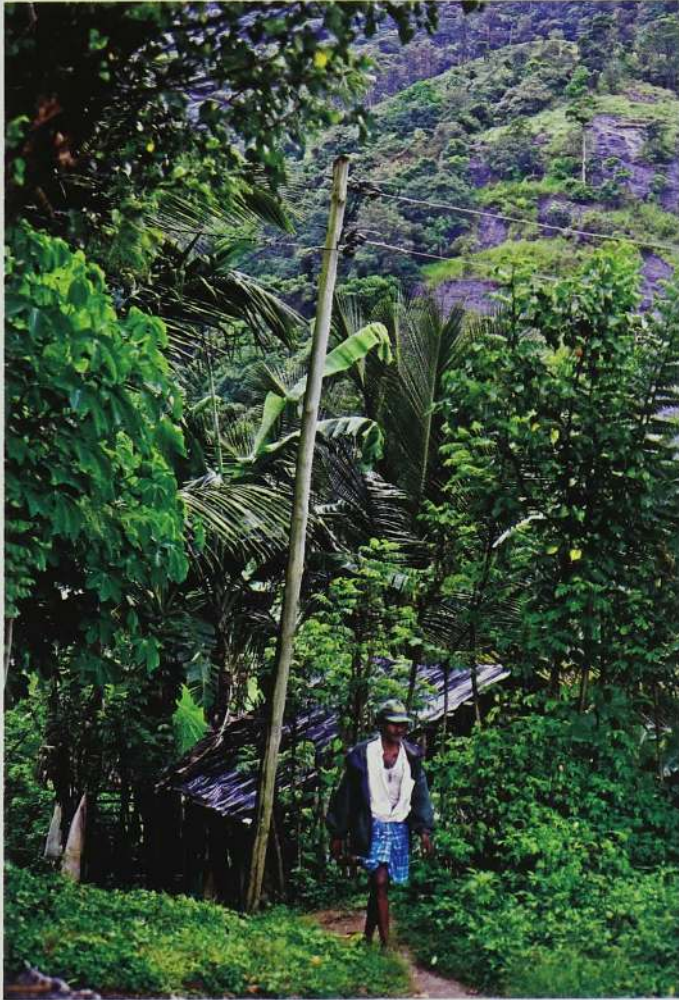
relatively short-term foreign commercial borrowings. Apart from the inherent risk of financing long-term projects with short-term facilities, these borrowings have also led to a 'bunching' of repayments, particularly in 2009, which could have negative BOP impacts considering that the reserve cover is not particularly large. In parallel, the average maturity of the domestic debt has been declining, which increases roll-over risks. Recently, however, exploiting the currently downward sloping yield curve, the Central Bank has taken steps to increase the average maturity of domestic debt. In the MF, it is assumed that to finance a higher public investment program the Government may need to mobilize around US\$400



Rehabilitated Nittambuwa - Kandy road.
Road Sector Assistance Project.

මහ මාර්ග අමාත්‍යාංශය - මාර්ග සංවර්ධන අධිකාරිය
 මාර්ග අංශ සහායක ව්‍යාපෘතිය
2 වන පකේජය - නිරිටිවෙල-මහලුවර මාර්ග පුනර්ජීවනය (39,300කිමී සිට 114,500කිමී)
 මූල්‍ය ආධාර: ලෝක බැංකුව, පිරවනය : රු. 1,863,947,668.00
 දැනටමත් කටයුතු කිරීමේ මහලුවර සිදුවන අවස්ථාවෙන් පිළිබඳ අපගේ කණගාටුවලදී කරන අතර
 එම අවස්ථාව අවම කිරීමට උපරිම උත්සාහය දරන බව දන්වා සිටිමු.
 ආරම්භක කාලය: 2006.03.15 දිනය: 2007.12.14
நெடுஞ்சாலைகள் அமைச்சு-வீதி அபிவிருத்தி அதிகார சபை
 வீதி பிரிவின உதவித்திட்டம்
2 ம் படிமுறை - நிட்டம்புவ - கண்டி வீதிபுனர்நிர்மாண செயற்திட்டம் (39+300KM TO 114+500KM)
 நிதியுதவி: உலக வங்கி, மதிப்பீடு : ரூபா 1,863,947,668.00
 பொதுமக்களுக்கு எங்களால் ஏற்படும் அசௌகரியங்களுக்கு மனம் வருந்துவதுடன், அவ்வாறான
 அசௌகரியங்களை முடியுமான வரை குறைத்துக் கொள்ள முயற்சிக்கின்றோம்.
 ஒப்பந்தக்காலம் : 2006-03-15 ஆரம்ப திகதி: 2007-12-14
MINISTRY OF HIGHWAYS - ROAD DEVELOPMENT AUTHORITY
ROAD SECTOR ASSISTANCE PROJECT
PACKAGE 2 - REHABILITATION/IMPROVEMENTS TO NITTAMBUWA - KANDY (39+300KM TO 114+500KM)
FUNDED BY: WORLD BANK, COST : Rs 1,863,947,668.00
WE REGRET ANY INCONVENIENCE TO THE PUBLIC AND ARE TRYING OUR BEST TO KEEP IT TO A MINIMUM
 CONTRACTOR : KEANGNAM ENTERPRISES LTD. ENGINEER : BCEOM / RDC
 START DATE : 2006.03.15 COMPLETION DATE : 2007.12.14

Farmer Kandy District.



million annually from international capital markets, in addition to the expected concessional financing. The impact of such borrowing on Sri Lanka's debt sustainability hinges critically on growth and the primary budget deficit, and on the terms that the Government is able to obtain for this borrowing. In this respect, it should be noted that incremental borrowings may easily come under stricter covenants and/or higher risk premiums.

37. A key factor behind the MF's projected acceleration in growth is a sharp increase in investments. The vision is to build modern, high quality and efficient infrastructure facilities to expand

access to markets. Specific areas of emphasis include maintaining and rehabilitating the existing road network; constructing highways and expressways; increasing accessibility to safe drinking water; upgrading the railway sector; expanding the generation, transmission and distribution of electricity, and; transforming the port and airport sectors to create an air-sea hub and logistics center. Consequently, total investments are assumed to increase from 27.9 percent of GDP in 2007 to 33.2 percent in 2011. The projected increase, it is mainly assumed, will result from a sharp increase in private investments from 20.7 of GDP to 27.0 percent of GDP between 2007 and 2012. Higher public investments, it is expected, will contribute another almost 2 percentage points, as public investments are assumed to reach about 8 percent of GDP compared to 6.1 percent of GDP in 2007.

38. It may be difficult to realize the sharp increase in domestic savings required to finance the envisaged investment program. The MF assumes a significant increase in total domestic savings—from 17.6 percent of GDP in 2007 to 24.5 percent of GDP in 2011, equivalent to an increase of 6.9 percent of GDP—to provide the financing for the increase in investments. The public sector, it is assumed, will contribute about two-thirds of the increase in savings, with the private sector providing the balance. The projected increase in the public sector's savings hinges critically on the Government's ability to achieve fiscal consolidation which, as noted above, may be challenging in the current environment of rising commodity prices and the ongoing conflict.

Five year old Biguni is well on the way to recovery after an accident at home and is in the children's ward with her mother Indrani Abeykoon at Mahiyangana Base Hospital. Health Sector Development Project.



A caring health service to the people of the Uva province by the Mahiyangana Base hospital. The hospital has won national and international awards for providing quality health services to an economically poor province. Health Sector Development Project.



LESSONS FROM THE LAST CAS AND PUBLIC CONSULTATIONS

The CAS public consultations revealed high expectations for a continued strong Bank engagement in Sri Lanka, despite an ever-changing operational environment that requires constant adaptations and adjustments. The implementation of the last CAS showed the importance of ensuring Government ownership and continued political commitment for successful policy implementation. The Bank is cognizant of the critical need to make the most of openings for incremental policy changes, if and when they occur, rather than necessarily pursuing “grand reforms”. The public consultations also showed the need for the Bank to continue to build constituencies for policy change by facilitating dialogue and timely dissemination of relevant knowledge to broad audiences.

A IMPLEMENTATION LESSONS

39. The CAS Completion Report (CAS CR) emphasizes the significant change in the operational environment during the last CAS period.

The proposed program in the 2003 CAS was highly relevant to Sri Lanka's needs and well-aligned with the priorities of the Government at the time, focusing on Peace, Growth and Equity, with a Tsunami reconstruction pillar subsequently being added. However, as noted previously, the 2003 CAS was approved in a context that was significantly different from the one in which its implementation took place. Not only did actual developments on the peace front depart from initial expectations, but also unforeseeable events—in particular the December 2004 tsunami—combined with political developments to require adjustments in the shape and reach of the CAS' original objectives and expected outcomes. These adjustments, which were introduced within the context of the 2006 CAS Progress Report (CAS PR), acknowledged the fact that: (i) the Poverty Reduction Strategy (PRS) that provided the CAS foundation was discarded by the new coalition Government; and (ii) prospects for rapid and deep reforms were curtailed. Consequently, the CAS PR introduced a significant shift in the structure of the Bank's activities and a major prioritization and associated reduction (from 33 to 16) of key CAS outcomes.

40. Overall, the CAS CR assesses the outcomes of the 2003 CAS as moderately satisfactory. The CAS CR concludes that 11 of the 16 revised outcomes were satisfactorily met. For two outcomes, the assessment is inconclusive due to lack of data, while achievement of three outcomes is assessed to be unsatisfactory. In terms of the Peace pillar—where Bank activities mainly focused on rehabilitation and reconstruction of infrastructure—outcomes were generally satisfactory. But the re-emergence of the armed conflict and the ensuing difficulties in project implementation have, to

M.P. Charlis an asthmatic patient being looked after by Attendant Nandawathie, Dambana Rural Hospital. **Health Sector Development Project.**



some extent, slowed progress and raised questions of sustainability of outcomes. It has also emphasized the need for the Bank to be adequately realistic and modest about its capacity and role in the area of peace building. Progress on the Growth pillar outcomes was mixed, as more politically contentious policy changes (for example, reforms related to civil service, the labor market and SOEs) were unsuccessful, while less controversial reforms (for example, organizational changes in the Central Bank) were more successful. Projects under the Equity pillar (education, health and community-driven development projects) had several notable results on the ground, even if data on country-wide trends in equity does not point to a reduction in inequality during the CAS period. Finally, the Bank's tsunami reconstruction efforts were generally successful. There remain, however, lingering concerns about the overall tsunami reconstruction effort (see Box 2).



Box 2. Lessons from Tsunami Reconstruction

The devastating effects of the December 2004 tsunami in Sri Lanka and several other countries are well known. Overall, the agency responsible for Sri Lanka's reconstruction efforts (TAFREN/RADA) suffered from a serious lack of capacity to handle the massive aid inflows and was ineffective in dealing with donors, including NGOs. This has created many problems, especially related to the donor-driven housing reconstruction program which was to resettle and construct houses for many of the affected families. It also led to poor oversight of the reconstruction efforts, and some auditing irregularities. In addition, there is the perception that reconstruction aid has been unequally directed and, in fact, significant geographical inequalities have materialized. Compounding these problems is the resumption of the conflict which means that access to the North and East has become increasingly difficult. As a result, the South and West have received more aid than the North and East.

Despite this context that casts a cloud over Sri Lanka's overall tsunami reconstruction efforts, the IDA-financed operations were relatively successful. Immediately after the tsunami, the IDA carried out a portfolio restructuring and reallocated US\$ 75 million from other projects to the Tsunami Emergency Reconstruction Program I (TERP I). In February 2005, a new credit of US\$ 75 million was approved for TERP II. The IDA is also administering US\$ 25 million from the International Federation of Red Cross (IFRC) which is being used for housing reconstruction. A significant share of the support (TERP I & II) was used to help restore livelihoods and rebuild houses (through a homeowner-driven model), with lesser amounts allocated for reconstruction in health and road infrastructure and costs associated with operations of key implementing agencies such as the Reconstruction and Development Agency (RADA). More than 100,000 families benefited from livelihood cash grants and about 23,500 partially damaged houses were fully repaired (97 percent), along with 15,600 fully-damaged houses (62 percent). The housing program is wrapping up in the South and West, but some areas of the North and East are expected to continue to experience a lack of or very slow progress due to the poor security situation. While 90 percent of the fully-damaged units in the South and West have been reconstructed, only 57 percent of the units in the North and East have been completed. The tsunami-damaged roads from Kalutara to Matara (114 km) were also rehabilitated.

LESSONS FROM THE LAST CAS AND
PUBLIC CONSULTATIONS



Reconstructed tsunami houses in Nintuvur, Ampara in the East coast of Sri Lanka. As of March 2007, about 80 percent of eligible families have fully completed their houses under the World Bank funded tsunami housing cash grants program. Most of the unfinished houses are in the North and the East. 23,500 partially damaged houses have been fully repaired (97 percent), along with 15,600 fully-damaged houses (62 percent).



41. The Quality Assurance Group (QAG) reviewed the Analytic and Advisory Activities (AAA) program and concluded that, overall, it was moderately satisfactory. The QAG rated the AAA program satisfactory on strategic relevance (aligned with CAS priorities), internal quality (high-quality teams that in many cases worked closely with relevant counterpart teams), and on coherence and integration (consistent focus on key areas of public sector management, expenditure control and service delivery). The program was rated marginally satisfactory in its dimension of participation, consultation and dissemination. The QAG review notes that the overall level of the dialogue between the Government and the Bank on critical issues merits some strengthening, and that more aggressive dissemination of some of the basic findings of the AAA work would have been desirable. The QAG rated the AAA program's likely impact moderately unsatisfactory. The review concluded that while the focus on public sector issues was appropriate and policy changes in this area would contribute significantly to the CAS objectives of growth and equity, changes in the political leadership and policy priorities did not prompt sufficient significant change in the areas covered in the AAA program. Part of the reason was the necessary and urgent response to the tsunami which consumed the full attention of the Bank and Government in the initial period of the new Government's tenure and which, therefore, might have delayed the needed adjustment. The subsequent escalation in the armed conflict further compounded these difficulties.

42. The IFC rapidly scaled up its program during the last CAS period. As of March 2008, the IFC had invested in 12 companies in Sri Lanka with a total exposure of US\$ 211 million, all from IFC's own account. The investments include projects in the

LESSONS FROM THE LAST CAS AND PUBLIC CONSULTATIONS

information technology and financial services sectors. The IFC invested in Suntel, Dialogue and, more recently, Telekom Malaysia, to significantly expand the IT infrastructure. In the financial sector, IFC activities included investments in commercial banks and the country's first credit rating agency and, more recently, extending IFC's Global Trade Finance program to Sri Lanka. Portfolio performance has so far been good, with no loan arrears and strong unrealized capital gains. IFC's advisory services program is too young yet to fully evaluate. However, early indications based on two completed projects (totaling \$100,000 of spending) indicate that the program is making a positive contribution to the development of the financial services, ICT and tourism sectors. Increasingly, IFC is looking to integrate the investment side and advisory side of its activities and provide a combined package. In the Sri Lanka Country Office of the IFC, this is facilitated by, among other things, having one country manager oversee both investment and advisory work. The Multilateral Investment Guarantee Agency (MIGA) has also been active in Sri Lanka in the past, insuring projects in the finance and infrastructure sectors. Currently, MIGA has no outstanding guarantees in the country but will remain available to support the inflow of FDI into the country.

B MESSAGES FROM PUBLIC CONSULTATIONS

43. The Sri Lanka Client Survey conducted in the summer of 2007 shows that the Bank in Sri Lanka is more valued for its financial resources than for its knowledge services. The findings from the Sri Lanka Client Survey demonstrate a number of areas where the Bank has developed a strong and positive

Iresha Balasuriya, a teleworker at the remote Mahavillachiya e-village.



reputation and excellent working relationships. At the same time, the findings suggest a number of areas where the Bank should strengthen attention in order to improve its work and results. According to the Client Survey, the top development priorities of the country are economic growth and resolving the conflict. Poverty, Government effectiveness, and corruption are equally important. The Bank is perceived as doing well in several areas including, for example, infrastructure and education. The Bank received its lowest ratings in the areas of peace building efforts, transparency and governance. Of particular concern are the low ratings that the Bank received for work in safeguarding against corruption in its own projects and programs. Respondents rated the value of the Bank's knowledge services quite low: while 43 percent of respondents chose financial resources as the greatest value brought to the country by the Bank, only 11 percent identified knowledge as the top value. This raises questions about the quality, timeliness, emphasis, and dissemination of the Bank's knowledge products in Sri Lanka.



44. During the public consultations carried out for this CAS, high expectations were expressed for the Bank's continued strong engagement in Sri Lanka.

The public consultations gave insights from a wide spectrum of Sri Lankan society, both about what the Bank should be doing and how it should be operating⁶.

- In terms of priority areas for the Bank's engagement, the public consultation forums repeatedly emphasized the need to improve infrastructure to enhance connectivity to markets and facilitate private sector development. This was also seen as a critical element in fostering inclusive growth. Another area that was often emphasized was education, where many participants expressed strong concerns about poor quality and where it was also pointed out that strengthened language teaching could be a very important instrument in ethnic reconciliation. There was also a strong request for the Bank to continue its engagement in local and community development to improve living conditions in villages and rural areas. In addition,

there were very strong demands from the people in the conflict-affected areas for Bank involvement in reconstruction and development. At the same time, participants cautioned that the Bank should be vigilant that its assistance does not fuel the conflict or become determined by political consideration; it should, instead, reach the neediest people. Many participants expressed concerns and frustration about the deterioration in governance but also questioned the extent to which the Bank would be able to make a difference in this area. Finally, the consultations showed a desire to see stronger engagement by the Bank in several areas where Bank involvement has been limited in recent years. Examples of such areas include the estates sector, gender issues, problems of urban poverty, and adaptation to climate change-some of which the Bank should consider enhanced engagement in during CAS implementation.

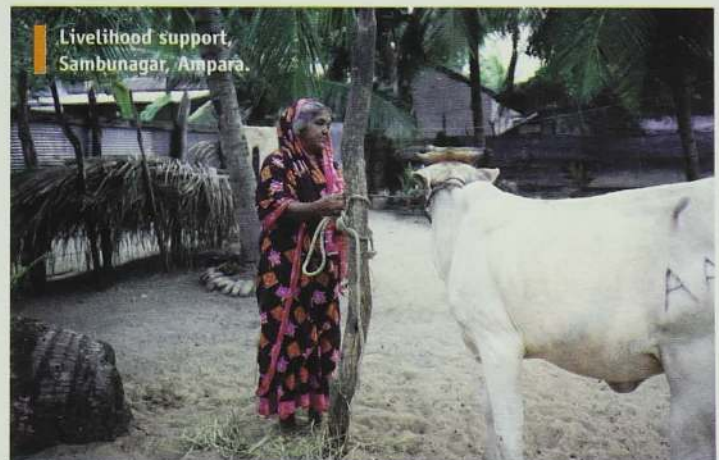
- In terms of the Bank's *modus operandi* in Sri Lanka, participants in the public consultations had several

⁶ The public consultations are summarized in Annex 1.

useful observations. First, participants clearly recognized the limitations of the Bank's 'leverage' to bring about dramatic changes in the situation on the ground, both on account of the modest and declining share of Bank financing in total public sector financing and on account of the complex domestic political situation. Against this background, participants encouraged the Bank to further prioritize dissemination of information and stimulation of public debate on broad policy issues (for example, macroeconomic management, investment climate, climate change, energy sector reform, and governance). Second, there was a strong request for the Bank to engage more thoroughly at the grassroots and local levels—including with communities, NGOs, the private sector, and local governments that would like to be more involved in the planning and execution of development interventions at the local level. Finally, participants urged the Bank to further emphasize the M&E of not only its own programs but also support Government agencies in strengthening M&E as a way of increasing transparency and accountability in public spending.

45. The experiences from implementing the last CAS and the inputs from the public consultations point to several lessons going forward. First, in view of the volatile conflict situation, there is a need to both adapt and also exploit openings for policy changes if and when they appear. Second, it is critical to ensure Government ownership and continued political commitment for successful implementation of policy changes. This requires careful reading of the often complex political landscape. It also requires a willingness to accept that it may not be feasible to pursue 'grand reforms' but more productive to pursue

Sinnaidevar Perumiah's grocery shop has the only fridge and phone in this small village running on electricity generated by a micro hydro project.
Renewable Energy for Rural Economic Development Project.



incremental improvements whenever possible. This implies that there is a need for continued consultations to build constituencies for policy and institutional changes. Finally, despite the fact that the Bank's knowledge services are not rated well in the Client Survey, there are still strong expectations that the Bank will provide knowledge and facilitate dialogue in many areas. It is critical that the Bank capitalize on these demands to disseminate knowledge, in a timely manner, to wider audiences beyond the immediate counterparts of the Government.

Rahina Jameel, seamstress is a beneficiary of the *Community Livelihoods in Conflict Affected Areas Project*, Sambunagar, Ampara. The Project helps conflict-affected communities in the North and East provinces to restore livelihoods, enhance agricultural and other production and incomes, and build capacity for sustainable, social and economic reintegration.



For students like Dissanayake Mudiyanalage Sudharshan (16) electricity has a value that cannot be measured as it enables him to study at night in their one roomed house. Each family in the village pays Rs 100 (less than a 1US\$) a month for the electricity from a micro hydro project under Renewable Energy for Rural Economic Development Project.



BANK GROUP ASSISTANCE STRATEGY

The three strategic objectives of the CAS are to:

- expand economic opportunities in the lagging regions for inclusive and equitable economic development,
- improve the investment climate and competitiveness for accelerated economic growth, and
- strengthen the quality, efficiency and effectiveness of service delivery.

The conflict has been an impediment to long-term development and poverty alleviation in Sri Lanka. Recognizing this, the CAS interventions will be highly conflict sensitive, subjecting all projects to a “conflict filter”. The Bank would also seek to further strengthen governance in flexible and pragmatic ways by supporting core governance institutions such as Auditor General's Office, and strengthening beneficiaries' voice in projects the Bank is supporting.

A SUPPORTING GROWTH AND POVERTY REDUCTION

Strategic Objective 1 Expanding Economic Opportunities in Lagging Regions

46. The Bank will assist the Government's strategic goal of enhancing rural economic growth with a view to achieving more regionally balanced development. Several factors have led to relatively low growth in the largely rural areas outside the Western Province. First, growth in these areas has been hindered by poor market access because of poor infrastructure—in the joint ADB/World Bank Investment Climate Assessment (ICA) rural business-owners reported transport as the most important constraint to growth of their businesses. This, coupled with poor access to finance, has impeded the transition from agriculture to non-farm economic activities in rural areas. Agro-business and other rural enterprises have been slow to take off, despite the emergence of some out-grower schemes established by Sri Lankan supermarket chains. At the same time, agricultural growth has been sluggish for years—agriculture GDP has only grown by about 2 percent per annum during the last five years. Agriculture development has been hampered by a skewed policy framework which shows a high reliance on subsidies and fosters restrictive land policies. Increasing water scarcity and human/wildlife conflicts are further barriers to agricultural growth, as is inadequate diffusion of technology and knowledge. The conflict-affected areas in the North and East face particular challenges to achieving sustainable growth because of a serious infrastructure backlog, comparatively low levels of human development, and recurring displacement of large numbers of citizens in these areas.

47. Supporting integrated rural development (CAS outcome 1.1). The recent worldwide increase in food prices and its likely persistence in the medium-term is creating a new environment for the agriculture sector. The rising cost of food is a significant burden on net food buyers (mostly urban consumers). At the same time, the farming community will benefit from higher farm prices which would eventually trigger the required supply response that will mitigate the pressure on prices. This is the right time for improving the efficiency of agriculture supply chains and marketing channels, and promoting partnerships with a private sector that is increasingly attracted by the agriculture sector and is searching for new business models. Moreover, the expansion of programs that aim at rural livelihood development will foster village institutions and farmers organizations that will generate the required scale to reduce transaction costs, facilitate better access to markets, and interaction with private players. In parallel, poverty reduction will also critically depend on the rate at which the rural off-farm sector can absorb workers from the growing rural labor force. Off-farm employment makes up about two-thirds of all employment in rural areas. Among rural households that own and operate off-farm enterprises, the poverty rate is 13 percent compared with 23 percent for households without income from off-farm enterprises. Limited employment expansion in the agricultural sector means that poverty reduction will critically depend on the rate at which the rural off-farm sector can absorb workers. Growth of rural enterprises is limited by weak market connectivity and poor access to other infrastructure (for example, electricity). To address these challenges, the Bank intends to align its engagement with the *Maga Neguma* and *Gama Neguma* programs to support access to infrastructure and services in rural areas. In addition to our ongoing interventions supporting rural electrification and community water supply, areas of

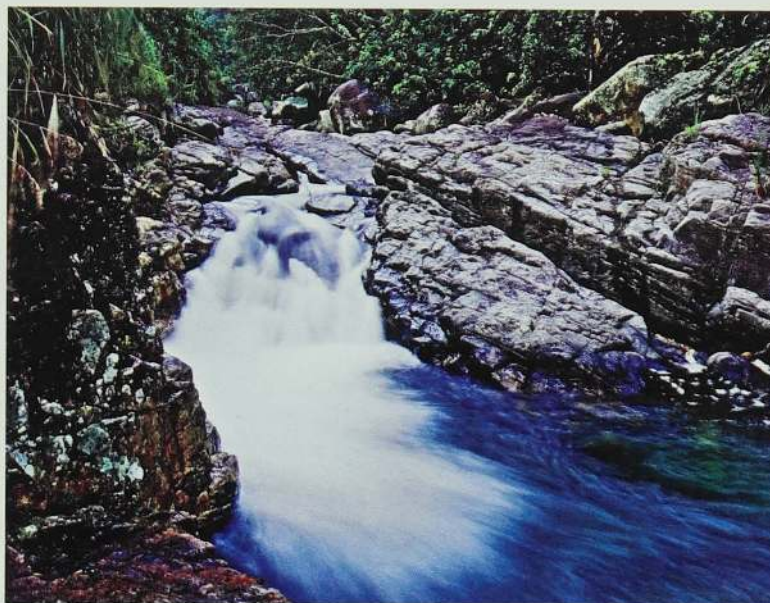
29 year old A. Shantini, has rebuilt her conflict damaged house with support from the North East Housing Reconstruction Project. She is here with her parents and children in their new house in Vallathapitiya, Ampara. The US\$ 43 million additional financing for this project will help rebuild 13,615 more houses to assist the conflict affected resettle.



focus would include community-driven livelihood improvements, improving inter-connectivity through integrated rural infrastructure development, improving the existing road network, and enhancing the reliability of electricity provision by improving transmission and distribution. The Bank also supports access to micro-finance through village-based credit schemes established under Bank-funded community driven development programs, including *Gemi Diriya* and the Community Livelihood in Conflict Affected Areas Project. In parallel, recognizing the importance of raising agricultural productivity and agricultural diversification to higher value crops for reducing rural poverty and for enhancing food security in the context of high global food prices, the Bank would support PPPs for agricultural competitiveness, strengthening agricultural research and extension, improving water resource management, investing in irrigation and dam safety, and reducing competing demands for scarce resources between humans and elephants. Finally, building on the recommendations of the recently completed Poverty Assessment and the Tea and Rubber sector studies, and the experiences from projects like the Bank-financed Community Water Project, the Bank would work with stakeholders to address the increase in poverty within the estates sector.

48. Improve economic opportunities in the North and East (CAS outcome 1.2). More than two decades of conflict have had far reaching economic and social repercussions for the people of the North and East. The conflict-affected regions lag behind the rest of the country in availability of economic infrastructure, access to markets and financial services, and key human development outcomes. Only 46 percent of the population of the North and East has access to safe drinking water, compared with 62 percent for the rest of the country. Less than one-half of the households in the region have access to water-sealed toilets. The

Micro-hydro projects generate electricity from fast flowing streams.



2002 ceasefire agreement and subsequent cessation of hostilities spurred economic recovery in the North and East. Real GDP growth in the North increased four-fold to about 13 percent while that of the East doubled to 10 percent from the pre-ceasefire to post-ceasefire years as security-related mobility restrictions were lifted, fishing restrictions relaxed, investments increased, and people's confidence in the future improved. Sustainable growth in the North and East will ultimately depend on whether durable peace is achieved. But the serious backlog in infrastructure, community and social services, as well as employment opportunities, including access to quality roads, telecommunications, and water and electricity would also have to be addressed. Mindful of the difficult and sensitive operating environment in the North and East, the Bank intends to remain substantially engaged in this part of the country to help people and communities rebuild their lives, by supporting housing and village rehabilitation and construction, psycho-social services for traumatized individuals, and inter-village connecting infrastructure-including rehabilitation of provincial roads.

49. The IFC will contribute to this outcome. The IFC will pursue investment opportunities which have a broad reach and benefit across the country, for example, by looking to support companies which source from and sell to the Northern and Eastern Provinces. The IFC will also consider stand-alone investment opportunities in conflict-affected areas where risk can appropriately be mitigated, for example, through the use of guarantees. IFC advisory services will seek to support the tourism and ICT sectors outside of the Western Province which have been the focus of private sector growth in recent years. MIGA guarantees are available as well.

Strategic Objective 2

Improving the Investment Climate and Competitiveness

50. Higher investments and higher productivity are required to accelerate economic growth in Sri Lanka. With an average investment-to-GDP ratio of 26.2 percent in the past 5 years (of which the private sector contributed 22.4 percent), investment levels in Sri Lanka are lower than the South Asia average and well short of the levels of a number of fast-growing East Asian economies. The Government is targeting an increase in the investment-to-GDP ratio of about 5 percentage points by 2010, to bring it into line with the level of other lower-middle income countries. It plans to do so by prioritizing infrastructure investments at the national level (through the *Randora* program) and at district and local authorities level (through the *Maga Neguma* program). In parallel, impediments to private investments remain. The 2005 joint ADB/World Bank Investment Climate Assessment (ICA) concluded that the top-five constraints to

private businesses⁷ were: (i) policy uncertainty, in particular on account of the conflict; (ii) macroeconomic instability; (iii) cost of finance; (iv) poor infrastructure, including unreliable and expensive electricity supply; and (v) a rigid labor market. Sri Lanka also faces challenges in terms of moving towards an economy increasingly based on knowledge. Research and development spending is low, as is FDI and its associated knowledge transfer. The ICT sector needs to be further developed even though much progress was made after the telecom sector was opened up for competition in the mid-1990s. Against this background, the Bank would support improvements in the investment climate and competitiveness by seeking to achieve the following outcomes:

51. Improving infrastructure provision (CAS outcome 2.1). In support of the Government's effort to reduce the country's infrastructure deficit, the Bank will scale up its support for the roads sector at both the national and provincial levels. There are several reasons why the Bank would focus its infrastructure assistance in the roads sector. First, inadequate road infrastructure is a critical constraint for sustainable and inclusive growth in Sri Lanka as highlighted, for example, in the Bank's Poverty Assessment which pointed to a robust linkage between poverty reduction and accessibility measured by travel time to markets. This was also echoed during the CAS consultations where participants repeatedly emphasized the need for better roads and access to markets and jobs to spur regional development. Improvements in the road network would also complement other Bank activities aimed at strengthening rural development and networking between rural entrepreneurs and the private sector in cities—for example, the proposed Integrated Community Development/*Gama Neguma*

⁷ These were the constraints identified by firms in urban areas where the vast majority of firms are located.



project and the Community Livelihood in Conflict Affected Areas (CLCA) project. To further increase the returns on these investments, other improvements in the policy environment (for example, in agricultural policy and land policy) should also be pursued by the Government. Second, the Bank's strengthened engagement in the roads sector would complement other donors' activities in other infrastructure sectors (for example, Japan and China in power, ADB and Japan in water supply, and China and ADB in ports). Finally, the envisaged focus on the provincial councils as key stakeholders in part of the roads sector assistance program also offers an opportunity to provide much-needed strengthening to the devolved entities in Sri Lanka. Donor coordination in the roads sector is excellent through the Transport Forum which was established jointly by the three main donors in the sector (ADB, Japan and the Bank) and the Government. As agreed by the Transport Forum, ADB has taken the lead in supporting the development of the Road Sector Master Plan which, originally, was developed in 2005 but was recently updated. Japan

⁷ These were the constraints identified by firms in urban areas where the vast majority of firms are located.

has taken the lead in supporting the development of a competitive and capable road construction sector, while the Bank has focused on strengthening the institutional framework for road maintenance through the establishment of a Road Maintenance Fund. The Bank's engagement would be further guided by an infrastructure assessment that the Bank would conduct in collaboration with the Government, with a view to establishing a holistic overview of infrastructure provision across sectors and locations. This would include areas where the Bank has so far not engaged strongly—for example, urban development, with a view to assess the livability and competitiveness of the Colombo metropolitan area which is of critical importance for Sri Lanka to solidify its middle income country status. The IFC, through its recently established South Asia Infrastructure Facility, can provide infrastructure advisory assistance to the Government (on a fee basis) for developing bankable projects, largely utilizing the PPP model. The IFC will also look for opportunities to enhance the provision of infrastructure through direct investments.

52. Improving the business environment for stronger entrepreneurship and a knowledge-based economy (CAS outcome 2.2). Sri Lanka ranks poorly on a number of Doing Business indicators (for example, 22 procedures and 214 days are needed to receive the necessary licenses and permits to start a business). Such constraints, as also recognized by the Government, impede the growth of private business to the detriment of job creation. Also, vibrant small- and medium-sized enterprises (SMEs), which are critical for growth and job creation, often lack sufficient capacity for business development, have poor vertical and horizontal linkages, and limited access to finance. Moreover, as pointed out in the Bank's recent

Knowledge Economy Report, Sri Lanka faces considerable challenges in terms of improving ICT, research and development, and the quality of education to make a decisive move towards becoming a knowledge-based economy. The Bank would also support improvements in the business environment for the tourism sector, including exploring efforts for joint initiatives with the IFC.

53. The IFC would play a key role in strengthening the business environment, including in the ICT sector, and improving opportunities for SMEs. First, through equity investments and associated advisory work with six commercial banks, the IFC has made a concerted effort to improve access to finance for SMEs. In 2007, these six banks provided 40 percent of all commercial bank lending to SMEs. The IFC's investments are underpinned by a Banking Survey of the SME market in Sri Lanka, completed in 2006 and accompanied by capacity building and training through the IFC's SEDF (South Asia Enterprise Development Facility) which focuses on helping banks develop SME lending strategies; process re-engineering; improve automation, design and implementation of credit risk management tools; create or strengthen SME lending departments; and introduce new financial products. Second, by providing patient equity capital and associated advisory services in the areas of corporate governance, risk management and SME financing, IFC will continue to play an important role and add to efforts in helping develop the financial sector. Third, through its 'Business Enabling Environment' work, IFC will seek to address policy and regulatory constraints to SME development, with a focus on selected municipalities in order to improve impact. Fourth, IFC's Value Addition to Firms Advisory Program supports the growth of export-oriented manufacturing and service

companies, including knowledge-based companies, by: (i) facilitating linkages between large and small enterprises; (ii) capacity-building for support services providers (for example, training organizations and associations); and (iii) providing information services (for example, e-based services and trade fairs). Finally, IFC would support the further development of the ICT sector through equity investment in several ICT companies. MIGA guarantees are available for the SME sector too. MIGA has also introduced a streamlined product, the Small Investment Program (SIP), specifically targeted to small-scale investments. At the policy-level, the Bank would pursue financial sector improvements through AAA and policy dialogue, based inter alia on the recommendations of the Financial Sector Assessment Programs or FSAPs (jointly with the IMF). The Bank would also support the knowledge economy in Sri Lanka by providing technical assistance to the Tele-Regulator and through the on-going E-Sri Lanka project. The Bank liaises closely with several donors in this area, including USAID (which has just completed its large 5-year 'Competitiveness Program'), the Netherlands and the EU.

54. Improving the strategic relevance and transparency of public spending (CAS outcome 2.3). Reducing the high fiscal deficit and arresting inflation are the most critical factors for macroeconomic stability and growth. Containing the fiscal deficit will require improved selectivity and prioritization in public spending, in conjunction with continued progress in revenue mobilization. In the likely absence of development policy lending (see para 71), the Bank's assistance will be focused on technical assistance and economic and sector work (ESW) in selected areas. Priority areas include enhancing the effectiveness of public spending on infrastructure-based on

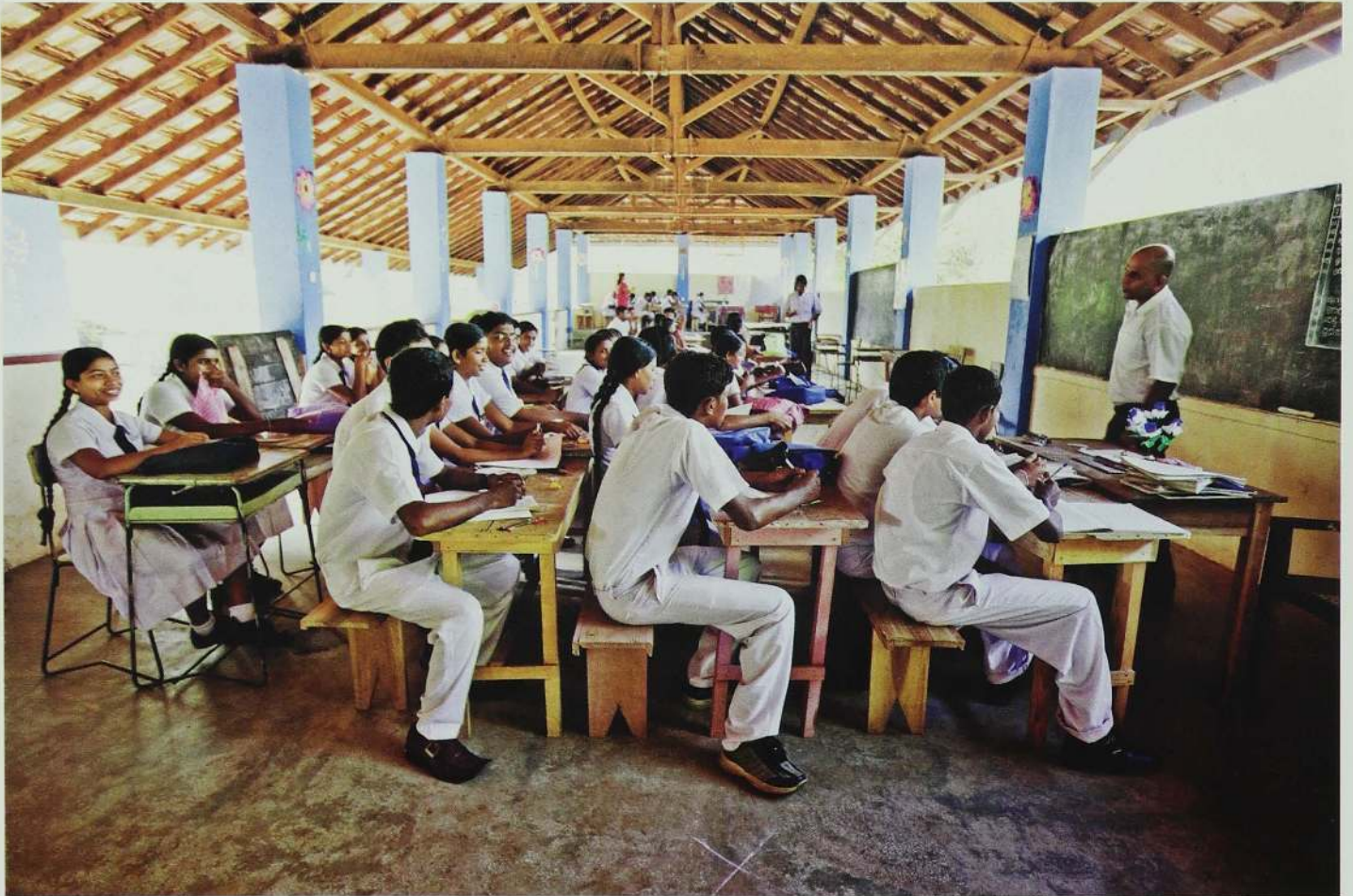
recommendations from the Infrastructure PER (Public Expenditure Review), enhancing the strategic relevance of public expenditures through technical assistance to the Medium Term Expenditure Framework, and exploring ways to improve the financial sustainability and efficiency of SOEs. Moreover, the envisaged Bank support for the Auditor General's Office and the selected parliamentary oversight committees would help to strengthen accountability in public spending. In addition, strengthening the capacity of the Department of Census and Statistics (DCS) will improve the evidence base for policy planning, ensuring that Sri Lanka's national policies are based on more accurate and timely statistical information and analyses. Led by the World Bank Institute (WBI), the Bank is also working to enhance the capacity for budgeting and planning at the provincial council level. Finally, the Government envisages that a part of its planned public infrastructure will be financed through PPPs. However, considerable work remains to be done for establishing an adequate policy framework to facilitate PPPs in terms of design, appraisal and selection of potential projects. The Bank stands ready to provide technical expertise and advice to the Government to support its efforts to strengthen the PPP framework. Other partners in this area include the ADB which is providing technical assistance to the Revenue Department to further improve the effectiveness of revenue collection, and the IMF which is providing technical assistance on select tax policy issues-particularly on broadening the VAT base.

Strategic Objective 3

Enhancing Quality Services and Accountability

55. Sri Lanka has achieved impressive results in providing access to services for its population but concerns about quality and relevance are mounting. Many social indicators in Sri Lanka are at impressive levels: a net primary school (grade 5) enrolment rate of 97 percent, life expectancy of 74 years, and an infant mortality rate of 13 per 100,000 live births are all comparatively high indicators for a country with a per capita income of US\$ 1,600. Despite these achievements, however, delivery of basic public services faces a number of challenges that have their roots in emerging economic, social and demographic changes. Economic changes (higher incomes, increasing need for adaptability, and increased international competition) are resulting in a growing premium on quality and relevance in service delivery, in addition to efficiency considerations. For example, in basic education, not only is the completion rate (grades 1-9) only 78 percent, but the quality of education is inadequate, with a mere one-third of primary school children achieving mastery in language and mathematics skills. In parallel, Sri Lanka has one of the fastest aging populations in the world. Population aging is significantly changing the demands on the health sector where the rising prevalence of non-communicable diseases (for example, diabetes) and an inefficient hospital network result in a high disease burden. Similarly, affordable and adequate social security for the aged will eventually become a critical need.

Promoting secondary education in key subjects such as English, science and mathematics is an important component of the World Bank's support. **Education Sector Development Project.**



56. Improved quality, relevance and governance of education (CAS outcome 3.1). Enhancing quality and relevance of education at all levels is a central challenge as current achievement levels are modest. Among primary school children, only 69 percent score above 50 percent in first language (Sinhalese or Tamil) tests, and only 67 percent of children achieve scores above 50 percent in mathematics. In addition, policy makers are seeking to ensure that 85-90 percent of children complete grade 9 over the medium-term (against less than 80 percent today), especially children in poor and disadvantaged regions, children with special learning needs, and children from conflict-affected areas. Finally, the governance of the basic and secondary education system can be strengthened by:

(i) decentralizing education service delivery through the provincial councils; (ii) improving school-community partnerships through school-based management; and (iii) strengthening M&E, and research and policy analysis. The Bank intends to support efforts to strengthen transparency and accountability in the education sector by strengthening internal audit systems and enhancing parents' voice in school management. The Bank has a long-standing and strong relationship with the Government in the education sector and is supporting its education program through a programmatic education sector development operation. The Bank is also promoting education research and evaluation, including regular National Assessments of Learning



Sewamuktha Kandawura MahaVidyalaya, Polonnaruwa holds this class under the shade of a tree for lack of accommodation at present. The primary and secondary school now has 1496 pupils and 65 teachers and is a selected school being developed by the Government of Sri Lanka with support from the World Bank funded Education Sector Development Project.



Outcomes, surveys on school enrollment and attendance, an annual school census, and evaluations of important initiatives such as school-based management. These studies are used to measure the performance of the Government's current education sector development plan.

57. In higher education-where Sri Lanka was at one point the shining star of the South Asia region-the country has not kept up with its reputation.

Quality, even in universities with strict student admission criteria, is at low levels. Not a single Sri Lankan higher education institution is ranked among the top 500 institutions in major international league tables. Student assessments show quality levels to be low and employers' assessments of graduates' cognitive and attitudinal skills are also largely negative. Moreover, both the relevance of existing study programs and employability of graduates are low-a relatively small number of students are enrolled in nationally defined priority programs and many graduates are idle for a long time between graduation and their first jobs. The Bank is currently, along with the authorities, undertaking a detailed assessment of the higher education system in Sri Lanka and intends to implement its recommendations through the envisaged Higher Education Project.

58. Improved health and social protection services (CAS outcome 3.2). The health and social protection sectors in Sri Lanka are at a challenging turning point, given the ongoing demographic transition:

- In the **health sector**, the growing burden of non-communicable diseases (NCDs)-such as chronic diseases, injuries, and mental illnesses-is now common and an increasing cause of morbidity. For example, about 14 percent of adults in Sri Lanka

have diabetes. In 2001, NCDs accounted for 71 percent of all deaths in Sri Lanka. Going forward, as pointed out in the Bank's recent Aging Report, the incidence of NCDs is likely to increase even more rapidly. Also, Sri Lanka continues to suffer from widespread malnutrition among children: data suggests that approximately one-fifth of all under-5 children suffer from malnutrition and about 14 percent may be stunted. Malnutrition in children affects them for life, impacting their future economic potential. Third, there are significant unmet needs in the conflict-affected areas and among marginalized population groups. In addition to its ongoing lending operation (Health Sector Development), the Bank plans an expansion of AAA activities in the areas of NCDs, health financing and health system reform. The Bank also intends to review, together with the Government, the hospital delivery system, and help the Government prepare a strategy to further develop the hospital sector over the next decade. To improve accountability, relevance and responsiveness in health services, the Bank is supporting strengthened stakeholder participation in the formulation of health policy.

- In **social protection**, Sri Lanka has a fairly comprehensive social protection system but it is neither financially sustainable nor well-targeted. Also, the coverage of social services (for example, community-based rehabilitation services for the disabled and elderly, protection for vulnerable children, etc.) and employment services (for example, cost-effective job search and placement services) is low. The weaknesses of Sri Lanka's social protection system are particularly noticeable in conflict-affected areas and during the times of natural disasters. The Bank intends to support the

social protection agenda through a variety of ESWs and TAs-including on administration; targeting; M&E of social safety nets to improve social service delivery; and a referral system for vulnerable children, the disabled and elderly poor. The Bank would also provide TAs to the ministries of Social Welfare, Resettlement, and Nation Building to enhance institutional capacity for effective delivery of cash transfers in post-disaster situations in Sri Lanka..

59. Strengthening environmental protection (CAS outcome 3.3). Sri Lanka suffers from environmental degradation on several fronts, including land degradation due to soil erosion, pollution from unsafe solid waste disposal, pollution of inland waters, depletion of coastal resources, loss of biodiversity, and deforestation. The emphasis in the Mahinda Chintana on large-scale infrastructure and the proposed enhanced reliance on fossil fuels make it even more critical that environmental management become an integral part of the development planning process to avoid significant environmental degradation. In this respect, the Bank will work with the Ministry of Power and Energy and the Ministry of Environment and Natural Resources to assess the environmental consequences of coal power generation, with a view to developing strategies for mitigation of adverse environmental impacts. It will also work on helping prepare a regulatory framework for environmental management for the power sector. Sri Lanka's regulatory framework for environmental management is reasonably good and the Government has been quite effective in identifying environmental issues and developing policies and strategies to mitigate these. But implementation and enforcement remain weak. The Bank intends to support the Government's effort to

strengthen implementation of enforcement through a combination of AAAs and lending, by identifying and remedying key bottlenecks to effective enforcement of environmental safeguards, including lack of capacity in key agencies, overlapping mandates among competing agencies, and distorted incentives. The Bank's support in this area would also help define the Government's response to the impact of climate change. Finally, the Bank would seek to facilitate the development of the ecotourism industry in ways that contribute to poverty alleviation and conservation, restoring critically damaged ecosystems and ensuring sustainability in the development process. The Bank's engagement in this area would complement activities already undertaken by the ADB and the Netherlands. In addition, the IFC and MIGA will continue to ensure that all current and future investment clients meet their environmental performance standards. IFC's advisory services will work with Sri Lankan SMEs on upgrading environment protection.

B ADDRESSING THE CAUSES AND CONSEQUENCES OF CONFLICT

60. This CAS recognizes that the decades-old armed conflict is an important stumbling block to long-term development and poverty alleviation in Sri Lanka. The conflict is highly complex and has deep historical roots. It has no single cause but involves multiple issues such as ethnicity (including language), education, and access to economic opportunities—including to land and employment. In the words of a prominent Sri Lankan researcher, the conflict “has blighted [Sri Lanka's] political, social and cultural traditions and has become the biggest obstacle to the country achieving its full development potential⁸”. This

⁸ Saman Kelegama (2006), “Development Under Stress-Sri Lankan Economy in Transition”.



is not to say that the conflict is solely responsible for all poverty in Sri Lanka—as noted in para 7, Sri Lanka has been able to sustain a 5 percent real GDP growth during the past 25 years of armed conflict. Nevertheless, it is clear that the conflict has had a particularly adverse impact on, for example: (i) investments, especially foreign investments which have not seriously taken off in Sri Lanka despite its open economy (although FDI inflows have increased somewhat recently); (ii) tourism—tourist arrivals have not increased significantly compared to 1982 despite a six-fold increase in tourist arrivals in East Asia and the Pacific during the same period; (iii) public finances, in

particular due to increases in defense expenditures—since 1982 there has been a sharp increase in the share of defense spending (from about 3 percent in 1982 to 20 percent in 2006) compared to total public spending, even if defense spending at an estimated 3.5 percent of GDP in 2007 remains moderate by international comparisons; (iv) brain drain—where the conflict, undoubtedly, has been a 'push' factor in many Sri Lankans' decisions to migrate, although 'pull factors' such as the ability to earn higher salaries abroad have also played an important role.

61. The Northern and Eastern provinces have been most severely affected by fighting and displacements. For the last 25 years, the North and East have experienced recurring interruptions in regular economic activity. It is estimated that up to 2003, around 326,700 houses had been partly or totally damaged by the conflict—half of them in the Jaffna and Batticaloa districts alone. Infrastructure was greatly debilitated with only 10-15 percent of the road surfaces intact. As of September 2007, 504,000 persons were internally displaced in Sri Lanka and 131,160 persons were registered as refugees in neighboring India and other countries. Among the 152,000 who were subsequently able to resettle (mostly in the Eastern Province), many faced difficult livelihood situations on their return as belongings and working tools had been looted, areas had not been mine-cleared, and access to fields and fishing waters was restricted for security purposes. Compared to other provinces, health indicators for the North and East point to a higher prevalence of underweight children at birth (25.7 percent compared to 18.0 percent for the rest of Sri Lanka), maternal malnutrition, and diarrhea. Educational attainment by primary school children in the North and East is also the lowest among Sri Lanka's regions, with a mastery of the

mother tongue ratio of 23 percent, compared to the 37 percent national average. The conflict has also impacted gender relations. In the conflict-affected areas there is a high proportion of female-headed households—decades of armed conflict have created a large pool of widows who are solely responsible for supporting their families yet have few options to earn incomes. By 2005, nearly one-fifth (19.7 percent) of households in the North and East were headed by females.

62. Against this background, the Bank will emphasize efforts to improve access to public services and enhance livelihood opportunities in conflict-affected areas. As mentioned above, based on its previous experience (see Box 3), the Bank aims to improve opportunities in the North and East and has identified an integrated rural infrastructure and livelihood project as one of the key interventions. Besides this area-based project, the Bank also aims to address specific needs for service delivery in the conflict-affected areas through other projects. From the service delivery point of view, a critical issue is resource constraints in health and education. School buildings have been damaged or used as temporary welfare centers for the internally displaced, and health clinics are damaged or inadequately maintained. In response to these needs, the Bank would assist with rehabilitation and reconstruction of schools and health care facilities. The Bank would also support the reduction of vacancies for teachers and medical personnel in the North and East. Moreover, for people suffering from the consequences of conflict in the form of damage to their lives, property and income generation opportunities, the Bank would assist in improving livelihoods and re-building the lives of conflict-affected people. This would be done through support for housing, rehabilitation of inter-village roads and community infrastructure, and improvements

to the business environment. The Bank would also support reduction in youth unemployment and assist in the introduction of trauma counseling programs at the village level. It would assess the impact of the conflict on women. Outside the main conflict zones, the Bank would cater to the housing needs of the long-term displaced and their host communities.

63. In addition, the Bank would-through the design and implementation of its projects- seek to enhance inter-ethnic awareness. In this CAS, the Bank would strive to enhance inter-ethnic awareness by expanding meeting surfaces between people belonging to different communities. This would be done, for example, by encouraging Tamil- and Sinhalese-speaking students to learn each others' languages, by supporting education in English which serves as a link language,

by working towards mixed Tamil-Sinhala schooling and teachers' education, and by encouraging members of different ethnic groups to work together around common goals in community-driven development. Issues of land contestation on ethnic grounds would be addressed in the context of the Bank's housing operations through a land dispute settlement mechanism. Moreover, the Bank would-through its ongoing activities financed by the Post Conflict Fund-support Sri Lankan civil society organizations in their promotion of dialogue on conflict-related issues across religious groups, in establishing community peace councils, and in enhancing the capacity of local organizations to deal with communal conflicts.

Konnes (14), the youngest of ten sons helps his farmer parents with their goat herd.
North East Irrigated Agriculture Project.



Box 3. Examples of How Existing Projects Address Causes and Consequences of Conflict

The Bank's *Education Sector Development Program* (ESDP) addresses some of the causes of conflict by reviewing textbooks to eliminate ethnic or religious bias, promoting mixed language schools and mixed teacher-training, and supporting English as a link language between different ethnic groups. Moreover, to ensure equality in the provision of education service delivery, the Bank focuses on strengthening education quality in the conflict-affected areas. This is done, for instance, through special education and non-formal education programs for conflict-affected children and through human resource development of education managers and school principals. Upcoming components of the Bank's education activities are expected to incorporate, for instance, curriculum issues.

The Bank's community driven development (CDD) initiatives help foster reconciliation and awareness. The *Community Livelihood in Conflict Affected Areas Project* targets conflict-affected communities that have settled or re-settled in their original villages in the North and East. Outstanding issues under dispute have to be settled by the community members before the projects can start. The Bank's *Gemi Diriya* project also encourages specific reconciliation-enhancing sub-projects, in particular those focusing on strengthening inter-ethnic relations and the youth. The project aims at empowering youth and providing them an alternative to joining the army or militant groups. This is done, for instance, by equipping youth with tools to participate in, and benefit from, project activities in the field of income generation. Other sub-project examples are counseling programs and art therapy activities to address war trauma. *Gemi Diriya* has also adopted a conflict sensitive approach in project management and administration. Appropriate language skills and inter-cultural awareness among project resource persons have not only strengthened trust but also enhanced the efficiency of project supervision.

The Bank's different housing projects also address several significant causes and consequences of conflict. The *North East Housing Reconstruction Project* (NEHRP) has helped address one frequently cited cause of contention: land. Conflict-induced population displacement and encroachments on the property of the displaced by people of different ethnic groups have given rise to land-related disputes. In order to regularize land titles and to resolve land disputes, the NEHRP set up eight mobile land task forces, one for each district of the Northern and the Eastern provinces. Between March 2005 and April 2006, the mobile land task forces registered 96,385 land disputes. The task force investigated 73,475 cases of disputed/unclear land titles and resolved 52,721 of them. The NEHRP also provides for the training of masons and carpenters involved in the reconstruction of houses; this has created livelihood opportunities and helped reduce unemployment which, like in the *Gemi Diriya* case, provides a disincentive for recruitment to armed groups. The NEHRP, along with housing constructed under another project—the *Tsunami Emergency Recovery Project* (TERP)—promotes ethnic integration. Where houses were reconstructed in multi-ethnic divisions and villages, the projects helped integrate multi-ethnic administrative divisions and villages through shared reconstruction activity. The NEHRP and TERP also deal with some of the consequences of the conflict. The NEHRP supported the reconstruction of houses damaged or destroyed by conflict. Beneficiaries were selected based on vulnerability criteria, including number of times displaced, war-related fatalities in the family, etc. While TERP was targeted at tsunami-destroyed houses, much of its activities took place in conflict-affected areas where populations had previously been displaced by the conflict. TERP also provided livelihood support cash grants to tsunami victims which helped them jumpstart livelihoods. TERP thus helped revive economic activity and injected much needed cash in the North and East coastal areas in 2005. The *Puttalam Housing Project* (PHP) also addresses some of the human consequences of the conflict by supporting populations that have been internally displaced for the long term. These internally displaced persons cannot return to their home villages in the North and have shown a willingness to stay in the Puttalam district.

C STRENGTHENING TRANSPARENCY AND ACCOUNTABILITY

64. Governance in Sri Lanka has several fundamental strengths, chief among them a long history of elections. Universal adult franchise was introduced in 1931. Turnout at elections is generally high by international standards, at 70-80 percent. A proportional representation system for electing Members of Parliament was introduced under the 1978 Constitution with the objective of creating stable and strong governments. Elections are broadly viewed as free and fair, although they have at times been marred by violence and voter intimidation. Following a change in the electoral rules that allows the Election Commission to annul the results of elections in an electoral district on specific criteria, there was a sharp drop in violence during the most recent parliamentary elections in April 2004. The President is chosen by a national electorate. In the 1978 Constitution, the President was granted considerable powers, including the right to dissolve Parliament one year after a parliamentary election.

65. There are increasing demands for systemic improvements in Sri Lanka's system of transparency and accountability. A key emerging governance weakness is the continued failure to reactivate a new Constitutional Council after the term of the last Council ended in October 2005. The Constitutional Council was created by the 17th Amendment to the Constitution that was passed unanimously by Parliament in 2001. The intent of the Amendment was to establish independent commissions and depoliticize appointments for key institutions of accountability, by shifting the responsibility for such appointments to the Constitutional Council from the Executive. The continued impasse regarding the formulation of a new Constitutional Council has—contrary to the objective of the Constitutional Council—resulted in several appointments being made directly by the President,

with the Government arguing the need to ensure the functioning of the Government machinery. The judiciary has traditionally been considered a source of strength in Sri Lanka but armed violence and associated human rights violations are exerting pressure on Sri Lanka's hard won reputation for the rule of law. In addition, Government effectiveness is being undermined by continued expansions in the number of ministries and ministers—though this has helped maintain political stability. With 105 ministers (52 Cabinet Ministers, 33 non-Cabinet Ministers and 20 Deputy Ministers), the present Government is the largest in Sri Lankan history. The proliferation in the number of ministers has increased the risk of overlapping functions and dilution of the policy agenda. A strong civil service has stood the country in good stead for much of the post independence period. But there are signs of deterioration in the quality and efficiency of the civil service, partly as a result of mostly unabated growth in the size of the public service, and possibly also as a result of increased politicization in the hiring of public servants.

66. Parliamentary oversight commissions have reported a number of cases of misuse of public funds. In recent years, the Parliamentary Commission on Public Enterprises (COPE), which oversees Government spending agencies, has become more active despite continued weak research capacity in the secretariat serving COPE. Two reports released by COPE (in August 2006 and August 2007) reported a number of instances of misappropriation and misuse of public funds. The COPE reports have played an important role in fostering increased awareness about issues of fraud and corruption. Still, follow-up action by the Government and relevant agencies needs strengthening, although some cases have been sent to the anti-bribery commission for further investigation.

It is a significant weakness that the anti-bribery commission lacks financial independence and has no mandate to initiate investigations; it must receive allegations in writing before investigations are identified. Nevertheless, several high-profile fraud cases involving Government officials have been exposed, including a VAT-scam that reportedly siphoned US\$ 300 million from the Department of Inland Revenue and for which 14 persons were indicted.

67. The Bank's strategy to support strengthened governance in Sri Lanka is deliberately flexible and pragmatic and focused on: (i) supporting core governance institutions; (ii) strengthening sectoral governance in sectors where the Bank is engaged; and (iii) fostering increased demand for good governance. The Bank's engagement on governance and anti-corruption must be flexible and responsive. To be effective, the Bank must be agile in responding to changing needs and exploiting entry points for dialogue on governance issues, as they appear. At the same time, there is a clear need to be realistic in terms of what can be achieved within a given period of time. In particular, it must be recognized that creating strong institutions, changing processes and fostering sustained public demand for good governance is a long-term process which will inevitably face obstacles along the way. To better exploit opportunities and facilitate synergies within the entire country program, a core accountability and transparency (CAT) team will be established. The CAT team will enhance information flows between operational staff and staff working on the broader governance agenda. It will also seek to identify emerging governance challenges and entry points for governance-related policy changes. It will also help



advise task teams on how to implement measures to reduce fiduciary and governance risks to Bank operations.

- **Supporting core governance institutions.** The Bank has positioned itself to scale up support to improve transparency and accountability and to combat corruption-as a prerequisite for improving quality, relevance and value-for-money in public service delivery. The Government has requested the Bank's assistance in strengthening the capacity of the Auditor General's Office; this would improve accountability and transparency in the use of public resources through faster preparation and improved quality and relevance of public audit reports. The Bank would also support the establishment of a professional secretariat for two key fiduciary parliamentary committees (Committee on Public Enterprises and Committee on Public Accounts). Moreover, Bank diagnostic work such as the CFAA, ROSC, and the analysis of the standards of public sector accounting and auditing have recommended a series of measures aimed at public

financial management (PFM) strengthening- including the establishment of a Public Sector Professional Accountancy Institute to improve the education and training of accountants with the aim of professionalizing services; better aligning public sector accounting and reporting with international standards; and strengthening the Sri Lanka Accounting and Auditing Standards Monitoring Board to enhance the oversight of SOEs. The Bank will work with the Government to prepare an integrated assessment of the entire public financial management cycle to help identify appropriate measures that further improve PFM performance. Improvements in these domains would not only enhance transparency and effectiveness in the use of public resources, but also facilitate a further move towards adopting country systems by donors, including the Bank, in line with the Principles of the Paris Declaration on Donor Harmonization. The Bank maintains a close dialogue on these issues with other donors, in particular the ADB and JBIC. There is also a considerable unfinished agenda in public procurement - even though significant progress has been made. The recent decision to disband the National Procurement Agency has resulted in increased uncertainty about the future functioning of procurement systems in the country and has set back the planning towards increasing reliance on country systems in procurement. The Bank remains committed to eventual full reliance on country systems. The speed with which the Bank will move along this track will, to a large extent, be determined by the Government's future actions in ensuring effective implementation of financial management and procurement regulations. The Bank will continue to keep the dialogue with the Government open with a view to identifying the best way forward under the new institutional setup.

- **Strengthening sectoral transparency and accountability.** A critical factor in improving service delivery standards across the board is to improve accountability. It is a common feature of public service delivery in Sri Lanka that the feedback mechanisms between users and suppliers are weak, that is, there is little transparency about service standards, resource allocation, etc., and only few opportunities for beneficiaries (be they primary school parents or neighborhoods) to hold service providers accountable in case of poor quality or lack of services. These problems have been exacerbated by excessive fragmentation of authority and responsibility at the local government level. The Bank, through ongoing and planned sector-level engagement, will pursue opportunities for strengthening feedback mechanisms between users and suppliers, broadening stakeholder participation in design, monitoring and evaluation, and bringing the decision-making process closer to the beneficiaries. The objective is to improve policy and strengthen sector-level governance mechanisms, and make efforts to strengthen the demand for transparency and accountability at the sectoral level.

Several ongoing and proposed activities explicitly aim to improve transparency and accountability in service delivery. For example, in education, the Bank is supporting the Program for School Improvement (PSI). The PSI seeks to empower principals and teachers to strengthen their professional motivation and enhance their sense of ownership of the school. It also enables schools to forge links with local communities to give stakeholders, including parents and pupils, greater voice in school affairs and the ability to



Fishing in calm waters of a reservoir for a living.

raise resources to help the school. It seeks to improve the speed and relevance of school-level decision making. The Bank is also supporting the establishment of a Public Expenditure and Quality Education Tracking System in this sector. The Bank will support the rollout of this plan to the Government of Sri Lanka. In health, the Bank is seeking to strengthen stakeholder participation, including by the private sector, civil society, the development partners, and the patients in the policy making process, by organizing regular Health Forums. In addition, the Bank intends to support upgrading of internal audit manuals and the Government's internal auditor accreditation course of studies, to lay the foundation for a stronger internal audit function in the future, including more frequent use of performance audits.

- **Increasing demand for good governance.** An important objective of the Bank's community-based operations is to empower local communities to make transparent, collective decisions and improve accountability at the local level. To this end, the

Bank's community driven development projects support the introduction of social and public accountability mechanisms like participatory budgeting, community report cards, and social audit and expenditure tracking, to trigger changes in responsiveness and accountability among local government institutions and communities. Gemi Diriya also includes a policy dialogue sub-component to help policy-makers develop policies, rules, systems, and institutional arrangements that would allow the Government to transfer funds and technical support to communities on a demand-driven basis. Finally, another avenue for the Bank to increase demand for good governance is the WBI program which focuses on increased voice and accountability in poor communities, enhancing the capacity of diverse key segments of Government and society to scale up social accountability tools and mechanisms, and improving media reporting on economic governance and development issues. The Bank will also work to strengthen its partnerships with civil society, academia, think tanks, and the media to help create a stronger voice on governance and to strengthen local analytical capacity in areas of governance.

Uruwarige Kadirala Eththa (14) belongs to a Sri Lankan indigenous tribe of forest dwellers. Now these forest dwellers seek treatment for ailments at the Dambana Rural Hospital which has been upgraded from a rural dispensary to one with resident care facilities. Health Sector Development Project.



Heeloya, Watawala village micro hydro project is managed by an Electricity Consumers Association drawn from the 52 or so village households and is headed by its Chairman K.G. Dharmadasa. Villagers are trained to manage the power house. Repair and replacement costs are kept low by regular maintenance. "We don't allow for breakdowns, living without electricity now would be like living without your eyes," says Dharmadasa. Renewable Energy for Rural Economic Development Project.



PARAMETERS AND INSTRUMENTS FOR THE BANK GROUP'S ENGAGEMENT

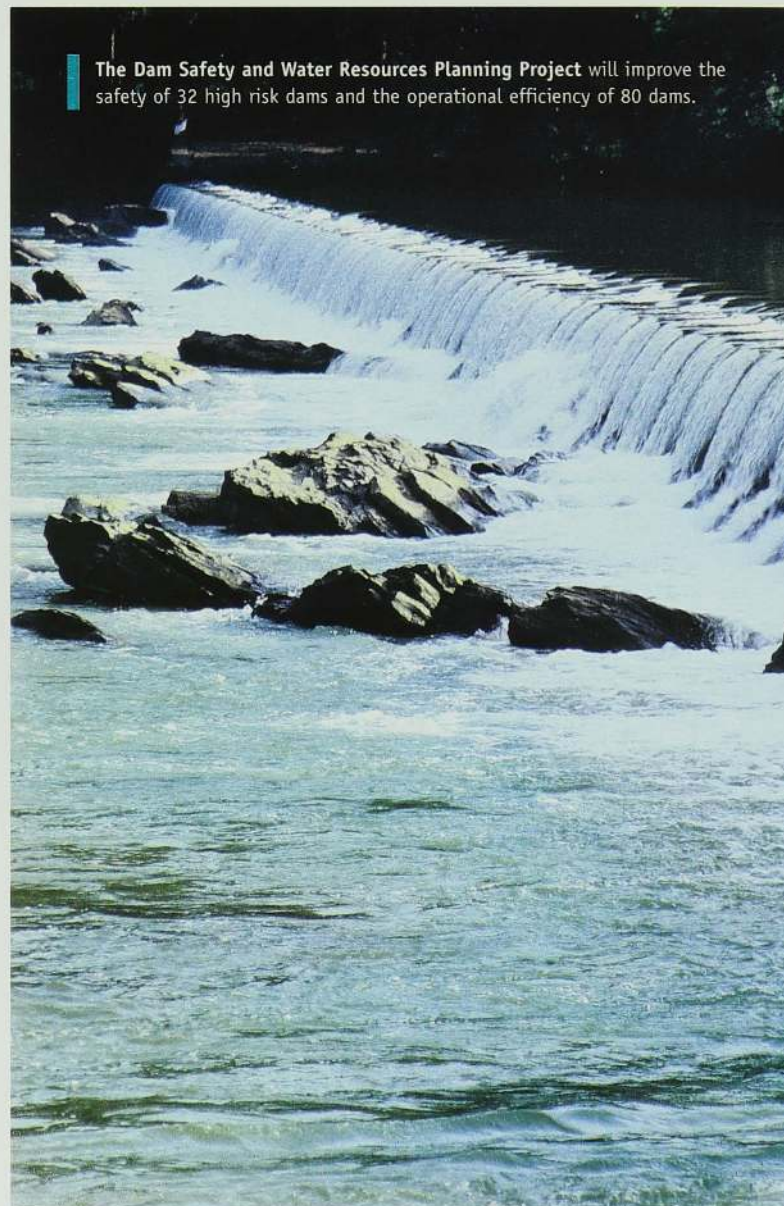
Sri Lanka is likely to remain an IDA borrower for the present. The IDA allocation is determined by the World Bank's performance-based allocation system. The proposed lending program has a strong emphasis on community-focused projects and projects delivered through local and provincial governments to provide public services, infrastructure and livelihoods. The program is vulnerable to deterioration in the country situation and requires careful monitoring, implementation and adaptation. The IFC will continue to provide longer-term financing than is usually available in the Sri Lankan financial markets for private enterprises, and provide business advisory services through its South-Asia Enterprise Development Facility.

A COUNTRY DEVELOPMENTS AND THE BANK'S PROGRAM

68. Sri Lanka is currently an IDA-only borrower ('hardened terms'), and is likely to remain so for the time being. Sri Lanka's per capita GNI of US\$ 1,600 in 2007 is higher than the operational income cut-off for IDA of US\$ 1,065. However, Sri Lanka's access to IBRD lending is determined by creditworthiness considerations. A formal creditworthiness assessment has not yet been carried out by the Bank. Sri Lanka has some points in its favor in terms of creditworthiness, including sustained solid rates of economic growth, an open economy, good social and human development indicators, and proven ability to tap international financial markets. At the same time, current macro policies, weak macro indicators and existing debt stocks, in addition to uncertainties about the course of the conflict, raise concerns about debt sustainability, reflected by a relatively weak credit rating (B+ from S&P and the recent downgrading to B+ from Fitch). Since these factors are at the heart of creditworthiness, the Bank is of the view that it would be preferable to not pursue the issue of access to IBRD lending for the time being. At the same time, it is clear that Sri Lanka is now a middle-income country and likely to remain so going forward. For this reason, the Bank intends to, in consultation with the Government, revisit the issue of IBRD access at the CAS mid-term review, or even earlier should the Government wish..

69. Sri Lanka's overall IDA allocation is determined in conformity with the Bank's performance-based allocation system. Sri Lanka's overall Country Policy and Institutional Assessment (CPIA) Score for 2007 is 3.5. This is a decline from 3.6 in 2006 and reflects the deterioration in macro-management indicators and public sector management and institutions indicators, partly on account of the escalation of armed violence. The indicative country envelope for the three years of

IDA-15 is SDR 440 million, equivalent to approximately US\$900 million for the four-year CAS period. However, the actual IDA envelope will depend on: (i) Sri Lanka's own performance as measured by the CPIA; (ii) its performance relative to the performance of other IDA countries; (iii) the amount of overall resources available to IDA; (iv) changes in the list of active IDA-eligible countries; and (v) the terms of financial assistance provided.



The Dam Safety and Water Resources Planning Project will improve the safety of 32 high risk dams and the operational efficiency of 80 dams.

70. The proposed Bank program takes into consideration the ongoing uncertainties and risks, while also acknowledging the existing needs and opportunities in Sri Lanka. In several ways, the current period is one of extraordinary uncertainty, even by Sri Lankan standards—armed confrontations have resumed in the North while the East is undergoing a tenuous transition, and the macroeconomic situation continues to present significant challenges. The Bank

expects that the current scenario of high uncertainty could continue for a while. Against this background, the Bank has designed a cautious program of interventions that can deliver positive development outcomes in poor and under-served areas even in these circumstances. The IFC is also mindful of increasing macro risks in Sri Lanka and will adapt project selection and project structuring (including pricing) appropriately.

71. Accordingly, the proposed lending program is based on a narrow set of investment projects, assuming the current unpredictable situation prevails. The proposed program has a strong emphasis on community-focused projects and projects delivered through local and provincial governments that aim to provide public services, infrastructure and livelihoods at the local level (the proposed Gama Naguma/Rural Infrastructure, Provincial Road Sector Support, and Water Supply projects). The program would, in particular, prioritize funding for reconstruction and service delivery in conflict-affected areas, including support for nascent local government institutions in the East. Subject to final design and appraisal of the pipeline projects, it is estimated that more than 30 percent of the Bank's commitments during the CAS period would benefit conflict-affected areas. It should, however, be emphasized that the pipeline for the last two years of the CAS period should be considered indicative. It is based on the prevailing conditions on the ground and on the Government's indicative priorities as of today. The program, in the outer years, will be revisited at the time of the CAS Progress Report in view of the country situation and priorities at that time.



© World Bank Photo Library

PARAMETERS AND INSTRUMENTS FOR THE BANK GROUP'S ENGAGEMENT



Ariza and baby Nuha are beneficiaries of the Community Livelihoods in Conflict Affected Areas Project, Ampara.

72. The proposed program remains vulnerable to further deterioration in the country situation and requires careful implementation and adaptation. A combination of scenarios-resumed violence in the East, protracted fighting in the North, and a rapidly deteriorating governance situation-including excessive politicization in project management and sharply increasing fiduciary risks, could likely lead to a significant reduction in new commitments as well as lower disbursements from the existing portfolio. Two pipeline projects are particularly vulnerable to increased violence and politicization in the North and East (Gama Naguma/Rural Infrastructure project for the East and the Provincial Roads project in the North and East). As for the Government's request on funding for the national highway network, the Bank has made it clear that the selection of segments of highways for Bank funding require thorough consideration of not only impacts on poverty reduction but also the security and conflict sensitive dimension of the interventions. In addition, a sharp deterioration in governance and/or the macroeconomic situation could jeopardize the ability of the Higher Education Project and Health Sector Development Project to sustainably achieve their objectives. Under those circumstances,

the Bank would carefully assess the situation and decide if it needs to slow down the implementation or preparation of projects which are vulnerable to risks. The Bank's ongoing networking with civil society organizations and development partners would help the Bank to monitor and assess these risks. In summary, it is conceivable that there will be measurable variations, either for the better or for the worse, along one or more of the key determinants for development effectiveness (conflict, governance, and macro), to which the Bank would adapt its program. As such, the proposed lending program can be considered a 'core program', designed to deliver results on the ground even under the uncertain conditions prevailing today.

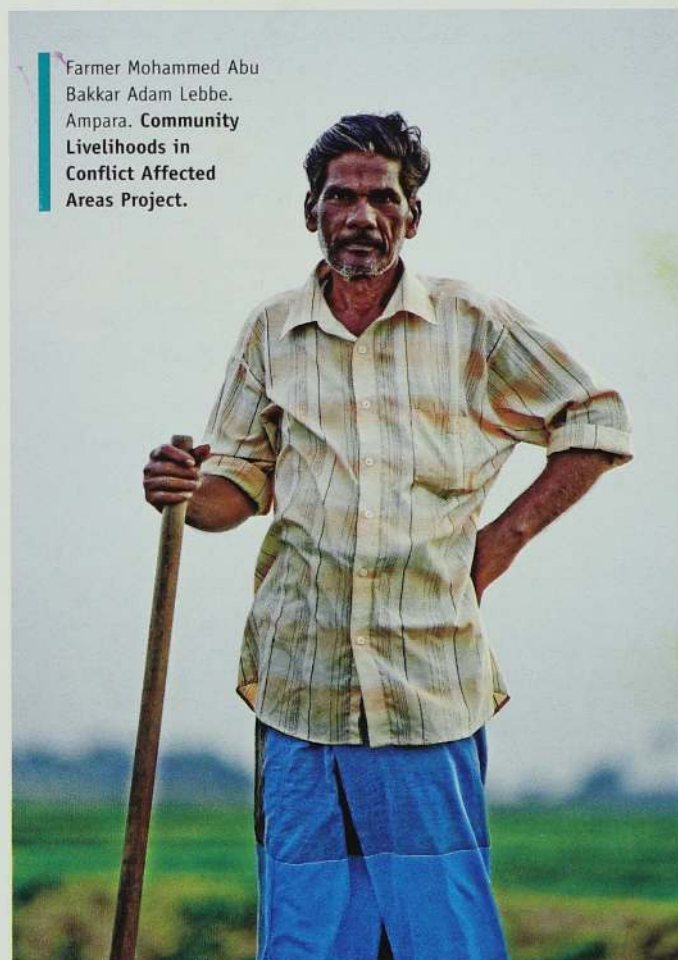
73. More radical changes in the country situation-both for the worse and for the better-are possible, and the Bank would reconsider its strategy accordingly. If armed confrontations were to further intensify or there were to be a dramatic deterioration in governance and the rule of law-to the point where the Government's attention was diverted from development policies and where the Bank lost confidence that Bank-supported projects could deliver effective results on the ground-the Bank could be forced to stop new lending and would also most likely have to suspend ongoing operations. Likewise, given Sri Lanka's many fundamental strengths, it is possible that there could be a rapid turnaround for the better in terms of the conflict and macroeconomic management. In such a situation, the Bank would consider broadening the available menu of lending instruments. For instance, if the Government initiates a broader range of decisive reform measures to strengthen macroeconomic management and improve sectoral performance in key sectors, the Bank would be ready to support such reform efforts through Policy Lending. Furthermore, solid reforms and improved macroeconomic conditions could pave the way for access to IBRD lending.

B ENHANCING THE CONFLICT-SENSITIVITY OF BANK ASSISTANCE

74. Irrespective of the country situation, it is vital that the Bank's engagement in Sri Lanka be highly 'conflict sensitive'. The overriding reason for the need to be conflict-sensitive is to minimize the risk that Bank activities may inadvertently fuel ethnic tensions and further strain Sri Lanka's social fabric. It is also important to manage reputational risks to the Bank that could come from being perceived as a partial or biased actor on the development scene. For these reasons, the Bank will apply several principles and practices to enhance the conflict-sensitivity of its engagement when implementing this CAS. At the program level, the Bank has decided to not allow resources committed for the North and East to be re-programmed to other parts of the country, even when deterioration in the country situation renders it impossible to implement these activities. This principle has both the effect of signaling the Bank's genuine commitment to development in the conflict-affected areas and of leading to a de facto reduction in the country envelope if the situation in the conflict-affected areas deteriorates.

75. At the project level, enhanced conflict-sensitivity would be achieved by subjecting all ongoing and future lending operations to a 'conflict filter'. The objective of the 'conflict filter' is two-fold. The first objective is to help mitigate reputational risks to the Bank. The second objective is to enhance development effectiveness by ensuring that opportunities for addressing causes and consequences of the conflict are pursued to the maximum extent. To achieve the first objective, it is vital that projects are not implemented in a manner that inadvertently fuels the conflict. To mitigate this risk, the conflict filter would require projects to ensure that benefits from

projects are transparently distributed and potential tensions are mitigated through broad consultations and redressal mechanisms, and that project implementation is sufficiently conflict-sensitive (points a-c in Box 4). To achieve the second objective, the conflict filter would seek to ensure that conflict-generated needs are adequately identified and addressed in projects, and opportunities to strengthen reconciliation and inter-ethnic awareness have been adequately identified. In terms of Bank processing, a special semi-structured questionnaire has been developed that will form the basis for assessing a project's conflict-sensitivity during the concept, design and implementation/supervision stages.



Farmer Mohammed Abu Bakkar Adam Lebbe. Ampara. **Community Livelihoods in Conflict Affected Areas Project.**

Box 4. Conflict Filter to Enhance Effectiveness and Reduce Reputational Risks

The Bank would review its upcoming activities against a 'conflict filter' — at the concept, design and implementation stages. In parallel, efforts would be launched to review ongoing Bank activities against the conflict filter, with a view to making adjustments if warranted and feasible. The conflict filter would highlight a number of issues which, if adequately addressed, would help in both mitigating reputational risks to the Bank and enhancing the effectiveness of the Bank's activities.

- a. *Have sufficiently broad stakeholder consultations been conducted?* The Bank seeks to ensure that broad-based consultations take place during project preparation and implementation to enable stakeholders of diverse ethnicity, gender and religion to contribute to project planning and design. Consultations would include ethnic groups, beneficiaries, affected communities, Government (including local governments), civil society organizations, and political parties. Such consultations evidently have both a pro-active side and a risk mitigation dimension. Maintaining the civilian nature of the development decision-making process is similarly required to enhance its long-term sustainability.
- b. *Have adequate impartial grievance mechanisms been established?* When appropriate, strong, transparent and impartial grievance-redressal mechanisms should be established as part of project design.
- c. *Are project management and administration adequately sensitive to inter-ethnic issues?* To ascertain project inclusiveness and outreach to relevant stakeholders, project management would: (i) ensure that project material and communication is produced and distributed in all three languages—English, Tamil and Sinhalese; (ii) have an appropriate ethnic composition and possess requisite language and cultural skills; and (iii) make development-related decisions—in particular, prioritization of community-based investments that reflect the needs of the communities and do not reflect other auxiliary interests.
- d. *Are conflict-generated needs adequately identified?* The conflict may have generated needs that are specific to the areas and populations affected by violence and displacement. Each project would be asked to identify these specific conflict needs and address them. Examples include psycho-social components under community-driven projects, special measures to fill human resource shortages in the nationwide health and education projects, etc.
- e. *Have opportunities to strengthen reconciliation and inter-ethnic trust been adequately identified?* Each activity would be requested to identify opportunities strengthening reconciliation and inter-ethnic trust, such as inter-ethnic, functional collaboration in project planning, decision-making and implementation. For example, for community driven projects, multi-ethnicity could be included as one of the criteria for village selection.

C IFC INSTRUMENTS

76. The IFC will support the pillars of the World Bank Group strategy through both investment and advisory services. With investment services, the IFC currently provides US dollar loans and also takes minority equity stakes in companies. The IFC will continue to provide financing where companies are unable to access sufficient financing on appropriate terms. The IFC's additionality in Sri Lanka comes through providing longer tenor than that available in the market, patient equity capital, global and regional expertise and experience, and technical assistance to enhance investments in areas such as corporate governance advice and management of environmental and social risks. During the period of the CAS, the IFC will look for opportunities to provide local currency debt financing where it can appropriately hedge the currency exposure. Such financing would allow IFC to reach out to companies and sectors which generate local currency revenues (such as the infrastructure sector and second-tier smaller clients) and enhance the development of the local financial markets.

77. The IFC investments are guided by the following five overarching considerations: First, IFC prioritizes working with companies seeking to export regionally and globally. Second, the IFC supports companies that seek to expand in the region, to move from being national players to international ones. Third, the IFC extends existing financial products to those that are currently under-served (such as SMEs) and helps introduce innovative financial products in the market- for example, providing debt beyond the tenor currently available (5-7 years). Fourth, the IFC works with companies which conduct operations (sourcing, selling, etc.) across Sri Lanka, beyond the Western Province. Finally, the IFC supports the development of sectors within which Sri Lanka has a long-term comparative advantage.



Y. G. Chandrawathi manages the power house of a Micro-hydro project. **Renewable Energy for Rural Economic Development Project.**

78. In addition, the IFC provides advisory services through the South-East Asia Enterprise Development Facility (IFC-SEDF). The IFC-SEDF was extended to Sri Lanka and the Maldives in 2006, with funding from a separate five-year, multi-donor trust fund. The initial funding of US\$ 5.5 million has been provided by the IFC and the Governments of the Netherlands and Norway. Fund-raising efforts are continuing and program activities will be expanded as more donors participate in the program. The program aims to support the growth of SMEs through three components: access to finance, value addition to firms, and business-enabling environment. Initially, the activities of the IFC-SEDF will focus on three key sectors: financial services, tourism, and ICT. All advisory services provided by the IFC are priced on a sliding scale depending on the public/private mix of beneficiaries; in FY08, IFC's cost recovery ratio was 60 percent.

PARAMETERS AND INSTRUMENTS FOR THE BANK GROUP'S ENGAGEMENT

D PARTNERSHIPS AND DIALOGUE

79. The donor landscape in Sri Lanka is undergoing significant changes. The Bank has traditionally been one of the 'big three' donors in Sri Lanka, next to Japan and the ADB. The three donors, together, provide the country about US\$ 700 million annually, or about 60 percent of all donor assistance. Recently, several new donors have emerged in Sri Lanka—including China which, in terms of commitment, became the largest donor in 2007. Iran too, in late 2007, offered Sri Lanka a credit line facility for the Petroleum Corporation and financing for a much-needed upgrade to an oil refinery. The UN-family, together with a number of international NGOs, is mostly active in providing humanitarian assistance which has been increasing in the recent past on account of the escalation in the conflict and associated displacements. Meanwhile, several bilateral donors have either scaled down or terminated their assistance, mainly on account of Sri Lanka's income status, but also because of the intensification in the armed conflict. Currently, the Bank's share in total commitment is about 10 percent, implying that the Bank's comparative advantage is not the amount of assistance any longer. This implies that the Bank must identify other areas and methods of engagement where it can make a decisive impact.

80. The Bank will strengthen its transfer of global knowledge through enhanced dialogue and partnerships. The lessons from the last CAS, the Client Survey and the outcomes of the public consultations (para 43-44) point to the need for the Bank to strengthen its outreach and involvement in debates on broad policy issues. Against this background, and recognizing that it is not a major player in all areas, the Bank would more systematically attempt to engage diverse audiences, including through partnerships with local think tanks and institutions. The Bank would

also more proactively seek to facilitate the transfer of international best-practices and expertise to Sri Lankan audiences.

81. The Bank will select its areas of engagement within the strategic objectives, based on its comparative advantage among key players as well as pragmatism in donor coordination. The Bank has assisted the Government in making institutional and



policy changes, and in introducing best practices other donors can employ. Examples include the provision of reconstruction assistance to the conflict-affected areas, where the Bank has provided assistance through an owner-driven housing scheme and community-driven development schemes, for which other donors have provided co-financing. Through these interventions, the Bank wishes to help establish good practices in conflict-sensitive development. The Bank

has also introduced a performance-based budgeting system in education through SWAPs and will continue to seek the same approach in other areas whenever possible. In the roads sector, the Bank has provided assistance to set up a road maintenance fund to enhance the sustainability of investments in the sector.

82. Through participation in a number of development partners' forums, the Bank seeks to strengthen the effectiveness of development assistance to Sri Lanka.

The apex forum between the Government and donors is the Development Forum which is generally held every other year and was most recently held in January 2007. Donor coordination on the ground takes place through the monthly Development Partners' meetings which are a common forum for multilateral agencies and bilateral donors. There is also a separate coordination structure focusing on humanitarian assistance. Sri Lanka is a signatory to the Paris Declaration on Donor Harmonization, with the Ministry of Plan Implementation being the focal point for donor coordination efforts. Donor coordination is less active than it used to be when donors were enthusiastically engaged in reconstruction and reconciliation under the Ceasefire Agreement of 2002, and tsunami-related activities after 2004. At the same time, civil society organizations, as well as the private sector, have shown growing interest in working together in areas like, for example, Eastern development and the estates sector. The Bank is keen on strengthening its working relationship with them, both through its own interventions as well as by coordinating their efforts with that of the larger donor community. Partnerships with think tanks are also important, given their interest in macro and thematic policy issues.



PARAMETERS AND INSTRUMENTS FOR
THE BANK GROUP'S ENGAGEMENT



Saheeda Umma (Right) was among the first wave of IDP's from Mannar that came to Puttalam in 1990. Almost 28 years later she is in her own house with Grade 8 student Hilmiya, who was born in the camp, and a relative Waseela. Puttalam Housing Project, Mujahidiepuram, Puttalam.



D PORTFOLIO MANAGEMENT

83. The difficult operating environment makes it a continued challenge to maintain the quality of the portfolio. During the previous CAS period, the number of ongoing projects remained fairly constant (around 16-18 projects). But, recently, the number dipped to 14 as several pipeline projects have had unusually long gestation periods. Commitments have varied between US\$ 693 million and US\$ 867 million. The average disbursement ratio during the CAS period was 27.9 percent, which is somewhat higher than regional and Bank averages during this period. The high disbursement rate is partially explained by the focus on rapidly disbursing for projects implemented in the aftermath of the signing of the CFA, and also following the tsunami. There is mostly concurrence between ICR ratings and ratings by the IEG, suggesting an adequate degree of candor in the task team's evaluation of project outcomes. That said, considering the volatile operating environment explained below, and emerging signs of deterioration in the portfolio, there is a need for continued vigilance. There is also a need to further strengthen M&E to ensure sufficient focus on results in the Bank's operations.

84. Currently, there are four projects (see Box 5) at risk in the portfolio, equivalent to 26 percent of total commitments, representing two broader sets of issues. The first set of issues is related to the intensification of the armed conflict. The Bank's projects have continued to operate in the North and East. But a multitude of conflict-related factors—including disruptions in supply of materials and other inputs, population displacements, delays in staffing of project implementation units—have resulted in implementation delays and lower disbursements rates. The Bank has taken a number of mitigating actions to

PARAMETERS AND INSTRUMENTS FOR THE BANK GROUP'S ENGAGEMENT

safeguard achievement of project development objectives, including utilizing local agencies to carry out implementation and monitoring, and shifting project activities from infrastructure to livelihood support. A second set of issues relates to weakening governance, reflected by instances of increased political interference in project implementation, poor project management oversight, and lack of leadership provided by central ministries to districts. Procurement risk ratings range from medium to high, in part

because some Government staff lack the appropriate technical qualifications to oversee and process procurement activities. In addition to the need for designing and implementing projects in a conflict-sensitive manner, these issues point to the need for the Bank to be extraordinarily diligent in project preparation, to design simple and robust projects, and to ensure that adequate fiduciary safeguards are in place.

Box 5. Projects at Risk and Mitigating Actions

As noted, an important reason for the relatively high share of projects-at-risk in the portfolio is our exposure in conflict-affected areas and the particular challenges of project implementation there. Two projects which, to a large extent, focus on the North and East (*the Community Livelihood in the Conflict Affected Areas (CLCA) and the Tsunami ERP*) make up 70 percent of the commitment at risk. In response to the poor performance of the CLCA, the Bank has worked with the Government to restructure the project to better respond to the changing ground situation over the past year and a half. Specifically, the CLCA now places a stronger emphasis on livelihood support to help villagers rebuild their economic base. In parallel, the project's fiduciary safeguards are being strengthened by introducing third-party monitoring, hiring an independent consultant to review—on a sample basis—financial management and procurement transactions in target villages, and developing a framework for supervision which allows us to visit a sample of randomly selected villages to review practices at the community level. The restructuring has just been completed and it is expected that project performance would begin to turn around shortly. The *Tsunami ERP* suffers from significant financial management and project management issues, exacerbated by the politically charged environment in which the tsunami reconstruction is taking place. Of the remaining two problem projects, the E-Lanka Project has suffered from weak project management, especially in terms of procurement. During the recently concluded mid-term review, several steps were agreed on to strengthen procedural and management issues within the implementing agency. Finally, the *HIV/AIDS Project* suffers from dwindling Government commitment, as evidenced by the difficulties in securing counterpart funding and a host of project management issues that it has not been possible to rectify. The Project is scheduled to close on June 30, 2008, and will not be extended.



Many communities that have undergone much hardship during the years of conflict are given a helping hand to resume livelihoods. Livestock breeding is popular among many. Community Livelihoods in Conflict Affected Areas Project Puthukkudieruppu, Arayampathy DS Division, Batticaloa.

Saheeda Umma, boils water for the first early morning cup of tea in her old temporary abode's kitchen Her new house is right next to this and is nearly finished. Puttalam Housing Project, Mujahidiepuram, Puttalam



MANAGING RISKS

The over-riding risk to the effectiveness of the Bank's work is the negative impact of a further escalation in the armed conflict. This will not only adversely affect the Bank's operations but also increase the stress on the macro-economic situation. Project beneficiary selection will be based on sound analysis and technical criteria to minimize the risk to the Bank of being perceived to be disproportionately favoring one ethnic group over another. Early project-specific risk assessments and enhanced use of third-party monitoring of project activities, will also strengthen Bank's attention to fiduciary risks in project design and project supervision.

85. In Sri Lanka, where the operating environment is fraught with conflict and tensions, the risks to the Bank's engagement are considerable. There are two over-riding sources of risk to the Bank's effectiveness: a dramatic escalation in the conflict and a serious macroeconomic crisis. The Bank faces considerable reputational risks—for example, of being perceived as being biased against any one side in the ethnic conflict. Finally, the Bank's fiduciary risks are also non-negligible. While the Bank's ability to fully mitigate some of these risks is ultimately limited, it must be recognized that there are substantial potential benefits to the Bank's engagement in terms of working towards resolution of the long-running conflict in Sri Lanka. In this sense, there may also be significant development and reputational risks to not being materially engaged.

A DEVELOPMENT EFFECTIVENESS RISKS

86. A further escalation in the armed conflict remains the over-riding risk to the effectiveness of the Bank's work. A sharp escalation in the armed conflict would have an immediate impact on the Bank's ongoing operations in the North and East, either through direct security and logistics constraints or further pressures on politicization of projects. An escalation could also further undermine the stability of the macro-fiscal situation in the country and divert the attention of policy makers away from development issues. The Bank would seek to respond flexibly to the evolving situation but could ultimately be forced to hold back disbursements of certain projects if the security situation deteriorates to the extent that development effectiveness is undermined.

87. Derailment of the macroeconomic situation is another key risk. This risk can only be mitigated by decisive action on the part of the Government. The Bank monitors the evolving macro-situation closely, including through frequent meetings with the Central Bank and sharing its analysis and concerns with key counterparts. At the same time, the Bank will strengthen attempts to nurture the public debate on macroeconomic policy formulation to build consensus around a stability-oriented policy stance.



B THE BANK'S REPUTATIONAL RISKS

88. The conflict is a key source of reputational risk to the Bank. Reputational risks can arise, in particular, if the Bank is perceived—even inadvertently—to be disproportionately favoring one ethnic group over another and thereby contributing to inter-ethnic tensions. In implementing the CAS, the Bank will take several measures to mitigate these risks. The Bank is committed to an objective approach, based on sound analysis of where the needs are greatest, and strict technical criteria for project selection. One measure to

The vast majority of Sri Lankans live in rural villages and are small scale farmers.

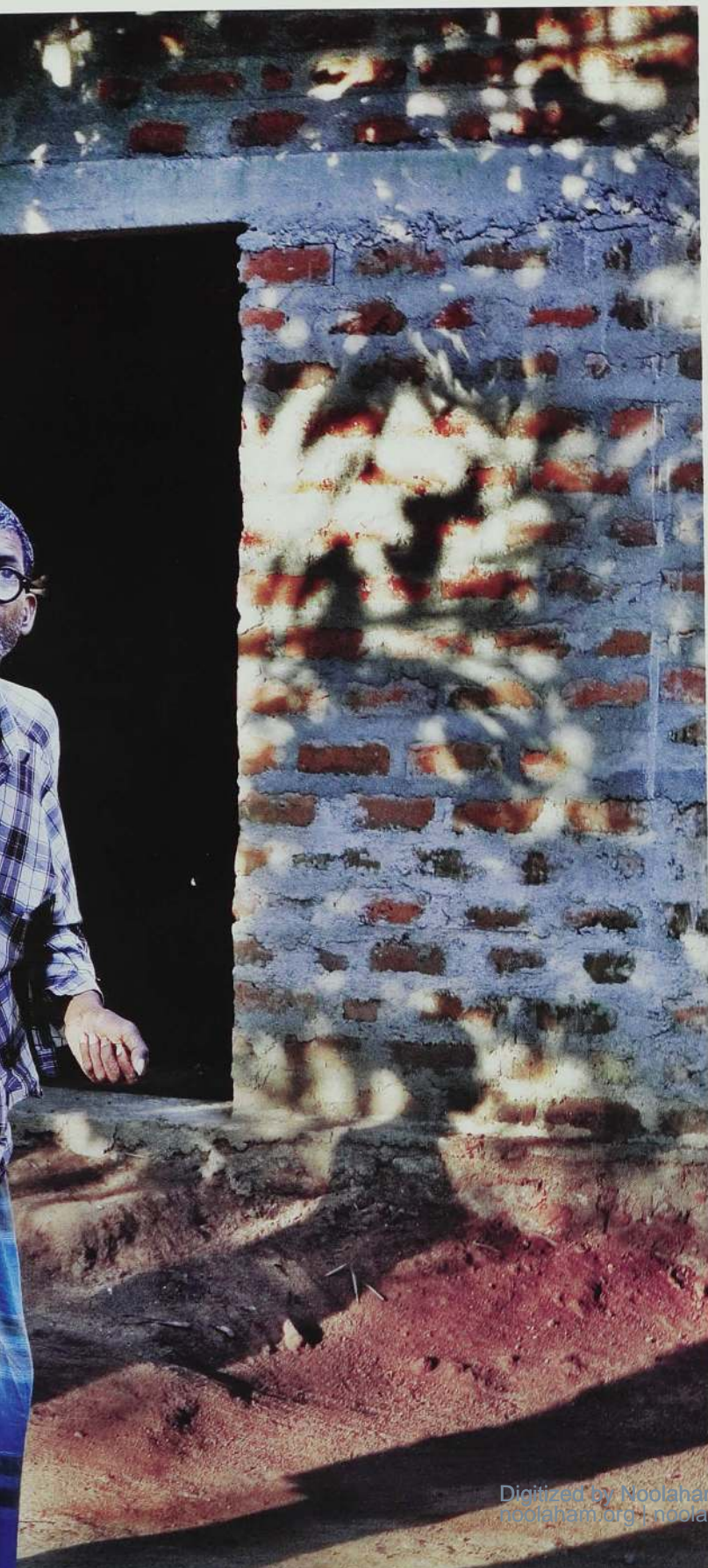


safeguard the Bank against allegations of disfavoring the North and East would be that the Bank would not approve reallocation of already committed resources from the North and East to other parts of the country. This would mean that if funds allocated for the North and the East are not fully utilized, the funding envelope for the country as a whole would effectively shrink. In addition, as described earlier, all ongoing and future lending activities of the Bank would be subjected to a 'conflict filter'. To effectively implement the conflict filter and enhance the conflict-sensitivity of the Bank's program, the country team would proactively seek support and guidance from relevant Bank departments, in particular the Fragile and Conflict-Affected Countries group and the Social Development Department. It is also expected that an externally funded full-time conflict advisor would be added to the Country Office staff. Moreover, the Bank is collaborating with other development partners, including through the Donor Peace Support Group, to develop and improve conflict-sensitive approaches to development assistance in Sri Lanka.

89. The evolving governance situation also exposes the Bank to reputational risks. These risks may materialize if the Bank is associated in its projects with individuals/institutions who/which are controversial or seen as corrupt. A perceived failure to address possible corrupt practices in Bank-financed projects would add to these reputational risks. The Bank expects that its stepped-up focus on the governance and anti-corruption agenda, better efforts to reach out to other stakeholders in this area, and enhanced attempts at managing fiduciary risks (see below) will go quite some way towards mitigating these risks.



It is common to see elderly parents living with their children and cared for by the children in the conflict displaced families in the North and the East. 62 year old Paramakutty Nadarajah is looked after by daughter Nadarajah Siridevi. North East Housing Project Puthukkudieruppu, Arayampathy DS Division, Batticaloa.

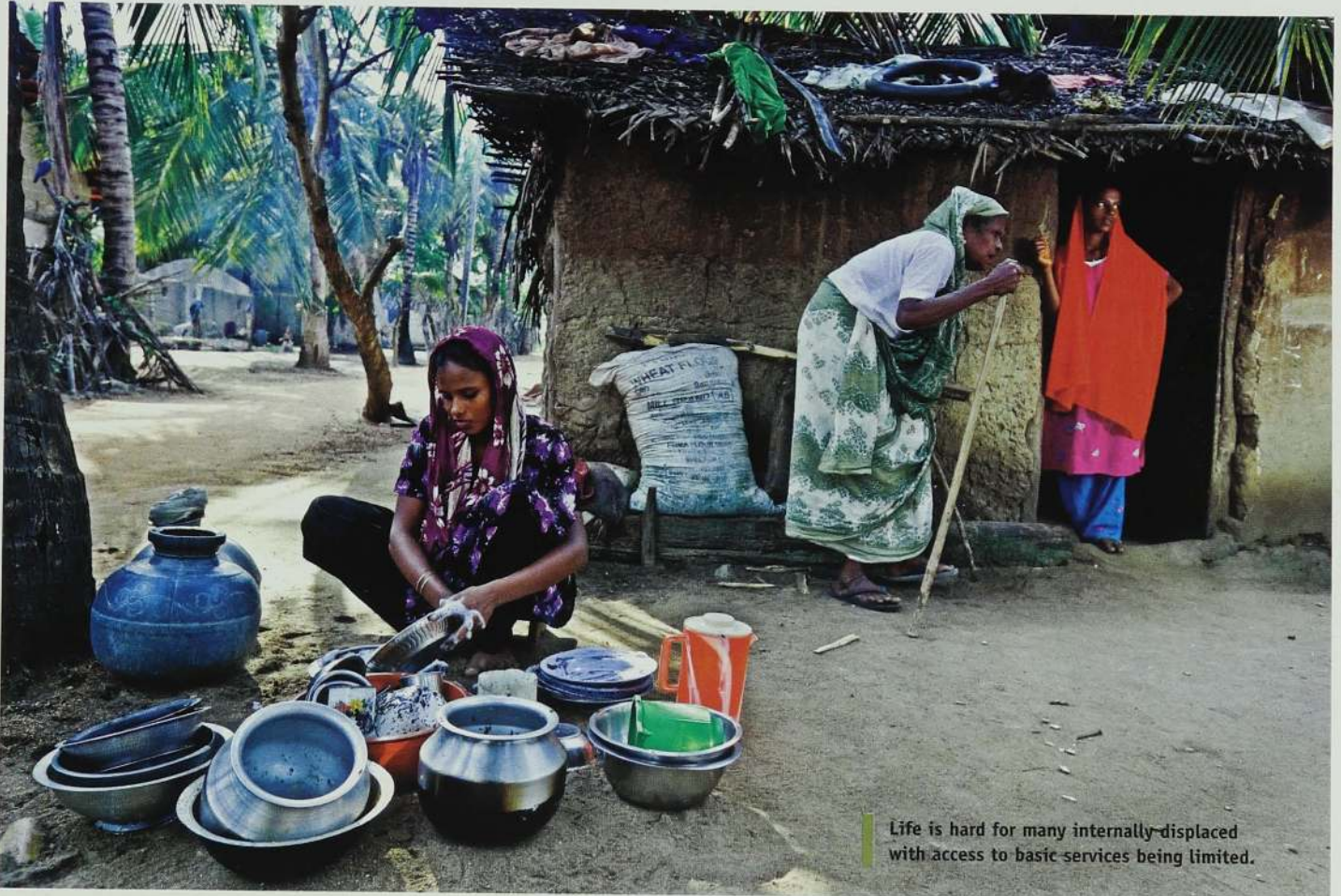


C FIDUCIARY RISKS TO BANK-FINANCED ACTIVITIES

90. Fiduciary risks in Sri Lanka are considered substantial⁹. This rating is based mainly on three issues: (i) the volatile situation in the North and East which impedes supervision and increases the risk of interference in project implementation by various outside stakeholders, including militant groups; (ii) examples of political interference in decision-making and appointment of key project management staff which undermine the effectiveness of project management and coordination; and (iii) the disbanding of the National Procurement Agency (NPA) which, at least temporarily, has resulted in increased uncertainties about the strength of the institutional set-up for public procurement.

91. There are weaknesses in both financial management and public procurement. In financial management, key weaknesses are capacity constraints in public external and internal audits; poor compliance and weak enforcement mechanisms of financial regulations; an input focused culture; weaknesses in a fixed asset and inventory management framework; and inadequate institutional arrangements to professionalize public sector accountants and provide them with continuous professional development. In public procurement, a great deal of work has taken place over the past several years to develop the regulatory and organizational foundation for effective public contracting. Under the direction of the NPA, modern regulations have been drafted, standard bidding documents have been developed, procurement units have been established in major spending agencies, officials have been trained, and the basic structure for reporting and monitoring on procurement

⁹ This is the second-highest risk rating on the Bank's four-point scale (Low, Modest, Substantial, High).



Life is hard for many internally displaced with access to basic services being limited.

has been initiated. The challenges that face the procurement system primarily relate to effective implementation of procurement rules. Procurement procedures continue to be irregularly applied and cases of post-contract manipulation, payment stoppages and inadequate post-award supervision remain significant issues. A robust performance monitoring system does not yet exist and oversight is further weakened by the lack of an effective grievance-redressal mechanism. The recent decision to disband the NPA and shift its functions to a unit in the Ministry of Finance has raised concerns about the Government's commitment to ensuring full implementation of the existing procurement regulations, although the Government has assured that it remains fully committed to good public

procurement. The ultimate implication of these changes for public procurement will not be known anytime soon and the Bank will liaise with the Government in monitoring the situation closely.

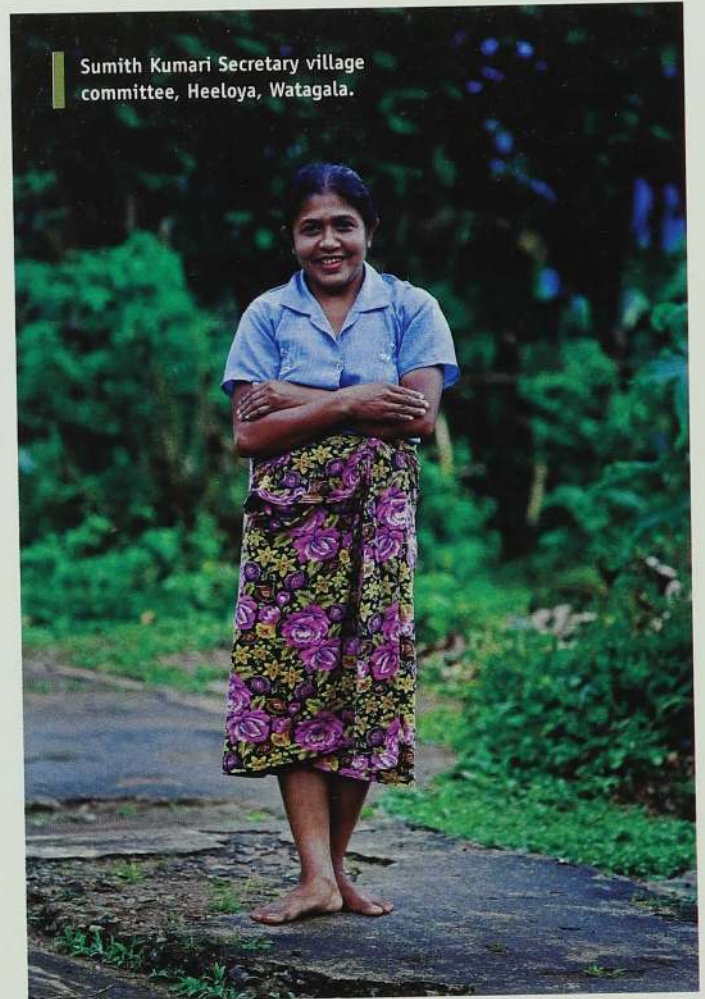
92. Going forward, the Bank will strengthen its attention to fiduciary risks in project design and project supervision, building, inter alia, on the lessons from the India Detailed Implementation Review (DIR).

- In terms of project design, fiduciary staff will be engaged on project teams to carry out preliminary, project-specific risk assessments already at the PCN stage. Sector fiduciary risk assessments would help to identify cross-cutting issues, opportunities for

corruption, and potential incentives and disincentives for corruption. Where warranted, anti-corruption Quality Enhancement Reviews (QERs) would be held with the objective of: (i) brainstorming for and documenting potential entry points for corrupt practices within overall sectors and specific projects; (ii) assessing the likelihood of each corrupt activity occurring; (iii) estimating the impact on the project outcomes should the corruption activity occur; and (iv) identifying a set of tailored risk mitigation measures to combat the corrupt activity. Project-specific anti-corruption strategies would be developed as necessary. Project design would also place more emphasis on: (i) enhancing transparency and social accountability by designing better communication channels with beneficiaries and other stakeholders, including civil society; (ii) enhancing the disclosure of accurate, timely, and clear project information across a wide array of public fora and media; and (iii) developing policies to promote detailed value-for-money reviews in the use of project and government resources. The Bank will also focus more strongly on establishing effective multi-language complaint mechanisms, mobilizing third party and community monitoring of procurement transactions and outcomes, and using information technology in procurement in order to enhance transparency.

- In terms of supervision, the fiduciary teams employ a risk-based approach. Currently, 5 of the 14 ongoing projects are considered fiduciary 'high risk' for a variety of reasons, including comparatively weak implementation capacity, perceived high risk of political interference in project implementation,

¹⁰ The five projects are the Tsunami Housing Project, Community Livelihoods in Conflict Affected Areas Project, HIV/AIDS Prevention Project, Health Sector SWAP, and E-Lanka (the latter is only considered high risk with respect to procurement).



Sumith Kumari Secretary village committee, Heeloya, Watagala.

or high exposure in conflict-affected areas . Additional implementation and fiduciary safeguards are being put in place for these projects. In the Community Livelihood in Conflict Affected Areas project, which has recently been restructured, the Bank intends to strengthen third party monitoring of project implementation and review, on a sample basis, financial management and procurement transactions in target villages. The risk-based approach allows the Bank to tailor supervision more closely to the risks associated with different types of projects-for example, in SWAPs that are particularly exposed to weaknesses in country systems or community driven projects that face

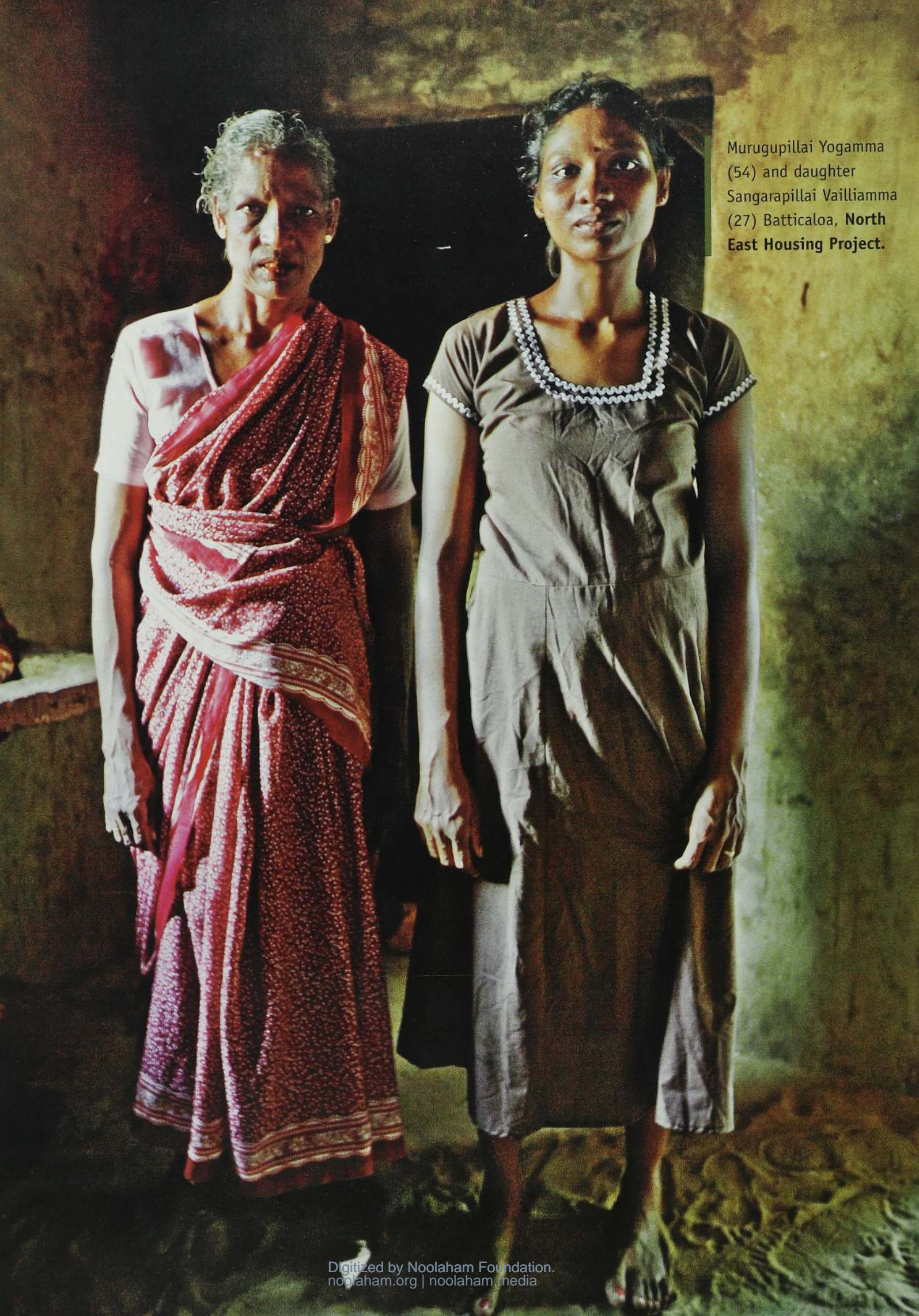
The indigenous people break out in a dance at the Dambana Rural Hospital grounds.



risks from low fiduciary capacity in communities. Supervision would be focused on not only ensuring compliance with agreed covenants and procedures but ensuring that: (i) funds have reached the intended beneficiaries; (ii) physical progress is aligned with payments; and (iii) suppliers are paid on time and against deliverables. Finally, increased use of joint financial management, procurement, technical supervision, and post reviews-including post-contract asset auditing, would be employed.

93. Project implementation and supervision in the conflict-affected areas pose particular challenges due to limited access. In particular, the LTTE-held districts of Kilinochchi and Mullaitivu in the North are currently off-limits to Bank staff, as are the areas on the frontlines in the Mannar,

Vavunia and Jaffna districts. To supervise activities in these areas, the Bank relies on inputs from local authorities, consultants and civil society organizations. For example, for our Education SWAP which provides funding for teacher skills development, text books, some school equipment, etc., in the entire country (including the Kilinochchi and Mullaitivu districts), a special unit in the Finance Commission has been established and charged with inter alia supervision of implementation in these districts. In other cases (for example, the North East Housing Reconstruction Project), it has been decided to temporarily suspend disbursements, in part because of difficulties in supervision and in part because of difficulties in ensuring a steady flow of necessary materials and equipment.



Murugupillai Yogamma
(54) and daughter
Sangarapillai Vailliamma
(27) Batticaloa, **North
East Housing Project.**

Paddy fields nurtured by restored
irrigation scheme Ampara. North East
Irrigated Agriculture Project



SRI LANKA



COUNTRY
ASSISTANCE
STRATEGY

Annexes

ANNEX 1. RESULTS MATRIX

Strategic Objective 1: Expanding Economic Opportunities in Lagging Regions

Long Term Country Development Objectives	World Bank CAS Objectives		Bank Activities
Objective	Constraints	Objectives to be influenced by the Bank	Milestones to track progress
Inclusive and equitable economic development <ul style="list-style-type: none"> • <i>Halve poverty by 2015</i> • <i>Increase rural economic growth</i> 	<ul style="list-style-type: none"> • Limited access to markets by rural entrepreneurs and farmers • Poor access to infrastructure (including roads, electricity, water supply) and finance in rural areas • Limited agricultural diversification to higher value crops • Increasing water scarcity • Damage and destruction of crops, property and life due to human/elephant conflicts 	Supporting integrated rural development (CAS outcome 1.1) <ul style="list-style-type: none"> • 40 percent increase in rural households electrified by off grid electrification (90,000 households today) • Share of rural households with access to improved water source reach 74 percent (71 percent today) • Share of rural roads (in nine pilot <i>Pradeshe Sabahis</i>) in 'good' or 'fair' condition reach 64 percent (47 percent today)) • Share of underweight estate sector children under age 5 reduce to 34.9 percent (from 44.1 percent in 2000) • <i>Increase share of CDD projects that involve functional collaboration across ethnic groups</i> • <i>Establishment of community peace councils</i> 	Ongoing activities: <ul style="list-style-type: none"> • Second Community Water project • Rural Electrification and Renewable Energy Development project (inc. IFC PADGO) • Dam Safety and Water Resources Planning project
		Proposed Activities: <ul style="list-style-type: none"> • Integrated Community Development — <i>Gama Naguma</i> (South) (FY09) • Irrigation Maintenance and Water Resource Management (FY11) • National and Provincial Road projects (FY09–FY12) • Agricultural Research and Productivity Improvements (FY11) • Community Water and Poverty Alleviation in Plantation Districts project (FY11) • Provincial Water Supply (FY12) 	

Strategic Objective 1: Expanding Economic Opportunities in Lagging Regions

Long Term Country Development Objectives	World Bank CAS Objectives	Bank Activities
Objective	Objectives to be influenced by the Bank	Milestones to track progress
Constraints		
<ul style="list-style-type: none"> • <i>Improving economic opportunities in the North and East</i> • Weak public service provision in conflict-affected areas in North and East—for example, education quality, access to electricity, water. • Large infrastructure backlog, including residential housing 	<p>Improving access to public services and infrastructure in the North and East (CAS outcome 1.2)</p> <ul style="list-style-type: none"> • Share of rural population with access to basic infrastructure facilities in North and East to reach 15 percent (9 percent today). • Share of destroyed residential houses in North and East rehabilitated to reach 37 percent (27 percent today) 	<ul style="list-style-type: none"> • Agricultural Research and Productivity Improvements (FY11) • Infrastructure Assessment (AAA) • Lagging Regions (Programmatic AAA) <p>Ongoing Activities:</p> <ul style="list-style-type: none"> • Tsunami Emergency Reconstruction Program • Puttalam Housing • Community Livelihoods in Conflict Affected Areas project • North East Housing Reconstruction Project <p>Proposed Activities:</p> <ul style="list-style-type: none"> • Integrated Rural Development—<i>Gama Naguma</i> (East) (FY10) • Provincial Road Project (FY09- 12) • Provincial Water Supply Project (FY12) • IFC investment and advisory work in agri-business • FIAS conflict-affected investment climate diagnostic study (AAA) • Impact Evaluation of <i>Gama Naguma</i> (TA)

Strategic Objective 2: Improving the Investment Climate and Competitiveness

Long Term Country Development Objectives Supported by the World Bank	World Bank CAS Objectives	Bank Activities
Objectives	Key Constraints	Objectives to be influenced by the Bank
<p>Accelerate and sustain economic growth</p> <ul style="list-style-type: none"> • Reducing the infrastructure deficit • Create a well-functioning road network 	<ul style="list-style-type: none"> • Significant road maintenance backlog • Inefficient transportation systems • High transport costs 	<p>Milestones to track progress</p>
		<p>Improving infrastructure provision (CAS outcome 2.1)</p> <ul style="list-style-type: none"> • Reduction in Average Road Network Roughness to 8.4 (based on the International Road Roughness Index-IRRI) (IRRI equal to 9.5 in 2005) • 4 percent decline in Average Network Vehicle Operating Costs (23.8 in 2005) • Reduction in road network in poor or bad condition to 35 percent (52 percent in 2005)
		<p>Ongoing activities</p> <ul style="list-style-type: none"> • Road Sector Assistance • Second Community Water <p>Proposed activities</p> <ul style="list-style-type: none"> • National and Provincial Road Sector Projects (FY09-FY12) • Infrastructure Assessment (AAA) • TA for Regulatory Agencies

<ul style="list-style-type: none"> • Establish a vibrant SME business sector • Increase investments and inflow of FDI 	<ul style="list-style-type: none"> • Limited development of capital markets, especially for SMEs • Cumbersome judicial procedures • Limited access to and high cost of IT services 	<p>Improving the business environment for stronger entrepreneurship and a knowledge-based economy. (CAS outcome 2.2).</p> <ul style="list-style-type: none"> • Share of commercial lending for SMEs from Bank increased by 10 percent. • 20 e-government services established and used by private sector (nine today) • Time to start up a business reduced by 25 percent (70 days today) 	<p>Ongoing activities:</p> <ul style="list-style-type: none"> • IFC investments and associated advisory with commercial banks • IFC Business Enabling Environment reforms in selected municipalities • E-Sri Lanka • IFC investment and advisory work with ICT sector companies <p>Proposed activities:</p> <ul style="list-style-type: none"> • IFC investments and associated advisory with commercial banks • IFC Business Enabling Environment reforms in selected municipalities • AAA on Growth, Outsourcing and Jobs • Private Sector Development in Tourism Resources Project
---	---	---	---

Strategic Objective 2: Improving the Investment Climate and Competitiveness

Long Term Country Development Objectives Supported by the World Bank	World Bank CAS Objectives	Bank Activities
Objectives	Objectives to be influenced by the Bank	Milestones to track progress
<ul style="list-style-type: none"> <i>Strengthen macroeconomic management</i> [Public sector deficit reduced to 5 percent of GDP (7.7 percent today); public debt reduced to 70 percent (85 percent today); Inflation reduced to 5 percent (24 percent today)] 	<p>Improving the strategic relevance and transparency of public spending (CAS outcome 2.3)</p> <ul style="list-style-type: none"> Share of budget expenditures classified as 'other' in the MTEF reduced to 5 percent (30 percent in 2006) Quasi-fiscal losses of SOEs reduced to less than 0.5 percent of GDP (2 percent in 2006) Improved public procurement, public financial management and parliamentary oversight over public spending. 	<p>Ongoing activities</p> <ul style="list-style-type: none"> TA on Public Spending and Services Promoting policy change in State-Owned Enterprise (AAA) <p>Proposed Activities</p> <ul style="list-style-type: none"> Public Sector Capacity Building Project (FY08) IDF Grant for COPE/COPA Infrastructure Assessment (AAA) Public Financial Management Assessment (AAA) TA for Public Private Partnership Framework WBI program to strengthen budget preparation and planning in Provincial Councils

Strategic Objective 3: Improving Quality of Services and Accountability

Sri Lanka's Long Term Development Objectives	World Bank CAS Objectives	Bank Activities
<p>Objectives</p> <p>Provision of high quality, relevant and cost effective public services, including in conflict-affected areas.</p> <ul style="list-style-type: none"> • Increase access, enhance quality and improve governance of basic and secondary education • Sufficient supply of highly skilled and productive people in demand by employers 	<p>Key Constraints</p> <ul style="list-style-type: none"> • Low organizational and managerial capacity at national and provincial levels of the education system. • Lack of accountability to students and parents • Outdated curriculum and low teacher skills • Low enrolment and poor quality of higher education <p>Objectives to be influenced by the Bank</p> <p>Improving quality, relevance and governance of education (CAS outcome 3.1)</p> <ul style="list-style-type: none"> • School survival rates through grade 9 increased from 79 percent to 85 percent. • Proportion of primary school students attaining competence in mathematics increased from 67 percent to 71 percent. • School based management increased from 16 zones (17 percent of zones) to at least 46 zones (50 percent of zones). • Higher education development strategy completed and notified • IT achievement scores of undergraduates rise from 49 percent to 60 percent. • English language achievement scores of undergraduates rise from 59 percent to 67 percent. • Promote a multi-ethnic and multicultural society through the school curriculum. 	<p>Milestones to track progress</p> <ul style="list-style-type: none"> • School attendance committees active in at least 80 percent of zones • Teacher training programs on the modernized primary curriculum introduced in all zones • Number of zones in which school based management is established to reach at least 37 (baseline 16 zones) • Draft higher education development strategy presented for stakeholder consultations • IT learning programs implemented in all universities • English language improvement programs implemented in all universities • Multi-ethnic and multicultural curriculum review committees functioning for civics, history and English. <p>Ongoing activities:</p> <ul style="list-style-type: none"> • Education Sector Development Project • Increasing Relevance and Quality of Undergraduate Education <p>Proposed activities:</p> <ul style="list-style-type: none"> • Higher Education Project (FY10) • General Education Project (FY12) • Impact evaluation of school based management (TA) • Higher Education Study (AAA)

Strategic Objective 3: Improving Quality of Services and Accountability

Sri Lanka's Long Term Development Objectives		World Bank CAS Objectives		Bank Activities
Objectives	Key Constraints	Objectives to be influenced by the Bank	Milestones to track progress	
<ul style="list-style-type: none"> • Reduce incidence of non-communicable diseases. • Lower incidence of malnutrition, • Lower disease burden for the poor. • Improve effectiveness and targeting of the social protection system 	<ul style="list-style-type: none"> • Inadequate non-communicable diseases prevention system. • Inefficient hospital network • High exclusion of eligible poor in cash transfer programs; no exit procedure from cash transfer programs • Weak linkages between safety net programs and the labor market 	<p>Objectives to be influenced by the Bank</p> <p>Improving health and social protection services (CAS outcome 3.2)</p> <ul style="list-style-type: none"> • Percentage of districts with MMR of 46.9/100,000 or lower equal to 80 percent (in 2006 it was equal to 19.2 percent (6/26) • Number of women more than 35 years screened for cervical cancer increased by 25 percent (57,639 screened in 2007) • Coverage of HH receiving Samurdhi benefits reduced from 47 percent to 40 percent while the share of Samurdhi beneficiaries in the East increases from 11.7 percent to 15 percent, and in the North from 3.5 percent to 5 percent. • 30 percent increase in the coverage of the Employment Promotion and Creation Program (baseline 3,000 per year) • 30 percent increase in social care centers for vulnerable groups (baseline 27 centers in 2008) 	<p>Milestones to track progress</p> <ul style="list-style-type: none"> • National Action Plan for prevention of NCDs which includes a national surveillance system is finalized • Number of districts which use logical framework and report regularly—once a year—on performance increased to 75 percent (in 2006 it was equal to 26.9 percent (7/26)) • Samurdhi Management Information System improved—providing timely data on coverage. • Information about insurance products for the unorganized sector improved. • Employment Promotion and Creation Program evaluated and results reflected in program design. • Existing social care centers used as planned. 	<p>Ongoing activities:</p> <ul style="list-style-type: none"> • Health Sector Development Project • National HIV/AIDS <p>Proposed activities:</p> <ul style="list-style-type: none"> • Health Sector Development Project (FY12) • Roll-out of 'IFC Against AIDS' program with IFC clients where appropriate • Health Delivery System Review and Non-Communicable Diseases Strategy (AAA) • <i>IDF to improve targeting and administration of Samurdhi</i> • Towards a Social Protection system for the poor (programmatic TA) • AAA on female migration • TA for post-disaster cash payments

Strategic Objective 3: Improving Quality of Services and Accountability

Sri Lanka's Long Term Development Objectives	World Bank CAS Objectives	Bank Activities
Objectives	Objectives to be influenced by the Bank	Milestones to track progress
<ul style="list-style-type: none"> <i>Environmentally sustainable development</i> 	<p>Strengthening environmental protection (CAS outcome 3.3)</p> <ul style="list-style-type: none"> 25 percent reduction in time for processing environmental approvals (180 days today for EIAs and 45 days for EPLs) 20 percent of GOSL policies and programs will be subject to Strategic Environmental Assessments (none today) 40 percent increase in international tourist visitation to protected areas and forest reserves (Currently 50,000 international tourists per annum) Reducing the human/elephant conflict; annual number of human deaths from wild elephants reduced by 25 percent (75 deaths in 2006); number of wild elephants killed reduced by 25 percent (160 killed in 2006) 	<p>Ongoing activities:</p> <ul style="list-style-type: none"> Sri Lanka Country Environmental Analysis—Natural Resources, Environment and Development (AAA) <p>Proposed Activities:</p> <ul style="list-style-type: none"> Environment Resource Management Project (FY10) All IFC investment clients to meet E&S performance standards AAA on environmental impacts of coal power generation

(Note): Objectives and Milestones shown in italics refer to those identified under 'Addressing Causes and Consequences of the Conflict'.

ANNEX 2. SUMMARY OF CAS CONSULTATIONS

Consultation Process

Extensive consultations with a broad section of Sri Lankan society were carried out as part of the preparations for this CAS. The objective of the consultations was to achieve an open and constructive engagement with a wide section of stakeholders in Sri Lanka, to ensure that the World Bank's priorities for development assistance in the country would be aligned with the needs of the people and the Government's priorities.

The bulk of the public consultations were carried out during the month of March 2008. In total, 26 public meetings were held in Colombo, in the Southern Province and in the Eastern Province (a limited number of representatives from the Northern Province attended the consultation forums in the East). Participants in the consultations represented many different stakeholders, including Government ministers; opposition Members of Parliament; Central Government officials; provincial council and local government representatives from the South, North and East; media; trade unions; NGOs covering a wide section of areas (social services, advocacy, environment, agriculture, etc.); representatives from the Chamber of Commerce; academics and think-tanks; and bilateral and multilateral donors and UN agencies.

In order to facilitate a structured discussion, all participants had been provided in advance with a four-page briefing note explaining the Bank's role and summarizing the Bank's initial thinking about its strategic priorities for the CAS. Detailed minutes were taken of each meeting, and translation into Tamil and Sinhalese was provided whenever needed. Most meetings were very well attended and the discussions were frank and lively. Almost all participants expressed a sincere gratitude to the Bank for organizing the consultations.

While it is not possible to give due credit to all the comments received during the consultations, this note attempts to extract some of the main recurrent themes expressed by the participants in the consultation process.

Causes and Consequences of the Conflict

Many participants identified the conflict as the leading obstacle to growth and development in Sri Lanka and associated it with low private investments, diversion of public resources away from poverty reduction, deterioration of quality of public services, lack of predictability, and loss of skilled personnel due to brain drain. As expected, for participants from the North and East, the conflict has had-and continues to have-the most direct impact on day-to-day life. A spreading gun culture was often identified as a concern, as was a perceived militarization of the public administration in the East. Participants also pointed to the existence of various security measures as resulting in higher cost of living, fewer economic opportunities, and slower rehabilitation and resettlement. For example, restrictions on traveling have reduced access to essential public services such as health facilities and the designation of high security zones has resulted in loss of fishing and agricultural livelihoods. In addition, respondents from the East were concerned about perceived attempts to alter the ethnic distribution in the Eastern Province. Poor Tamil language skills among staff in key Government agencies, like the police, were seen as a critical factor in reducing trust and slowing down reconciliation by many: *"99% of the police are Sinhalese. They can't talk a word of Tamil. So the minute someone gets scared because he can't talk Sinhalese, he becomes a suspect"*. The consultations revealed stark differences in the opinions about the

root cause of the conflict, with some arguing that *“I don't think we have an ethnic conflict. It is terrorism. We have to eliminate this terrorism and bring peace,”* and others countering with *“If there is no ethnic conflict why is there violence? From 1956, the Tamils were neglected by the others. That is why there is violence. Also Muslims are affected”*. There was a very strong request expressed by participants from the North and East that the Bank extend further assistance to the conflict-affected areas, in particular, in the areas of livelihood, public service delivery and infrastructure. The participants also emphasized that the assistance should be provided in a conflict-sensitive manner given the sensitivity on the ground.

Governance and Anti-corruption

Governance was seen as a critical challenge for Sri Lanka. Some participants argued that poor governance is the most important cause of the conflict. Many participants traced the erosion in governance back to the 1978 Constitution which vested concentrated power in the executive president while diluting the influence of the Parliament. Others argued, however, that the problems of governance are less rooted in the constitutional framework and result more from its implementation. For example, the failure to reconstitute the constitutional council established under the 17th Amendment to enhance check and balances in the constitutional setup, was repeatedly noted as a key weakness.

Corruption was seen to arise from mainly two failures: First, a perception of insufficient parliamentary oversight over public spending—beginning with the Parliament's limited involvement in the upstream budget preparation and review (the fact that there is no formal Budget Estimates Committee in Parliament

was emphasized in this regard), the failure to adhere to the targets of the Fiscal Management Responsibility Act, and the need for stronger parliamentary follow-up of the COPE/COPA reports. The lack of financial independence—and low capacity—of the Anti-Bribery Commission was also noted. The second factor that was often used to explain corruption is the almost complete absence of accountability to the final beneficiaries. As one community representative noted: *“No one monitors project spending, and politicians decide by themselves which contractor gets the job; that's why most is wasted”*. Others argued that corruption was also a result of low capacity: *“Corruption is there, but there are procedures and systems in place. We have to build capacity”*. Finally, participants reminded the Bank that corruption is not confined to the public sector but also, often, involves private sector participants.

Inclusive Development

Sluggish growth outside the Western Province was noted by a wide set of participants and the importance of the agriculture sector in inclusive development was emphasized. Poor agricultural development was attributed by many to the distorted policy framework: *“Wrong policies have impacted on this sector contributing to an increase in poverty”*. It was also repeatedly emphasized that the sector requires modernization, market development and access to markets. In addition, several participants noted the vulnerability of agricultural producers to natural disasters and requested the Bank to help develop safety nets for rural farmers and fishing communities. Many participants also emphasized that macroeconomic instability was hurting the poorest, as evidenced by the increasing hardships faced by the working masses due to the rising cost of living.

Devolution

The consultations revealed a strong demand for enhanced inclusiveness in decision making: *“The people have been left out of decision making”*. Several local government officials pointed out that they were often not consulted on development projects within their jurisdictions, and noted that lack of clarity of mandates, power struggles between regional and central government, and inadequate funding undermined the effectiveness of local service delivery. As one private sector participant from the South noted: *“We don't want to go to Colombo for everything; we want real devolution”*. The prospects for full implementation of the 13th Amendment to the Constitution was intensively debated, with some arguing that the Government was already making significant progress and others believing that progress was limited and not likely to ever go far.

Investment Climate and Economic Growth

Poor infrastructure outside the Western Province was seen by almost all participants—from community, local and Colombo private sectors; local and central governments; and NGOs—as a key reason for imbalanced growth and inequity. In particular, poor roads to facilitate access to markets and enable connectivity were seen to be a major drawback to fostering investments. The increasing cost of electricity was also seen as a major deterrent for investments and growth of existing enterprises. Many participants suggested that there be greater emphasis on developing alternative energies and developing mechanisms to transfer such alternative energy solutions to rural areas. Macroeconomic instability was highlighted by many participants as a reason for poor investment and deteriorating competitiveness, because the high degree of unpredictability made it difficult to plan for the future.

In particular, private sector representatives noted that existing laws, including labor laws, must be modernized for Sri Lanka to be competitive. They called for stronger independent regulatory bodies in various sectors to encourage competition and innovation. Difficulties in accessing credit were seen as a major obstacle to growth and development of SMEs and micro-enterprises. Several participants argued that enhanced reliance on public-private partnerships (PPPs), for example in areas such as ICT and infrastructure, would be a promising way to increase investments. However, there was consensus that the overall framework for PPPs would have to be improved for greater clarity and user-friendliness. As one Government official noted: *“Although we talk of Public Private Partnerships (PPP) we don't have legal documentation for that kind of funding. We advertised the rail extension but the documents are confusing. So the tender was not successful. But other countries have very user friendly documents for PPP. We have to focus on how to promote PPP projects and documentation”*. In the East, security concerns and existing security arrangements such as restrictions on transportation and travel were seen as the primary reasons for low investments. The conflict was also linked to the perception of significant brain drain—both out of the country and from the rest of the country to the metropolitan Colombo area.

Education

Recognizing Sri Lanka's limited natural resource base, many participants strongly associated building human capital with private sector development and economic growth in the country. For this reason, concern about the quality of education was perhaps the most recurrent theme during the consultations. With regard to primary and secondary education, concerns were especially strong about the quality of English language

education and about the teaching of science subjects. A perceived stark disparity in educational facilities between the Western Province and other provinces was highlighted as a critical concern. In particular, it was emphasized that there is a need for the public sector to more aggressively fill existing teacher vacancies and enhance the capacity and quality of existing training for teachers, nurses, and other staff in the Eastern Province. At the higher education level, participants pointed to a significant mismatch between the skills of the graduates and the needs of the private sector—a mismatch that participants noted was further aggravated by the fact that many of the most talented graduates were leaving the island.

Additional Areas Where Bank Engagement was Requested

During the consultations, participants brought up a large number economic and social issues in which they expressed a desire to see the Bank more engaged. Many of them have been mentioned above—such as, macroeconomic management, infrastructure development, agricultural development, and the business environment. However, a number of issues—summarized below—that had not explicitly been included in the briefing note, were repeatedly brought up during the consultations, suggesting other possible areas for strengthened Bank engagement.

(i) **Gender equity:** At the broadest level, many participants emphasized the need for development programs to be gender sensitive. In addition, several NGOs and private sector representatives noted the importance of directly targeting rural women as a means to enhancing the effectiveness of community-based programs; it was also suggested the Bank pay particular attention to programs that can help scale up female-owned micro-enterprises. Finally, it was also

noted that gender issues are particularly important in the conflict-affected areas.

(ii) **Estate poverty:** Throughout the consultations, participants repeatedly emphasized the need to address estate poverty which was seen as a major social problem and a source of continued inequalities. The historical tendency for estate workers to be relatively isolated from the rest of the economy was recognized as a contributing factor to the high incidence of poverty in the estates. But poor public service delivery and lack of vocational training opportunities were also seen as contributing factors.

(iii) **Environmental sustainability and climate change:** Civil society organizations made a strong call for enhancing the environmental sustainability of development programs and many participants emphasized the need to strengthen water resources management and solid waste management. They also noted that the conflict was causing significant environmental damage, in particular in the North. Finally, many participants noted the need to enhance awareness and preparedness for the possible impact of climate change, including the need for more effective mitigation strategies against the impact of rains and floods.

(iv) **Targeted policies for groups with special needs:** Three groups were identified for whom targeted policies and interventions should be considered. First, disabled persons—a perceived significant 'hidden' problem which has been enlarged by the conflict. Second, the elderly—Sri Lanka's rapidly aging population was considered to be a huge potential problem in the making. Third, urban slum dwellers—perceived as being caught in a poverty trap with very limited escape options.

How Should the World Bank Engage?

While most participants emphasized a desire to see a stronger engagement in Sri Lanka by the Bank, many were critical about the way the Bank has engaged in the past—they made several suggestions as to how the Bank can enhance its effectiveness. These observations and suggestions can be summarized in the following four points:

(i) Adapt to recognize the Bank's **limited 'leverage'**:

Most participants recognized that the Bank's 'leverage' is limited, in part due to the complex domestic political situation and in part due to the Bank's declining share in the overall financing for the country. As one participant noted: *"Beware of the political economy: There are many issues which cannot be tackled head-on under current circumstances. And don't overestimate your ability to influence the Government"*. Against this background, many participants recommended that the Bank should not spread itself too thinly across a wide spectrum of activities but focus, instead, on areas where it has shown proven success or has a comparative advantage. Some participants tried to alert the Bank to not aim at engagement in the politically charged areas. However, participants, while recognizing that the Bank's leverage may be limited, also suggested that the Bank should emphasize the facilitation of policy dialogue and discussions on thematic issues with broader audiences. They expressed the expectation that the Bank would share global knowledge and play a convening role.

(ii) The importance of strong **monitoring and evaluation** of Bank-funded programs, to facilitate public oversight over spending under Bank-funded projects: *"... if there is no post project evaluation or monitoring of World Bank projects, then there is no one*

to tell if something is wrong". Participants also expressed that the Bank should facilitate 'learning by doing': *"The World Bank has been here for 50 years. What are your success stories? What is the learning? I think it is important for the World Bank and the people to know"*. They also suggested more systematically involving the beneficiaries in the monitoring and evaluation of projects: *"In the monitoring mechanism make sure there is room for people"*.

(iii) Many participants also noted the importance of establishing effective **grievance mechanisms** in projects, and making the Bank more approachable to ordinary citizens. *"There is no grievance mechanism. If we propose something we don't know what has happened to the proposal...The World Bank works with the Government, not with people. You should establish mechanisms so people can access you directly, because if it goes through the Government it will never reach you"*

(iv) Finally, there was a strong consensus about the need for Bank assistance to be as **conflict-sensitive** as possible. The proposed 'conflict filter' was discussed in some detail and there was broad support for it as an instrument to enhance conflict-sensitivity. It was repeatedly emphasized that the Bank, at a minimum, should ensure that its assistance *"do no harm"*. The importance of a balanced distribution of assistance across the country was also noted.

ANNEX 3. DONOR COMMITMENTS ACROSS SECTORS

	Water and Sanitation	Ports/Rail /Aviation	PSD/SME	Roads	Power /Energy	Social Development	Health	Fisheries	Housing	Agriculture /Irrigation
ADB	45%	60%	0%	39%	8%	0%	0%	0%	0%	0%
Australia	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Austria	3%	4%	0%	1%	0%	0%	0%	0%	0%	0%
China	0%	13%	0%	1%	46%	0%	0%	62%	0%	0%
EC	0%	0%	1%	2%	0%	0%	0%	0%	0%	0%
EIB	0%	0%	24%	0%	0%	0%	0%	0%	0%	0%
FAO	0%	0%	0%	0%	0%	0%	0%	38%	0%	2%
Finland	1%	0%	0%	0%	0%	0%	0%	0%	0%	0%
France	12%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Germany	6%	0%	17%	0%	2%	0%	0%	0%	5%	5%
IFAD	0%	0%	0%	0%	0%	0%	0%	0%	0%	16%
India	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Japan	29%	24%	40%	38%	33%	0%	21%	0%	0%	61%
Korea	2%	0%	0%	2%	0%	0%	6%	0%	0%	0%
Kuwait	0%	0%	0%	2%	0%	0%	0%	0%	0%	0%
Malaysia	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Norway	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
OPEC	0%	0%	0%	1%	0%	0%	0%	0%	0%	0%
Saudi Fund	0%	0%	0%	1%	0%	0%	10%	0%	0%	16%
Spain	2%	0%	0%	3%	0%	0%	0%	0%	0%	0%
Sweden	0%	0%	2%	2%	2%	12%	0%	0%	0%	0%
Switzerland	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
UNDP	0%	0%	5%	0%	0%	0%	0%	0%	0%	0%
UNFPA	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
UNICEF	0%	0%	0%	0%	0%	12%	0%	0%	0%	0%
USA	0%	0%	10%	0%	0%	13%	0%	0%	0%	0%
World Bank	0%	0%	0%	9%	8%	2%	62%	0%	95%	0%
WFP	0%	0%	0%	0%	0%	61%	0%	0%	0%	0%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Total Commitments US\$	864	523	287	1,087	992	95	116	15	112	142

... continued	Finance	Education	Rural/CDD	Estates	Environment	Tsunami	Governance	Local Gov't	Other
ADB	100%	52%	25%	60%	14%	14%	6%	100%	0%
Australia	0%	0%	0%	0%	1%	0%	0%	0%	0%
Austria	0%	0%	0%	0%	0%	0%	0%	0%	0%
China	0%	0%	0%	0%	0%	0%	0%	0%	3%
EC	0%	0%	0%	0%	0%	0%	0%	0%	0%
EIB	0%	0%	0%	0%	0%	9%	0%	0%	0%
FAO	0%	0%	0%	0%	0%	0%	0%	0%	0%
Finland	0%	0%	0%	0%	0%	0%	0%	0%	0%
France	0%	0%	0%	0%	0%	0%	0%	0%	0%
Germany	0%	9%	8%	0%	0%	1%	0%	0%	1%
IFAD	0%	0%	5%	0%	0%	2%	0%	0%	0%
India	0%	0%	0%	0%	0%	0%	0%	0%	15%
Japan	0%	0%	40%	27%	7%	16%	0%	0%	2%
Korea	0%	3%	0%	0%	1%	0%	2%	0%	3%
Kuwait	0%	7%	0%	0%	0%	0%	0%	0%	0%
Malaysia	0%	0%	0%	0%	0%	0%	0%	0%	0%
Norway	0%	0%	0%	0%	0%	0%	0%	0%	0%
OPEC	0%	0%	1%	0%	0%	0%	0%	0%	0%
Saudi Fund	0%	0%	0%	0%	0%	0%	0%	0%	0%
Spain	0%	0%	0%	0%	0%	0%	0%	0%	0%
Sweden	0%	0%	0%	12%	0%	0%	1%	0%	3%
Switzerland	0%	0%	0%	0%	0%	1%	0%	0%	0%
UNDP	0%	0%	6%	0%	77%	21%	74%	0%	71%
UNFPA	0%	0%	0%	0%	0%	1%	0%	0%	1%
UNICEF	0%	0%	0%	0%	0%	13%	0%	0%	0%
USA	0%	0%	0%	0%	0%	6%	4%	0%	1%
World Bank	0%	29%	16%	0%	0%	16%	12%	0%	0%
WFP	0%	0%	0%	0%	0%	0%	0%	0%	0%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Total Commitments US\$	136	361	731	55	737	1,084	700	53	879

Source: "Partnership for Accelerate Growth", Department of External Resources, Ministry of Finance

Note: Include all signed agreements as of September 30, 2007. Since table only include financial assistance, it does not give a fully comprehensive picture of donor activities.

ANNEX 4. THE GOVERNMENT'S MEDIUM TERM MACROECONOMIC FRAMEWORK

The Government's Medium Term Macroeconomic Framework 2007 - 2011

	Units	2006	2007(b)	2008	2009	2010	2011
Real Sector							
GDP at Market Prices	Rs. bn	2,939	3,578	4,307	5,047	5,923	6,911
Real GDP Growth	%	7.7	6.8	7	7.5	8.2	8.5
Inflation-GDP Deflator	%	11.3	14	12.5	9	8.5	7.5
Total Investment	%of GDP	28	27.9	30	31.5	32.5	33.2
Private Investment	%of GDP	20.9	20.7	22	23	24.4	25.2
Public Investment	%of GDP	7.1	7.2	8	8.5	8.1	8
Incremental Capital Output Ratio (ICOR)		3.4	4.1	4	4	3.8	3.8
Domestic Savings	%of GDP	17	17.6	20.4	22.1	23.3	24.5
Private Savings	%of GDP	19.4	19.2	19.5	20.3	20.8	21.6
Public Savings	%of GDP	-2.4	-1.6	0.9	1.8	2.5	2.9
National Saving	%of GDP	22.3	23.4	25.7	27.4	28.5	29.5
External Sector							
Trade Gap	US\$ mn	-3,371	-3,560	-3,970	-4,365	-4,803	-5,149
Exports	US\$ mn	6,883	7,740	8,529	9,395	10,339	11,356
Imports	US\$ mn	10,254	11,301	12,499	13,760	15,142	16,505
Services	US\$ mn	257	238	312	370	414	478
Receipts	US\$ mn	1,625	1,712	1,938	2,156	2,364	2,592
Payments	US\$ mn	1,368	1,474	1,626	1,786	1,949	2,114
Current Account Balance	US\$ mn	-1,498	-1,369	-1,545	-1,664	-1,881	-1,974
Current Account Balance	%of GDP	-5.3	-4.2	-4	-3.9	-3.9	-3.7
Overall Balance	US\$ mn	204	531	400	396	388	376
External Official Reserves							
(Months of Imports)	Months	3	3.3	3.3	3.2	3.2	3.2
Debt Service Ratio (c)	%	12.8	13	14.9	13.3	9.6	8.8
Fiscal Sector (d)							
Revenue	%of GDP	16.3	15.8	17.4	18	18.5	18.5
Expenditure	%of GDP	24.3	23.5	24.2	23.9	23.7	23.3
Current Account Balance	%of GDP	-2.4	-1.6	0.9	1.8	2.5	2.9
Overall Budget Deficit	%of GDP	-8	-7.7	-6.8	-5.8	-5.2	-4.8
Domestic Financing	%of GDP	5.6	3.6	3.6	2.6	2.2	2.1
Financial Sector (e)							
Reserve Money Growth	%	21.2	10.2	15	15	14.5	14.5
Broad Money Growth (M2b)	%	17.8	16.6	15.5	15.5	15	15
Narrow Money Growth (M1)	%	12.6	2.7	5.5	5.5	5	5
Growth in Credit to Private Sector	%	24	19.3	17.5	17	16.5	16.8
Growth in Credit to Public Sector	%	38.8	8.9	-3.1	-0.7	-0.7	-0.7

Source: Central Bank of Sri Lanka, 2008 Annual Report

ANNEX 5. A NOTE ON THE SIZE AND SUSTAINABILITY OF PUBLIC DEBT

Composition of Public Debt

Sri Lanka's nominal public debt has been growing over time due to sustained high fiscal deficits. However, as a percentage of GDP, public debt peaked at 102.3 percent in 2004, but has gradually declined since then to reach 86 percent of GDP in 2007. The decline has been due to faster growth in the nominal GDP relative to debt, a reduction in the primary deficit in recent

years, and a relatively low effective real interest rate (in part due to the high share of concessional debt and modest exchange rate movements). At the end of 2007, the public debt stood at Rs 3,070 billion (US\$ 28.2 billion). Domestic public debt amounted to 48 percent of GDP (56 percent of total debt), while the foreign public debt amounted to 38 percent of GDP (44 percent of total) at the end of 2007¹¹.

End-year Composition of Outstanding Central Government Debt

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007(b)
	-----Rs. Billion-----									
Foreign Debt	6.8	7.0	6.8	6.8	7.5	8.7	9.5	9.4	10.5	12.4
Project Loans	5.9	6.2	6.0	5.8	6.6	8.0	8.7	8.5	9.1	10.0
Non-Project Loans (b)	0.9	0.9	0.8	1.0	0.8	0.8	0.8	0.9	1.4	2.4
Domestic Debt	6.8	7.5	8.5	8.8	9.8	10.5	10.9	12.4	13.7	15.7
Treasury Bills	1.8	1.7	1.7	1.8	2.2	2.3	2.3	2.3	2.4	2.8
Treasury Bonds	0.7	1.5	2.5	2.5	3.6	5.0	6.1	7.4	8.2	9.3
Sri Lanka Development Bonds	..	..	..	0.2	0.2	0.1	0.2	0.2	0.6	0.8
Other c), d)	4.3	4.3	4.2	4.3	3.8	3.2	2.2	2.5	2.5	2.8
Total	13.6	14.6	15.2	15.6	17.3	19.3	20.5	21.8	24.2	28.2
	-----% of GDP-----									
Foreign Debt	45%	46%	43%	46%	44%	46%	48%	39%	38%	38%
Project Loans	39%	40%	38%	39%	39%	42%	44%	35%	33%	30%
Non-Project Loans (b)	6%	6%	5%	7%	5%	4%	4%	4%	5%	7%
Domestic Debt	46%	49%	54%	58%	58%	56%	55%	52%	50%	48%
Treasury Bills	12%	11%	11%	12%	13%	12%	12%	10%	9%	9%
Treasury Bonds	5%	9%	16%	16%	21%	27%	31%	31%	30%	28%
Sri Lanka Development Bonds	..	..	..	1%	1%	0%	1%	1%	2%	2%
Other c), d)	29%	28%	27%	29%	22%	17%	11%	10%	9%	8%
Total	91%	95%	97%	104%	102%	102%	102%	91%	89%	86%

Source: Central Bank of Sri Lanka
Ministry of Finance and Planning

(a) This excludes medium and long term government guarantee, short term IMF drawings amounting and other short term debt.

(b) Includes cash loans received from the ADB, USA, OPEC, outstanding defence differed payments, foreign investment in Treasury bonds and sovereign bond issues, and other non-project loans.

(c) Excludes contributions to international financial organizations.

(d) Includes rupee loans, administrative borrowings arising from foreign loans channeled through government or semi-government agencies and outstanding National Development Bonds. Outstanding balance of borrowing from offshore Banking Units (OBUs), and Central Bank advances are also included

¹¹ The public foreign debt makes up more the 97 percent of total foreign debt; this share is not expected to change significantly in the near to medium term. For this reason, a separate assessment of the total foreign debt is not carried out. In the following pages, 'public domestic debt' and 'public foreign debt' will be referred to simply as domestic debt and foreign debt, respectively. Debt of state-owned enterprises or other contingent liabilities are not included in the assessment.

Domestic debt mainly consists of Treasury bonds (59 percent of the total outstanding domestic debt¹²) and Treasury bills (18 percent of domestic debt). T-bonds and T-bills are either placed with captive market participants, such as the Employers Provident Fund (EPF), Employee Trust Fund (ETF), or sold to primary dealers at regular auctions. In addition, Sri Lanka Rupee Loans-which was the long term borrowing instrument of the Government prior to the introduction of Treasury bonds in 1997, and which are in the process of being retired-make up about 8 percent of domestic debt outstanding. Finally, 11 percent of domestic debt consists of foreign currency denominated debt, mainly in the form of Sri Lanka Development Bonds (which are US\$ denominated bonds of 2-3 year maturity placed with domestic commercial banks) and facilities extended by the offshore banking units (OBUs) of local commercial banks.

Out of total **foreign** debt outstanding, 83 percent is on concessional terms, provided by bilateral and multilateral donors, and with a stable currency composition of US\$, Yen and SDR. In 2007, total non-concessional foreign debt increased nearly three-fold to US\$ 2.1 billion. This increase was in part due to Sri Lanka's maiden issue of a foreign currency denominated bond in October 2007 for a total of US\$ 500 million, and in part due to the Government's decision to open up some of the (rupee denominated) domestic Treasury bond market to foreign investors (the book value of foreign subscriptions reached approximately US\$ 450 million by end-2007).

Debt Dynamics for the External Public Debt¹³

There are three basic drivers of public debt dynamics: (i) economic growth; (ii) the interest rate; and (iii) the primary deficit.

In the **baseline scenario**, real GDP growth is expected to follow the Bank's medium-term projection, which implies a further weakening of the growth momentum to 5.7 percent in 2008 and a growth rate of 5.4 percent per annum in the longer term. With respect to interest rates, a gradual increase in real interest rates¹⁴ in Sri Lanka's non-concessional debt-from its expected relatively low level of 1.6 percent in 2008 to 2.8 percent in the longer term-is assumed. The exchange rate, it is assumed, will depreciate slightly in the initial years to compensate for higher inflation in Sri Lanka than in the rest of the world, but will otherwise remain stable. Finally, the primary deficit is assumed to remain at its current level of 2.6 percent of GDP¹⁵. It is also assumed that the share of concessional debt will gradually decline as Sri Lanka's GDP per capita increases.

Sri Lanka's external debt is below the five indicative debt thresholds used by the Bank and the Fund (Table 2). The ratio of NPV of debt over exports is equal to 128 percent, compared with the indicative threshold of 150 percent. The flow-variables are comparatively better, reflecting the large share of concessional debt. For example, debt service to export is estimated to be 12 percent in 2008, against the indicative threshold of 20 percent.

¹² Excluding Treasury bonds held by foreign investors.

¹³ It should be emphasized that the scenarios presented here are illustrative. Certain simplifying assumptions have been made, which implies that there may not be exact correspondence between the actual repayment profile of the current debt and what is presented here.

¹⁴ Defined as the effective interest rate, adjusted for inflation, measured by the percentage change in the GDP deflator. Nominal interest rates are assumed to ease slightly as the rate of inflation gradually declines.

¹⁵ This assumption is consistent with public capital spending being equal to 7.1 percent of GDP, which is 1.5 percentage points higher than its level during the past decade, to provide room for most of the Government's planned infrastructure investment.

Table 2. Debt sustainability scenarios

	Indicative	--- Baseline Scenario ---		
	Threshold	2008	2018	2028
NPV of debt/export	150%	129%	87%	78%
NPV of debt/GDP	40%	37%	26%	23%
NPV of debt/revenues	250%	222%	129%	88%
Debt service/exports	20%	12%	15%	20%
Debt service/revenues	30%	20%	22%	23%
		1/	--- Higher interest rate ---	
		2008	2018	2028
NPV of debt/export	150%	131%	90%	87%
NPV of debt/GDP	40%	38%	26%	26%
NPV of debt/revenues	250%	225%	134%	97%
Debt service/exports	20%	12%	15%	23%
Debt service/revenues	30%	20%	23%	26%
		2/	--- Lower growth ---	
		2008	2018	2028
NPV of debt/export	150%	135%	97%	101%
NPV of debt/GDP	40%	39%	31%	37%
NPV of debt/revenues	250%	234%	155%	137%
Debt service/exports	20%	12%	16%	26%
Debt service/revenues	30%	20%	26%	36%
			--- Policy Scenario ---	
		2008	2018	2028
NPV of debt/export	150%	127%	85%	75%
NPV of debt/GDP	40%	37%	27%	28%
NPV of debt/revenues	250%	220%	135%	103%
Debt service/exports	20%	12%	15%	21%
Debt service/revenues	30%	21%	24%	28%

1/ A permanent increase of 1 percentage point in the average interest rate is assumed

2/ A permanent 1 percent reduction in growth is assumed.

PUBLIC LIBRARY
JAFFNA
SPECIAL COLLECTION

Under the baseline scenario, the NPV of debt to GDP declines from its estimated 2008 level of 38 percent to 24 percent in 2028. The decline is mostly driven by the growth-interest rate differential, which is initially negative but eventually turns positive as the share of concessional debt declines and is replaced by higher-interest commercial debt (both domestic and foreign).

The external public debt dynamics is relatively more sensitive to changes in growth compared to changes in interest rates. A one percentage point lower growth than assumed in the baseline scenario would have measurable adverse implications for debt dynamics. While the NPV debt/GDP ratio still declines over time, it does so much slower than in the baseline scenario: by 2028 the ratio would be 101 percent¹⁶, compared to 79 percent in the baseline. A permanent one percent across-the-board increase in interest rates (except for concessional debt) has a more muted effect, exactly because of the 'dead weight' of the

concessional debt. The importance of fiscal prudence is also clearly illustrated by the 'policy scenario' in which the primary balance is assumed to improve by one percent of GDP in response to the two adverse shocks described above; this measure brings the 2028 values quite closely back to the baseline scenario. It should be noted that developments in the total public debt are generally somewhat more adverse than for the foreign debt. Again, this is mainly due to the relatively higher share of commercial debt (whether domestic or foreign) in the total debt, compared to foreign debt only.

¹⁶ Note that this increase is a lower bound as it does not take into account the likely deterioration in the primary balance that would accompany the lower growth.

ANNEX 6. CAS COMPLETION REPORT

Country:	Sri Lanka
Date of CAS:	April 23, 2003
Date of CAS Progress Report (PR):	January 6, 2006
Period covered by the CAS CR:	FY04-FY08
CAS CR completed by:	Elaine Tinsley, Country Officer

The objective of this CAS Completion Report (CAS CR) is to evaluate the effectiveness of the World Bank's Country Assistance Strategy for Sri Lanka for FY04-FY07, by examining the extent to which expected CAS outcomes were achieved. The report evaluates the CAS against the outcomes established in the April 2003 CAS and the modified outcomes established in the January 2006 CAS Progress Report (CAS PR). The Bank's performance in designing and implementing the CAS toward achieving these outcomes is also assessed. Finally, the CAS CR identifies lessons relevant to the design and implementation of the next CAS for Sri Lanka.

A. Government Objectives and the CAS Context

At the time the 2003 CAS was being formulated, Sri Lanka was emerging from a period of escalating violence, peace prospects were more positive than they had been in a while, and the economic reform environment was promising. In December 2001, a new Government, headed by Prime Minister Ranil Wickremasinghe, assumed control and moved decisively towards implementing a comprehensive reform program. Soon after, in February 2002, the Government and the Liberation Tigers of Tamil Eelam (LTTE) signed a ceasefire agreement, paving the way for peace talks to end the long-running conflict. By the time the CAS

was submitted, five rounds of peace talks had been completed and the political environment in the country was expected to improve considerably.

The Government's economic program and Poverty Reduction Strategy (PRS) were articulated in its *Regaining Sri Lanka: Vision and Strategy for Accelerated Development (RSL)*¹⁷. The RSL sought to accelerate growth and reduce poverty through private sector-led growth. The principle objectives of the PRS included: (i) building a supportive macroeconomic environment; (ii) reducing conflict-related poverty; (iii) creating opportunities for pro-poor growth; (iv) investing in people; (v) empowering the poor and strengthening governance; and (iv) implementing an effective monitoring and evaluation (M&E) system.

However, in the same month that the CAS was submitted (April 2003), the LTTE suspended their participation in the peace talks. In April 2004, early general elections were held amid a political power struggle and the Government changed. The new Government, under the United People's Freedom Alliance (UPFA), advocated greater state intervention in the economy on many issues. However, it did not fundamentally question past decisions to open the economy and also maintained a positive attitude toward foreign direct investment. The new Government also had a more tentative attitude towards working with the Bank. In November 2005, Mahinda Rajapakse of the Sri Lanka Freedom Party (SLFP) won the presidential election, ensuring the continuity of the economic policies of the UPFA.

¹⁷ The Poverty Reduction Strategy (PRS) was launched in Sri Lanka in 2000 and went through a rather substantial process of consultations and formulation. However, it was not complete at the time of the change in Government in December 2001 and, subsequently, the new Government formed the above RSL-which was added to the existing version of the PRS and submitted to the World Bank and the IMF as Sri Lanka's PRS.

In December 2004, Sri Lanka was hit by a tsunami which killed more than 30,000 people in the coastal areas and made many more homeless. The CAS PR, originally scheduled for FY05, was delayed for a year as the country team focused its efforts on responding to the emergency needs created by the disaster. In December 2005, the CAS PR was prepared to reflect the significantly changed political operating environment. While the program continued to provide strong support to the Peace and Equity pillars articulated in the 2003 CAS, along with added assistance for tsunami-related reconstruction and recovery, it also changed direction. Given the continued uncertainty over both the reform and peace process, the emphasis of the Bank's program shifted from reforms to a core program of investment lending and analytical activities that would support outcomes in the three thematic areas of the CAS (Peace, Growth, Equity), while providing the option of adding policy-based lending in a high case scenario.

In summary, the 2003 CAS was approved in a context that was significantly different from the one in which its implementation took place. Not only have actual developments on the peace front departed from initial expectations but unforeseeable events, like the December 2004 tsunami, have forced adjustments in the shape and reach of the CAS' original objectives and expected outcomes.

B. CAS Objectives and Outcomes

The 2003 CAS was formulated around three central themes: Peace, Growth and Equity. A return to **Peace** was considered critical to create a framework for sustainable poverty reduction. **Growth** was considered the main instrument for achieving prosperity and creating more resources for distribution. **Equity** was important to ensure a balance within society and especially to address the deep pockets of poverty in

the North, South and East. Given the magnitude of Bank activities that had to be restructured to address the needs emerging from the tsunami, a fourth pillar- **Tsunami**-was added during the CAS PR.

On account of the significant changes in the situation on the ground, the 2006 CAS PR introduced several important changes to the Bank's focus and strategy. The changes acknowledged the fact that: (i) the PRS which provided the foundation for the CAS was discarded by the new coalition Government; (ii) prospects for rapid and deep reforms were severely curtailed; and (iii) there was an urgent need to respond to the consequences of the tsunami. The CAS PR introduced a significant shift in the structure of the Bank's activities and a major prioritization and associated reduction (from 33 to 16) of key CAS outcomes. In the revised program of support, the focus moved towards lending operations that: i) supported human development; ii) furthered recovery in conflict-affected areas; and iii) assisted road and irrigation as the core infrastructure needed to support pro-poor growth via reduced transport costs and sustained access to water for agriculture.

Overall, in terms of achievement of its outcomes, the CAS is rated moderately satisfactory:

- The outcomes under the **Peace** pillar are rated *moderately satisfactory*. This rating partly reflects the fact that the expected outcomes under the Peace pillar-as described in the 2006 CAS PR¹⁸-were

¹⁸ As is standard practice, the CAS CR only reviewed the outcomes that were maintained in the CAS PR of 2006. As one of the Bank's first results-based CAS, the original 2003 CAS document was overly ambitious in setting outcome indicators; to monitor and evaluate these was found to be virtually impossible. Moreover, as the CAS PR was conducted a year later than scheduled (due to the need to focus on tsunami-related issues), this provided a longer period over which to assess the direction of the outcomes.

kept adequately realistic (perhaps even conservative). In particular, the two objectives pursued under this pillar were to restore education facilities and increase water supply for irrigation in the conflict-affected areas, both of which were achieved (although the recent outbreak of armed conflict has put the sustainability of these achievements in doubt). Importantly, however, even if it was considered important to show some 'quick gains' from the peace process, it is evident that the achievement of the CAS objectives would not in itself have been sufficient to cement peace, something that those formulating the CAS were keenly aware of. Against this background, the outcomes of the Peace pillar are rated moderately satisfactory.

- The overall rating of outcomes under the **Growth** pillar is, on balance, *unsatisfactory*. While economic growth was broadly in line with expectations (at 6.2 percent during the CAS period, compared to an expected 6.5 percent), the Bank did not achieve several of its stated objectives in terms of structural reforms (for example, increased flexibility of the labor market, improved financial performance of State Owned Enterprises or SOEs, or reduced politicization of the civil service) which would have given confidence that the economy had jumped to a sustained higher growth-trajectory. Even for otherwise satisfactory outcomes—for example, helping the Central Bank refocus on managing its core functions—concerns linger about the sustainability of the achievements.
- Outcomes of the **Equity** pillar are rated *moderately satisfactory*. The positive rating is mainly on account of the Bank's support to strengthening

service delivery in health and education, and because of the positive experiences with a number of community-driven development (CDD) programs. At the same time, it must be emphasized, that although solid data for trends during the CAS period is not available, there is a strong sense in the population that inequalities are widening—both between geographic areas and among various population groups.

- Finally, the outcomes under the **Tsunami** pillar are rated *satisfactory* although there remain concerns about, for example, the equitable distribution of overall tsunami reconstruction efforts. The fact that the Bank's project adopted a 'home-owner driven model', with a high degree of involvement by the ultimate beneficiaries, helped mitigate serious capacity constraints on the part of the agency responsible for overall reconstruction efforts.

It is also noteworthy that throughout the CAS period the task team addressed problems in a timely, realistic and proactive fashion—this clearly helped sustain the progress in project implementation.

Peace Pillar

The original key objectives envisioned for the CAS under this pillar were: i) to restore infrastructure in health, education and irrigation; and ii) build technical capacity to implement the reconstruction and poverty reduction efforts. Moreover, as the North and the East had been starved of investments for the past 20 years and had the highest poverty levels, these areas, in particular, were targeted for assistance. Most of the Bank's efforts under this pillar were addressed through several lending instruments, with the Analytic and Advisory Activities (AAA) playing a minor role.

Table 1. Summary Assessment of Bank Outcomes under the Peace Pillar

Peace Pillar Objectives and CAS Outcomes	Assessment of Bank	Bank Instruments
<i>Restore access to health, education and irrigation in conflict-affected areas</i>		<i>Lend: North East Irrigated Agriculture Project (I and II), North East Emergency Reconstruction Project, North East Housing Reconstruction, and Puttalam Housing.</i>
Outcome 1: Education facilities restored in the conflict-affected areas.	Moderately Satisfactory	
Outcome 2: Water supply for irrigation increased in conflict-affected areas.	Moderately Satisfactory	

Given that the 2002 ceasefire agreement was abrogated and there has been a rise in armed confrontations, it would seem ironic to claim success under the Peace pillar. However, despite the broad connotation implied by the title 'Peace Pillar', the Bank's objectives under this part of the program were more focused on restoring physical infrastructure and improving technical capacity—both of which were achieved. The Bank was even able to continue operating its projects, as compared to other donors, in the conflict areas, due to the local institutional arrangements it had in place for its projects. This said, the reemergence of armed conflict raises concerns about the sustainability of these achievements. Moreover, progress has stalled in some areas due to security and other complications. An example of this is the housing reconstruction project in the North and the East. The renewed conflict has forced the housing project to selectively scale back to safer areas due to supervision constraints and material shortages.

Although the strategic objectives selected under the Peace pillar were realistic and feasible, and have been achieved, the gains could be undone by the resumption of hostilities. The Bank has been able to

restore needed infrastructure—in education, health, water supply and irrigation, rebuild technical capacity, and aid in the resettlement of 84,000 Internally Displaced Persons (IDPs). In addition, IDA support has also helped bring in other donors, thereby extending the number of beneficiaries.

Two specific CAS outcomes were identified for this pillar, and although both have exceeded the project's initial expectations, they are rated only as moderately satisfactory due to the sustainability risk.

Outcome 1: Education facilities restored in the conflict-affected areas

In recognition of the fact that schools are a stabilizing element in communities, the focus on restoring education facilities was deemed an important outcome of the Peace pillar. Educational facilities were rehabilitated and refurnished. Progress was also made in increasing access to education in the conflict-affected areas. In the North and East the number of out-of-school children was reduced by nearly 1,400 in 2006—seven times higher than the target of 200 children.

Outcome 2: Water supply for irrigation increased in conflict-affected areas

Increase in irrigated farming area exceeded initial expectations of the World Bank North East Irrigated Agriculture Project (NEIAP). The original expectation for increasing agricultural production in the project was for 55,000 MT of paddy; however, the latest estimate noted in the Implementation Completion Report (ICR) is 90,113 MT. Likewise, the number of farm families that benefited is 33,250, compared to an initial target of 24,000. The success of the NEIAP led to a follow-on project; however, this faced initial implementation problems and had been redesigned.

The outcome on improving technical capacity was dropped for lack of measurable indicators. However, one of the key successes of the Bank's program was the help it provided to reestablish administration units at the provincial and divisional levels, several of which had been closed down as a result of the conflict. The Bank's North East Emergency Reconstruction Project (NEERP) financed the reconstruction of administrative buildings, procurement of vehicles and training to help strengthen the provincial and divisional administrations. The reopening of divisional administrations was instrumental in allowing the resumption of service delivery and restoring civil service.

Although loosely linked to the CAS outcomes, another major area of activity for the Bank-related primarily to the Peace pillar-was its becoming the potential custodian of two different multi-donor trust funds: (i) the North East Reconstruction Fund (NERF) in 2003; and (ii) the Sri Lanka Tsunami Reconstruction Fund (SLTRF) in 2005. Despite considerable efforts, these trust funds never got off the ground. The NERF ran into difficulties when the peace process was suspended in 2003. The SLTRF could not take off because the

Post-Tsunami Operational Management Structure (P-TOMS) was indefinitely placed on hold following a Supreme Court ruling¹⁹. One purpose of both these trust funds-in addition to mobilizing money for reconstruction-was to enhance trust and confidence between the two parties. It was believed that a trust fund-type vehicle could help support the peace process while further supporting reconstruction and livelihoods/economic development in the North and the East. The close involvement of the Bank in this process is testimony to the high level of trust shown towards it by both the LTTE and the Government at the time.

Growth Pillar

The key results envisioned under the Growth pillar were to: i) create an enabling macro environment for private sector-driven investment and growth; ii) expand employment opportunities and increase flexibility in the labor markets; iii) improve the soundness of the financial system; iv) increase the productivity of the rural economy; and v) improve the quality of public service delivery. Bank interventions in the Growth pillar were primarily through the AAA and a few select lending instruments.

¹⁹ President Kumaratunge negotiated the P-TOMS with the LTTE to oversee reconstruction efforts, including allocation of resources, in the North and the East. It was hoped that this agreement would create a conducive environment for the resumption of the peace process. There was strenuous opposition to the agreement from the People's Liberation Front (JVP) and also concerns from the Muslim community which opposed the deal on the grounds that it was not included as a signatory. With tensions growing, the JVP quit the Government in protest of the impending agreement on June 16, 2005. On June 24, the P-TOMS was signed. The JVP challenged the P-TOMS in the Supreme Court and an interim stay order was issued on July 15, pending a judicial review. On September 12, the stay order was extended and a hearing scheduled for November 21. Subsequently, the Presidential elections held on November 17 resulted in victory for Mr. Mahinda Rajapakse who, during his campaign, had stated that he would abandon the P-TOMS and renegotiate the ceasefire agreement. Ultimately, the hearing on the P-TOMS was indefinitely postponed and the interim order stayed in effect.

Table 2. Summary Assessment of Bank Outcomes under the Growth Pillar

Growth Pillar Objectives and Outcomes	Assessment of Bank	Bank Group Instrument
<i>Create enabling macro environment for private sector-driven investment and growth</i>		<i>Lend: Economic Reform TA (Technical Analysis), Poverty Reduction Support Credit I (PRSC I)</i>
Outcome 3. Higher sustained economic growth	Unsatisfactory	AAA: Development Policy Review, Improving Rural and Urban Investment Climate, Roads Policy Note, Garment and Textile Policy Note, Public Expenditure Analysis TA
Outcome 4. Results-based budgeting system established	Unsatisfactory	
Outcome 5. Improved financial performance of key state-owned enterprises (SOEs)	Unsatisfactory	<i>IFC: Investments in banking and telecommunications sectors. Technical assistance program in the tourism and financial services sectors.</i>
<i>Expand employment opportunities and the flexibility of the labor market</i>		<i>Lend: Economic Reform TA, PRSC I</i> AAA: Development Policy Review
Outcome 6. Legal framework to increase flexibility in labor markets and promote harmonious labor relations	Unsatisfactory	<i>IFC: Investments in banking and telecommunications sectors. Technical assistance program in the tourism and financial services sectors.</i>
<i>Improve the soundness of the financial system</i>		<i>Lend: Central Bank strengthening</i>
Outcome 7. Central Bank of Sri Lanka (CBSL) re-focused towards managing its core functions	Satisfactory	AAA: Access to Finance, Housing Finance <i>IFC: Investments and technical assistance in the banking sector.</i>
<i>Increase productivity in the rural economy</i>		<i>Lend: North East Irrigated Agriculture Project (I and II), Renewable Energy for Rural Development, Community Water Supply II, Road Sector Assistance, North East Housing Reconstruction.</i> AAA: Rural and Urban Investment Climate, Agriculture Research and Extension
Outcome 8. Off-farm income generation activities promoted through sustainable rural electrification, including in conflict-ridden areas.	Satisfactory	
<i>Improve the quality of public service delivery</i>		<i>Lend: Economic Reform TA, E-Sri Lanka, Legal and Judicial Reform</i>
Outcome 9. Politicization of the civil service reduced and public service accountability improved	Unsatisfactory	AAA: Country Procurement Assessment Review, ROSC Accounting and Auditing Assessment, Governance Policy Note, Decentralization and Service Delivery, PER Policy Dialogue

The CAS originally envisioned using a series of programmatic Poverty Reduction Support Credits (PRSCs) to provide budget support in implementing the PRS and to tackle the economic reforms needed to promote private sector activity. The PRSC I outlined the broad policy direction and indicative prior actions for subsequent PRSCs. The three subsequent PRSCs were to build on earlier actions and deepen policy and institutional reforms. PRSC II was to focus on rural development and welfare system reform. PRSC III was to focus on public sector reform, including the rationalization of administrative structures and the size of the civil service. And PRSC IV was to follow up on the areas that the Development Policy Review (FY04) was expected to identify. However, the weakening in the dialogue with the Government resulted in the PRSC series being discontinued. Although the CAS PR still included the PRSCs in the lending program as standby operations, no opportunity arose to conduct another PRSC. As a result, instead of having a strong reform agenda supported by a series of programmatic support credits, the program became more focused on capacity building activities that were supported by a strong AAA program and selected technical assistance activities.

On the first objective of the Growth pillar-creating an enabling private sector environment-three outcomes were identified: growth, results-based budgeting and SOE reform. The Bank Group's contribution to these objectives and outcomes has primarily been in the form of AAAs and a limited IFC investment and technical assistance program. Several of these AAAs were initiated under a Government that was contemplating further and extensive reforms, but by the time the AAAs were completed the Government had changed and was not interested in the policy dialogue outlined in the reports. Therefore, although

the quality of the AAAs was rated satisfactory by the Quality Assurance Group (QAG), the likely impact was rated only moderately satisfactory. The key lending instrument (Economic Reform Technical Assistance-ERTA) that was to provide support for capacity building in the Government for reforms, ended up being less effective with the new Government (the project was closed early and the remaining funds transferred to the tsunami project). And while economic indicators show support of private sector development-in the form of higher growth and private investment-these are short-term developments that have not yet stood the test of time. The economy remains vulnerable to weaknesses in macro-management, as evidenced by continued high fiscal deficits and accelerating inflation (though the last has been caused in part by the fiscally prudent removal of subsidies on fuel and food).

Outcome 3: Higher sustained economic growth

Overall, the Sri Lankan economy has continued to expand at a relatively high rate, averaging over six percent annually during 2004-2006. While some of this growth is attributed to reconstruction efforts following the tsunami, in general growth has been broad-based and resilient despite possible detrimental setbacks such as the escalating conflict, the end of the Multi-Fiber Arrangement and high oil prices.

The two key AAA studies the Bank conducted to identify what is needed for higher economic growth in Sri Lanka were both rated satisfactory. The Development Policy Review (DPR) concluded that an unfinished reform agenda and relatively low investments have combined to hold back long term growth in Sri Lanka. The lack of investments in agriculture accounts for the poor growth performance and high poverty incidence in the rural economy.

Policy recommendations suggested are improved public financial management, including public debt reduction, the rationalization of public spending, and public investments in roads and power. In addition, the DPR recommended improving the performance of SOEs, followed by fiscal consolidation and adequate tax policies. Growth prospects for a small open economy such as Sri Lanka will depend on accelerating policies for export growth, implementing a competitive real exchange rate, and avoiding trade policy reversals. The DPR also identified the importance of improving education quality to sustain long-term growth. The Government endorsed some elements of the DPR diagnosis, emphasizing investments in infrastructure and education while economic reforms took a back seat. In the Rural and Urban Investment Climate study, the key recommendations were to improve access to and quality of energy and transport, reduce costs and improve access to finance, and improve policy uncertainty and macroeconomic stability.

Higher sustainable growth will require reliable sources of energy. To this end, in the power sector, the Government, with the Bank's assistance, has moved more progressively toward renewable energy. It plans to set up an authority to facilitate wind, biomass, solar power, and other mini hydro projects, with the expectation that the renewable energy sector will meet at least 10 percent of the country's total power requirements by 2015.

Although Sri Lanka, recently, has been successful in attaining high rates of economic growth, further supportive reforms and prudent economic management that contain the current inflationary environment would most likely be needed to sustain such high growth rates in the medium-term.

Outcome 4: Results-based budgeting system established

Overall, the budget is broadly linked to the Government's development priorities and strategies as contained in various strategy documents, though more work is needed to explicitly link policies, priorities and outcomes with the budget. Although budget preparation involves increased consultations between the Ministry of Finance (MoF) and spending ministries, there is still no formal forum for contestation at the Cabinet level. The Government has introduced a medium-term budgetary framework (MTBF) to strengthen the strategic focus of the budget but this remains, primarily, input-based. When the government changed in 2004, the new Government indicated that it did not want to work with the Bank in budget formulation; as a result the Bank stopped work on this task in mid-2004. Instead, similar work was taken up by the Asian Development Bank (ADB), which is helping the Government to improve its budget framework and overall public financial management. In 2005, the Government requested that the ministries and spending agencies start providing results-based indicators to facilitate the monitoring of the effectiveness and value of expenditures, thereby contributing to more predictable budget outcomes. The Bank became re-engaged in this sector through conducting a series of public expenditure TAs.

Outcome 5: Improved financial performance of key SOEs

The need for enterprise restructuring was also recognized by the current Government, with the principle difference that privatization was ruled out. The Bank remained open to this approach and even engaged with SEMA (Strategic Enterprise Management Agency), the agency charged with overseeing the restructuring of twelve SOEs. The outcome was mixed.

The restructuring of state-owned banks, which had commenced before the previous Government, resulted in improved profitability and financial performance. The key focus, however, has primarily been on improving the performance of the Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB), and this has been less successful. Only recently were some key difficult measures taken to improve the financial performance of these key state enterprises. In 2006, the Government eliminated oil subsidies and some electricity tariff adjustments were made in the last quarter of the year. However, the CPC continues to suffer losses on the order of a quarter to half percent of GDP due to delays in price adjustments of oil products. For the CEB, the losses are more significant (1.5 percent of GDP in 2005). As losses for both SOEs are partly financed through bank credits, this heightens the exposure of the public banks and, given their dominance in the banking sector, risks exposure of the whole financial system. Reforms in the SOEs have fallen far short of what was originally envisioned.

The key Bank instrument to help with the SOE reforms was the Economic Reform TA (ERTA) and the PRSC I. In this respect, major changes were made to the legislative framework to allow for greater private sector participation in infrastructure (for example, Electricity Reform Act, Petroleum Products Act, Petroleum Regulations Act, and Public Utilities Commission Act), establish a multi-sector regulator, and train key staff members. The rail reforms achieved included transforming the Department of Railways into an independent Rail Authority. However, this progress was quickly reversed as the Authority was turned back into a Department and all private sector participation was put on hold. Impasses with the Government over the reforms ended up shifting the project almost

entirely away from its progressive reform focus to only providing funding for training, capacity building and study tours. Although the project was designed to be flexible and it was recognized that not all the reforms would be implemented, far less was achieved than originally anticipated.

Outcome 6: Legal framework to increase flexibility in labor markets and promote harmonious labor relations

Higher growth, not surprisingly, has helped expand employment opportunities, with the result that unemployment has gone down from 8.1 percent (2003) to 6.5 percent (2006). However, though this meets the CAS objective of expanding employment, labor market constraints continue to represent one of the top constraints to doing business in Sri Lanka. Hiring is constrained by limitations on the use of fixed-term contracts, working hours are inflexible, and workers are strongly protected from dismissal both by procedural difficulties and high firing costs. The PRSC I supported the enactment of key legislative changes to reform Sri Lanka's labor regulations with the objective of reducing costs and increasing transparency. The rules governing the Termination of Employment of Workmen's Act (TEWA), which apply to firms with at least 15 employees, were amended in 2003 to require the application of a uniform compensation formula for retrenchment. In addition, the Industrial Disputes Act was changed to impose time limits for completing labor tribunal cases, arbitration cases, and termination of workers' applications. However, following the change in Government, the quantum of severance payments under the formula was revised in March 2005 due to trade union pressure and, as a result, Sri Lanka's severance pay system is one of the costliest and most restrictive in the world—severance payments are 1.5–2.5 months of wages per year of service, compared to 0.8

months in the region. Notwithstanding these limitations, the formula has made the system more transparent and predictable.

Outcome 7: Central Bank re-focused towards managing its core functions

The Bank played an instrumental role in supporting the restructuring and reorganization of the Central Bank of Sri Lanka in order to create a more lean, well-functioning, modern, and efficient institution that would be at the center of the reform of Sri Lanka's fragile financial system and thereby help achieve the CAS objective of making the system more sound.

Despite the still dominant presence of the State in the banking sector (accounting for over 40 percent of total banking assets), significant progress had been made in improving the soundness of the financial system—the reduction of non-performing loans from 12.5 percent of total loans in 2003 to 5.4 percent in 2006 is one clear sign of this. The sector was liberalized in 2003 when the Government permitted 100 percent foreign ownership of commercial banks. The Central Bank has continued to strengthen its bank supervision capacity and has adopted a more market-oriented monetary policy regime. Following the amendments to the Banking Act, the Central Bank has tightened prudential norms, capital standards, loan classifications, exposure limits, public disclosure, and market discipline. Legislative changes have been made to fill the gaps in the regulatory framework (for example, Financing Leasing Act, Suppression of Terrorist Financing Act and Payments Act, and the anti-money laundering Financial Transactions Bill). Under a restructuring plan, net profits and deposits at the state-owned banks have risen and the ratio of non-performing loans has fallen.

While improving the role of the Central Bank is a key aspect of financial stability—for which the Independent Evaluation Group (IEG) review commended the

Government's performance as highly satisfactory—the Bank's AAAs on Access to Finance and Housing Finance have opened up other entry points to deepen financial intermediation to help spur economic growth.

Outcome 8: Off-farm income generation activities promoted

A key means to enhancing rural productivity and income was to increase access to sustainable rural electrification as a means of helping generate off-farm income. In this respect, the Bank achieved notable success. Following the funding of the RERED project for \$75 million, an additional financing of US\$ 40 million was approved in June 2007 to help bring electricity to remote rural communities and promote private sector investments in power generation from renewable energy resources in urban areas. Other means of increasing rural productivity and incomes were identified in the Bank's AAA on Rural Investment Climate and in the Agriculture Research and Extension System Review - the latter cited the need for Sri Lanka's agriculture extension system to become more market-driven rather than supply-driven, as a better means of increasing farmers' incomes.

With the state owning 85 percent of the land, with limited land use and transfer rights, another key means to improving the rural economy was to improve the functioning of land markets. As noted in the CAS, a major constraint to rural development was the regulations preventing farmers from converting restricted land grants to freehold—these had to be changed so farmers could more readily sell, lease or use their land as collateral. The PRSC I addressed this issue. The Government was to remove restrictions on 1.4 million hectares, though progress on this has been slow. Also, legislation was introduced to address these concerns but has been challenged in the Supreme Court and is now stalled.

Outcome 9: Politicization of civil service reduced and public service accountability improved

Improving the functioning of the civil service was seen as a key element to make the Government more efficient and responsive to the public. A better functioning Government would better support the private sector and lead to higher growth. However, rather than streamlining the public sector and despite fiscal pressures the public administration has continued to expand.

Overall, this was one of the outcomes that the Bank had the least success in. Not much progress was made on reducing the politicization of the civil service and, in fact, evidence on implementation in several IDA projects suggests a worsening of political interference. The series of PRSCs and a Government capacity building project, which were to be the key vehicles to achieve the outcome, never materialized in the case of the former and the latter has been under preparation for over two years. However, the Bank in early 2004 helped persuade the Government to put on hold a Voluntary Retirement Scheme (VRS). The VRS did not have sound exit provisions and, if implemented, would have resulted in large expense and the planned retrenchments would have been easily reversed.

Towards achieving the CAS outcome of improved public service accountability, the financial management team has been engaged in a wide range of activities including: (i) carrying out a gap analysis of Sri Lankan accounting and auditing practices (compared to international standards) that is currently being translated into an implementation action plan; (ii) convening key stakeholders to launch a Public Expenditure and Financial Accountability (PEFA) exercise; and (iii) capacity building to meet International Public Sector Accounting Standards'

(IPSAS). Steady progress is being made toward adopting the accrual basis of accounting at the country level.

E-government was seen as having a high potential to make the Government more accessible to citizens and businesses. Moreover, the open-access nature of the internet would provide more equitable opportunities for marginalized groups, geographically and economically, to attain Government information and services. To this end, the Bank's E-Lanka project is set to improve the information and communication technology (ICT) services of the Government, though the project is experiencing implementation challenges due to procurement delays.

To make the **legal and judicial sector** more attuned to modern business needs, the Bank has been involved in providing the required physical infrastructure to modernize the court system, improve the efficiency of proceedings and reduce the backlog of cases. Overall, the Bank's Legal and Judicial Reform Project was rated moderately unsatisfactory, in large part because delays in project implementation negatively affected achievements of outcomes, and because several project components were dropped, diminishing expected outcomes. However, the Bank's project enhanced the capacity of the Law School by improving the curricula in commercial law and enhancing the capacity of the teaching faculty with international and local training. Skills have been improved in other agencies such as LD and the Attorney General's department by providing and institutionalizing training to sustain the capacity building exercise for expediting the legislative process. In addition, the judicial staff has received international training on court administration and new commercial concepts to improve the quality of the judiciary and enhance their knowledge of advanced commercial practices.

Equity Pillar

Under the Equity pillar, the key outcomes envisioned for the CAS were to: i) improve access to and the quality of public services in education, health and water supply; and ii) expand the empowerment of communities to address their own development needs. These issues were addressed in the CAS by a mix of

both AAAs and lending products. The AAA products sought to identify the conditions of poverty, whereas the lending products employed community-driven development projects, which could target the poorer communities via selection criteria, as the key means of empowering communities and thereby improving service delivery.

Table 3. Summary Assessment of Bank Outcomes under the Equity Pillar

Growth Pillar Objectives and Outcomes	Assessment of Bank	Bank Instruments
<i>Improve overall equity in the country.</i>		<i>Lend:</i> All projects listed in the pillar
Outcome 10. Reduction of poverty; improvement in social outcomes in the estates sector, and; better targeting of welfare programs to the poor.	Moderately satisfactory	AAA: Attaining Millennium Development Goals (MDGs), Poverty Mapping, Poverty Assessment, Poverty and Social Impact Analysis, Social Protection Note, Development Forum: Lagging Regions, and Tea and Rubber Estate Study,
<i>Improve the quality of the basic education system</i>		<i>Lend:</i> General Education Project, Education Sector Development, Improving Relevance and Quality of Undergraduate Education
Outcome 11. Investment in education increased, especially in poor schools	Satisfactory	AAA: Education Sector Report
<i>Improve health status of the population</i>		<i>Lend:</i> Health Sector Development
Outcome 12. Effectiveness in the health sector's use of existing resources improved	Moderately Satisfactory	AAA: Poverty and Social Impact Analysis
<i>Curb spread of HIV infection</i>		<i>Lend:</i> Health Sector Development, National HIV/AIDS Prevention
Outcome 13. Health awareness increased to ensure that HIV prevalence rate remains low	Unsatisfactory	
<i>Improve access to services in the poor districts</i>		<i>Lend:</i> Gemi Diriya, Community Water Supply, and Sanitation
Outcome 14. Number of empowered communities implementing sub-projects contained in their development plans expanded	Satisfactory	AAA: Decentralization and Delivery of Services

The most recent poverty survey was conducted in 2006-7 and the Department of Census and Statistics has recently reported that the national poverty headcount (excluding the North and most of the East), as measured by the Household Income and Expenditure Survey (HIES) 2006-07, is 15.2 percent, which is a sharp decline from the 23 percent headcount reported in 2002. This positive development is coupled with the good news that most of the reported decline has occurred in regions outside the Western Province (WP), reducing somewhat the large gaps seen in 2002 between WP and the rest of the country. However, at least in the non-conflict areas, the challenge of accelerating and sustaining growth in the poorest provinces and estate sectors remains.

Outcome 10: Improve equity and social outcomes in lagging rural areas and estates

Improving overall equity in the country means addressing poverty in the lagging rural areas and in the estates, which are where the poorest can be found. Bank interventions to address this outcome relied primarily on AAA studies that identified the poor and made recommendations on how their equity and social outcomes could be improved.

A key instrument to identify the poor was the Poverty Mapping TA exercise. It helped the Government compare poverty levels with the coverage provided by *Samurdhi*. It also uncovered the extent of mis-targeting and helped generate a consensus on the need for better targeting.

The people living on the estates are among the poorest in the country. The prevalence of malnutrition among children under the age of five is nearly 33 percent in the estates compared to 13 percent among children in other rural areas. While the CAS mentions

estate communities as a target group, intervention in this area has so far been limited to one AAA on the Tea and Rubber Sector. The analysis sheds light on the deteriorating conditions in the sector and the growing discrepancy in poverty indicators between estate workers and other rural workers. It recommends the sector undertake efforts to improve the living and economic conditions of the estate workers. A pilot program under CWSSP II is providing water supply and sanitation services in eight estate communities. The lessons learned will help scale up interventions under the proposed *Gama Neguma* operation.

Outcome 11: Increase investment in education

In the education sector, several positive results were achieved under the Education Sector Development Project (ESDP) and the Improving Relevance and Quality of Undergraduate Education Project (IRQUE), which have both shown satisfactory implementation progress, in large part due to strong commitment by the education authorities. Among the notable results is a reduction in the number of out-of-school children by 12,000-four times the targeted number of 3,000 children-and an increase in the share of qualified teachers to 88 percent, against a target of 86 percent. The Government has also emphasized improving learning outcomes in schools where the national assessments of cognitive achievement have shown low learning levels-such as schools in conflict-affected areas, poor rural schools, and schools in the estates sector. The AAA effort underpinning sectoral interventions has been generally strong and effective, with the 2005 Education Sector Report complemented by the MDG Review and Poverty Assessment. Nevertheless, there remain significant challenges to improve quality and relevance of the education system in Sri Lanka, at the primary, secondary and tertiary levels.

Outcome 12: Improve effectiveness of health sector resources

In the health sector, the strategic relevance, thrust and implementation track record of the ongoing Health Sector Development Project (HSDP) has been moderately satisfactory. This project supports the difficult process of transformation towards a results-based, decentralized service delivery model, while attempting to improve the focus of interventions on preventive care services. Progress has been steady at the district and provincial levels but less clear at the central level where problems associated with resistance to change are compounded by the complexity and overly ambitious design of the central level-related components. The process of increasing allocations to the provincial councils and districts was reversed in 2007 and there were attempts to recentralize several health functions. The funds released to provincial councils were reduced, particularly for capital expenditure. Of some concern are the lack of satisfactory monitoring and evaluation (M&E) arrangements which hamper the tracking of results and progress towards expected outcomes.

Though the number of districts performing at a minimum standard for various health indicators has risen, the amount spent per capita has also increased. Therefore, although progress has been made on the CAS' strategic objective of improving the health status of the population, whether this has been brought about by improved effectiveness in using existing health sector resources or because more money is being spent on a per capita basis is inconclusive.

Outcome 13: Keep prevalence rate of HIV low by increasing awareness

Sri Lanka has one of the lowest prevalence rates of HIV in Asia with only an estimated 5,000 people living with HIV out of a population of 20 million (<0.025%).

The challenge is to keep this rate low. Starting in 1992, the Government initiated HIV control and prevention measures. There are several coordinated efforts among the different Government agencies to reduce transmission and prevent further spread of HIV (for example, screening 90 percent of all blood donations, mass media awareness campaigns, etc.). While overall awareness is high, HIV awareness and knowledge levels in underserved communities remain drastically low. Only 40 percent of women working in rural tea estates, for example, have even heard of HIV/AIDS, as compared to 90 percent of women in other rural and urban areas.

The Bank's support focuses on improving prevention efforts for highly vulnerable sub-populations and the general population; enhancing surveillance and M&E systems; reducing stigma and discrimination against people living with HIV and groups at highest risk; and addressing the synergy between tuberculosis and HIV. Prior to the 2003 CAS, the Bank successfully supported the above endeavors through the Health Sector Development project. The new HIV/AIDS project, however, is more problematic. While good progress has been made on the TB and blood transfusion programs and some of the awareness-raising activities at the provincial and district levels, the prevention interventions and activities to strengthen health institutions, which were expected to be implemented by the Ministry, have been plagued by managerial and fiduciary problems.

Outcome 14: Number of empowered communities implementing sub-projects contained in their development plans expanded

Building on the global successes of community-driven development projects, this outcome was selected to track the outreach of community-managed projects.

Sub-projects that are selected and managed by communities address the immediate needs of communities and, in the medium-term, tend to be better maintained. The CAS had several projects with this focus, namely *Gemi Diriya*, RERED and the Second Community Water Project - all are successful operations that are in the process of being scaled-up/replicated. Overall, with the exception of projects in the North and the East, implementation progress has been good. Carefully designed community-driven development (CDD) approaches account for this success and the recently restructured Second North East Irrigated Agriculture Project (NEAIAP) II has been strengthened along similar lines. Impressed with the achievements of the *Gemi Diriya*, the Government has decided to employ its principles to *Gama Neguma*, the Government's flagship rural development project.

Tsunami Pillar

In response to the December 2004 tsunami, a portfolio restructuring of eleven projects was conducted in February 2005 to provide US\$ 75 million in emergency support for tsunami reconstruction. Given the redirection of a substantial amount of the Bank's portfolio, the CAS PR created a new pillar under which the progress of tsunami-related activities could be monitored. Under the Tsunami pillar, the key outcomes to be measured were: 1) restoration of housing for the poorest households in the affected districts; and 2) rebuilding the livelihoods of the tsunami-affected families to help revive the local economies of the affected districts.

Table 4. Summary Assessment of Bank Outcomes Under the Tsunami Pillar

Tsunami Pillar	Assessment of Bank	Bank Instruments
<i>Restore livelihoods destroyed by the tsunami and start the recovery and reconstruction process</i>		<i>Lend: Tsunami Emergency Reconstruction Project (I & II)</i>
Outcome 15. Restored housing of the poorest households in affected districts	Satisfactory	AAA: Preliminary Damage and Needs Assessment, Development Forum: The Economy, Tsunami, and Poverty Reduction
Outcome 16. Livelihoods of the tsunami-affected families rebuilt to help revive the local economies of the affected districts	Satisfactory	

The agency responsible for Sri Lanka's reconstruction efforts-TAFREN/RADA²⁰ -has suffered from a serious lack of capacity to handle the massive aid inflows and has been ineffective in dealing with donors, including NGOs. This has created many problems, especially related to the donor-driven housing reconstruction program which was to construct houses for and resettle many of the affected families. Many of the reconstructed residential areas have been developed without due attention to environmental and social issues, provision of basic services, and at a distance from employment opportunities. In addition, there is the perception that reconstruction aid has been unequally directed and, in fact, significant geographical inequalities have materialized. Compounding this is the resumption of the conflict which means that access to the North and the East has become increasingly difficult. As a result, the South and the West have received more aid than the North and the East. In fact, in some Southern districts, more houses have been rebuilt than were damaged by the tsunami.

Despite this context that casts a cloud over Sri Lanka's overall tsunami reconstruction efforts, the IDA-financed operations have been relatively successful. A significant share of the support (TERP I & II) has gone towards restoring livelihoods and rebuilding houses (through a homeowner-driven model), with lesser amounts made available for reconstruction of health and road infrastructure and costs associated with the operations of key implementing agencies such as RADA. Indeed, the health expenditure portion of the tsunami projects was the least successful component due to weak institutional arrangements in the Government. The tsunami-damaged roads from Kalutara to Matara (114 km) have also been rehabilitated.

Overall, these outcomes were successfully achieved with, as in the other projects, implementation problems faced in the North and the East. Still, the Bank was more successfully able to operate in the conflict areas than NGOs, mainly because of its reliance on local counterparts and agencies to implement works in the conflict areas.

Outcome 15: Restored housing of the poorest households in affected districts

For the 42,000 families eligible for housing cash grants, about 23,500 partially damaged houses have been fully repaired (97 percent), along with 15,600 fully-damaged houses (62 percent). As with other projects, most of the uncompleted houses are in the North and the East. The housing program is wrapping up in the South and the West but some areas of the North and the East are expected to continue to experience a lack of or very slow progress due to the poor security situation²¹.

²⁰ The Task Force for Rebuilding the Nation (TAFREN) was created soon after the tsunami, with the mandate to provide overall coordination of tsunami-reconstruction activities. Following the November 2005 election, TAFREN was renamed as the Reconstruction and Development Agency (RADA).

²¹ While 90 percent of the fully-damaged units in the South and the West have been reconstructed, only 57 percent of the units in the North and the East have been completed.

Outcome 16: Livelihoods of the tsunami-affected families rebuilt to help revive the local economies of the affected districts

More than 100,000 affected families received four installments each of the cash grants. Disbursement of the livelihood cash grants was successfully concluded in 2005.

Capacity Building

Following on the previous CAS CR recommendation to enhance capacity-building, the 2003 CAS placed special emphasis on this area. To realize the capacity-building objectives, numerous sectoral and TA operations, as well as key pieces of the non-lending program-carried out jointly with local counterparts-were included in the program. All investment operations approved during the CAS period contained institutional strengthening or capacity-building components, and approximately 20 percent of the total funding approved was allocated towards these activities.

Major efforts continue to be directed towards the strengthening of institutional and human capacities in the fiduciary areas (procurement, financial and safeguards). The IDF-financed public procurement strengthening program has also shown that a more demand-driven, competence-based skills enhancement program, which draws resources from the private sector and professional institutions, is required. Reasonable progress is being made in procurement, with the Country Office staff providing significant training and other forms of capacity-building support to the procurement staff in numerous ministries/agencies, with a view to fostering the use of local systems in Bank operations. The Bank's expanding governance agenda calls for a similarly robust effort on the financial management front. Improved institutional

capacity has been a major achievement of the Bank's current environmental support, and proposals put forward by the Environment Unit are aimed at consolidating these achievements by fostering the integration of the environmental capacity built being effectively used to monitor IDA projects in the broader sector agency and ministry programs.

The Bank has also been deeply involved in supporting the design and implementation of improvements in the functioning of the public procurement system. The procurement team conducted a Country Procurement Assessment Review (CPAR) in 2003, jointly with the Government and other key donors. The recommendations in the CPAR became the road map for the Government's reform efforts. In 2004, the National Procurement Agency (NPA) was set up under a directive issued by the then President Chandrika Kumaratunge. Supported by an IDF grant from the Bank, the NPA spearheaded an active and dynamic reform program that included: issuing new procurement guidelines; mandating the use of standardized documents in all procurement transactions; creating the Procurement Appeal Board; establishing a public procurement cadre and procurement cells in most of the large procuring entities; reducing the number of unsolicited procurements; initiating a computerized system for procurement monitoring; and launching an extensive procurement capacity-building program. The Bank also provided assistance to the NPA in conducting a self-assessment of its own performance, as part of the pilot OECD-DAC effort on Strengthening Procurement under the Improvement of Aid Effectiveness initiative. The recent decision to disband the NPA has, however, resulted in increased uncertainty about the future functioning of procurement systems in the country and has set back the planning towards increasing reliance on country systems in procurement.

C. MEASURING BANK GROUP PERFORMANCE

1. Quality of Products and Services

Lending

During the CAS period under consideration, ten World Bank projects were closed-ICRs were completed for all ten projects and eight were reviewed by the Independent Evaluation Group (IEG). Table A4 presents the results of both the completed ICRs and the IEG ratings. Overall, the project ratings were mixed, with about half the projects rated either satisfactory or highly satisfactory. Projects that closed in the early part of the CAS period were generally rated satisfactory. Projects that closed in the latter part of the CAS period and had gone through the change in Government administration and policy direction were, not surprisingly, rated more poorly. There is mostly consistency between the ICR and IEG ratings on the outcomes, although of the eight projects reviewed by the IEG, two were rated one category below the ICR ratings. But given the worsening governance trend, it could be that by the time the IEG ratings were done, the outcomes and sustainability were less likely to be achieved. During the CAS period, IFC invested \$62 million in four projects with three companies in the financial services and telecommunications sectors. These investments are performing well.

During the CAS period, there was a Quality at Entry Assessment (QEA) for one project and Quality of Supervision Assessments (QSAs) for three projects (Table 5). Despite the 5-year project preparation time, the QEA rating for the Second Community Water project was positive. QSAs for the other three projects were far less favorable. Although the sample of the other three is too small to extrapolate to the overall lending portfolio, it does raise a few key general issues.

First, the projects need to have well-defined development objectives that are stated in terms of key outcomes sought. This enables an adequate M&E framework from which the project's progress can be judged and key learning captured. Second, the Implementation Status and Results (ISR) reports should be used by the task teams to frankly raise issues of concern for management attention-of the QSA subcategories, Candor and Quality of the ISRs was the worst rated, followed by Focus on Development Effectiveness. On the other hand, Supervision of Fiduciary/Safeguards was rated positively in all the QSAs.

Economic and Sector Work

In terms of planned versus actual deliverables, of the original 14 studies planned in the CAS report for FY04-

Table 5. QEA and QSA Reviews in the CAS Period

	Date Approved	Assessment Date	Overall Rating
QEA			
Second Community Water Project	05/06/2003	06/30/2003	2
QSA			
Distance Learning Initiative	03/05/2001	09/01/2004	4
Teacher Education & Teacher Development	06/13/1996	09/15/2004	3
Legal and Judicial Reforms – Stage II	06/20/2000	11/09/2006	5

06, three were dropped (Table A3). All three were planned for FY06 and were replaced by other studies. Between FY04 and FY06, 20 reports were delivered, six more than the initial number envisioned. Four additional reports were delivered in FY07, bringing the total tally in the CAS period to 24 reports. Ten of these studies were policy notes. Of the seven new studies identified in the CAS PR, only one has been dropped (Youth Transitions, planned for FY06). However, to date, there are no plans to conduct the study, Urbanization, which was requested by the Government and initially planned for FY08. The average time taken to complete each Economic and Sector

Work (ESW) was about 12 months, with five studies taking over 18 months.

In the fall of 2006, the QAG undertook a review of the AAAs in Sri Lanka. Table 6 shows the ratings received by the different studies within the CAS period that were reviewed by the QAG. Overall, the ratings point to a satisfactory assessment of the AAAs. In particular, the review strongly showed the strategic relevance of the AAAs. However the weakest aspect of the AAA work was found to be the 'Likely Impact'.

Table 6. QAG Ratings of AAA Work in Sri Lanka

AAA	Year Delivered	Strategic Relevance	Internal Quality	Participation, Consultation and Dissemination	Likely Impact	Bank Inputs and Processes	Overall
Decentralization and Delivery of Services	2006	1	2	2	3	2	2
Public Sector Reform Policy Note	2006	2	2	2	3	2	2
Sri Lanka PER (1)	2006	1	2	2	3	2	2
Poverty Assessment	2006	2	2	2	2	2	2
PSIA	2006	2	2	3	2	3	2
Rural Investment Climate	2005	2	2	2	3	2	2
MDG Assessment	2005	2	4	2	2	3	3
Public Sector Reform TA	2004	2	2	2	5	2	3
LK-PER (2)	2004	2	4	5	4	4	4
Development Policy Review	2004	2	2	2	3	2	2
Average (3)		1.8	2.2	2.1	2.9	2.2	2.2

Ratings: 1-Highly Satisfactory, 2-Satisfactory, 3-Moderately Satisfactory, 4-Moderately Unsatisfactory, 5-Unsatisfactory, 6-Highly Unsatisfactory

(1) This is a non-lending TA.

(2) In a second-stage panel review, it was recognized that the PER had been wrongly coded as an ESW when it should have been a nonlending TA, especially as no formal report was delivered. In light of this error, the QAG panel saw no basis for and no need to review the previous ratings.

(3) Averages do not include the LK-PER.

When the studies were initiated, most had strong ownership by the Government. The objectives of the studies were well-aligned with the CAS and PRSP, leading to high QAG ratings on the strategic relevance of the AAAs. However, by the time the studies were completed QAG found that the recommendations were watered down and too general, which did a disservice to the good quality analysis arising from several of the AAAs, and was a key reason for the low ratings of 'Likely Impact'. This was particularly true for the AAAs under the Growth pillar where dialogue with the Government on public sector reforms stalled. The other ratings (Internal Quality Participation, Consultation and Dissemination, and Bank Inputs and Processes) were favorable as there was considerable outreach to stakeholders and Government officials; efforts were also made to co-author some studies with the Government and thereby build capacity within the Government.

2. Portfolio Performance

During the CAS period, the number of projects remained fairly constant, with around 16-18 projects a

year, and commitments varying from US\$ 693 million to US\$ 867 million. While problem projects were fairly limited in the first three years, at one point, this number rose to four in FY07, mainly due to the escalation in violence and the implementation problems of accessing conflict-affected areas. Other problems rose due to increased politicization in personnel selection or lack of Government commitment in properly staffing the implementing agency. Despite the entrenched and external problems, projects at risk were kept under control, leading to realism and proactivity rates of 100 percent.

In terms of disbursement, the average disbursement ratio for Sri Lanka during this period was 27.9 percent. And as Table 7 shows, the Sri Lanka disbursement ratio was better than that for the region and the Bank during this period.

Table 7. Portfolio Performance Indicators

Indicator	FY04	FY05	FY06	FY07
Number of Projects	17	18	16	13
Net Commitment Amount	693.4	867.4	806.6	786.4
No. of Projects at Risk	2	1	1	2
Commitments at Risk (%)	4.4	0.6	8.0	8.3
Realism (%)	100	100	100	100
Proactivity (%)	100	100	100	100
Disbursement Ratio	25.6	27.4	28.9	29.6
<i>SAR</i>	21.6	26.2	27.8	24.7
<i>Global</i>	21.4	23.4	23.9	22.9

Source: Business Warehouse

D. Aid Coordination

During the CAS period, the Bank has worked effectively with its development partners, particular in two key areas where donor coordination has been most active and critical: the conflict and the tsunami.

The Conflict

Following the 2002 cease-fire agreement (CFA), there was an increased level of consultation between the Government and its development partners, and also within the development partner community. During this time the Multilateral Group - which included the World Bank Group, IMF, ADB, the regular United Nations (UN) Agencies, and the International Organization for Migration (IOM) - was formed. This Group continues to meet regularly, once a week, and has established a close working relationship. By mid-2004, the Administration and the development partners created a more systematic coordination framework, leading to deeper sector-wide coordination and policy dialogue. A high-level Donor Assistance Coordinating Committee (DACC) was created, comprising of key senior Government officials and the Heads of Donor Missions. The core remit of the DACC was to have a dialogue/updating between the authorities and development partners on the national development strategy and the planning and utilization of support for its implementation, ensuring a focus on poverty reduction while contributing to the achievement of the MDGs.

The Tsunami

During the early days following the December 26, 2004 tsunami, a large amount of assistance was spontaneously offered by individuals, NGOs and the private sector. Coordination was made difficult by the large number of agencies and organizations involved, and by the sheer size of the affected area. The UN system helped greatly in establishing the Center for

National Operations (CNO) which coordinated the logistics and other dimensions of the relief effort; it was succeeded by the Task Force for Rebuilding the Nation (TAFREN) and, more recently, the Reconstruction and Development Agency (RADA). By early 2005, a Steering Committee-consisting of the Bank, ADB, Japan Bank for International Cooperation (JBIC), the UN Humanitarian Coordinator, two other UN agencies, two bilaterals, three NGOs, and a private sector representative-was created to implement an action plan for addressing the tsunami reconstruction efforts. The Government found this useful and established a regular framework for interaction between the steering committee and senior officials.

In addition, the Bank participated with other development partners in a series of themed Development Partner Forums hosted by Government to discuss Sri Lanka's development strategy. The Development Forum in 2005 focused on the tsunami and the last Development Forum, in 2007, discussed the Government's *10 Year Vision-Mahinda Chintana*.

E. Client Feedback

A Client Survey was conducted in 2007. Almost 300 people-including those from the private sector, ministries, NGOs, and the media (in order of respondents)-were surveyed. When asked to rate the Bank's overall effectiveness on a scale of 1-10 (with 1 being very unfavorable and 10 being extremely favorable), they provided a mean rating of 6.1. Three-quarters of the people said that the Bank should be more involved in Sri Lanka's development strategies, and only 7 percent felt the Bank should be less involved.

The Survey found that the Bank receives high ratings in key areas of its work, particularly in its work related to outreach. Stakeholders were positive about working

with the Bank, and nearly all agreed that the Bank is responsive to their requests for information, engages in meaningful dialogue and communicates in an open and timely fashion. In addition, the Bank's efficiency and M&E efforts, its disbursement practices and how it collaborates with other donors, are all viewed positively.

This said, the Bank was faulted for not being vocal enough in criticizing the Government's weak commitment to reforms and in pressing for a peaceful resolution to the conflict. More specifically, respondents were quite negative about the Bank's effectiveness in helping the Government reduce corruption, increase transparency in governance, safeguard against project corruption, and provide support to the peace building efforts.

Respondents also said the Bank would be most productive if it would focus its resources on growth and infrastructure, and that Bank research efforts should focus on education, poverty and governance.

F. Lessons for the Next CAS

Within each pillar, there were several broad lessons related to CAS design and operational issues.

Under the **Peace pillar**, although the outcomes were achieved, peace was not sustained. The Peace pillar's strategy was based on maintaining peace by providing a peace dividend in the form of reconstruction and capacity building. The strategy was drawn up at a time of optimism in the country, and therefore understandably focused on dealing with the consequences of the conflict as one of the three pillars. In retrospect it is doubtful whether the Bank would have been able to fully prevent the current deterioration in the situation through any of its

projects. The lesson would be that the Bank should be adequately realistic and modest about its capacity and role in the area of peace building.

On an operational note, several of the projects faced implementation problems due to the escalating conflict, causing a slowdown in disbursements and a reworking of project documents to address the impasse. This posed serious reputational risks as the Bank had to balance progress in work with maintaining the principle of equity towards beneficiaries. Projects operating in the North and the East should have had contingency plans, exit plans or other scenarios in the event that the conflict resurfaced; the Government should have been made aware of the consequences it would face rather than the Bank renegotiating the terms of the project in the midst of the conflict where biases could more likely emerge. Some of the lessons learnt from operating projects in the conflict-affected areas in Sri Lanka are noted in Box 1.

The Bank's contribution in the **Growth pillar** suffered the most from a weakening engagement with the Government. A key lesson is the need to get broad-based political support for reforms through a wider array of key stakeholders, both within and outside the Government, and seek upfront commitments from key partners. Providing a forum for stakeholder participation in policy formulation can ensure long-term sustainability of the reform agenda beyond the projects. This is particularly important as changes in the Government are sometimes accompanied by changes at the political and technocratic levels, thereby changing priorities and weakening the implementation momentum.

On the **Equity pillar**, the Bank was more successful in its education projects, in part, due to the close

Box 1. Lessons Learnt from Projects in Conflict-affected Areas

1. *Project management:* Anchoring a project at the provincial level in Sri Lanka increases ownership at the local level and facilitates project implementation. In a conflict situation, securing technical assistance to build local capacity is critical. Community Based Organizations (CBOs) need sufficient training and technical backup to sustain project-created assets.
2. *Project design:* Innovation and flexibility in project design, initial piloting of project activities and close and competent supervision are important if projects are to be implemented quickly in conflict-affected situations.
3. *Project beneficiaries:* Selecting villages in poorer areas, and activities targeted at poor and landless people, ensures that the benefits of the projects reach communities and families most in need of assistance. Livelihood support to women's groups can make projects more inclusive and have tremendous potential for alleviating poverty. However, care must be taken not to cause friction between beneficiaries and non-beneficiaries. Having a grievance-redressal system helps alleviate tensions and resentment by giving non-beneficiaries (either individuals or villages) a mechanism to seek redress for being excluded. Such a mechanism also acts as a check against bureaucratic discretion in the face of established beneficiary selection criteria.
4. *Project monitoring:* Continuous monitoring and assessing of project processes and impact, with beneficiary participation, should be part of project M&E and MIS systems. It is not sufficient to have technical auditing without a clearly defined, practical and quality management system in place. Independent technical and financial auditors who provide impartial and transparent quality control should also be appointed.

relationship it has nurtured with the Ministry of Education for numerous years. In this respect, continuing a dialogue even in the absence of projects can help foster the Bank's relationship in the sector. As in other countries, the Bank was also quite successful in its CDD type projects.

The **Tsunami pillar** offers lessons on conducting emergency style operations. In the interest of quickly delivering the emergency loan, several safeguards were lifted to streamline the project, and a new institution was used to bypass the traditional ministries and avoid bureaucratic impasse. In retrospect, however, this led

to poor oversight and auditing irregularities. Using a new institution rather than existing mechanisms also created problems as new procedures had to be created from scratch, delaying the initial start-up time; staff at the new agency were paid more than the line ministries, leading to resentment and poor cooperation; and the sustainability and continuance of the projects is more problematic as the projects were not rooted in ministries.

Within projects, regardless of pillars, there are also lessons related to systemic issues in Sri Lanka which need to be addressed to improve performance. First, it

is paramount to have qualified staff for key positions to ensure strong and consistent project implementation progress. Staff trained in project and financial management and procurement need to be in place prior to the commencement of implementation. Second, knowledgeable advisors who are in a position to train, guide and encourage staff can enhance the units' skill capacities better than multitudes of training courses. Third, establishing effective monitoring and data collection systems at the start of projects is vital to the successful monitoring and evaluation of project achievements and outcomes.

On the Bank side, the length of time taken to prepare projects, aside from being costly, means there is a lack of continuity for the task team, in particular in its leadership. Feedback from the clients indicates they had considerable difficulties in dealing with the changes in Bank staffing.

Finally, because this was a results-based CAS, the outcomes identified were at times very specific for the strategic objectives being measured, and the indicators narrowed them even further - hence it was quite possible to do well on an indicator but miss the strategic objective. Indicators should fully capture the outcomes they are trying to measure; at the same time, the indicators must be readily monitored. For example, the use of poverty incidence indicators was ineffective because the survey only comes out once every five years and hence missed the whole CAS period. The best indicators are those that are either monitored by a project - assuming the project is taken to the Board in a timely way- or have existing time series that the Government regularly tracks.

TABLE A1: CAS COMPLETION MATRIX

Table A1: CAS Completion Matrix

Strategic Objectives	Outcomes	Lessons Learnt/ Indicators
Peace Pillar		
Peace Pillar <i>Restore access to health, education and irrigation in conflict-affected areas.</i>	1. Education facilities restored in the conflict-affected areas to pre-war levels.	Moderately Satisfactory. The number of schools in the Northern province rose from 866 (2002) to 892 (2006), and in the Eastern province from 936 to 971 in the same time period. Under Bank financing, about 183 schools were reconstructed/rehabilitated out of a revised target of 197 (up from 157), and 44 libraries were completed. Furniture was provided to 164 schools. Indicator Percentage of children enrolled in basic education (grades 6-9) in North and East: 71 percent (2004). Increase in number of students in basic education (grades 6-9) in North and East: 195,444 (2002) to 220,493 (2006), an increase of 13 percent, or 3.2 percent average annual increase compared to a -0.02 percent annual decrease for all of Sri Lanka.
	2. Water supply for irrigation increased in conflict-affected areas.	Moderately Satisfactory. As of June 30, 2005, 369 of 379 schemes were completed, achieving 98 percent of the target and covering 24,980 ha.
Growth Pillar		
Growth Pillar <i>Create enabling macro environment for private sector driven investment and growth</i>	3. Higher sustained economic growth	Indicator Agricultural (paddy) production in North and East ('000 MT): 202.4 (1996-2001); 1,372 (2002-2004) Unsatisfactory. With per capita income rising to about US\$ 1,300 in 2006, Sri Lanka is on a steady path to achieving the status of a middle-income country. Gross fixed investment/GDP averaged 26.5 percent in 2004-06, compared to 21.5 percent for 2002-03. Despite major economic challenges, growth was 7.5 percent in 2006. However, the sustainability of recent rates of growth remains questionable.
	4. Results-based budgeting system established	Indicator GDP Growth: GDP growth averaged 6.2 percent from 2004-06, above the historical average of 4-5 percent. Growth for 2007 is estimated at 6.5 percent. Unsatisfactory. The Government has introduced a medium-term budgetary framework to strengthen the strategic focus of the budget, but this remains primarily input-based. Policy goals are now included in the ministerial budget submissions but are still not well-linked. Bank involvement in public expenditure management became limited soon after the change in Government.
		Indicator Budget allocations for operations & maintenance (% of total expenditure): 31 percent (2002); 28 percent (2004). Budget allocations for infrastructure (% of capital expenditure/total expenditure): 14.5 percent (2002); 17.6 percent (2004). Capital expenditure/Total expenditure: 18.1 percent (2002); 20.4 percent (2004).

Table A1: CAS Completion Matrix

Strategic Objectives	Outcomes	Lessons Learnt/ Indicators
Peace Pillar		
	5. Improved financial performance of key state owned enterprises (SOEs)	<p>Unsatisfactory. Despite declines in system losses — from 19.2 percent (2002) to 17.3 percent (2005) — and improvements in revenue collections, the CEB continues to make financial losses due to non-implementation of a cost reflective tariff and higher fuel prices. Only in 2006 did the CEB start to raise prices. Since the PRSC I, Bank engagement on SOEs has been limited.</p> <p>Indicator Total profit/losses of key SOEs CEB: -\$76 million (2002), -\$38 million (2003), -\$150 million (2004), -\$67 million (2005). CPC: \$75 million (2002), \$50 million (2003), \$37 million (2004). Public transfers to SOEs CEB: \$111 million (2005) subsidy.</p>
<i>Expand employment opportunities and the flexibility of the labor market</i>	6. Legal framework established to increase flexibility in labor markets and promote harmonious labor relations	<p>Unsatisfactory. Although efforts were made to introduce greater flexibility, there was also considerable backtracking. Labor markets remain rigid and represent one of the top constraints to doing business in Sri Lanka. Severance costs are also among the highest in the world. As a result, employment in the informal sector accounts for 62 percent of total employment. Discounting agricultural employment, informal employment accounts for 51 percent of non-agricultural employment.</p> <p>Indicator Unemployment in the formal sector: Unemployment fell from 8.1 percent (2003) to 6.5 percent (2006). Male unemployment fell from 6.0 percent to 4.7 percent and female unemployment fell from 12.3 to 9.7 percent during the same period.</p>
<i>Improve the soundness of the financial system</i>	7. Central Bank of Sri Lanka (CBSL) re-focused towards managing its core functions	<p>Satisfactory. Through its project, the Bank has helped the CBSL restructure and reorganize to become a modern, strong and efficient institution. Success was predicated on strong commitment by the CBSL to undergo such change and the implementation of a Voluntary Retirement Scheme by which productivity and efficiency were increased despite a 40 percent reduction in staff.</p> <p>Indicator Ratio of non-performing loans to total loans outstanding: State Banks: 16.9 percent (2002); 11.4 percent (2004). All commercial banks: 14.5 percent (2002); 12.5 percent (2003); 8.9 percent (2004); 6.8 percent (2005); 5.4 percent (2006). Announcement of monetary policy: Monthly</p>
<i>Increase productivity in the rural economy</i>	8. Off-farm income generation activities promoted through sustainable rural electrification, including in conflict-ridden areas.	<p>Satisfactory. An additional 84,000 households/small enterprises have been supplied with off-grid renewable electricity. A total of 18,957 household-based livelihood support activities were completed with cash loans. All loan recipients were women and the activities undertaken were in most cases geared toward the women's own economic empowerment and household food security — such as animal husbandry and agriculture-related businesses.</p> <p>Indicator Number of economic activities using off-grid electricity: 400 (2004), 782 (2007) households/small enterprises undertaking income-generating activities using off-grid electricity.</p>

Table A1: CAS Completion Matrix

Strategic Objectives	Outcomes	Lessons Learnt/ Indicators
Peace Pillar		
<i>Improve the quality of public service delivery</i>	9. Politicization of the civil service reduced and public service accountability improved	Unsatisfactory. In 2006, public employees accounted for 13.4 percent of the employed. The Bank's activities to address public accountability were curtailed. Funds in the project were moved to tsunami reconstruction activities. Indicator Growth of public sector employment: Between 2002 and 2006, public sector employment grew by 9 percent; during this period, private sector employment grew by 3.1 percent.
Equity Pillar		
<i>Improve overall equity in the country.</i>	10. Reduction of poverty, especially in lagging rural areas and estates; improvement in social outcomes in the estates sector, and; better targeting of welfare programs to the poor.	Inconclusive. Latest poverty survey was conducted in 2002. The Bank has been engaged in several AAA activities that specifically address the needs of lagging rural areas and estates. These have been recently released to the Government. Indicator National poverty headcount ratio: 23 percent (2002) Urban-rural gap in poverty headcount: 17 percentage points (2002) Coverage of Samurdhi among the poorest 10 percent of population: 69 percent (2000) Share of poorest 20 percent of population in total Samurdhi benefits: 25 percent (2000) Poverty headcount ratio for estates sector: 30 percent (2002)
<i>Improve the quality of the basic education system</i>	11. Investment in education increased, especially in poor including in learning resources and teaching materials.	Satisfactory. About 12,000 out-of-school children in the age range 6-14 years were brought into the education system in 2006. Capital education budget prioritized for higher-order spaces and assets, such as IT centers, libraries, equipment and books, rose to 35 percent in 2007 compared to less than 20 percent in 2006. Likewise, the recurrent education budget prioritized for higher-order processes and inputs rose from less than 0.5 percent of the recurrent education budget to 2.4 percent, exceeding the 2007 target. An important factor was the introduction of the Norm Based Unit Cost Resource Allocation Mechanism, a formula which has been applied successfully to increase equity in basic education. Indicator Survival rate to grade 9: 78 percent (2004) Proficiency of graduates in English: 42 percent (2004) Average English scores of graduates: 59 (2005); 67 (2007)
<i>Improve health status of the population</i>	12. Effectiveness of the health sector's use of existing resources improved	Moderately Satisfactory. The number of districts (out of 25) that have an infant mortality rate of lower than 12.2/1000 live births has increased from 14 (2001) to 17 (2003). Similarly, for maternal mortality, the number of districts with rates lower than 46.9/100,000 has increased from 12 (2001) to 16 (2004). Public health per capita expenditure rose from \$13.7 (2002) to \$17.4. Indicator Percent of districts with satisfactory annual financial and physical progress reports: 100 percent of districts presented timely Annual Health Plans in 2006, up from 0 in 2004. And 75 percent of districts submitted outcome and output based progress monitoring reports.

Table A1: CAS Completion Matrix

Strategic Objectives	Outcomes	Lessons Learnt/ Indicators
Peace Pillar		
<i>Curb spread of HIV infection</i>	13. Health awareness increased to ensure that HIV prevalence rate among: (a) women (aged 15-24) attending antenatal clinics remains below 1 percent; and (b) STD clinic population stays below 5 percent.	Unsatisfactory. With only an estimated 5,000 people with HIV out of a population of 20 million, Sri Lanka still has one of the lowest prevalence rates of HIV in Asia. However, the proportion of women among those infected with HIV has increased from 21 percent (1987-91) to 47 percent (2002-05), though this is partly as a result of increased testing of women. While progress on this outcome has been satisfactory, Bank efforts have been stalled by poor implementation of the HIV project. Indicator HIV prevalence among women (aged 15-24): <1 percent (2007) Number of new cases of HIV in young adults (aged 15-24): 50 (2002); 91 (2004) HIV prevalence among STD clinic population: <1 percent
<i>Improve access to services in the poor districts</i>	14. Number of empowered communities implementing sub-projects contained in their development plans expanded	Satisfactory. In <i>Gemi Diriya</i> , within a short period of time, the project has reached over 80 percent of the 1000 targeted villages. In the CWSSP, 172 villages (or 34,500 households) have been covered. Progress has been thwarted in conflict-affected areas. Indicator Poverty incidence in participating villages by district: <ul style="list-style-type: none"> ■ Galle: 26 (2002) ■ Matara: 27 (2002) ■ Mon'gala: 37 (2002) ■ Badulla: 37 (2002) ■ Ratnapura: 34 (2002) ■ Hambantota: 32 (2002) ■ Polonnaruwa: 24 (2002) ■ Matale: 30 (2002) ■ Nuwara Eliya: 23 (2002) ■ NATIONAL: 22.7 (2002)
Tsunami Pillar		
<i>Restore livelihoods destroyed by the tsunami and start the recovery and reconstruction process.</i>	15. Restored housing of the poorest households in affected districts. 16. Livelihoods of the tsunami-affected families rebuilt to help revive the local economies of the affected districts.	Satisfactory. As of March 2007, about 80 percent of eligible families had fully completed their houses; most of the uncompleted houses are in the North and the East. The assistance has been fairly well targeted, with only about 6 percent of housing support cash grant recipients found ineligible. Indicator Number of totally damaged houses repaired: 15,600 (97 percent) Number of partially damaged houses repaired: 23,500 (62 percent) Satisfactory. Among the group that was hit the hardest — the self-employed and casual workers — more than 80 percent regained employment within a year and a half of the tsunami. The 114km of road section between Galle and Colombo has been rehabilitated. The livelihood support component was successfully concluded in 2005. Indicator Share of deserving families reached through cash grants: 100,000 families Percent disbursed of financing required for cash for work programs: 41 percent.

Table A2: Planned Lending Program and Actual Deliveries: FY03-FY07

CAS Plans			Current Status	
FY	Projects	US\$M	Status	US\$M
2003	PRSC I: Factors of Production	110.0	Actual	125.0
	Economic Reform Technical Assistance	15.0	Actual	15.0
	Second Community Water	40.0	Actual	39.8
	National HIV/AIDS Prevention	10.0	Actual	12.6
	Improving Relevance & Quality of Undergraduate Education	30.0	Actual	40.3
	Subtotal	205.0		232.7
2004	PRSC II: Welfare Reform & Rural Development e-Lanka	90.0	Dropped	
	Rural Poverty Reduction Initiative (NEIAP II)	50.0	Slipped FY05	
	Health Sector Operation	40.0	Actual	64.7
		50.0	Actual	60.0
	Subtotal	230.0	<i>Additional Products:</i> <i>Gemi Diriya</i>	175.7 51.0
2005	PRSC III: Public Sector Reform	90.0	Dropped	
	NE Infrastructure Rehab/Capacity Building	40.0	Actual	75.0
	Public Sector Reform Technical Assistance	15.0	Dropped	
	Education Sector Operation	50.0	Slipped FY06	
	Subtotal	195.0	<i>Additional Products:</i> e-Lanka Tsunami ERL 1/	203.0 53.0 75.0
2006	PRSC IV: TBD	90.0	Dropped	
	Land and Water Administration	40.0	Dropped	
	Services for the Urban Poor	40.0	Dropped	
	Governance and Capacity Building (PR)	30.0	Slipped to FY08	
	Education (PR)	60.0	Actual	60.0
	Road Sector Assistance (PR)	100.0	Actual	100.0
	North East Housing Reconstruction (PR)	15.0	Slipped to FY07	
	Subtotal	170.0*		160.0
2007	<i>Gemi Diriya II</i> (PR)	50.0	Slipped to FY09	
	Water Management (PR)	50.0	Slipped to FY08	
	Local Service Delivery (PR)	50.0	Dropped	
	Land Titling (PR)	30.0	Dropped	
			<i>Additional Products:</i> Puttalam Housing	32.0
			Renewable Energy for Rural Development Supplemental	40.0
			72.0	
Total	800.0	Sub-total	818.4	

(PR) New lending identified in CAS Progress Report. *Planned lending subtotal from original CAS. 1/ The Tsunami response amounted to a total of US\$150 million. It consisted of two parts, the first part one through restructuring of 7 on-going projects, for a total of US\$75 million and the second part in a separate US\$75 million ERL.

Table A3: Planned Non-lending Services and Deliveries: FY03-FY07

	CAS Plans	Current Status
FY	AAA	Status
2003	Land Policy	Actual
	Country Procurement Assessment Review	Actual
	Country Financial Accountability Assessment	Actual
2004	Report on Millennium Development Goals	Slipped to 2005
	Investment Climate Survey (Urban and Rural)	Slipped to 2005
	Public Expenditure Analysis	TA
	Development Policy Review	Actual
	Education Sector Report	Actual
	Financing of Municipal Services	Slipped to 2006
		<i>Additional Actual Products:</i>
	<ul style="list-style-type: none"> ▪ Governance Policy Note ▪ Roads Policy Note ▪ ROSC Accounting and Auditing Assessment 	
2005	Public Expenditure Analysis	Actual
	Poverty Update — Poverty Mapping Policy Note	Actual
	Nutrition and Environmental Health	Slipped to 2008
	Land Policies: Lessons from the LIL	Slipped to 2006
		<i>Additional Actual Products:</i>
	<ul style="list-style-type: none"> ▪ Tsunami Preliminary Damage and Needs Assessment ▪ Improving the Rural and Urban Investment Climate ▪ Garment and Textile Policy Note ▪ Attaining MDG in Sri Lanka ▪ Development Forum: The Economy, Tsunami and Poverty Reduction 	
2006	Public Expenditure Analysis	Dropped
	Country Economic Update	Dropped
	Update on Rural Development Issues	Dropped
	Social Protection Note	Actual
	Youth Transitions (PR)	Dropped
	Access to Finance (PR)	Actual
	Poverty Assessment (PR)	Actual
	Decentralization and Delivery of Services (PR)	Actual
	Tea and Rubber Estate Sector Study (PR)	Slipped to FY07
		<i>Additional Actual Products:</i>
	<ul style="list-style-type: none"> ▪ Public Sector Reform ▪ Gap Analysis of Public Accounting ▪ Poverty and Social Impact Analysis 	
	Land Policy and Conflict	
2007	Study on Ageing (PR)	Slipped to FY08
	Development Forum: Lagging Regions (PR)	Actual
	Agriculture Research and Extension (PR)	Actual
		<i>Additional Actual Products:</i>
	<ul style="list-style-type: none"> ▪ Tea and Rubber Estate Sector Study (PR) ▪ Housing Finance 	

*(PR) indicates new studies identified in the CAS Progress Report.

Table A4. Projects Closed During the CAS Period

Code	Project	Amount	Appr-oval FY	Closing Date	ICR Rating for:			IEG Rating for:				
					Outcome	Institutional Development	Sustain-ability	Outcome	Institutional Development	Sustain-ability	Bank Perform.	Borrower Perform.
P081718	Poverty Reduction Support Credit I	125.0	2003	Dec-03	S	Modest	L	MU	Modest	UN	S	U
P058070	North-East Irrigated Agriculture Project	27.0	2000	Jun-05	S	Substantial	L	S	Substantial	L	S	S
P069784	Sri Lanka: Distance Learning Project	2.3	2001	Jun-05	U	Modest	L	U	Modest	L	U	U
P042266	Teacher Education and Teacher Deployment	64.1	1997	Oct-05	S	Substantial	L	MU	Modest	L	S	U
P010525	General Education Project	70.3	1998	Nov-05	S	Substantial	L	S	Substantial	L	S	S
P034212	Mahaweli Restructuring and Rehabilitation	57.0	1998	Dec-05	U	Modest	UN	U	Modest	UN	U	U
P071131	Sri Lanka Central Bank Strengthening	30.3	2002	Dec-05	HS	High	HL	HS	High	L	S	HS
P050738	Land Titling and Related Services*	5.0	2002	Sep-06	MU	Risk to Develop. Outcome	Bank Perform. U	U	Risk to Develop. Outcome	H	Bank Perform. MU	Borrower Perform. U
P010517	North East Emergency Reconstruction Program -Component Z**	31.0	1997	Dec-06								
P044809	Legal and Judicial Reforms*	18.2	2001	Feb-07	MU	M	MU MS					
P077586	Economic Reform TA	16.7	2003	Jun-07	MU	M	S MU					

Outcome: HS=Highly Satisfactory, MS=Moderately Satisfactory, S=Satisfactory, MAS=Marginally Satisfactory, MU=Moderately Unsatisfactory, U=Unsatisfactory

Institutional Development: High, Substantial, Modest, Partial, Negligible

Sustainability: HL=Highly Likely, L=Likely, UN=Unlikely, HUN=Highly Unlikely

Bank/Borrower Performance: HS=Highly Satisfactory, MS=Moderately Satisfactory, S=Satisfactory, MAS=Marginally Satisfactory, MU=Moderately Unsatisfactory, U=Unsatisfactory

*Rating categories for the ICR/IEG changed

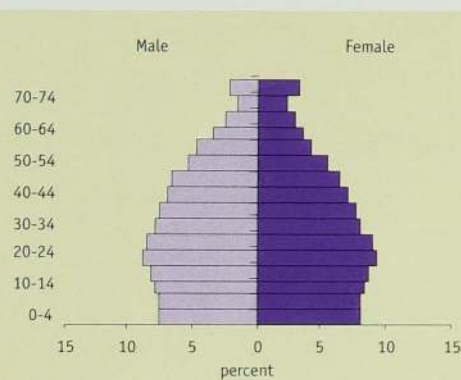
** The NEERP project resulted from a portfolio restructuring of three projects: Private Sector Infrastructure Development (\$21 million), Central Bank Strengthening (\$5 million) and Mahaweli (\$5 million). A Component Z was added to the three projects and the project agreements amended to reflect this. When the rest of the PSID project was closed in June 2003, Component Z or NEERP, was left open. OPCS ruled that an ICR was not needed as one had already been submitted for the original project

ANNEX A2. COUNTRY AT A GLANCE

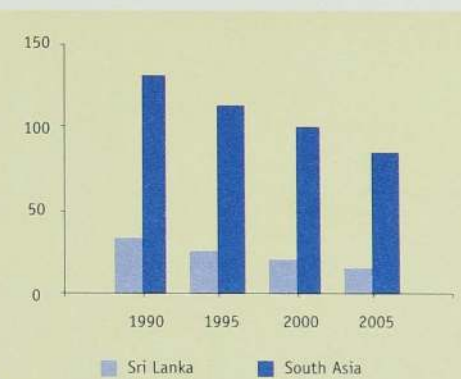
Sri Lanka at a glance

Key Development Indicators	Sri Lanka	South Asia	Lower middle income
(2006)			
Population, mid-year (millions)	19.8	1,493	2,276
Surface area (thousand sq. km)	66	5,140	28,549
Population growth (%)	0.7	1.5	0.9
Urban population (% of total population)	15	29	47
GNI (Atlas method, US\$ billions)	26.0	1,143	4,635
GNI per capita (Atlas method, US\$)	1,320	766	2,037
GNI per capita (PPP, international \$)	5,010	3,444	7,020
GDP growth (%)	7.4	8.6	8.8
GDP per capita growth (%)	6.6	6.9	7.9
(most recent estimate, 2000–2006)			
Poverty headcount ratio at \$1 a day (PPP, %)	6	31	..
Poverty headcount ratio at \$2 a day (PPP, %)	42	77	..
Life expectancy at birth (years)	75	63	71
Infant mortality (per 1,000 live births)	12	62	31
Child malnutrition (% of children under 5)	29	..	13
Adult literacy, male (% of ages 15 and older)	92	70	93
Adult literacy, female (% of ages 15 and older)	89	46	85
Gross primary enrollment, male (% of age group)	102	115	117
Gross primary enrollment, female (% of age group)	101	105	114
Access to an improved water source (% of population)	79	84	81
Access to improved sanitation facilities (% of population)	91	37	55

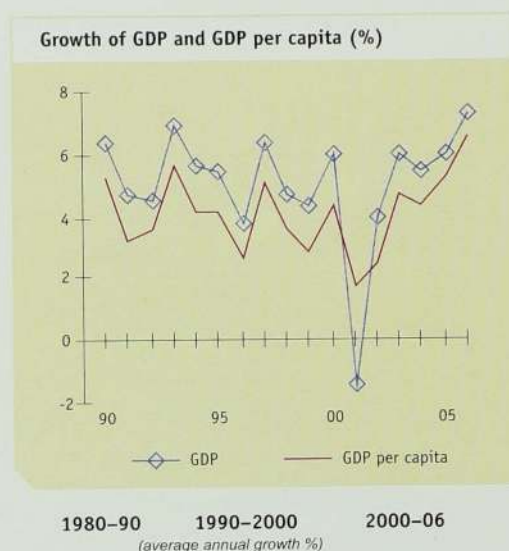
Age distribution, 2006



Under-5 mortality rate (per 1,000)



Net Aid Flows	1980	1990	2000	2006
(US\$ millions)				
Net ODA and official aid	387	728	276	1,189
Top 3 donors (in 2005):				
Japan	45	176	164	313
Germany	19	26	21	75
Norway	11	23	15	66
Aid (% of GNI)	9.5	9.1	1.7	5.1
Aid per capita (US\$)	26	43	14	61
Long-Term Economic Trends				
Consumer prices (annual % change)	26.2	21.5	6.2	13.7
GDP implicit deflator (annual % change)	20.0	20.1	7.3	10.3
Exchange rate (annual average, local per US\$)	16.5	40.1	77.0	103.9
Terms of trade index (2000 = 100)	62	76	100	96



Population, mid-year (millions)	14.7	17.0	19.4	19.8	1.4	1.3	0.4
GDP (US\$ millions)	4,025	8,033	16,331	26,964	4.0	5.3	4.8
		(% of GDP)					
Agriculture	27.6	26.3	19.9	16.5	2.2	1.8	1.2
Industry	29.6	26.0	27.3	27.1	4.6	6.9	4.4
Manufacturing	17.7	14.8	16.8	13.9	6.3	8.1	3.5
Services	42.8	47.7	52.8	56.5	4.7	5.7	6.3
Household final consumption expenditure	80.3	75.9	72.1	73.8	..	5.3	5.3
General gov't final consumption expenditure	8.5	9.8	10.5	9.0	..	10.5	1.4
Gross capital formation	33.8	22.2	28.0	28.7	0.6	6.9	8.0
Exports of goods and services	32.2	30.2	39.0	31.6	4.7	7.5	4.8
Imports of goods and services	54.8	38.1	49.6	43.2	3.4	8.6	6.4
Gross savings	19.1	20.3	21.5	24.8			

Note: Figures in italics are for years other than those specified. 2006 data are preliminary. .. indicates data are not available.

a. Aid data are for 2005.

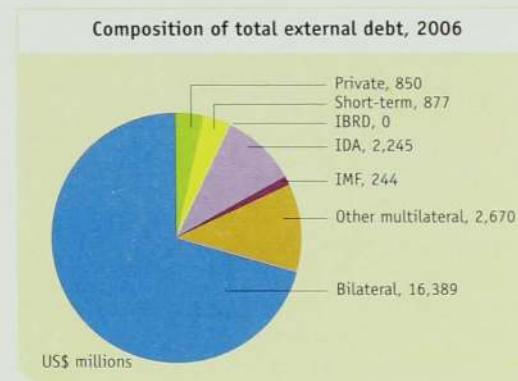
Development Economics, Development Data Group (DECDG).

PUBLIC LIBRARY
SPECIAL COLLECTION

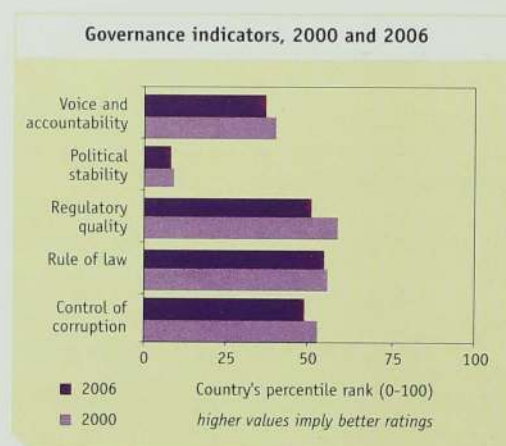
Balance of Payments and Trade	2000	2006
<i>(US\$ millions)</i>		
Total merchandise exports (fob)	5,522	6,883
Total merchandise imports (cif)	7,320	10,253
Net trade in goods and services	-1,760	-3,113
Current account balance	-1,067	-1,333
as a % of GDP	-6.5	-4.9
Workers' remittances and compensation of employees (receipts)	1,166	2,088
Reserves, including gold	1,147	2,947
Central Government Finance		
<i>(% of GDP)</i>		
Current revenue (including grants)	17.2	18.1
Tax revenue	14.5	15.3
Current expenditure	20.2	19.5
Overall surplus/deficit	-9.5	-7.3
Highest marginal tax rate (%)		
Individual	35	35
Corporate	35	35

External Debt and Resource Flows

<i>(US\$ millions)</i>		
Total debt outstanding and disbursed	9,157	23,275
Total debt service	789	1,121
Debt relief (HIPC, MDRI)	-	-
Total debt (% of GDP)	56.1	86.3
Total debt service (% of exports)	10.1	10.1
Foreign direct investment (net inflows)	173	0
Portfolio equity (net inflows)	-35	0



Private Sector Development	2000	2006
Time required to start a business (days)	-	50
Cost to start a business (% of GNI per capita)	-	9.2
Time required to register property (days)	-	83
Ranked as a major constraint to business (% of managers surveyed who agreed)		
Electricity	..	41.3
Economic and regulatory policy uncertainty	..	34.0
Stock market capitalization (% of GDP)	6.6	28.8
Bank capital to asset ratio (%)	4.4	6.7



Source: Kaufmann-Kraay-Mastruzzi, World Bank

Technology and Infrastructure	2000	2005
Paved roads (% of total)	85.8	81.0
Fixed line and mobile phone subscribers (per 1,000 people)	62	235
High technology exports (% of manufactured exports)	2.3	1.5
Environment		
Agricultural land (% of land area)	36	36
Forest area (% of land area)	32.2	29.9
Nationally protected areas (% of land area)	..	27.3
Freshwater resources per capita (cu. meters)	..	2,548
Freshwater withdrawal (% of internal resources)	25.2	..
CO2 emissions per capita (mt)	0.53	0.54
GDP per unit of energy use (2000 PPP \$ per kg of oil equivalent)	8.2	8.1
Energy use per capita (kg of oil equivalent)	418	485

World Bank Group portfolio	2000	2006
<i>(US\$ millions)</i>		
IBRD		
Total debt outstanding and disbursed	13	0
Disbursements	0	0
Principal repayments	5	1
Interest payments	1	0
IDA		
Total debt outstanding and disbursed	1,610	2,245
Disbursements	47	100
Total debt service	30	60
IFC (fiscal year)		
Total disbursed and outstanding portfolio of which IFC own account	39	55
Disbursements for IFC own account	9	15
Portfolio sales, prepayments and repayments for IFC own account	0	10
MIGA		
Gross exposure	3	2
New guarantees	0	0

Note: Figures in italics are for years other than those specified. 2006 data are preliminary.

.. indicates data are not available. - indicates observation is not applicable.

Development Economics, Development Data Group (DECDG).

ANNEX B2 - SELECTED INDICATORS OF BANK PORTFOLIO PERFORMANCE AND MANAGEMENT

As of April 24, 2008

Indicator	2005	2006	2007	2008
Portfolio Assessment				
Number of Projects Under Implementation ^a	18	16	13	13
Average Implementation Period (years) ^b	3.7	3.4	3.3	4.0
Percent of Problem Projects by Number ^{a, c}	5.6	6.3	15.4	23.1
Percent of Problem Projects by Amount ^{a, c}	0.6	7.9	8.3	16.6
Percent of Projects at Risk by Number ^{a, d}	5.6	6.3	15.4	30.8
Percent of Projects at Risk by Amount ^{a, d}	0.6	7.9	8.3	26.1
Disbursement Ratio (%) ^e	27.4	28.9	29.7	11.5
Portfolio Management				
CPPR during the year (yes/no)	no	no	no	no
Supervision Resources (total US\$ thousand) ^f	1882	2268	1790	1214
Average Supervision (US\$/project) ^f	94.1	113.4	105.3	93.4

Memorandum Item	Since FY 80	Last Five FYs
Proj Eval by OED by Number	76	10
Proj Eval by OED by Amt (US\$ millions)	2,128.8	316.4
% of OED Projects Rated U or HU by Number	30.1	50.0
% of OED Projects Rated U or HU by Amt	36.4	55.7

- a. As shown in the Annual Report on Portfolio Performance (except for current FY).
 b. Average age of projects in the Bank's country portfolio.
 c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
 d. As defined under the Portfolio Improvement Program.
 e. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: Investment projects only.
 f. FY08 portfolio management figures are as of January 31, 2008.

* All indicators are for projects active in the Portfolio, with the exception of Disbursement Ratio, which includes all active projects as well as projects which exited during the fiscal year.

ANNEX B3. IBRD/IDA PROGRAM SUMMARY – SRI LANKA

CAS Annex B3 - IBRD/IDA Program Summary

As of May 3, 2008

Sri Lanka

<i>Fiscal year</i>	<i>Project</i>	<i>US\$(M)</i>	<i>Strategic Rewards b (H/M/L)</i>	<i>Implementation b Risks (H/M/L)</i>
2008 1/	Dam Safety and Water Resources Planning	65.3	H	H
	Education Development Project (addt'l finan.)	10.0	M	M
	Public Sector Capacity Building	22.6	H	H
	Road Sector Assistance (addt'l finan.)	99.1	H	M
	North East Housing Reconstruction (addt'l finan.)	43.0	H	M
	FY08 Total	240.0		
2009	Integrated Community Development - Gama Naguma / Lagging Regions	75.0	H	M
	Provincial Road (East and Sabagaragamuwa) Development	150.0	H	H
	FY09 Total	225.0		
2010	Integrated Rural Development - Gama Naguma / Lagging Regions for East	50.0	H	H
	Higher Education	40.0	H	M
	Environmental Resource Management	20.0	H	M
	Private Sector Development in Tourism Resources	15.0	H	M
	National and Provincial (Western and Uva) Road Development 3/	115.0	H	H
	FY10 Total	240.0		
2011 2/	National and Provincial (North Central and North Western) Road Development 3/	100.0	H	H
	Irrigation Maintenance & Water Resource Management	50.0	H	M
	Community Water Supply & Poverty Alliviation in Plantation Districts	40.0	H	M
	Agriculture Research and Productivity Improvements	35.0	H	M
	FY11 Total	225.0		
2012 2/	General Education	50.0	H	M
	Health Sector Development	35.0	H	M
	Water Supply in the Northern Eastern and Sabaragamuwa Province	75.0	H	M
	National and Provincial (North Central and Northern) Road Development 3/	50.0	H	H
	FY12 Total	210.0		
	Overall CAS total (FY2009-2012)	900.0		

(Note) 1/ FY08 Projects were prepared under the previous CAS.

2/ FY11 and FY12 lending program is indicative, and subject to review at the time of CAS progress report.

3/ The final selection of provinces will be agreed upon during further discussion with the Government.

CAS ANNEX B3 (IFC & MIGA) FOR SRI LANKA

Sri Lanka - IFC and MIGA Program, FY 2005-2008

	2005	2006	2007	2008
IFC approvals (US\$m)	0	0	9.38	100
Sector (%)				
Information	0	0	0	100
Finance & Insurance	0	0	100	0
Investment instrument (%)				
Quasi-Equity (Equity Type)	0	0	0	0
Straight Equity (incl. Fund)	0	0	79.1	30
Client Risk Management	0	0	0	0
Guarantee	0	0	20.9	0.1
Loan-LN	0	0	0	69.9
Quasi-Equity (Loan Type)	0	0	0	0
MIGA guarantees (US\$m)				

CAS ANNEX B4 - SUMMARY OF NON-LENDING SERVICES - SRI LANKA

As of April 24, 2008

<i>Product</i>	<i>Completion FY</i>	<i>Cost (US\$000)</i>	<i>Audience^a</i>	<i>Objective^b</i>
Recent Completions				
Malnutrition in Sri Lanka	2008	165	G,D,B,P	KG,PD,PS
Study on Ageing	2008	450	G,D,B,P	KG,PD,PS
Agriculture Research and Extension	2007	295	G,D,B,P	KG,PD,PS
Tea and Rubber Estate Sector Study	2007	311	G,D,B,P	KG,PD,PS
Housing Finance	2007	114	G,D,B	KG,PS
Development Forum Report	2007	75	G,D,B,P	KG,PD,PS
Poverty Assessment	2006	530	G,D,B,P	KG,PS
Decentralization and Service Delivery	2006	376	G,D,B,P	KG,PD,PS
Poverty and Social Impact Analysis	2006	282	G,D,B,P	KG,PD,PS
Social Protection	2006	132	G,D,B,P	KG,PD,PS
Land Policy and Conflict	2006	140	G,D,B,P	KG,PD,PS
Access to Finance	2006	163	G,D,B	KG,PS
Public Sector Reform	2006	75	G,D,B,P	KG,PD,PS
Underway/Planned				
Banking Governance	2008	100	G,D,B	KG,PS
Private Renewable Energy Policy	2008	150	G,D,B,P	KG,PD,PS
Higher Education	2008	130	G,D,B,P	KG,PD,PS
Markets and Growth in Agriculture	2008	330	G,D,B,P	KG,PD,PS
Cost of No Reform	2009	100	G,D,B,P	KG,PD,PS
Growth Potential in Lagging Regions	2009	275	G,D,B,P	KG,PD,PS
Country Environmental Analysis	2009	350	G,D,B,P	KG,PD,PS
Infrastructure Assessment	2009	300	G,D,B,P	KG,PD,PS
Coal Power Assessment	2009	150	G,D,B,P	KG,PD,PS
Female Migration	2009	150	G,D,B,P	KG,PD,PS
Social Protection	2010	150	G,D,B,P	KG,PD,PS
Health Service Delivery Strategy	2010	250	G,D,B,P	KG,PD,PS
Public Financial Management Assessment	2010	150	G,D,B,P	KG,PD,PS
Growth, Outsourcing and Jobs	2010	250	G,D,B,P	KG,PD,PS

a. Government (G), Donor (D), Bank (B), Public Dissemination (P).

b. Knowledge Generation (KG), Public Debate (PD), Problem-solving (PS).

Indicator	Actual										Proj.			
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
National accounts (as % GDP at current market prices)														
Gross domestic product	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Agriculture ^a	20.7	19.5	19.5	20.5	19	17.8	17.3	16.5	16.0	15.5	15	14.5	14	13.5
Industry ^a	27.3	27.5	26.7	26.3	26.4	26.8	27.1	27.1	26.7	27.0	27.0	27.0	27.0	27.0
Services ^a	52.1	53	53.8	53.2	54.6	55.4	55.6	56.5	57.3	57.5	58.0	58.5	59.0	59.5
Total Consumption	80.5	82.8	84.7	85.6	84.0	83.6	82.1	83.0	82.4	83.0	83.2	83.4	83.2	82.8
Gross domestic fixed investment	27.3	28	22	21.2	22.0	25.3	26.8	28.0	27.9	28.0	28.4	28.9	29.4	30.0
Government investment	3.2	3.3	3.0	2.0	2.5	2.5	3.8	3.6	4.8	5.0	5.2	5.5	5.7	6.0
Private investment (includes increase in stocks)	24.1	24.7	19	19.2	19.5	22.8	23.0	24.4	23.1	23.0	23.2	23.4	23.7	24.1
Exports (GNFS) ^b	35.5	39.7	37	36.1	34.7	35.3	32.3	30.1	29.2	27.2	26.4	25.7	25.3	25.0
Imports (GNFS)	43.3	50.5	43.7	42.8	40.7	44.2	41.3	41.1	39.5	38.6	38.7	39.0	39.2	39.2
Gross domestic savings ^c	19.5	17.2	15.3	14.4	15.9	15.9	14.7	17.0	17.6	18.4	19.0	19.5	20.1	20.7
Gross national savings ^c	23.5	21.4	19.5	19.8	22.3	19.5	27.9	22.7	23.6	24.1	24.7	25.2	25.9	26.6
<i>Memorandum items</i>														
Gross domestic product (US\$ million at current prices)	15,657	16,305	15,396	16,913	18,246	20,055	22,530	28,264	32,595	38,625	42,667	48,231	53,351	58,514
Gross national product per capita (US\$, Atlas method)	820	850	830	850	930	1010	1110	1180	1290					
Real annual growth rates (%, 2002 prices)														
Gross domestic product at market prices	4.3	6.0	-1.5	4.0	6.0	5.4	6.0	7.4	6.8	5.7	5.6	5.4	5.4	5.4
Real annual per capita growth rates (%, calculated from 2002 prices)														
Gross domestic product at market prices	2.7	4.5	-2.9	2.5	4.7	4.3	4.9	6.2	5.6	4.6	4.5	4.3	4.3	4.3
Total consumption	3.8	3.3	-1.1	5	4.9	4.4	3.4	3.2	2.7	3.3	3.3	3.3	3.3	3.3
Private consumption	3.8	2.7	16.9	6.3	3.9	4.6	5.3	3.0	2.4	2.9	2.9	2.9	2.9	2.9

COUNTRY - KEY ECONOMIC INDICATORS (CONTINUED)

Indicator	Actual										Proj.			
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Balance of Payments (US\$m)														
Exports (GNFS) ^b	5,578	6,475	6,183	5,967	6,544	7,284	7,707	8,517	9,517	10,957	12,083	13,653	15,082	16,507
Merchandise FOB	4,610	5,522	4,817	4,699	5,133	5,757	6,098	6,892	7,805	8,986	9,910	11,197	12,369	13,538
Imports (GNFS) ^b	6,800	8,235	7,135	7,080	7,684	9,108	10,338	11,627	12,870	14,671	16,087	18,176	20,079	21,976
Merchandise FOB	5,980	7,320	5,974	6,106	6,672	8,000	9,171	10,259	11,396	12,991	14,244	16,094	17,779	19,459
Resource balance	-1,222	-1,760	-952	-1,113	-1,140	-1,824	-2,631	-2,671	-2,643	-3,714	-4,003	-4,523	-4,997	-5,469
Net current transfers (including official current transfers)	912	998	960	1,128	1,241	1,380	1,603	2,004	2,329	2,619	2,876	3,265	3,657	4,097
Current account balance (after official capital grants)	-564	-1,066	-272	-238	-70	-647	-1,252	-1,494	-1,381	-1,495	-1,567	-1,757	-1,898	-1,997
Net private foreign direct investment	177	176	172	185	171	217	276	452	554	695	811	965	1,120	1,287
Long-term loans (net)	397	297	354	326	520	457	1,197	566	871					
Official	155	154	184	232	485	288	565	497	1,063	984	1,002	1,119	1,192	1,223
Private														
Other capital (net, including errors and omissions)	-351	-26	16	65	-119	-232	194	291	271	270	256	241	213	176
Change in reserves ^d	340	619	-270	-338	-502	205	-415							
<i>Memorandum items</i>														
Resource balance (% of GDP at current market prices)	-7.8	-10.8	-6.1	-6.7	-6.2	-9.1	-11.7	-9.5	-8.1	-9.6	-9.4	-9.4	-9.4	-9.3
Real annual growth rates (1995 prices)														
Merchandise exports (FOB)	4.5	9.8	2.4	5	10.1	6.5	5.1	7.4	6.1	5.2	5.2	5.3	5.3	5.3
Primary	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Manufactures	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Merchandise imports (CIF)	3.7	13.7	1.3	11.4	11.3	9.0	2.7	6.9	4.4	4.0	4.4	5.0	5.0	5.0
Public finance (as % of GDP at current market prices)^e														
Current revenues	17.2	17.7	16.8	16.6	16	15.3	16.1	16.4	16.9	16.3	16.8	17.3	17.8	18.3
Current expenditures	19.6	18.7	20.2	20.9	19	19.2	18.7	19.5	18.4	17.4	17.4	17.9	18.4	18.9

(Continued)

COUNTRY - KEY ECONOMIC INDICATORS (CONTINUED)

Indicator	Actual										Proj.			
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Current account surplus (+) or deficit (-)	-2.4	-1.0	-3.4	-4.4	-3.0	-3.9	-2.7	-2.3	-1.6	-1.1	-0.6	-0.6	-0.6	-0.6
Capital expenditure	5.3	5.5	5.4	4.6	5.0	4.8	6.0	5.6	6.1	6.6	7.1	7.1	7.1	7.1
Foreign financing	1.7	0.7	0.7	0.5	2.9	2.2	3.4	2.5	3.7	3.7	3.7	3.7	3.7	3.7
Monetary indicators														
M2/GDP (at current market prices)	37.1	38.7	38.5	39.4	40.8	42.3	42.1	43	43.3	41.3	41.2	41.4	41.9	42.8
Growth of M2 (%)	13.2	13.4	12.8	13.4	15.3	19.6	15	17.8	16.6	15.5	15.5	15.0	15.0	15.0
Private sector credit growth/total credit growth (%)	61.4	43.0	55.5	87.5	130.4	89.5	65	86.5	79.9	100	100	100	100	100
Price indices (1995 =100)														
Merchandise export price index	91.4	84	91.7	141.2	150.2	161.1	158.7	157.7	155.7	155.7	155.7	155.7	155.7	155.7
Merchandise import price index	94.7	97	108.2	137.7	136.3	154.1	161.9	162.5	161.4	161.4	161.4	161.4	161.4	161.4
Merchandise terms of trade index	96.4	86.6	84.7	102.6	110.2	104.5	98.1	97.1	96.5	96.5	96.5	96.5	96.5	96.5
Real exchange rate (US\$/LCU) ^f					90.1	88.4	99.3	103.5	108	108	108	108	108	108
Real interest rates														
Consumer price index (% growth rate)	9.4	4.7	6.2	9.6	6.3	7.6	11.6	13.7	15.8	16.5	10.8	9.8	8.7	7.6
GDP deflator (% growth rate)	9.2	4.2	6.2	8.1	5.1	8.8	10.4	11.3	14.0	14.7	9.6	8.7	7.7	6.8

a. If GDP components are estimated at factor cost, a footnote indicating this fact should be added.

b. "GNFS" denotes "goods and nonfactor services."

c. Includes net unrequited transfers excluding official capital grants.

d. Includes use of IMF resources.

e. Should indicate the level of the government to which the data refer.

f. "LCU" denotes "local currency units." An increase in US\$/LCU denotes appreciation.

COUNTRY - SELECTED INDICATORS TABLE

Base-case (most likely) projection

	Actual										Proj.			
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Part A: Main Macro Aggregates														
<i>Annual growth rates, calculated from constant 2002 price data</i>														
GDP (mp) per capita	2.7	4.5	-2.9	2.5	4.7	4.3	4.9	6.2	5.6	4.6	4.5	4.3	4.3	4.3
Total consumption per capita	3.8	3.3	-1.1	5.0	4.9	4.4	3.4	3.2	2.7	3.3	3.3	3.3	3.3	3.3
GDP at market prices	4.3	6	-1.4	4.0	6.0	5.4	6.2	7.7	6.8	5.7	5.6	5.4	5.4	5.4
Total consumption	4.9	4.4	0.0	6.1	6.0	4.1	3.3	7.1	4.9	4.4	4.4	4.4	4.4	4.4
Private consumption						3.7	2.8	6.7	4.3	4.0	4.0	4.0	4.0	4.0
Gross domestic investment (GDI)					24.2	13.3	9.3	13.4	8.7	7.8	7.8	7.9	7.9	7.9
Gross dom. Fixed investment (GDFI)	..	..	..	..	13.1	17.8	9.8	12.9	9.5	8.3	8.3	8.3	8.3	8.3
Exports (GNFS)	..	16.1%	-4.5%	-3.5%	3.4%	7.7%	6.6%	3.8%	6.8%	5.0%	5.0%	5.0%	5.0%	5.0%
Imports (GNFS)	..	21.1%	-13.4%	-0.8%	11.3%	9.0%	2.7%	6.9%	4.4%	4.0%	4.4%	5.0%	5.0%	5.0%
Savings-investment balances, as percentage of GDP														
Gross Domestic investment	27.3	28	22	20.9	22.1	25	26.4	28.0	27.9	28.0	28.4	28.9	29.4	30.0
of which Government investment	3.2	3.3	3	2	2.3	2.2	5.3	4.1	5.4	5.5	5.6	5.8	6.0	6.3
Foreign savings	3.8	6.6	2.5	1.1	-0.2	5.5	-1.5	5.3	4.2	3.9	3.7	3.6	3.6	3.4
Gross national savings	23.5	21.4	19.5	19.8	22.3	19.5	27.9	22.7	23.6	24.1	24.7	25.2	25.9	26.6
Government savings	-2.4	-1.0	-3.4	-4.4	-3	-3.9	-2.7	-2.3	-1.6					
Non government savings	25.9	22.4	22.9	24.2	25.3	23.4	30.6	24.9907	25.2229					
Gross domestic savings	19.5	17.2	15.3	14.4	15.9	15.9	14.7	17.0	17.6	18.4	19.0	19.5	20.1	20.7
Other														
GDP inflation	9.2	4.2	6.2	8.1	5.1	8.8	10.4	11.3	14.0	14.7	9.6	8.7	7.7	6.8
Annual average exchange rate (LCU/US\$)	70.4	75.8	89.4	95.7	96.5	101.2	100.5	104.0	109.8	112.3	117.6	119.1	122.3	125.5
Index real average exchange rate (=100)	..	..	..	..	90.1	88.4	99.3	103.5	108.0	113.4	116.8	118.6	118.6	118.6
Terms of trade index (=100)	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Incremental capital-output ratio (GDI based)	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Import elasticity with respect to GDP	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Money growth	13.2	13.4	12.8	13.4	15.3	19.6	15.0	17.8	16.6	15.5	15.5	15.0	15.0	15.0

	Actual										Proj.			
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Part B: Government Finance Indicators														
Percentage of GDP														
Total revenues, of which	17.2	17.7	16.8	16.6	16	15.3	16.1	16.3	15.8	38.7	39.7	40.7	41.7	42.7
Tax revenues	..	..	..	14	13.2	13.9	14.2	14.6	14.2	14.7	15.2	15.7	16.2	16.7
Total expenditures, of which	24.9	24.2	25.6	25.5	24	24	24.7	24.2	23.5	24	24.5	25	25.5	26
Recurrent Consumption	..	..	..	..	..	..	..	18.6	17.4	17.4	17.4	17.9	18.4	18.9
Deficit(-)/Surplus(+)	-7.7	-6.5	-8.8	-8.9	-8	-8.7	-8.6	-7.9	-7.7	-7.7	-7.7	-7.7	-7.7	-7.7
Financing:	7.7	6.5	8.8	8.9	8	8.7	8.6	8.1	7.7	7.7	7.7	7.7	7.7	7.7
Foreign	1.7	0.7	0.7	0.5	2.9	2.2	3.4	2.6	3.7	3.7	3.7	3.7	3.7	3.7
Monetary sector	..	..	..	..	..	..	-1.4	1.4	0.9	0.0	0.0	0.0	0.0	0.0
Other domestic	..	..	..	..	..	..	6.6	4.4	3.1	4.0	4.0	4.0	4.0	4.0
Other														
Total Debt/GDPmp	..	..	..	105.4	105.8	105.5	93.9	93.0	85.7	81.1	79.6	78.6	77.8	77.0
Total interest payments/ Tax revenues	..	..	..	..	..	..	..	34.9	35.9	45.1	40.4	37.8	34.2	30.8
Part C: Debt & Liquidity Indicators														
Total Public DOD and TDS														
DOD (US\$ millions)	14,578	15,222	15,594	17,268	19,267	20,452	21,762	24,211	27,965	30,828	33,062	36,616	39,845	43,157
DOD / GDPmp ratio	94.8%	97.2%	104.0%	102.1%	102.3%	102.3%	90.6%	88.7%	85.8%	81.1%	79.6%	78.6%	77.8%	77.0%
TDS (US\$ millions)	..	..	..	..	..	..	..	..	..	..	..	..	..	..
TDS / exports (XGS) ratio	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Total gross reserves (months' imports G&S)	..	..	..	..	..	..	..	..	..	..	..	..	..	..

CAS ANNEX B7 - KEY EXPOSURE INDICATORS -SRI LANKA

As of April 24, 2008

Indicator	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt outstanding and disbursed (TDO) (US\$m) ^a	9732	9019	8529	9546	10238	10887	12114	13171	14393
Net disbursements (US\$m) ^a	788	-714	-490	184	507	1425	1288	1306	1474
Total debt service (TDS) (US\$m) ^a	738	777	716	718	605	766	909	912	896
Debt and debt service indicators (%)									
TDO/XGS ^b	143.1	115.8	115.2	130.2	126	120.9	128.2	131.5	138.5
TDO/GDP	62.2	55.3	54.4	57.7	56.1	54.3	53.8	54	54.3
TDS/XGS	10.8	10	9.7	9.8	7.4	8.5	9.6	9.1	8.6
Concessional/TDO	..	..	..	76.4	80.4	80.9	..	..	..
IBRD exposure indicators (%)									
IBRD DS/public DS	1.3	1	0.9	0.8	0.4	0.3	0.1	0	0
Preferred creditor DS/public DS (%) ^c	27.1	24.2	28.3	26.5	27.5	36.4	36	28.9	26.8
IBRD DS/XGS	0.1	0.1	0.1	0.1	0	0	0	0	0
IBRD TDO (US\$m) ^d									
Of which present value of guarantees (US\$m)	19.7	13.3	8.3	4	3	1	0	0	0
Share of IBRD portfolio (%)	0	0	0	0	0	0	0	0	0
IDA TDO (US\$m) ^d	1652	1610	1570	1734	2051	2167	2170	2285	2391
IFC (US\$m)									
Loans		50			54				
Equity and quasi-equity/ ^e		18			21	2.9			
MIGA									
MIGA guarantees (US\$m)	4.7	3.4	3.2	1.7	1.7	1.7	1.7		

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net shortterm capital.

b. "XGS" denotes exports of goods and services, including workers' remittances.

c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the

c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.

d. Includes present value of guarantees.

e. Includes equity and quasi-equity types of both loan and equity instruments.

CAS Annex B8 (IFC) for Sri Lanka

Statement of IFC's
Committed and Outstanding Portfolio
As of April 24, 2008
(In US Dollars Millions)

Commitment Fiscal Year	Institution Short Name	Committed				Outstanding				
		Loan	Equity	Guarantee	Total IFC	Loan	Equity	Guarantee	Total IFC	Total Partner
2001/2002	Apollo Lanka	0.00	0.00	2.26	2.26	0.00	0.00	2.26	2.26	0.00
1997	Asia Power	0.00	2.27	0.00	2.27	0.00	2.27	0.00	2.27	0.00
2003/2004/2007	CBC	0.00	20.18	0.00	20.18	0.00	20.18	0.00	20.18	0.00
2004	Dialog	70.00	26.55	0.00	96.55	25.00	11.65	0.00	36.65	0.00
2000	Fitch Srilanka	0.00	0.06	0.00	0.06	0.00	0.06	0.00	0.06	0.00
2007	NDB SriLanka	0.00	0.00	1.96	1.96	0.00	0.00	1.96	1.96	0.00
2008	NTB SriLanka	0.00	0.00	0.11	0.11	0.00	0.00	0.09	0.09	0.00
2000	SAGT	7.23	3.62	0.00	10.85	7.23	3.62	0.00	10.85	0.00
2001	Suntel	0.00	4.20	1.14	5.34	0.00	4.20	1.14	5.34	0.00
Total Portfolio		77.23	56.88	5.47	139.57	32.23	41.98	5.45	79.66	0.32

CAS Annex B8 - Sri Lanka

Operations Portfolio (IBRD/IDA and Grants)

Closed Projects **91**

IBRD/IDA*	
Total Disbursed (Active)	423.8
of which has been repaid	0.0
Total Disbursed (Closed)	2,298.0
of which has been repaid	546.5
Total Disbursed (Active + Closed)	2,721.9
of which has been repaid	546.5
Total Undisbursed (Active)	468.4
Total Undisbursed (Closed)	0.0
Total Undisbursed (Active + Closed)	468.4

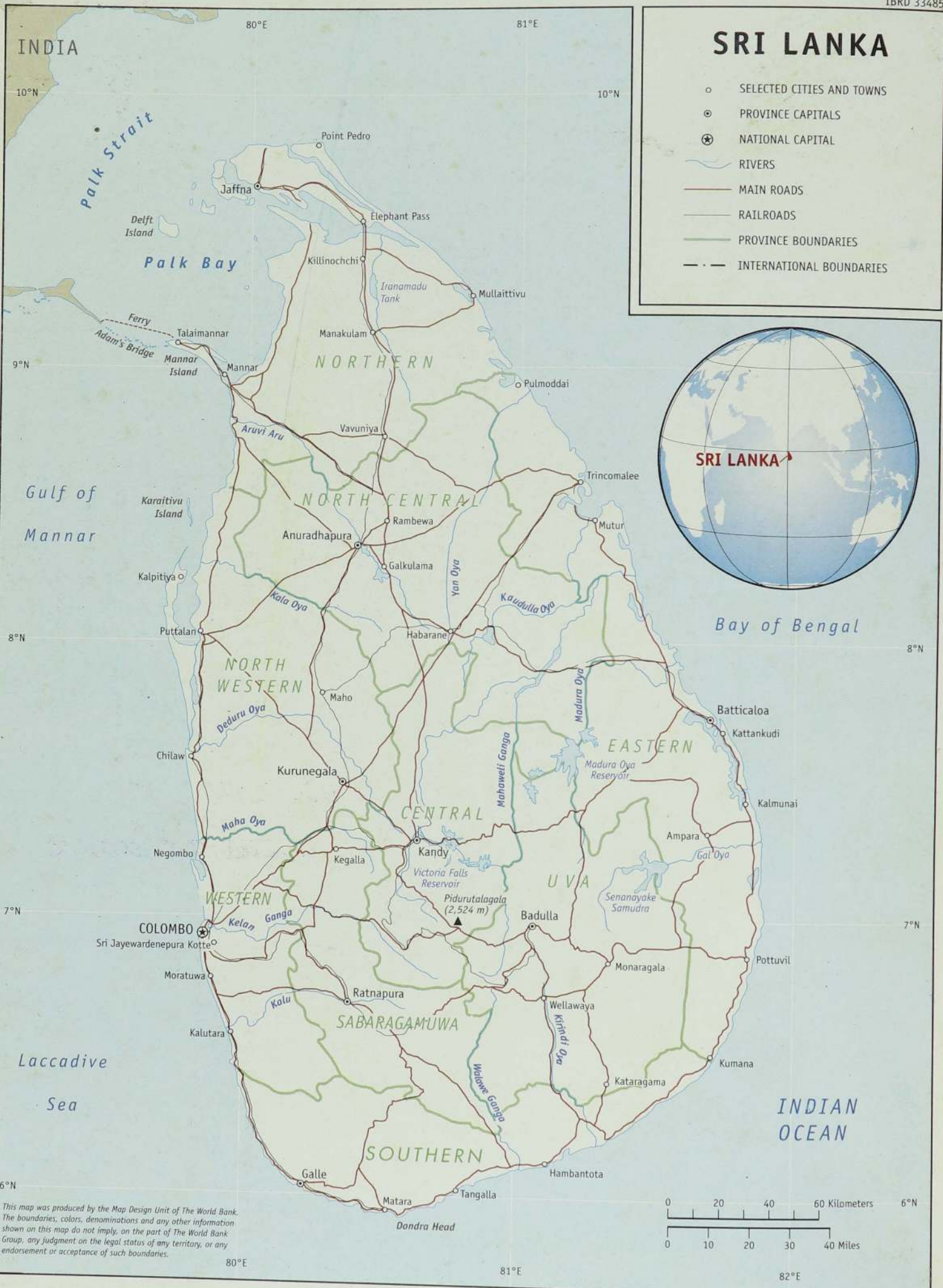
Active Projects	Project ID	Project Name	Last PSR Supervision Rating		Fiscal Year	IDA	GRANT	Cancel.	Undisb.	Orig.	Frm Rev'd	Difference Between Expected and Actual Disbursements ^{a/}
			Development Objectives	Impl. Progress								
	P074872	Community Development & Livelihood "Gemi	S	S	2004	51.0			24.2	7.6		
	P086747	Community Livelihoods in Conflict Areas	MS	U	2004	64.7			55.4	18.9		4.9
	P093132	Dam Safety and Water Resource Mgmt	NA	NA	2008	65.3			65.3			
	P081771	E-Sri Lanka Development	MU	MS	2005	53.0			36.3	27.4		
	P084580	Education Sector Development Project	S	S	2006	60.0			44.4	5.3		
	P050740	Health Sector Development	MS	MS	2004	60.0			18.1	1.2		
	P074730	National HIV/AIDS Prevention	MU	U	2003	12.6			7.1	5.0		
	P083932	North East Housing Reconstruction Progra	S	S	2005	75.0			26.8	9.0		
	P050741	Relevance and Quality of Undergrad. Educ	S	S	2003	40.3			17.3	9.1		
	P077761	Renewable Energy for Rural Economic Dev.	S	S	2002		8.0		0.8	0.6		
	P076702	Renewable Energy for Rural Economic Dev.	S	S	2002	115.0			45.9	-10.2		4.6
	P058067	Second Community Water	S	S	2003	39.8			17.6	8.8		2.1
	P086411	Sri Lanka - Road Sector Assistance	S	S	2006	100.0			73.4	17.5		
	P094205	Sri Lanka Tsunami ERL	S	MS	2005	75.0		0.1	4.6	5.8		
	P100390	Sri Lanka: Puttalam Housing Project	S	S	2007	32.0			31.2	-0.7		
Overall Result						843.7	8.0	0.1	468.4	105.2		11.6





SRI LANKA

- SELECTED CITIES AND TOWNS
- ⊙ PROVINCE CAPITALS
- ⊛ NATIONAL CAPITAL
- RIVERS
- MAIN ROADS
- RAILROADS
- PROVINCE BOUNDARIES
- INTERNATIONAL BOUNDARIES

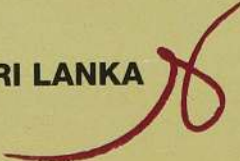


This map was produced by the Map Design Unit of The World Bank. The boundaries, colors, denominations and any other information shown on this map do not imply, on the part of The World Bank Group, any judgment on the legal status of any territory, or any endorsement or acceptance of such boundaries.



Ensuring babies stay healthy with immunization and growth checks at the Well Baby clinic at Mahiyangana Base Hospital. **Health Sector Development Project.**

PUBLIC LIBRARY
SPECIAL COLLECTION

SRI LANKA  COUNTRY
ASSISTANCE
STRATEGY



THE WORLD BANK
IN South Asia

The World Bank
73/5, Galle Road
Colombo 03
Sri Lanka
Telephone : 94 11 5561329
Facsimile : 94 11 2440357
www.worldbank.org/lk

Digitized by Noolaham Foundation
noolaham.org | noolaham.media