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Country Paper: Development Strategies, Welfare Regime and Poverty Reduction in Sri Lanka

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Introduction

Sri Lanka has been always praised for its achievements in human development despite being a developing country. The achievements in human development are indicators of the success of different policies on social welfare followed by the country's governments. Sri Lanka's achievements in social development were arrived at in a short period of time after political independence despite a low per capita income and low levels of economic development. What is more impressive is that the country had been able to continue this level of social development despite various downfalls in the economy and in different economic and political regimes. This can be seen from Sri Lanka's Human Development Index (HDI) which was 0.743 for the year 2005, ranking 99th in the country list of 117. According to UNDP (2006), the life expectancy at birth is 71.6 years (2005), adult literacy 90.7 (% ages 15 and older – 1995-2005), infant mortality rate is 12 (per 1,000 live births - 2005) and maternal mortality ratio reported 1990-2005 is 43 (per 100,000 live births). However, it is argued that Sri Lanka's high achievements in human development indicators, despite downturns in the economy, have concealed many issues in social development. Hence it is worthwhile to examine its development strategy in historical perspective and with a special emphasis on social development and its evolution over the years. This will also help to understand certain drawbacks too.

A) Development Strategies, Structural Transformation, Inequality and Poverty

Development Strategy in a Historical Perspective

At the time Sri Lanka gained political independence from the British in February 1948, the country had a successful primary exports based economy. The predominantly agricultural based economy hitherto gradually transformed into a more diversified one, with increasing dependence on the manufacturing sector. For the easy analysis of the development strategies over time, the report will discuss the development strategies of the entire period from 1948 to date, divided into two periods (i) 1948–1977 and (ii) 1978 to present, for each topic under discussion.

A Historical Perspective of Development Strategies

(i) 1948–1977 Period

The first period represents the first three decades after independence, when the country had a favourable terms of trade. The country had a predominantly agriculture-based economy based on plantation crops, mainly tea, rubber and coconut. During the period between 1948 to 1955, although the country's economy was heavily dependent on a few primary commodities, the increasing commodity prices allowed the country to retain favourable terms of trade. The prices of tea and rubber continued to rise. However, during this period, with the weak budgetary policy of the Government and the weak monetary policy of the Central Bank, there was no adequate control on the increasing incomes of the people or the high liquidity of the economy. Personal incomes were on the rise and private consumption was increasing-especially due to the consumer subsidies available at that time. Consumer imports also increased tremendously during this period. The major problem with these strategies is that investment was not considered as seriously as it should have been to ensure sustenance. Government efforts to lay a good infrastructure foundation were far from adequate. As a result, the productive capacity of the economy remained static. Further, the government policies did not lay any foundation to diversify agriculture, which led the economy to depend on the three main primary exports of tea, rubber and coconut until very recently. Nor did the government identify the importance of reducing Sri Lanka's dependence on agriculture by diverting investment or developing the industrial sector. Government expenditure was utilized mainly for maintaining the redistributive expenditure rather than on capital formation (Indraratna 1998).

The period from 1956 to 1977 is significant due to the restrictive policies adopted by the regimes at the time. During this period, the country had experienced a considerable deterioration in the economic situation. By the middle of 1955, the export boom collapsed when the commodity terms of trade began to deteriorate, and the economy kept deteriorating during subsequent periods. Despite the obvious shrinking of the economy the government continued to adhere to the same policies until the 1960s. Food subsidies absorbed a major portion of the government budget while imports kept increasing at a relatively higher rate than exports.

By about 1958/59, with the long term objective of increasing private sector savings and investment, the government introduced a new direct taxation scheme. However, this had to be abandoned later due to problems that arose in implementation. In 1957, the State Industrial Corporation Act was passed and several State Corporations were established to produce import substitutes. Some State-Owned Enterprises (SOEs) which came into operation before the Act too were nationalized.

Another turning point came about in 1960 with the Sri Lanka Freedom Party (SLFP) coming to power, while the economy still was in a downturn. The government pursued a policy to protect the domestic market, by restricting imports through elevating the tariff levels, imposing licensing quotas and banning selected imports which would harm the domestic producers. As such, the Government followed a policy of Import Substitution in Industry (ISI). The ISI policy promoted the expansion of industries (which were earlier mainly confined to government corporations) by encouraging the entrance of the private sector with a wide range of small and medium enterprises (SMEs) in manufacturing. However, the whole ISI policy became a failure, mainly due to the fact that domestic substitution was not adequate to offset the shortfall in curtailed imports, except in a few product lines. The government was unable to maintain good macroeconomic conditions and many SOEs were running at a loss with high government subsidies. As Indraratna (1998) points out, 'the entire approach of the development policy during this whole time period had been marked by a spirit of experimentation'.

The replacement of the SLFP government in 1965, with the United National Party (UNP) government brought about some major changes in the policy arena. The new government followed an import substitution in agriculture replacing the ISI policy of the previous regime. Hence, the attention was diverted into import substituting subsidiary crops for plantation and arable agriculture. However, the country was still heavily dependent on the three primary products of tea, rubber and coconut. Though there was an increase in capital formation, this was not sufficient and the efforts were not strong enough to maintain a sustainable social and economic infrastructure. Even with these efforts economic conditions kept deteriorating and the terms of trade were more unfavourable for the country.

In 1970, the SLFP government resumed office, still with its inward-looking policy of import substitution. The new government also changed the constitution converting the country to the Socialist Democratic Republic of Sri Lanka. The new government got involved in nationalization in the form of Government-Owned Business Undertakings (GOBU) by passing the 1971 Business Acquisition Act. The plantations were nationalized and management was handed over to the Janatha Estate Development Board (JEDB) and State Plantation Corporation (SPC), under the 1972 Land Reform Law. Due to inefficiencies in management and politicization, Sri Lanka lost its competitive edge in exports of its primary products. Subsequently, all other sectors contracted due to the restrictive policies which inhibited the growth of these sectors. Despite the already high levels of import tariffs on all imports except for essential food items, all other goods came under licensing; foreign travelling, movement of capital and labour, etc. were heavily controlled. Sri Lanka became a highly restricted and regulated closed economy, in all ways, with a socialist policy. At this time, the government introduced a two-tier foreign exchange system for the fixed exchange rate system (Indraratna 1998).

(ii) Post-Liberalization Period (Post-1977)

The period from 1978 to present, represents the history of open market reforms. In 1977 with the change of the government and with the United National Party (UNP) coming to the power open economic policy was adopted. The reforms are a clear break from the past economic regime and it shows a reversal of the economic policies of the previous regime. The reforms are in the form of liberalization of trade and exchange control, moving towards an economic strategy with more dependency on private investment and market forces (Sanderatne 2005).

Within this policy frame, the government implemented a trade liberalization package by the end of 1977, which brought in a sequence of drastic changes to the economy. An important move was to reduce the restrictions on imports by licensing and quotas being replaced with tariffs. In addition, the government wanted to convert expenditure on the food subsidy into expenditure on investment. This meant that the government had to come to a compromise by only targeting the subsidy to the bottom half of the population. Restrictions were relaxed for foreign travel and movement of capital and labour. Furthermore, the new government changed the two-tier fixed exchange rate system to a unified managed float (Indraratna 1998; Jayawardena 2004).

The new development policy of the government focused on several measures for development such as promotion of exports by setting up the Export Development Fund (EDF) and Export Development Board (EDB), coupled with other measures such as establishment of an Investment Promotion Zone (IPZ), Export Processing Zones (EPZs) and a Free Trade Zone (FTZ) at Katunayake which is close to the international airport of the country. The establishment of the EPZs and the privatization programme can be mentioned as the two most important developments that occurred in the post-1977 period. This created an environment which is favourable to attracting more Foreign Direct Investment (FDI). In the recent past several new EPZs were established after starting the Katunayake FTZ, especially for the expansion of garment industries. This is mainly due to the Sri Lankan garment sector benefiting from the quotas imposed by the Multi Fibre Agreement (MFA). Another eight FTZs and two Industrial Parks have been added to the list afterwards. Likewise there were many other incentives for export promotion. At present, foreign investors are allowed to invest in any part of the country apart from the

EPZs and they still receive the same benefits. After realizing that privatization is a channel for entry of FDI and after realizing the important role that FDI can play in the economy, the government announced the privatization policy in 1987. As a result, in the period between 1989 and 2002, a total of 84 SOEs have been privatized (Indraratna 1998; Thennakoon 2007; Board of Investment 2007).

In keeping with its more market oriented policies, the government removed the domestic control of prices and subsidies were significantly reduced or cancelled altogether. The importation and distribution of essential food which was more of a government monopoly was opened up to the private sector. Together with these initiatives the government also commenced a number of massive investment programmes specially to provide infrastructure services. One of these is the Mahaweli Development Project, which was initially proposed to take 30 years but was ultimately accelerated and completed in six years. All these led to growth in imports and exports as well as expansion of economic activity within the country. The increase in public investment in infrastructure and active investment of the private sector contributed to the expansion of the economy. There was a significant contribution from foreign employment after opening up of foreign employment opportunities and tourism related sectors.

Although in the first few years of the open market reforms the economy was on an upswing, due to inappropriate policies inflation started to rise; the increasing interest rates crowded out private investment and terms of trade worsened. By about 1983, the country's economic state worsened which was partly affected by the intensification of terrorism (Indraratna 1998).

Recent Development Strategies

Elections in 1994 brought about a change of government, however, despite the change of rule the continuity of the economic policies was assured. The new government adhered to open economic policies 'with a human face'. While considering (both the domestic and foreign) private sector as the engine of growth by pursuing market friendly policies, government intervention was limited to areas where the markets failed to function, so that they served the welfare of the people (Sanderatne 2005).

The new government in 2002 presented a vision and strategy for accelerated development called 'Regaining Sri Lanka' (RSL). The framework identified the acceleration of the process of privatization of commercial activities, the reformation of the legal foundations of the economy and an increase in efficiency in the critical government functions as the key elements of the programme required for Sri Lanka to regain control of the economic situation. The RSL policy initiative of the United National Front (UNF) regime sought to eliminate the rigidities for investment which had made the country less competitive than other countries in East Asia. According to this report, implementing the second generation reforms of deepening economic liberalization was the solution. Accordingly, letting the private sector play a dominant role in the economy and deregulation were a means of putting the country back on track. Furthermore the country's Poverty Reduction Strategy Paper (PRSP) was also built into the RSL which emphasizes the trickling down of economic gains for poverty reduction. However, due to several reasons the strategy did not succeed as expected. One main reason is that the economic gains did not trickle down. The growth has been highly centred on the Western province with only little gains to other areas. However, with the change of government after the 2004 General Election there was a halt to these reforms. This shows the resilience of the people over the policy package and the peace process of the government (Government of Sri Lanka 2003; Kelegama 2006).

The coalition government (based on a Memorandum of Understanding between the Sri Lanka Freedom Party and the Marxist Janatha Vimujthi Peramunua) which took office in 2004 launched a five point nation building programme called ‘Rata Perata’ (Country Forward: Creating Our Future Building Our Nation), which included a new economic order, durable peace with dignity, investing in people, clean governance and ensuring law and order. The new United People’s Freedom Alliance (UPFA) adopted a different strategy to that of the UNF regime, realizing that social policies are essential for growth and economic stability. The policy of the new regime emphasized an equitable distribution of income by providing enhanced relief for the poor and vulnerable while encouraging more economic activities in the rural areas, through support of small and medium enterprises. Further, the government continued with welfare measures even at a time of high fiscal constraints despite the resistance of the multilateral financial institutions. Some polices such as restoring the fertilizer subsidy, broadening the poverty alleviation programme, and continuation of electricity, transport and petroleum subsidies were carried out to address the issues of poverty and unbalanced growth at the time (United People's Freedom Alliance 2004; Kelegama 2006).

The most recent development plan is the Mahinda Chinthana: Vision for a New Sri Lanka. It provides a development framework for the country with a ten year horizon, 2006-2016. Its aim is to raise the GDP growth rate in excess of 8 percent. Further, it tries to integrate the positive attributes of the market oriented economic policies while safeguarding the domestic aspirations by providing necessary support to domestic enterprises and encouraging foreign investment. The planning refers to creating an economy which is largely private sector driven, more dynamic and regionally integrated. It is important to note that the current development strategy emphasizes the importance of regional development, which is a timely issue. The social development plan covers many areas such as education, health, livelihood development, social protection, disaster management, water supply and development of the lagging regions. The post-2005 welfare regime strengthened targeted welfare expenditure in Samurdhi, a nutritional meal programme, free school uniforms, text books and season tickets, bursaries and scholarships, and a fertilizer subsidy (paddy and small holding agriculture) (Ministry of Finance and Planning 2006).

The Civil Conflict

In 1983, at a time when the economy of the country was on an upswing, the ethnic conflict flared up. Despite a temporary ceasefire in 2002 the situation still remains unresolved. The roots of the conflict go back to the colonial era. A conflict lasting more than two decades has caused immense economic and humanitarian losses to the country. Estimates suggest that the country lost about 2-3 percent of the GDP growth per year after 1983 due to the civil conflict. Military expenditure has risen from about half a percent of the GDP in 1970s to about 6 percent of GDP in 2000 and the size of the armed forces has also increased from about 10,000 to 300,000 during this period. The security expenditure in total government expenditure had risen from about 3 percent to over 20 percent from the 1980s to 1990s (The World Bank 2007).

Growth and Sectoral Structure

Trends in GDP and Sectoral Growth

The trends in GDP show the process of growth and development of the country. From the 1950s growth varied during different periods. In the 1950s, the economy grew only by 3 percent, in the 1960s, it grew by 4.7 percent. Again in 1970s, the economic growth slowed down to 3.9 percent. The growth of the semi-decades also differs highly and only in the period from 1960-69, the growth had been stable for both halves of the decade.

The very low growth rates of 1970-74 were due to external shocks, internal disruptions or both. Issues such as the international oil price hikes and the international food grain shortage are some examples. In addition, internal disruptions due to the insurgency of 1971 together with the drought worsened the situation.

Table 1: Economic Growth by Decades and Semi-Decades

Decade	**Semi-Decade**	**Annual Average GDP Growth**
1951-59		**3.0**
	1951-54	3.9
	1955-55	2.5
1960-69		**4.7**
	1960-64	4.5
	1965-69	4.8
1970-79		**3.9**
	1970-74	2.9
	1975-79	4.9

Note: Since GDP estimates commenced in 1950, there is no growth rate for 1950
Primary Source: Central Bank of Sri Lanka Annual Reports and Central Bank of Sri Lanka, 1998-economic progress of independent SL
Secondary Source: Sanderatne (2005)

Looking at the past two decades, it can be observed that the economy has been growing at a rate of about 5 per cent during the period 1980-2004. In the 1990s the average growth rate of GDP increased to about 5.2 percent compared to 4.2 percent growth during the 1980s. The growth during the recent years has declined to an average of about 4.0 percent during 2000-04. This was largely due to the significant negative growth of the economy in the year 2001, which took the growth of the country to a drastic downturn. The overall economic growth of the country of -0.5 per cent in 2001 was the lowest economic performance since independence in 1948.

A series of unfavourable occurrences resulted in this situation. Some contributory factors that led to this economic downturn are the global recession following the September 11 terrorist attack in the United States, the prolonged drought since 2000 that had an adverse impact on agricultural output and hydropower generation, and the terrorist attack on the Katunayake International Airport (in July 2001), which sharply reduced tourist arrivals and reduced external trade. The economic slowdown in 2001 reduced the output in all the major sectors. Nevertheless, the overall economy started to recover, with an increase in the growth rate to 4 per cent in 2002 and grow rates of over 5 per cent since 2003. By 2006, the economy achieved a growth rate of 7.4 percent which was impressive considering the ongoing conflict situation (Tilakaratna *et al* 2006; Central Bank of Sri Lanka 2007).

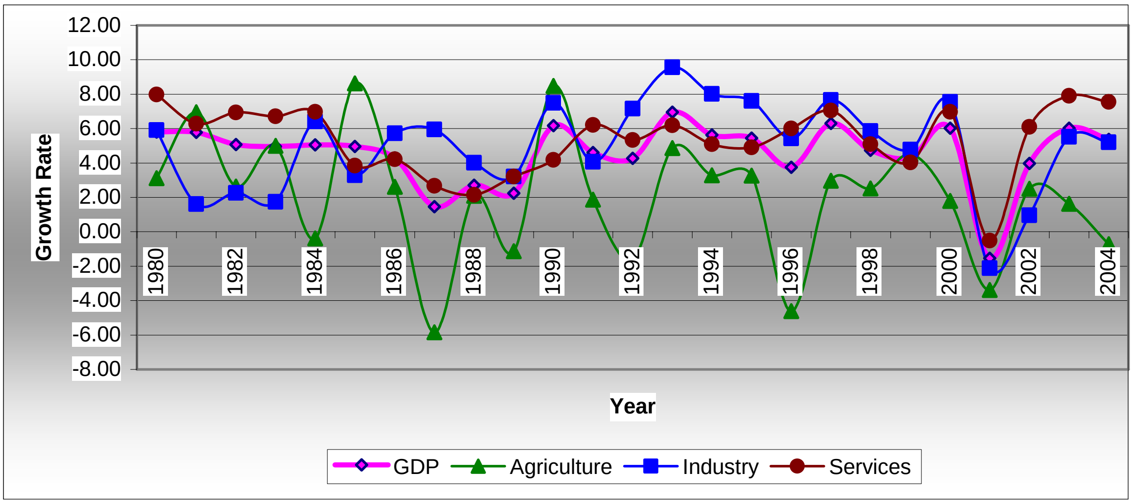
Table 2: Average Annual Growth Rates of Output: 1980s, 1990s and 2000-04 (%)

Sector	**1980s**	**1990s**	**2000-04**
GDP	**4.2**	**5.2**	**4.0**
Agriculture Sector	**2.4**	**2.6**	**0.4**
Agriculture	2.4	2.5	0.2
Forestry and logging	3.3	1.4	2.2
Fishing	2.7	4.2	-0.1
Industry Sector	**4.0**	**6.8**	**3.4**
Mining and quarrying	6.3	2.6	3.6
Manufacturing	5.3	8.0	3.3
Electricity and water	6.6	8.0	4.0
Construction	1.3	5.2	3.7
Services Sector	**5.1**	**5.4**	**5.6**
Transport, storage & communication	4.7	6.3	8.7
Banking insurance and real estate	9.4	7.9	8.5
Wholesale and retail trade	4.6	5.2	4.1
Public administration and defence	10.2	3.4	1.6
Hotels, restaurants & other services	2.2	5.7	4.7
Ownership of dwellings	2.9	1.3	1.4

Primary Source: Calculations made using data from the Central Bank Annual Reports, various issues.
Secondary Source: Tilakaratna *et al* (2006)

The agricultural sector has shown the lowest growth performance since 1980. Further, the sector shows huge fluctuations and negative growth rates in a number of years (e.g. 1987, 1989, 1992, 1996, 2001 and 2004) mainly due to adverse weather conditions (see figure 1). During the 1980s and 1990s the average growth rate of the agriculture sector was around 2.5 percent. This reduced to 0.4 percent during the 2000-04 period. The industrial sector shows an improvement in its growth rate to 6.8 percent in 1990s compared with a 4.0 percent average growth rate in the 1980s. However, the growth rate during 2000-04 period had reduced to 3.4 percent. All the sub-sectors of this sector, with the exception of mining and quarrying sub-sector, have shown higher growth rates in the 1990s than the comparable rates in the 1980s. Nevertheless, during the 2000-04 period, the manufacturing sub-sector in particular experienced around a 50 per cent decline in output growth, resulting from the negative growth in 2001. The industries sector has been moving back to a high growth path with growth rates of 8.3 percent in 2005 and 7.2 percent in 2006. The growth performance of the manufacturing sub-sector has been somewhat slow and considerably lower than pre-2001 levels. In 2005, the manufacturing sector recorded a growth rate of 6 percent, but in 2006 this fell to around 5.3 percent (Central Bank of Sri Lanka 2007).

Figure 1: Trends in GDP and Sectoral Growth Rates (1980-2004)



Primary Source: Based on the calculations made using data from the Central Bank Annual Reports, various issues
Secondary Source: Tilakaratna *et al* (2006)

Unlike the other sectors of the economy, the services sector has remained quite stable over the years with few exceptions. The average growth rate in 1980s, 1990s as well as in 2000-04 period has been more than 5 percent and on an increasing trend. The services sector is comprised of transport, communication, banking, trade, etc. Particularly during the post-2000 period, the telecommunication and banking sub-sectors have grown at significantly high rates. For example, the average annual growth rates of the telecommunication and banking sub-sectors during the 2000-04 period were 24.8 percent and 12.1 percent respectively. Further, the services sector recorded a growth of 8.3 percent in 2006 (Tilakaratna *et al* 2006; Central Bank of Sri Lanka 2007).

To summarize, categorizing the economic performances by two economic and policy regimes shows clearly how the alternating economic policies retard the economic growth of a country. Such different economic regimes raised uncertainties, reversal of policies which created a hostile climate for investment. Table 3 shows how the growth had changed in different regimes with high growth rates associated with periods of economic liberalization, free trade, lesser controls and lesser state management (Sanderatne 2005).

Table 3: Economic Growth by Regimes (Percent per annum)

Liberal Regimes		**Dirigisme Regimes**	
Period	**Growth**	**Period**	**Growth**
1951 - 55	4.3	1956 – 1959	1.6
1965 – 69	4.8	1960 – 1964	4.5
1978 – 93	4.9	1970 – 1974	2.9
1994 – 99	5.0	1975 - 1977	3.3
2000 - 04	4.0		

Primary Source: Central Bank of Sri Lanka Annual Reports
Secondary Source: Sanderatne (2005)

Change in Sectoral Composition of GDP

It is important to see the contribution of the major sectors of the economy to GDP. The change in the sectoral composition of GDP shows the changing role of the agricultural sector in the economy since 1960. Half of the contribution to GDP in 1960s had been from agriculture. The services sector also played a major role with a contribution of 42 percent in the 1960s. The industrial sector contribution was only about 11 percent. During the subsequent period, the services sector emerges to play the dominant role. The contribution of the agricultural sector reduced almost by half and the industrial sector contribution had increased up to 20 percent, mainly due to the increasing contribution of the manufacturing sector.

The agricultural sector in the pre-liberalization period is dominated by the plantation crops. However, due to the changes in the agricultural policies during this time frame, the composition of the agricultural output changed gradually. The plantation crops which dominated the agricultural sector, accounting for 70 percent of the agricultural output in 1950, reduced to less than 25 percent of the total agricultural output by 1977. Paddy and other food crops accounted for only 30 percent of the agricultural output in 1950. The share of domestic agriculture not only exceeded export agriculture in later years but also changed its composition. Despite a substantial increase in the output over years and being the mainstay of domestic agriculture, the role of paddy diminished in importance due to the growth of other food crops. This is evident by the fact that the contribution to GDP of other food crops was much more than the combined contribution of the three plantation crops and paddy by 1977 (Sanderatne 2005).

These changes occurred due to a number of policy changes at the time. One of the main reasons for the re-emergence of domestic agriculture is the increased emphasis paid upon food crop production, particularly, paddy. The roots of this re-emergence go back to the early years when the grant of internal self-government on the basis of universal franchise in 1931 gave thrust towards food self-sufficiency. After controlling malaria, during 1950-1965, approximately 200,000 acres of land were alienated under the Land Settlement in Dry Zone. This resulted in a significant increase of paddy production. More importantly, the Paddy Lands Act of 1958 provided a comprehensive package of policies including policies such as the Guaranteed Price Scheme (GPS) for paddy, expansion of institutional credit, improvements in agricultural extension and fertilizer subsidies which boosted the production of paddy and other food crops. Most importantly, it should be realized that all these supports were within the overall import substitution policy, which protected agriculture from 1960 to the end of the period (Sanderatne 2005).

On the contrary, the contribution of the agricultural sector has declined continuously from 32.5 percent in 1980 to nearly 17.9 percent in 2004, showing the transformation of the economy after economic liberalization. By end of 2006 the agriculture sector contributed the least to GDP (16.8 percent), industrial sector playing the second most dominant role, contributing to 27 percent of GDP and the services sector playing the dominant role by contributing 56.2 percent of the GDP (Central Bank of Sri Lanka 2007).

Table 4: Sectoral GDP Percentages

Sector	1960	1965	1970	1977
Agriculture Sector	**46.9**	**36.65**	**34.87**	**26.74**
Industrial Sector	**11.06**	**16.35**	**20.21**	**21.71**
Mining and quarrying	0.18	0.45	0.67	3.20
Manufacturing	5.18	12.38	13.63	14.66
Electricity and water	-	-	-	-
Construction	5.70	3.52	5.91	3.85
Services Sector	**42.04**	**46.82**	**44.73**	**50.73**
Transport, storage & communication	8.36	9.79	9.35	9.32
Banking insurance and real estate	0.85	1.19	1.21	1.83
Wholesale and retail trade	10.56	14.61	14.26	18.65
Public administration and defence	6.56	4.92	4.70	4.92
Ownership of dwellings	2.91	3.61	3.09	2.95
Other Services Sector	12.80	12.70	12.12	13.06

Source: Indraratna (1998)

It is important to note that even the smaller contribution of the service sector is ancillary to plantation crops in the pre-liberalization period. The supportive services included transport of fertilizer and other inputs for estates, transport of export produce by road, rail and ships. Moreover, this also included the banking and insurance services for export agriculture (Sanderatne 2005).

The comparison of the contribution of different sectors to GDP shows the dominant role of the services sector in the economy in recent decades. It accounted for over 50 percent of GDP since the 1980s and it shows an increasing trend. This is largely due to the expansion of sub-sectors of transport and telecommunication, and banking, insurance and real estate.

It is noteworthy to mention that in the 1950s, most of the manufacturing output consisted of processing of tea, rubber and coconut, accounting for about 60 percent of the manufacturing output. At the period other factory industries were a negligible component. Further, before 1970, there were only very few industrial products such as cement, chemicals glass and cottage industries. The import substitution strategy the country adopted, which attempted to manufacture a wide range of consumer goods from 1970 to 1977, did not have a significant impact on changing the structure of the economy. The main facts which underlie the failure of the import substitution strategy are due to the availability of few raw materials, being a small country; inadequate capital; inadequate technology; and a small domestic market, which did not allow production of quality material at competitive prices. Moreover, there were changes in the ownership and the management of the economic enterprises and the command of the economic enterprises at this time was taken over by the state. In 1958, the bus transportation service was nationalized and in 1961 the Bank of Ceylon was nationalized and the People’s Bank and the Insurance Corporation were established as state enterprises. Moreover, the plantations were taken over by the government and several industrial enterprises were established by the state (Sanderatne 2005).

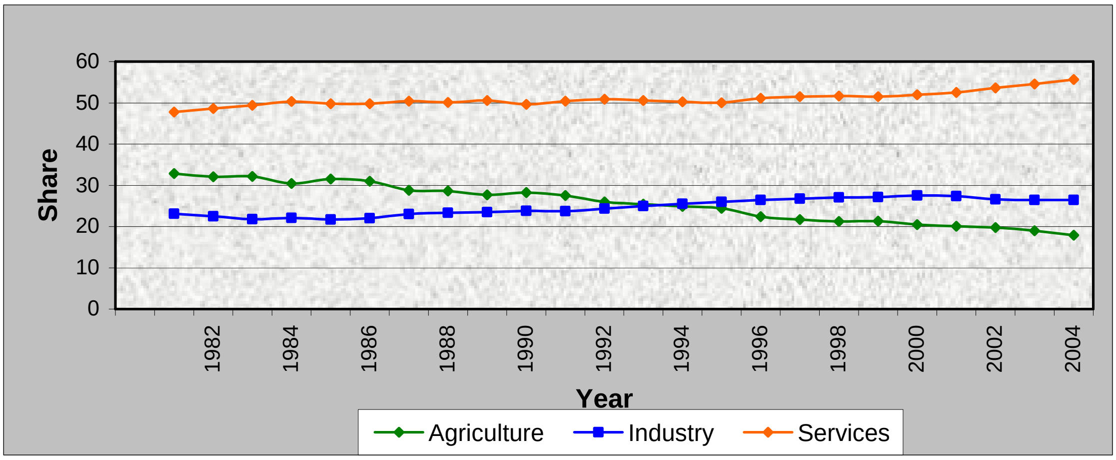
Since the 1980s, the contribution of the industrial sector to GDP has been around 25 percent and in recent years it has shown an increasing trend. Looking at the change in the composition of the industrial sector, it is evident that the growth was due to the increased contribution to GDP particularly by the manufacturing sub-sector. During the post-liberalization period, the export-led manufacturing sector gained a significant importance not only in quantitative terms but also in qualitative terms. The manufacturing sub-sector alone contributed 16 percent to GDP in 2006. In the pre-liberalization period, industrial output mainly consisted of tree crop processing; only few industrial products were available and there were a large number of small industries producing consumer goods for the protected domestic market and cottage industries. The later liberalization diversified the manufacturing sub-sector dominant role being captured by the factory industry, contributing 13 percent to the GDP in 2006. The trade liberalization which encouraged foreign investment is the cause of the transformation and the diversification of the industry sector.

Table 5: Sectoral Composition of GDP (1980-2004)

Sector	**1980**	**1984**	**1988**	**1992**	**1996**	**2000**	**2002**	**2004**	**2006**
Agriculture Sector	**32.5**	**30.5**	**28.6**	**26.0**	**22.4**	**20.5**	**19.8**	**17.9**	**16.8**
Agriculture	25.3	24.3	22.7	20.4	17.6	15.9	15.1	13.8	13.4
Tea	2.2	2.0	1.9	1.3	1.5	1.4	1.4	1.3	1.1
Rubber	1.3	1.1	0.9	0.6	0.6	0.4	0.4	0.3	0.3
Coconut	3.0	2.4	2.1	2.1	1.8	1.8	1.3	1.2	1.2
Paddy	6.2	5.7	5.1	4.0	2.9	3.2	3.1	2.6	2.9
Other	11.7	12.6	12.3	12.5	10.9	9.1	8.9	8.4	7.9
Forestry and logging	3.1	3.0	2.7	2.6	2.1	1.8	1.9	1.7	1.6
Fishing	4.0	3.0	3.1	3.0	2.7	2.7	2.7	2.3	1.8
Industry Sector	**24.1**	**22.1**	**23.3**	**24.4**	**26.4**	**27.6**	**26.6**	**26.5**	**27.0**
Mining and Quarrying	1.9	1.9	2.3	1.9	2.0	1.7	1.7	1.7	1.9
Manufacturing	11.2	11.4	12.7	14.3	16.2	17.4	16.6	16.3	16.0
Processing tea, rubber etc.	3.5	3.1	3.0	2.2	2.3	2.1	1.9	1.7	1.6
Factory industry	6.6	7.2	8.6	10.9	12.6	14.0	13.5	13.4	13.2
Small industry	0.7	0.7	0.7	1.2	1.3	1.3	1.2	1.2	1.2
Electricity and Water	0.9	1.1	1.1	1.2	1.3	1.5	1.4	1.5	1.9
Construction	9.9	7.8	7.2	7.0	6.9	7.0	6.9	7.0	7.2
Services Sector	**47.6**	**50.4**	**50.1**	**50.9**	**51.1**	**52.0**	**53.6**	**55.7**	**56.2**
Transport, storage & coms	10.1	10.9	10.5	10.8	10.6	11.8	12.8	14.4	
Port Services						0.8	0.8	0.9	
Telecommunications						2.6	3.7	5.4	
Transport						8.4	8.4	8.2	
Banking, Ins.& real estate	3.9	5.0	5.7	6.0	7.1	7.6	8.9	9.3	
Banking						2.8	3.8	4.0	
Insurance, Real Estate						4.8	5.1	5.4	
Wholesale and retail trade	21.4	21.7	21.8	22.0	22.3	22.1	21.3	21.6	
Public admin. and Defence	3.4	4.6	5.3	5.3	5.1	4.8	4.8	4.4	
Hotels & other services	5.0	4.7	3.9	4.3	4.0	4.0	4.1	4.3	
Hotels and Restaurants						0.7	0.6	0.7	
Other services						3.3	3.5	3.5	
Ownership of Dwellings	3.1	2.9	2.7	2.4	2.0	1.8	1.8	1.6	

Primary Source: Calculations made using data from the Central Bank Annual Reports, various issues.
Secondary Source: Tilakaratna *et al* (2006); Central Bank Annual Report (2007)

Figure 2: Pattern of Sectoral Composition of GDP (1980-2004)



Primary Source: Based on the calculations made using data from the Central Bank Annual Reports, various issues
Secondary Source: Tilakaratna *et al* (2006)

Change in the Composition of Imports and Exports

By 1950, the main export of the country was agricultural produce, which accounted for about 94 percent of the total exports. The major export products of agriculture were tea and rubber. This remained the case until the 1980s. Even by 1977, 79 percent of total exports were agricultural.

Table 6: Composition of Exports: 1950, 1977

Export Category/ Item	**1950**	**1977**
Agriculture	93.7	79.3
Of which: Tea, Rubber, Coconut	93.7	74.3
Other agriculture produce		5.1
Industrial	n.a.	14.2
Of which: Textiles and garments		2.1
Petroleum		9.0
Other industrial		3.0
Others (including minerals)	6.3	6.5
	100.0	**100.0**

Source: Sanderatne (2005).

The 1977 economic reforms included the liberalization of trade and exchange control. Table 6 shows how the composition of exports has changed over the years since 1978. In the year 1978, agricultural products, accounting for over 75 percent of the exports, indicate how trade in Sri Lanka had been based on primary exports. It is interesting to note the predominance of the tea sector in the economy, accounting for close to half of the exports at the time. This was followed by rubber and industrial products amounting for 15 percent and 14 percent respectively. The figures of 1990 show how the roles of each category had turned around over the 12 years. Agricultural and industrial products had exchanged their importance. By this time, industrial products dominated the exports, accounting for more than half of the total exports (52.2%), particularly the garment products accounting for 31.6 percent of the exports. However at the time, the agriculture sector still accounted for about 36 percent of the exports and the contribution of the tea sector had reduced to half what it had been in 1978 (25 percent).

Table 7: Composition of Exports: 1978 - 2006

	Composition (%)				
	1978	**1990**	**2000**	**2004**	**2006**
Agriculture	**76.1**	**36.3**	**18.2**	**18.5**	**18.8**
Tea	48.4	24.9	12.6	12.8	12.8
Rubber	15.3	3.9	0.5	0.9	1.4
Coconut	7.4	3.5	2.1	1.9	1.8
Other Agriculture	5.0	4.0	2.8	2.9	2.8
Industrial	**14.3**	**52.2**	**77.5**	**78.2**	**78.3**
Garment	-	31.6	54.0	48.8	44.8
Gems	**4.0**	**3.7**	**1.6**	**1.9**	**1.7**
Other	**5.5**	**7.1**	**2.5**	**1.1**	**1.2**
Total Exports	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Primary Source: Estimated from data available from the Central Bank of Sri Lanka, Annual Report, various issues.
Secondary Source: Weerakoon and Thennakoon (2006); Central Bank of Sri Lanka (2006)

Further, towards 2006, the role of industrial sector in exports is dominant, accounting for about 78 percent of exports and the garment sector accounts for about 45 percent of exports. The role of agriculture in exports reduced tremendously, now accounting for only about 19 percent of total exports. The contribution of rubber had become far less important, accounting for only about 1.4 percent of the exports.

Table 8: Composition of Imports (Percentage share)

Import categories/ Items	**1951**	**1960**	**1970**	**1977**	**2004**
Consumer goods	56.6	61.0	55.4	42.2	10.7
Food	44.6	38.4	45.7	36.3	5.8
(of which: rice)	(15.2)	(12.3)	(13.7)	(15.3)	(3.8)
Other consumer goods	11.9	22.6	9.7	5.9	4.9
Intermediate goods	17.5	20.3	20.0	44.1	62.8
Investment goods	25.7	18.1	23.6	12.4	5.0
Unclassified	0.2	0.7	1.0	1.3	0.1

Source: Economic Progress of independent Sri Lanka, Central Bank of Sri Lanka (1998); Sanderatne (2005)

Looking at the composition of imports shows that the import structure did not change much between the 1950s and 1977. As discussed earlier, though there was a shift in the focus of agriculture from plantations to domestic agriculture, food imports still remain dominant in the imports list. As the table 8 shows, in 1951, food imports alone account for 45 percent of total imports, with rice imports accounting for 15 percent of total imports. By 1977, though food imports has reduced marginally to 36 percent, rice imports still account for 15 percent of total imports. As Sanderatne (2005) explains, the answer to this paradox is the absorbance of the increased food production by the greater consumption of the population that increased by 85 percent between 1950 to 1977.

With the liberalization of the economy, the import structure too changed dramatically. Consumer goods which accounted for 57 percent of total imports in 1951, accounted for only 11 percent by 2004. More significantly, food imports, which accounted for 45 percent of the total imports and rice, which accounted for 15 percent in 1951, accounted for only 6 percent and 4 percent respectively by 2004. The import structure had changed in such a way that earlier dominance of consumer goods being surpassed by the intermediate goods accounting for closer to 63 percent of the total imports by 2004, starting from 17.5 percent in 1951 and 44 percent in 1977.

State Ownership of Banks and Credit Allocation

At the time of independence, the financial system of Sri Lanka was rudimentary and mainly dominated by foreign banks. These institutions were mainly there to facilitate the plantation economy and their related trade matters dominated at the time. By 1950 there were only twelve banks and 28 branches in the country. Out of twelve, ten were branches of foreign banks. There were only two national banks operating at that time. They were the Bank of Ceylon and the Hatton Bank Limited (which is now the Hatton National Bank).

At a time at which the banking infrastructure and finance was inadequate and poor, the Central Bank of Sri Lanka was established in 1949. With this change, Sri Lanka emerged from a dependent currency to central banking. The establishment of the Central Bank in the immediate aftermath of independence gave a boost to the Sri Lankan economy by laying the foundation for a sound financial sector. Subsequent to the establishment of the Central Bank, specialized banks such as development banks, National Savings Bank (NSB), State Mortgage and Investment Bank were established.

The Bank of Ceylon (BOC) was established in 1938. Under the 1938 Ordinance No.53, with which the bank was set up, the bank was allowed to maintain and manage current and savings accounts, to discount, buy and sell bills, to grant and issue letters of credit, and in general, to carryout all banking businesses. The bank was allowed to have several branches over the country under the ordinance and government provided financial assistance for this by providing government deposit of a hundred thousand rupees in every branch, which was to be repaid in ten years. During the period starting from 1956 when the socialist thinking became predominant, the banks also underwent changes to suit the existing status of the country. As a result the BOC was nationalized under the Finance Act No. 65 in 1961 and as a result all the shares of the bank held by private individuals were bought up by the government. Compensation was paid to the existing shareholders but it was based on the cost of the shares not the market price.

To cover the other areas of interests, which other banks did not cover sufficiently, the People’s Bank (PB) was established in 1961 as another commercial bank. It is the successor of the Co-operative Federal Bank. The bank was formed mainly to provide finance for production and development, going beyond the mandate of the BOC. It was established with a view to the provision of adequate finance to the rural sector, which the BOC was not able to reach. Hence, its mandate involves development of the co-operative movement and the promotion of rural finance and agricultural credit.

The nationalization of the BOC and the establishment of the PB was a major turning point in the banking history of Sri Lanka and this laid a firm foundation for expansion of the domestic banking sector in the country. During the time period up to 1977, the foreign banks were not encouraged to expand and permission was not granted to establish any new foreign banks. The BOC and the People’s Bank held the monopoly of the commercial banking and this gave way for them to expand the business. These banks together had about 900 branches at the time and opening up of new branches made financial services available in rural areas most of which were not reached earlier (Ratnayake 1998; Karunatilake 2004).

In 1972 the National Savings Bank was established, amalgamating the Post Office Savings Bank, Ceylon Savings Bank and the National Savings Movement, with the main objective of mobilizing savings on a large scale. The mobilized savings were to be invested in government securities, stocks, debentures, treasury bills or in any other similar instrument of the government. The State Mortgage and Investment Bank (SMIB) was also established in 1975 and was the successor of the Ceylon State Mortgage Bank. Though this bank was initially established to develop agriculture, industry and housing, in 1982, it was reorganized as a housing bank. Another major event is the enactment of the National Development Bank in 1979. It started operations as a government owned institution and was recently privatized. It is empowered to carry out development activities related to financing and refinancing.

Some major changes occurred after 1977 with the open market policy. The foreign banks re-entered the financial system of the country and many new Sri Lankan commercial banks also emerged. The banks expanded their networks by opening branches throughout the country. The banks were also exposed to heavy competition with the introduction of the technological improvements in banking. Particularly, the customer care services improved tremendously during this time period. The banking habits among the people also expanded and banking reached the rural areas too, which were neglected earlier (Ratnayake 1998).

At present there is a wide range of institutions involved in financial services including the public and private banks. Moreover, there are specialized financial institutions, leasing companies, insurance companies and microfinance institutions too. The government is also a key financial service provider in Sri Lanka, especially for the rural and the poor. Nevertheless, the government's involvement as a financial provider is criticized due to its related politicization. The government's role as a financial service provider has reduced since the 1990s with the significant reforms in the financial sector. Even though the financial sector is fairly developed compared to many developing countries, there are still many weaknesses in the financial system. Bank loans are disproportionately concentrated amongst the public sector and politicization has weakened commercial and rural banking tremendously. Hence, the banks have huge amounts for loan loss provisioning. However, the government is trying to establish a strong institutional and regulatory framework for the financial system (Duflos *et al* 2006).

Any discussion on the Sri Lankan financial sector also should pay due recognition to the Sri Lankan microfinance sector, since it is considered to be a relatively well-developed sector. Microfinance services are often provided by three levels of institutions in Sri Lanka: formal institutions, semi-formal institutions and informal sources. Formal institutions include both state-owned and private banks as well as the Regional Development Banks. Cooperative Societies such as the Thrift and Credit Cooperative Societies (TCCSs) and Non-Governmental Organizations (NGOs) can be considered quasi-formal institutions, as they have the flexibility to operate at a level between formal and informal sources. Informal sources might differ from relatives, friends to money lenders. Duflos *et al* (2006) show that there are more than 14,000 points of service for financial services in the country. Almost all the districts of the country have access to finance. On average, there is one point of service per 1,300 inhabitants, which is relatively high compared to many developing countries of the world.

Despite the considerable reforms, the government is the main stakeholder in microfinance provision. Apart from being a direct financial provider, the government also has other programmes of livelihood development or social protection, which include microfinance as an essential component, and sometimes absorbs a major segment of the microfinance market through these. Most recent major programmes are the *Gemi Diriya* programme and the *Samurdhi* programme. Both these programmes adopt microfinancing as a means of achieving the intended objectives of the programmes.

Table 10 shows the share of the government institutions in microfinance. Duflos *et al* (2006) have considered only Samurdhi Banks and Regional Development Banks (RDBs) as the government institutions providing microfinance services. The table shows that government involvement increased steadily from 2000 to 2004. Even in terms of the number of deposit accounts and number of loans, the government holds about a 50 percent share and this has been the case from 2000. The share in terms of value is also high for the government institutions, 56 percent and 45 percent respectively for loans and savings (Duflos *et al* 2006).

Table 9: Share of Government Loans and Deposits

Year	**No. of Deposit Accounts (%)**	**Amount of Deposits (%)**	**No. of Loans (%)**	**Loans Outstanding (%)**
2000	38.6	29.9	44.8	46.8
2001	40.4	29.6	50.2	50.7
2002	44.5	37.5	52.6	56.5
2003	48.0	42.4	51.8	56.9
2004	49.4	45.2	52.4	55.6

Source: Duflos *et al* (2006)

Studying loans and deposits by type of institution, Duflos *et al* (2006) show that the proportionate amounts have not changed significantly in the recent past. However, it mentions that Cooperative Rural Banks (CRBs) are an exemption to this, since CRBs have reduced their market share in number of deposits accounts and loans and volume of deposit accounts and loans. This loss in market share is captured by mainly the Samurdhi programme and RDBs.

As table 10 shows, the RDBs and the Samurdhi account for half of the microfinance market and CRBs being the next.

Table 10: Volume and Number of Loans and Deposits, by Institutional Type - 2004

Year	**No. of Deposit Accounts (%)**	**Volume of Deposits (%)**	**No. of Loans (%)**	**Loan Portfolio Outstanding (%)**
Development Banks	16	26	34	52
CRBs	42	46	27	28
NGOs	8	4	17	7
Samurdhi	34	24	21	13

Source: Duflos *et al* (2006)

Table 11: Changes in Labour Force, Employment and Unemployment by Gender

	1981/82	1985/86	1990	1992	1994	1996	1998	2000	2002	2004	2005
Mid year Population ('000)	**15,196**	**16,127**	**16,267**	**16,631**	**17,089**	**17,490**	**17,935**	**18,467**	**19,007**	**19,462**	**19,668**
Labour Force ('000)	**5,282**	**5,972**	**6,001**	**5,808**	**6,079**	**6,242**	**6,661**	**6,827**	**7,145**	**8,061**	**8,141**
Male	3,843	4,015	3,865	3,939	4,073	4,201	4,282	4,502	4,706	5373	-
Female	1,439	1,957	2,136	1,869	2,006	2,041	2,379	2,326	2,440	2,688	-
LFPR (% hh pop)	**34.3**	**38.9**	**51.9**	**48.2**	**48.7**	**48.6**	**51.7**	**50.3**	**50.3**	**48.6**	**48.3**
Male	49.7	52.7	67.2	66.5	65.4	65.9	67.5	67.2	67.9	66.7	67.1
Female	19.4	25.4	34.7	31.7	32	31.6	36.4	33.9	33.6	31.5	30.9
Employment ('000)	**4,673**	**5,132**	**5,047**	**4,962**	**5,281**	**5,537**	**6,049**	**6,310**	**6,519**	**7,394**	**7,518**
Male	3,543	3,581	-	-	3,679	3, 857	4,005	4,241	4,395	5,049	-
Female	1,130	1,550	-	-	1,603	1,680	2,045	2,069	2,124	2,345	-
Unempl. ('000)	**609**	**840**	**954**	**846**	**798**	**705**	**611**	**517**	**626**	**667**	**623**
Male	300	434	-	-	394	344	277	260	310	323	-
Female	309	407	-	-	403	361	334	257	316	344	-
Unemp Rate (%)	**11.7**	**14.1**	**15.9**	**14.6**	**13.1**	**11.3**	**9.2**	**7.6**	**8.8**	**8.3**	**7.7**
Male	7.8	10.8	7.6	9.4	9.7	8.2	6.5	5.8	6.6	6.0	5.5
Female	21.3	20.8	20.2	23.1	20.1	17.7	14	11	12.9	12.8	11.9

Note: (a) 1981-1991 gender breakdowns of employed and unemployed persons were estimated by using the labour force and unemployment/employment rates of the respective years; (b) LFPR – Labour Force Participation Rate

Primary Source: Central Bank Annual Reports, various issues, Labour Force Survey Quarterly and Annual Reports 2004 of the DCS

Secondary Source: Tilakaratna *et al* (2006)

Trends in Employment

Changes in the labour force give a clear picture about a country's economic performance. Hence, this section will concentrate on the past trends in employment in the country.

Table 11 shows that as the country's population grew, the labour force also grew over the years. It increased from about 5.3 million in 1981 to about 8.1 million in 2005. Though there is an increase in the labour force for both males and females, the male labour force is much higher than the female labour force. Males account for about two-thirds of the labour force of the country. The labour force participation rate (LFPR)[1] has remained around 50 percent in the post-1990 era. However, the male LFPR is much higher than female LFPR. For the year 2005, the LFPR for male is 67.1 percent while for females the LFPR is only 30.9 percent, less than half of the male LFPR. A similar pattern can be seen for employment[2] of the country where males employed account for over two-thirds of total employment.

Between 1981-2005, in addition to an increase in the total employed from about 4.7 million to about 7.5 million, the unemployment rate of the country declined from 11.7 per cent to 7.7 percent. Both male and female unemployment rates have shown a declining trend during this period. However, it is noteworthy that the female unemployment rate remained almost double that of males. However, in terms of numbers, total female and male unemployed figures have moved closer over the last two decades.

Table 12: Unemployment rate by Level of Education and Age Group

	1992	**1994**	**1996**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
By Level of Education											
No Schooling	3	2.6	2.8	1.0	0.4	} 1.0	1.3	1.8	1.7	2.0	1.8
Grade 0-4 / Year 1-5	4.7	5	3.4	2.4	1.9						
Grade 5-9 / Year 6-10	15.9	13	12.2	9.0	8.2	7.5	7.1	7.9	7.4	6.9	6.3
CE(O/L)	22.2	19.6	16.4	13.7	13.6	11.3	11.8	13.3	13.0	12.3	11.5
GCE(A/L) &above	22.4	23.7	19.0	17.5	17.9	14.9	15.3	16.8	16.5	16.8	13.8
By Age Group											
15 - 19 Years	37.6	40.7	36.5	27.3	28.4	23.4	29.8	30.1	30.3	28.3	30.8
20 - 29 Years	27.5	24.5	22.0	19.3	18.9	17.4	18.4	20.1	19.4	19.2	17.2
30 - 39 Years	7.8	7.6	6.0	4.9	4.4	3.6	3.4	4.0	3.9	4.0	3.8
40 - 49 Years	3.5	2.5	1.9	2.0	1.6	}1.1	0.9	1.6	1.1	1.3	1.2
50 Years and above	1.4	1.2	0.5	0.7	1.0						
ALL	**14.6**	**13.1**	**11.3**	**9.2**	**8.9**	**7.6**	**7.9**	**8.8**	**8.4**	**8.3**	**7.7**

Source: Tilakaratna *et al* (2006)

[1] Labour force is defined as persons who are aged 10 years and above, and able and willing to work, while LFPR is the ratio of the labor force to the household population aged 10 years and above.
[2] An employed person is defined as one who worked for pay, profit or family gain (unpaid) for one hour or more during the week preceding the survey (Central Bank of Sri Lanka 2005)

As shown in table 12, youth unemployment is a major problem in the country. Looking at the rate of unemployment by level of education shows that the highest unemployment rates are among those with the highest levels of educational qualifications. The unemployment rate is highest among those with GCE (A/L) or higher qualifications, at 13.8 percent in 2005.

Looking at unemployment according to age categories shows that the rate of unemployment is highest among the age groups of 15-19 years and 20-29 years. These age groups have contributed over 80 percent to the total unemployed among both males and females over the past decade, despite the various efforts of successive governments. In recent years, there have been various measures to reduce youth unemployment in the country. The implementation of the graduate employment programme in the public sector in 2005 was expected to ease this problem to some extent. As can be seen from the figures, unemployment among the GCE (A/L) and higher qualified category has shown a considerable decline in 2005 from the 2004 figure (from 16.8 to 13.5 percent). In fact, this category has recorded its lowest unemployment rate in 2005 since 1990. Furthermore, the age-group of 20-29 years, where persons with GCE (A/L) and above qualifications mostly fall in to, has also recorded a substantial decline in the unemployment rate in 2005 compared to 2004.

Table 13 shows the employment shares of the key sectors of the economy for agriculture, industries and services and their sub-sectors. It is worthwhile to mention that despite being the lowest contributor to GDP, the agriculture sector accounts for over one-third of the labour force of the country. Nevertheless, the employment share in the agricultural sector has shown a substantial decline over the past couple of decades from 51.2 percent in 1981 to 33.6 percent in 2004. The services sector, being the biggest contributor to GDP, has the highest share of employment. It accounted for about 42 percent of total employment in 2004. A sharp increase in the share of employment in the services sector can be observed during this period. The industrial sector (and its manufacturing sub-sector in particular) also shows a slight increasing trend in its employment share over the last couple of decades. While employment in the industry sector as a whole increased from 19.6 percent in 1981 to 24 percent in 2004, the employment share of the manufacturing sub-sector increased from 12.4 percent to 17.5 percent during the same period.

Table 13: Employment Share by Sectors and Sub-sectors during 1990-2004 (%)

Sector	1981/82	1986/87	1990	1992	1994	1996	1998	2000	2002	2004
Agriculture Sector	**51.2**	**47.7**	**47.7**	**40.7**	**38.2**	**37.1**	**39.1**	**36.0**	**34.5**	**33.6**
Agriculture	-	-	-	39.8	37.4	36.1	37.7	35.0	-	-
Forestry & logging	-	-	-	0.2	0.4	0.3	0.3	0.2	-	-
Fishing	-	-	-	0.7	0.5	0.7	1.1	0.8	-	-
Industry Sector	**19.6**	**21.6**	**20.5**	**20.1**	**19.8**	**22.2**	**21.9**	**23.6**	**22.4**	**24.0**
Mining & quarrying	1.7	1.9	1.6	1.6	0.8	1.6	1.4	1.1	1.3	1.1
Manufacturing	12.4	13.4	14.1	13.5	14.3	14.7	14.9	16.6	16.5	17.5
Electricity, water, sanitation	0.3	0.6	0.8	0.4	0.6	0.5	0.6	0.5	0.2	0.1
Construction	5.2	5.7	4.0	4.7	4.1	5.4	5.0	5.5	4.4	5.3
Services Sector	**29.2**	**30.7**	**31.8**	**37.6**	**40.7**	**40.4**	**38.8**	**40.3**	**42.8**	**41.9**
Transport & Communication	-	-	-	4.1	4.7	4.9	4.9	4.9	4.7	6.3
Transport & Port Services	-	-	-	3.6	4.2	4.3	4.3	4.4	4.3	5.5
Telecommunications	-	-	-	0.5	0.4	0.6	0.6	0.5	0.4	0.8
Banking Insur. & Real Estate	-	-	-	1.5	1.8	1.9	1.9	2.1	2.6	2.7
Banking	-	-	-	0.7	1.0	1.0	1.0	1.0	1.1	0.9
Insurance, Real Estate	-	-	-	0.8	0.8	0.9	0.9	1.0	1.5	1.7
Wholesale and Retail Trade	-	-	-	10.5	11.0	10.7	10.2	11.1	12.9	12.5
Public Admin and Defence	-	-	-	6.2	7.2	6.2	6.1	5.9	8.0	7.1
Hotels and Restaurants	-	-	-	0.9	1.2	1.2	1.3	1.6	1.8	1.5
Other services	-	-	-	14.4	14.8	15.5	14.3	14.8	12.8	11.8

Note: Other services category includes all other unclassified service such as education, health, private security, janitorial services, personal services and all other business services
Primary Source: Estimated by using Labour Force Survey Data (1990-2005) of DCS, Consumer Finance and Socio Economic Survey Reports, 1981/82 and 1986/87, Central Bank of Sri Lanka
Secondary Source: Tilakaratna *et al* (2006)

Trends in Wages

In the decade prior to liberalization, particularly during 1967-76, inflation was at a higher level than previous years, forcing the government to frequently adjust wages of government employees. Hence the government had to frequently adjust by providing allowances and few overall wage revisions. The wages of the government employees at the period had risen at an annual rate of 6.8 percent, just ahead of inflation and the private sector wages had risen sharply at 8.3 percent with workers in agriculture, industry and commerce having similar increases. The wages in the plantation sector increased after 1973 (Central Bank of Sri Lanka 1998).

Table 14: Annual Average Increase in Nominal Wages (a)

Year	**1952-1966**	**1967-1976**	**1977-1996**
Government Employees	1.7	6.8	12.5
Non-Executive Officers	1.4	5.7	11.9
Minor Employees	1.9	7.5	13.0
School Teachers	1.2	4.8	11.8
Wages Board Trades	1.2	8.3	14.0
Agriculture	1.1	8.3	14.9
Industry & Commerce	2.0	8.2	11.9
Services	n.a.	n.a.	8.9 (b)
CCPI	0.8	6.4	12.5

(a) Compound growth rates Source: Labour Department, Department of Census and Statistics, Central bank of Sri Lanka

(b) 1979-1996 Source: Economic Progress of Independent Sri Lanka, Central Bank of Sri Lanka (1998)

In the post-liberalization period there had been wage adjustments in the form of revisions and allowances for some categories of employees according to the salary levels due to the sharp increase of inflation. The overall annual compound increase in wages of the government sector up until 1996 was around 12.5 percent, just keeping pace with inflation. As a result, there was not much change in the real wages of 1977. However, the annual compound increase in wages of the organized private sector was above that at around 14 percent, mainly due to the growth in plantation wages. The workers in industry and commerce experienced an erosion of real wages until 1996 due to the trade restrictions prevailing at the time (Central Bank of Sri Lanka 1998).

The government plays a major role as the largest employer in the formal sector. Moreover, it plays an important role building the institutional set-up between the employer and employee through negotiations and reconciliations (especially through Wages Boards)

Table 15 shows that overall there has been a significant decline in the real wages for formal private sector as well as public sector workers. The downward pressure on wages was exerted by the excess labour supply. However, after 1999, though the formal private sector shows a declining trend, the public sector minimum wages show a significant improvement.

Table 15: Minimum Real Wage Rate Indices and Average Annual Growth Rates for Workers in Wages Boards Trades and Government Employees, 1990-2004 (1978=100)

Nominal Wage Rate Index								
Year	**Workers in Wages Boards (a)**				**Government Employees (b)**			
	Agriculture (c)	**Industry & Commerce (d)**	**Services (e)**	**Wages Board Trades (f)**	**All Non-Executive Officers**	**All Minor Employees**	**All Central Govt Employees**	**Govt School Teachers**
1990	122.7	89.9	63.5	107.6	104.3	121.8	113.2	96.0
1995	121.1	94.8	66.5	107.7	109.2	120.6	115.4	110.8
1999	111.7	83.0	56.0	97.8	76.0	103.0	100.2	80.6
2004	92.2	68.9	49.5	81.3	112.5	134.3	123.3	94.1
Growth								
1990-95	-0.3	1.1	0.9	-	0.9	-0.2	0.4	2.9
1995-99	-2.0	-3.3	-4.2	-2.4	8.7	-3.9	-3.5	-7.6
1999-04	-4.7	-4.5	-3.0	-4.5	10.3	6.9	4.8	3.9

Notes:

(a) The index numbers are calculated on fixed weights based on the numbers employed as at 31 December 1978. The wage rates used in the calculation of Index numbers are minimum wages for different trades fixed by the Wages Boards

(b) The Index for Central Government employees has been revised based on the number of employees and total salaries as at January 1986. The wage rates used in the calculation of Index Numbers are the initial salaries and wages in each respective scale.

(c) The index refers to wage rates of tea growing and manufacturing, rubber growing and manufacturing, coconut, cocoa, cardamoms and pepper growing trades only.

(d) Including baking, brick and tile manufacturing, match manufacturing, biscuit and confectionary, tea export and runner export trades only.

(e) This includes cinema, motor transport and nursing home trades only.

(f) Combined index for workers in agriculture, workers in industry, commerce and services.

(g) A combined index for non-executive officers and minor employees

Primary Source: Central Bank of Sri Lanka, Annual Reports, various issues
Secondary Source: SAARC Secretariat (2006)

In the informal sector there were sharp wage increases in all major categories of workers during the 1979-96 period. It is noteworthy that immediately after the liberalization, during 1979-83, the real wage levels of the informal sector grew sharply and at a faster rate than the formal sector which reflected the trickle down of benefits of the open market operations (Central Bank of Sri Lanka 1998)

Compared to the formal sector, there are high wage discrepancies for the agricultural sector, compared to the construction sector, in the informal sector. Nevertheless, there are marginal improvements in the year 2006 in the nominal daily wages for agriculture. There is an increase of the wages of workers in tea and rubber as a result of the improved prices during the year. However, the real wages for agriculture dropped within 2006.

Table 16: Informal Private Sector Daily Wages by Sector and Gender (a)

Sector		**Annual Average (Rs)**			**% Change (Real)**	
		2004	**2005**	**2006**	**2005**	**2006**
Agriculture Sector						
Tea	Male	304	300	333	-12.9	-2.5
	Female	218	217	234	-12.1	-5.3
Rubber	Male	304	305	335	-10.8	-4.0
	Female	229	230	249	-10.3	-5.4
Coconut (b)	Male	361	378	411	-6.6	-5.1
Paddy	Male	334	343	375	-9.2	-3.9
	Female	256	256	289	-11.7	-0.3
Construction Sector						
Carpentry	Master Carpenter – Male	505	542	616	-4.2	-0.3
	Skilled & Unskilled Helper - Male	349	353	398	-10.3	-1.0
Masonry	Master Mason – Male	499	537	608	-4.0	-0.6
	Skilled & Unskilled Helper -Male	347	353	394	-9.8	-1.9

Notes:
(a) Wage information were based on monthly wages from 93 centres
(b) Female participation is minimal in the Coconut and Construction sectors
Source: Central Bank of Sri Lanka (2006)

Poverty: Trends and Dimensions

Sri Lanka has adopted two major strategies for human development and poverty reduction. One is human capital development and the other is resource transfer programmes in many forms of welfare measures. For the purposes of this study, it is important to look at the historical levels of poverty in the country. However, until recently, there has not been a standard method of measuring poverty, hence, though available from various studies documented, the poverty figures are not comparable across the years.

Table 17: An Estimation of Poverty in Sri Lanka during Various Selected Household Survey Years

Year, Basic Source & Relevant Study			Urban	Rural	Estate	All Island
1969/ 70: Based on LFSS (DCS. 1970)	(a) Bhalla & Gleww, 1985		5.0	12.8	11.1	11.2
	(b) Visaria, 1978 Households %	Measure 1	58.3	52.3	38.5	52.0
		Measure 2	57.6	52.0	38.7	51.6
1978/ 79: Based on CFS (CB. 1983)	(a) Gunaratna, 1985a Urban Rural Estate All	Population %	19.4	25.0	7.6	22.3
		Household %	15.8	21.2	6.0	18.5
	(b) Khan, 1989	Population %	11.8			
		Household %	12.5			
	(c) Gunaratna, 1989		16.0	22.7	5.9	19.5
	(d) Anand & Harris, 1985 Population	Measure 1	24.4	23.8	8.9	22.7
		Measure 2	14.3	12.8	3.6	12.3
1985/ 86: Based on LFSS (Korale (ed.), 1987)	DCS (1987)	Population	27.6	45.7	5.7	39.4
		Household	32.7	51.1	9.9	44.7

Source: Ratnayake (1998)

Sri Lanka is well known for achieving high levels of human development at relatively low levels of GDP per capita. Nonetheless, despite significant performance in human development, Sri Lanka has continued to have a high incidence of poverty over the past decades. As per the Official Poverty Line for Sri Lanka[3], approximately 22.7 per cent of the population is identified as poor in 2002. In terms of households, this is about 19.2 per cent.[4]

3. According to the Official Poverty Line (introduced in June 2004), the persons living in the households whose real per capita monthly total consumption expenditure is below Rs 1423 in the year 2002 in Sri Lanka are considered poor. It takes into account both the food and non-food consumption expenditure. Incidence of poverty has been estimated using the Household Income and Expenditure Survey (HIES) of the Department of Census & Statistics (DCS). The poverty line for 2002 has been adjusted by using the Colombo Consumer Price Index (CCPI) to obtain poverty lines for 1995/96 and 1990/91. – (DCS)

4 According to the US$ 1 a day poverty line, only about 6.6 per cent of the population is considered to be poor.

Table 18: Incidence of Poverty (head count ratio) by Sector 1990 – 2002

Sector *	Period		
	1990-91 (%)	*1995-96 (%)*	*2002 (%)*
Sri Lanka[5]	**26.1**	**28.8**	**22.7**
Urban	16.3	14.0	7.9
Rural	29.4	30.9	24.7
Estate	20.5	38.4	30.0

Note: the total population shares of the rural, urban and estate sectors in Sri Lanka are approximately 80%, 15% and 5% respectively.[6]
Primary Source: Department of Census & Statistics (DCS); estimates based on HIES 1990/91, 1995/96 and 2002.
Secondary Source: Tilakaratna *et al* (2006)

As per the official poverty figures, there was a declining trend in poverty at the aggregate level during the 1990-2002 period. The inequitable distribution trend biased towards urban poverty decline is evident by comparing poverty figures across urban, rural and estate sectors. In the urban sector, the percentage of poor has more than halved during the last decade. Improved infrastructure facilities, industrial and commercial activities in urban areas have largely contributed to this progress. On the contrary, the estate sector has experienced a substantial increase in poverty levels during this period. Sectoral data also shows that poverty incidence is highest in the estate sector, as high as 30.0 percent. This is followed by the rural (24.7 percent) and urban sectors (7.9 percent). It should also be noted that despite a slight decline in poverty incidence during the last decade, the rural sector accounts for approximately 90 percent of the total poor, implying that poverty in Sri Lanka is largely a rural phenomenon.

Table 19: Incidence of Poverty (Head count ratio) by Province 1990-2002

Area	Period		
	2002	**1995/96**	**1990/91**
Western	10.8	16.2	19.1
Central	25.1	36.2	30.7
Southern	27.8	32.6	30.2
North Western	27.3	27.7	25.7
North Central	21.5	24.7	24.3
Uva	37.2	46.7	31.9
Sabaragamuwa	33.6	41.7	31.0
Sri Lanka	**22.7**	**28.8**	**26.1**

Primary Sources: Department of Census & Statistics, estimates based on HIES 1990/91, 1995/96 and 2002.
Secondary Source: Tilakaratna *et al* (2006)

[5] Household Income and Expenditure Surveys based on which the poverty levels have been estimated, have excluded the North and East (conflict areas) from their surveys. However, it is expected that exclusion of these areas has led to an underestimation of the level of poverty in the country, considering that over 800,000 people have been internally displaced, and that the majority of the inhabitants in these areas and their properties have been affected by the civil war that lasted for nearly 20 years.

[6] In the 2001 Census, urban sector comprises of all Municipal and Urban Council areas. Estate sector is defined as plantations of 20 acres or more in extent upon which there are 10 or more resident labourers. The rest of the areas are treated as rural sector.

The inequitable poverty reduction is also evident by looking at the poverty data across regions of the country. There are considerable variations in poverty across regions. As shown in table 19, while the Uva province has recorded the highest incidence of poverty at 37.2 percent, the Western province has recorded the lowest figure of 10.8 percent in 2002. The poverty level of the Uva province is more than three times higher than the poverty level of the Western province. Furthermore, in some districts of the Western province the poverty levels are as low as 6 percent (for Colombo the poverty headcount ratio is only 6 percent) which is more then 6 times lower than the percentage for Uva. Moreover, some provinces including Uva and Sabaragamuva have experienced an increase in poverty incidence from 1990/91 to 2002. A higher incidence of poverty in these provinces is a result of many factors such as poor infrastructure, weak urban-rural transport linkages and poor access to health facilities, safe water and sanitation. For example, in the Uva and Sabaragamuva provinces, the percentage of households with access to electricity is 37 percent and 47 percent respectively, which is almost half the figure for the Western province (80 percent) and much lower than the aggregate figure (56 percent). Moreover, the GDP shares of these two provinces have declined substantially since 1990. Furthermore, as highlighted earlier, in the Uva province, agriculture is the dominant sector and accounts for nearly two-thirds of employment and over one-half of the output. The share of employees in the industries sector is only about 10 percent; the lowest of the provinces. These factors may help to explain the high and rising incidence of poverty in provinces like Uva. On the contrary, the Western province where most of Sri Lanka's economic activities are concentrated and which accounts for half of the country's GDP, has experienced a substantial decline in poverty during the 1990-2002 period.

Table 20: percentage of poor households based on the official poverty line by sector and provinces

Area	Period		
	2002	**1995/96**	**1990/91**
Sri Lanka	**19.2**	**24.3**	**21.8**
Sector			
Urban	6.2	11.0	12.9
Rural	20.8	25.9	24.7
Estate	24.3	32.2	16.7
Province			
Western	9.2	13.0	15.6
Central	20.8	31.3	25.8
Southern	23.6	27.0	24.7
North Western	22.3	23.6	21.6
North Central	18.1	20.4	20.4
Uva	31.8	40.2	27.0
Sabaragamuwa	28.9	36.1	26.8

Source: Department of Census and Statistics (2004)

The percentage of households below the official poverty line of 2002 also shows a similar pattern to the headcount index. Though there is an increase in the number of households in poverty from year 1990/91 to 1995/96, by 2002 there is a slight decrease compared to 1990/91. However, as in the case of headcount incidence of poverty, the reduction of poor households is uneven across sectors. There is a significant reduction of poor households in the urban sector while there is only a slight decline of household in poverty for the rural and estate sectors. It is noteworthy to mention that the percentage of poor households in the estate sector is as high as four times the percentage of poor households in the urban sector by 2002. Comparison across provinces also shows a similar pattern to that of the headcount index where the Uva province records the highest number of households in poverty of 31.8 percent while it is only 9.2 percent for the Western province by 2002.

Table 21: Trends in poverty by gender of principal income earner, 2002[7]

Sex of the principal income earner	Poverty Incidence, 2002	
	%	No. of poor HHs
Male	19.7	632
Female	17.1	143

Primary Source: Household Income and Expenditure Survey, 2002, DCS
Secondary Source: SAARC Secretariat (2006)

As table 21 shows, the incidence of poverty in households where the principal income earner is a woman was slightly lower than for male headed households for the year 2002.

Table 22: Incidence of Poverty (Head Count Ratio) by Sector of Employment (%)

Sector	1995/96 (%) *	2002 (%) *
Agriculture	**40**	**39**
Agriculture	40	44
Forestry and logging	33	38
Fishing	34	31
Industry	**28**	**23**
Mining and quarrying	46	40
Manufacturing	25	20
Electricity, water & sanitation	9	8
Construction	32	30
Services sector	**16**	**18**
Transport storage & telecommunication	16	15
Banking, insurance, real estate & financial services	3	6
Wholesale, retail trade hotels & restaurant	21	17
Public administration, defence & other service	14	19
Total	**29**	**23**

* Authors' calculations based on regional poverty lines prepared by the DCS for 1995/96 and 2002 using HIES 1995/96 and 2002 of DCS.
Source: Tilakaratna *et al* (2006)

When looking at the poverty levels by sector of employment, according to table 22 the incidence of poverty is highest in the agricultural sector, which is 39 percent followed by the industrial sector where the poverty incidence is 23 percent and the services sector with a 18 percent poverty incidence. Within the agricultural sector, the agricultural sub-sector comprised of crops like tea, rubber and coconut. Paddy has the highest incidences of poverty, which is 44 percent, followed by the forestry and logging sub-sector accounting for a 38 per cent level of poverty headcount incidence. Poverty levels of these two sub-sectors have increased substantially during 1995/96 -2002. It is interesting to note that the

[7] This data excludes the North-East province

agricultural sector as a whole accounts for about 40 per cent of the poor in the country. Within the industrial sector, mining and quarrying sub-sector records the highest incidence of poverty of 40 per cent followed by the construction sub-sector which records a poverty level of 30 per cent. However, poverty incidences in both these sectors have declined during the 1995/96-2002 period. The services sector has recorded the lowest incidence of poverty among the three main sectors of the economy. However, this sector has experienced a slight increase in its poverty level in 2002 compared to the 1995/96 level. This is largely due to the increase in poverty in the public administration, defence and other services category. Moreover, despite the lowest incidence of poverty in the services sector, in terms of numbers, this sector still accounts for a substantial share of the poor in the country.

Table 23: Inequality: Gini coefficients for household incomes

Year	**All Island**	**Sector**		
		Urban	**Rural**	**Estate**
1969/ 70	0.34	0.40	0.31	-
1980/ 81	0.43	0.44	0.38	0.27
1958/ 86	0.46	0.48	0.43	0.31
1990/ 91	0.47	0.62	0.42	0.25
1995/ 96	0.48	0.46	0.48	0.44
2002	0.47	0.48	0.45	0.34

Primary Source: Socio-Economic surveys conducted by Department of Census and Statistics since 1969/ 70
Secondary Source: Nanayakkara (2006)

Table 23 shows that the gini coefficients for households by income has been below 0.4 only in 1969/70. It was over 0.4 in all the following survey years and was not subjected to significant changes thereafter. This has shadowed the sectoral disparities. The highest inequalities in household incomes can be seen in the urban sector while the lowest is seen in the estate sector where the socio-economic conditions are more or less homogenous.

There are a number of important causes for persistence of poverty in Sri Lanka. Neither the economic growth rate nor its distributive effects during the last decade have been sufficient to bring about a significant reduction in poverty levels of the country. One of the main reasons is the lack of economic growth outside the Western province which hindered the growth of the other regions of the country, affecting the overall performances of the country. Moreover, a large part of the lack of growth outside the Western province is due to the stagnant nature of agricultural development, since many of these rural areas depend largely on agriculture. The rural areas are home to 88 percent of the poor in the country and about 58 percent of the rural population depend on agriculture at least partially for their livelihood. Though growth in the agricultural sector is slow and contribution to national income over time is shrinking, still a large proportion is employed in agriculture, which has remained unchanged. Not only the stagnant productivity but also the lack of opportunities outside agriculture in these areas has limited the mobility away from agriculture. The inadequate infrastructure facilities further hinder the development of other regions. Not only the physical infrastructure but also lack of availability and access to social infrastructure also contributes to this situation. Despite the availability of education facilities, the quality of education affects the development of competencies of the rural population.

The most important reason, however, is the civil war that lasted for over 20 years and caused immense human suffering and deprivation. Coupled with these the restrictive labour market regulations and fiscal constraints have hampered the reduction of poverty in the country (The World Bank 2007).

Table 24: Total change in real per capita income, 1996-97 to 2003-04 (percent)

Quintile	**Urban**	**Rural**	**Estate**
All	**18.1**	**18.1**	**9.5**
1	- 5.5	4.3	- 0.7
2	1.4	9.5	- 1.4
3	11.0	14.9	0.0
4	17.3	16.5	1.4
5	26.4	24.7	25.5

Primary Source: CFSES Report (2003-04); Table 7.6
Secondary Source: The World Bank (2007)

Table 24 shows the sharp increase in inequality in all sectors of the economy, using per capita income figures. The aggregate growth in the real income for the bottom quintile is very low for all the three sectors. It is less than 4 percent for every sector while for the top quintile it is very high—close to 25 percent for every sector. The overall comparison of the growth of real per capita income also shows the low growth rate for estate sector than the other two sectors.

Investment in Human Capital Formation

Despite being a developing, low income country, successive governments of the country placed priority on improving the quality of life of the people. Two main concerns were education and health, which had contributed tremendously to the country's success in achieving human and social development.

Table 25: Social Development Attainments 1948 – to date

		Around 1950	**At present**
Adult Literacy Percent		57.8 (1945)	92.5 (2003/ 04)
Adult Literacy Percent	Male	70.1	94.5
	Female	43.8	90.6
Expectancy of Life (Years)		55	74 (2001)
Infant Mortality Rate per 1,000		82	11.1 (2003)
Maternal Mortality Rate per 100,000		560	140 (1995)
School enrolment 5-19 years – Percent		54.1 (1945)	97.2 (2000)

Source: Sanderatne (2005)

The investment in human capital formation in Sri Lanka mainly starts with the free education policy and the free health policy. The colonial education policies which created socio-economic, ethnic, religious and regional disparities in provision of education services and outcomes induced the emergence of welfare policies to address socio-cultural inequalities in the early 1940s. They were in the form of education, health and subsidized food policies (Jayaweera 1998). It is important to note that the country complemented the human resource development policies by emphasizing the protection of minimum consumption levels. The proactive health and education services in combination had contributed to the impressive achievements in human and social development. The strong economic background of the country supported such policies. With economic liberalization, structural adjustment policies undermined the achievements of such investments. Further the civil conflict in the country imposed heavy fiscal constraints on investment in human development. However, due to the competitive political environment, the country was able to further sustain such policies.

B) Welfare Regime and Poverty

The evolution of Sri Lanka's welfare state can be marked by three key milestones; the Education Act of 1945 (Kannangara Report 1943), the establishment of the Department of Social Services in 1948 (Jennings Report 1943) and the Health Act of 1953 (Cumpston Report 1950). Taking initiatives in implementing these three reports, laid a firm foundation for the collective provision of certain essential social services through state intervention. The proportion of public expenditure allocated to welfare during the time period 1958-68 amounted to about 40 percent of the total public expenditure or 10-12 percent of GDP and gives further evidence to support this. This figure includes the social welfare expenditures on education, health, transport, food subsidy and public welfare assistance (Jayasuriya 2000).

Education

The Education Act of 1945 which is the predecessor of the Kannangara Report of 1943 recommended a system of universal and compulsory free education from kindergarten level to university level. The free education policy adopted a radical approach to social policy. This radical approach was not only a mere revolution in the social policy of the country but also provided a degree of social mobility. It became the single most important determinant of the social and political transformation of Sri Lankan society (Jayasuriya 2000).

Until the mid-1960s, there were delays and contradictions in implementing such policies due to the resistance from the vested interests of the colonial legacy. Nevertheless, important pressures emerged as a result of frustrations created by political changes and the disadvantageous colonial administration, and these pressures did not allow the momentum that was created in the 1940s to be lost. As a result there was no reversal of education policies carried out and education facilities were extended further. The change of the medium of instruction from English to Sinhala and Tamil in secondary schools and the establishment of a network of schools to meet the social demand were major turning points. Though this resulted in positive achievements in macro level education statistics, there were policy distortions which resulted in inequitable distribution of benefits. Though the school structure was not changed, the biased allocation of resources made the elite and the middle class to be the immediate and major beneficiaries of free education. The establishment of the Central Schools in 1940s was the major attempt against this, which made extended and high quality education available to rural and disadvantaged districts, however, this was later abandoned in the 1960s (Jayaweera 1998).

The implementation of the common-curriculum in the 1970s and the introduction of intervention strategies to compensate for socio-economic differences are some major efforts at ensuring equitable access to education. The grade five scholarship which provide mobility to able children to prestigious schools in 1960s is one way. Introduction of an artificial mechanism to compensate for regional imbalances in entering universities is another measure introduced in 1979. However good these policies were, they did not lead to a reduction in the existing regional imbalances in facilities (Jayaweera 1998).

The educational policies survived despite the economic liberalization, though the structural adjustment package introduced in 1978 initially exerted pressure on educational policies through a reduction in social sector expenditure which widened disparities. However, later there were efforts in the welfare front to increase educational opportunities to mitigate the hardships created by macroeconomic policies to meet the international norms. Hence, successive governments brought in several changes to the education system in the 1980s and 1990s by implementing various policies/programmes, with the objectives of enhancing the quality of education and increasing educational opportunities for the poor and thereby improving the school enrolment and completion ratios, particularly at primary and secondary levels. Among several major welfare programmes/policies, the free school text book programme initiated in 1980 aimed to improve the quality of education. Some other important welfare policies emerged of which the free midday meal program, free uniform material programme and subsidized transport facilities are the most important (Tilakaratna 2006; Tilakaratna *et al* 2006; Jayaweera 1998).

The free school textbook programme was initiated in 1980 with the objective of providing text books free-of-charge to all students in grades 1-11 in all the state and state-aided schools**.** At present, it covers all students which accounts to about 4 million students from over 10,000 schools in all the districts in the country. Further, over 30 million copies covering more than 300 different subjects/titles in three basic languages of Sinhala, Tamil and English are distributed annually under this programme. The government is the main source of funding for the text book programme. At present, the government spends approximately Rs. 1,100 million (about US$ 11 million) annually for the programme. This amounts to approximately 2.8 per cent of the total education expenditure and is about 0.25 percent as a share of the total government expenditure. Moreover, the total cost of the textbook programme (in nominal terms)[8] has increased by almost twenty times from 1980 to 2002. Recently however, there has been support from the World Bank to improve the quality of the books and a Multiple-Book Option Programme (MBOP) under the General Education Project (GEP) II (Tilakaratna *et al* 2006).

Another major programme under the education welfare is the Free School Uniform Materials Programme, which was commenced in 1993. Under this programme all students (grade 1-13) in all the government schools are provided with free uniform material. The programme also provides relevant robe materials to student monks studying in *Pirivenas* (temple schools). The type of material and the quantity received by students depends on the gender and the grade in school (see table 26) (Tilakaratna *et al* 2006).

[8] Based on data obtained from the Ministry of Education

Table 26: Type and Quantity of Uniform Materials

Group	**Grade**	**Quantity (in meters)**
Primary	Grade 1-5 Boys Grade 1-5 Girls	Shirt material (1.15 m) Trousers material (0.68 m) Dress material (1.8m)
Junior Secondary	Grade 6-9 Boys Grade 6-9 Girls	Shirt material (1.37m) Trousers material (0.9m) Dress material 2.28m
Senior Secondary	Grade 10-13 Boys Grade 10-13 Girls	Shirt material (1.75 m) Trousers material (1.82 m) Dress material (2.75m)
Student Monks	Below age of 14 Above age of 14	Robe material (6.4m) Robe material (9.14m)

Sources: Collection of Circulars: Ministry of Human Resource Development, Education and Cultural Affairs, Vol-1 (1993-2003)

This is also funded entirely by the national budget. The government currently spends approximately Rs 1,200 million (about US$ 12 million) per year on this programme. Hence, this makes it the second highest item of the recurrent education expenditure, following the teacher salaries (which account for nearly 80 percent of the total recurrent education expenditure) (Tilakaratna 2006).

Another major welfare programme coming under education is the school midday meal programme.[9] It was initially started in 1989 with the aim of increasing school attendance and improving the nutritional status of the children. Initially it aimed at providing one meal to all children enrolled in primary and secondary schools throughout the country. The objectives of the programme were to raise the nutritional status of children at all levels by providing a wholesome midday meal of 600-800 calories. Under the initial programme, a student received a stamp of Rs 3 and was expected to bring a home prepared lunch to school. In this context, the programme was implemented in about 10,000 schools covering about 4 million students. The programme was later implemented as a targeted programme and was finally absorbed by the *Samurdhi* poverty alleviation programme in 1995. However, the government re-started the Midday Meal Programme in 2006 and it is carried out as a targeted programme aimed at improving nutritional status and enhancing the educational attainments of economically marginalized children. Hence, the target groups of the programme are the school children in difficult areas, children of marginalized families and identified schools where at least 30 percent of the students are malnourished. The programme at the moment covers only grades 1, 2 and 3, and in places where the number of students in the school is lower than 100, the programme provides the meal for the whole school. The programme uses the meals prepared by the *Samurdhi* beneficiaries according to a guided menu. Payments for students will be based on attendance and Rs 15 will be spent on each student’s meal. The Government had allocated Rs 1,500 million for this purpose in 2007. The programme covers all the districts in the country. At the moment it provides for 500,000 students in 6,440 schools of the country. In addition there is a similar programme carried out by the World Food Programme (WFP) in 15 districts which is being coordinated with the government programme in selecting the beneficiary schools. It covers 350,000 students in 1,482 schools.

[9] Data from the Ministry of Education

Education and Poverty

Sri Lanka's achievements on the education front are impressive. The country had neared universal primary school enrolment and gender parity in primary and secondary enrolments by the 1990s. However, despite the achievements there are several drawbacks as the macro-level achievements overshadow the regional disparities and quality of education.

Table 27: Key Educational indicators, 2002 (Percent)

	Formal education Completion (Grade 1-9)	**GCE O/L Pass**	**GCE A/L Pass**	**Tertiary Enrolment**	**Poverty Incidence (Percent)**
Sri Lanka	**82**	**37**	**56**	**11**	**23**
Western	87	48	54	16	11
Central	82	32	55	8	24
Southern	87	37	57	10	28
North & East	73	32	58	n/a	n/a
North West	78	38	58	7	27
North Central	81	31	53	6	21
Uva	81	31	52	7	37
Sabaragamuwa	85	34	57	9	33

Note: n/a – Not applicable
Primary Source: Consumer Finance and Socio Economic Survey 2003/04, Ministry of Education and World Bank estimates based on Labour Force Survey (DCS)
Secondary Source: World Bank (2007)

There are wide regional disparities in some educational outcomes as shown in table 27. This clearly can be seen in the pass rates of the GCE O/L (General Certificate of Education Ordinary Level) across provinces.

Comparing the poverty and education levels of the head of the household shows a clear relationship. According to the World Bank (2007), poverty incidence is higher among the less-educated and less than 2 percent of the household heads with tertiary education were poor in 2002, while about one-half of the household heads with no schooling are poor. There are even imbalances in the net enrolment rates for secondary and tertiary levels, depending on the different income groups.

Table 28: Net enrolment rates by income quintile

Income Quintile	**Primary (Grade 1-5)**	**Secondary (Grade 6-9)**	**Secondary (Grade 10-13)**	**Tertiary**
Lowest	95	61	31	2
2nd	96	66	35	2
3rd	95	67	41	4
4th	96	77	47	5
Top	97	76	60	13

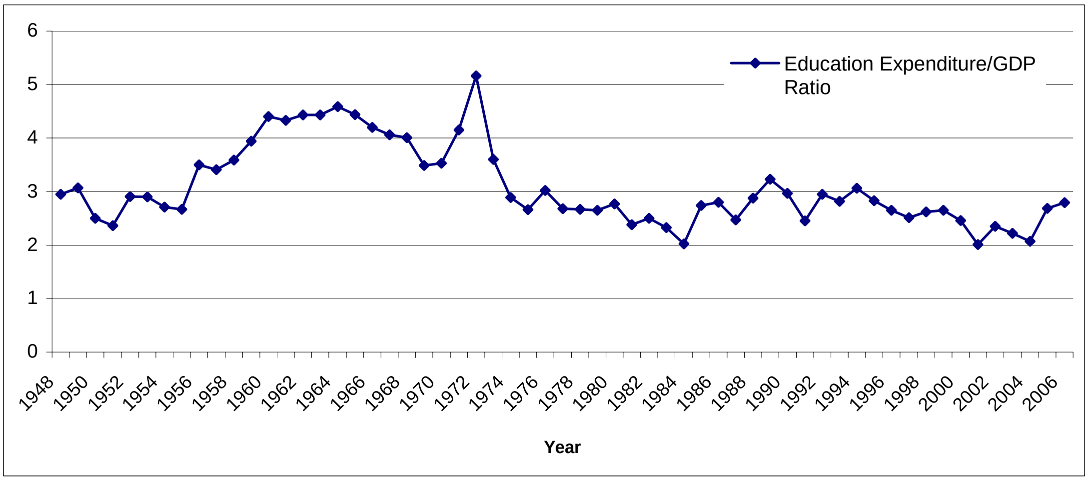
Primary Source: World Bank estimates based on the HIES 1995-96
Secondary Source: The World Bank (2007)

Moreover, according to the World Bank (2007), 18 percent of the students fail to complete the compulsory formal education. More interestingly, most of the students who drop out are from families living off the street, economically disadvantaged areas, conflict-affected areas, the estate sector or are disabled.

Pressures of Neo-Liberal Policy Reform on Education

The following figures show the change in the government expenditure on education expenditure over the years. Figure 3 shows the change in total expenditure per GDP after independence. Accordingly, it shows how expenditure increased with the existing welfare regime.

Figure 3: Public Expenditure on Education since independence to 2006



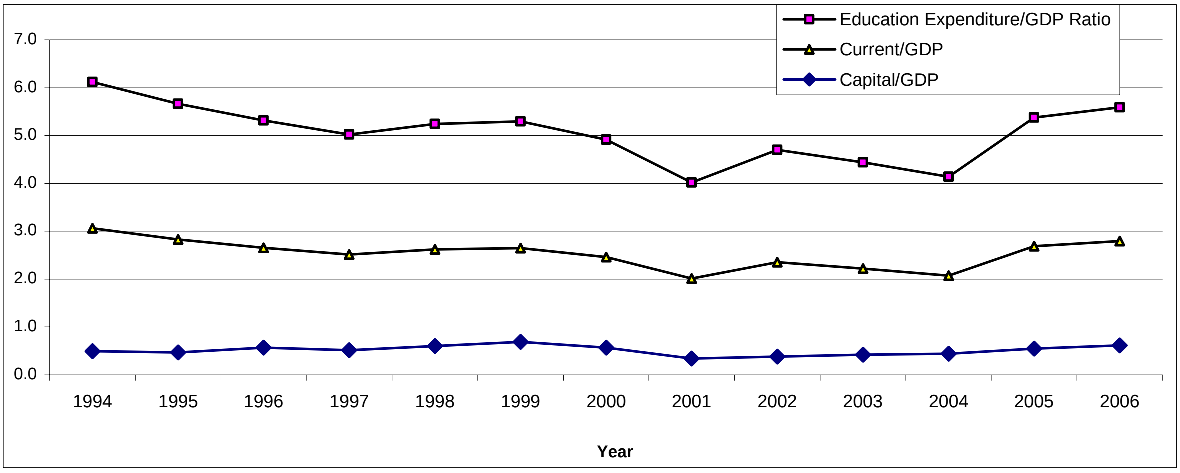
Source: Graphed from data obtained from Economic Progress of Independent Sri Lanka, Central Bank of Sri Lanka

The government's commitment to improve educational facilities gained momentum after independence in 1948. With the introduction of free education, public expenditure increased drastically from the 1950s to the mid-1960s. The government was able to reinforce its political commitment with adequate resources for education owing to favourable economic conditions during this period. Hence, the government was able to spend around 4 percent of GDP on education. Consequently, the literacy and school enrolments both among males and females improved significantly by the 1960s. Nevertheless, since the late 1960s[10] the weak economic conditions strained the government's capacity to sustain its commitment to education, resulting in a reduced allocation of 3 percent of GDP in the 1970s, this figure has not increased since then. The curtailed expenditure on education was only adequate to meet the essential recurrent expenditure such as teachers' salaries and the cost of expansion of schools necessitated by the increased school enrolment. Consequently, this was a set back to the quality of education which was unavoidable. Moreover, the Structural Adjustment Policies pursued by the government since 1977, led to the curtailment of social expenditure including education expenditure. This led to the further deterioration in the quality of education, increase in regional disparities in education and slowing down of further attainment in literacy and education (Tilakaratna 2006; Sanderatna 2000).

[10]Declining terms of trade due to depressed prices for the Sri Lanka's commodity exports in 1960s and the unfavorable global economic conditions particularly the two oil shocks and the international food crises, drought conditions in the country were the main factors affected the economy during this period.

The following figure 4 illustrates the recent trends of public education expenditure. The capital and current expenditure show a similar pattern to that of total expenditure. However, as mentioned above, total expenditure as a proportion of GDP has remained below 3 percent since 1996, reducing until 2004 and on an upward trend since then. The sharp increases in the military expenses have kept other expenditure low.

Figure 4: Public Education Expenditure from year 1994 to 2006



Source: Graphed from data obtained from various issues of Central Bank Annual Reports

From time to time, there have been several changes in the school midday meal programme too, due to the budgetary constraints. Initially it was not a targeted programme and absorbed a huge proportion of funds creating a huge strain on the government budget. Therefore the programme was restructured and implemented as a targeted program. Midday meals were provided to the poor students of the food stamp programme and also to the students who applied for such assistance. Accordingly the number of beneficiaries reduced to about 3 million out of 4 million students. Under the programme, a student was entitled to receive Rs 500 per month. The programme was absorbed into the *Samurdhi* poverty alleviation programme in 1995. However, after recognizing the declining nutritional status of school children, the present Government identified the importance of restarting the program. Accordingly, the Midday Meal Programme restarted in 2006 (Tilakaratna 2006).

In 2002, the government domestic revenue was the major source of financing of education expenditure, accounting for about 90 percent of the total public expenditure. Meanwhile foreign aid loans and foreign grants accounted for about 8 percent and 2 percent respectively. The World Bank and the Asian Development Banks have been the main sources of financing these aid loans while JICA had been the main source of grants followed by DFID, GTZ and SIDA (Aturupane 2004).

Health

Health is one of the most important concerns of the Sri Lankan welfare state. The history of the health service in the welfare state dates back to 1950s. The Cumpston Report of 1950 of Dr J.H.L. Cumpston led the way to the development of the Health Services Act of 1952. The major suggestions of the Cumpston Report were threefold: the abolition of private practices for doctors in the state sector; enabling the development concurrently of preventive and curative services; and setting out the rationale for an equitable universal health service as a matter of right. The policy recommendation was later fully implemented by 1972. As a result, a state-funded system of national health care based on principles of equity and justice was established, on which people benefit even to date. The background at the time with formally trained doctors and nurses already available was the strength in implementation of the policies (Jayasuriya 2000).

The success of the health sector can be attributed to two main policies, mainly free health care in the public sector and provision of services close to the patient since the 1930s. The health service includes health care infrastructures such as medical facilities, hospitals, health personnel, medical equipment and supplies. The health care system also addresses the problems associated with various communicable and non-communicable diseases and also includes a strong immunization programme against diseases such as tuberculosis, tetanus, polio and measles. Moreover, child and maternal care as well as various nutrition programmes are also covered extensively by the health care system. Sri Lanka health indicators show the success of the past policies. However, after about the 1960s, public sector spending on health was reduced due to resource limitation (de Silva 2004).

Health and Poverty

The health system in Sri Lanka displayed high levels of efficiency as well as equity, even by international standards. This is evident by observing the achievements in basic health indicators. The approach of support-led security was able to help the country reach such achievements. Such an approach, where the government provides health and social services promotes human and social development without waiting for economic growth to do so. Access to public health services is near-universal and free public care services are accessible and available owing to the well-developed network of preventive health care services and hospitals. In-patient care is free and people in rural areas have peripheral health care facilities within about 5-10 kilometres.

Table 29: Use of Maternal Health Services, by Wealth Quintiles

	Poorest	**Richest**	**Population Average**
% who received Tetanus Toxoid Immunization	93.2	95.5	95.1
% who received drugs to prevent Malaria	34.9	12.5	23.8
% who gave birth in an institution	91.4	99.2	96.7
% who gave birth in private hospital	0.2	20.0	5.5
% who received prenatal visits by midwife	75.6	80.7	82.9
% who visited facility for prenatal care	93.1	94.1	93.9
% who receiving postnatal visits by midwife or medical officer	69.0	68.8	72.6

Notes: World Bank staff calculations using Sri Lanka demographic and Health Survey (2000). Refers to maternal health services utilized during pregnancy by currently women aged 15-49 years with births within 5 years preceding the survey.
Source: The World Bank (2007)

Table 29 shows that there are few disparities between the lowest and highest wealth quintiles in the use of maternal health services.

Table 30: Child Nutrition and Health Status, by Wealth Quintiles

	Poorest	**Richest**	**Population Average**
% of children with low birth weight (< 2.5 kg)	24.7	9.2	17.4
% of children stunted (low height for age)	29.0	3.5	14.6
% of children wasted (low weight for height)	20.1	9.5	14.8
% of children underweight (low weight for age)	47.4	11.1	29.3

Note: Refers to children aged 3-59 months whose height and weights are measured
Primary Source: World Bank staff calculations using Sri Lanka Demographic and Health Survey (2000)
Secondary Source: The World Bank (2007)

Though there are no such disparities in child mortality and utilization of health services among the rich and the poor, in children's and women's nutrition there are clear disparities as shown by tables 30 and 31.

Table 31: Women's Nutritional Status, by Wealth Quintiles

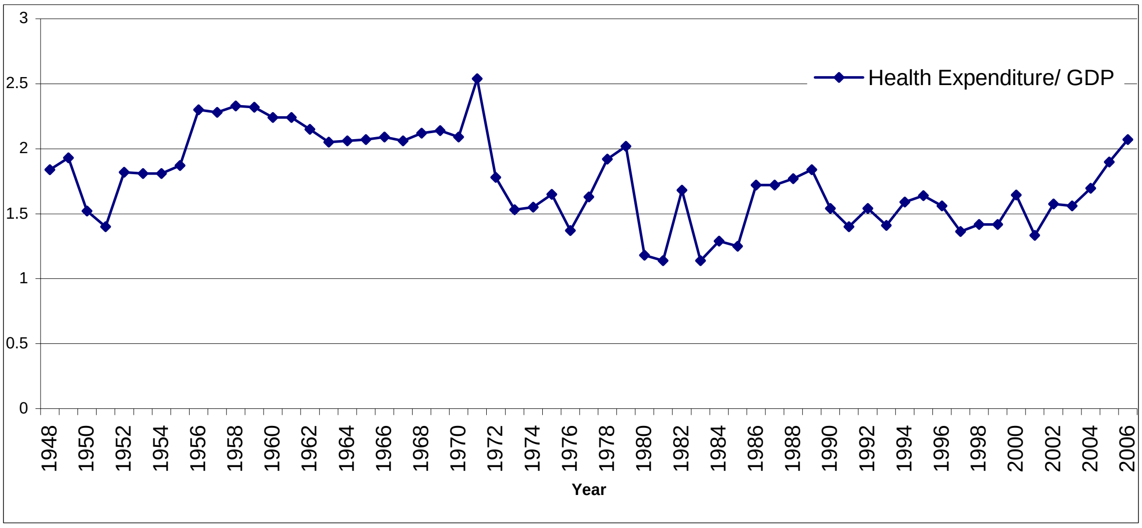
	Poorest	**Richest**	**Population Average**
% of women with low body mass index (< 18.5)	37.3	10.0	22.9
% of women with high body mass index (>= 25)	6.6	36.9	20.5

Note: Women aged 15-49 years
Primary Source: World Bank staff calculations using Sri Lanka Demographic and Health Survey (2000)
Secondary Source: The World Bank (2007)

Pressures of Neo-Liberal Policy Reform on Health

The public expenditure on health also shows a similar pattern to that of public education expenditure. Figure 5 shows that public health expenditure was relatively high during 1950s and it recorded a peak in 1971 reaching 2.5 percent of GDP. From the early years as 1903, there had been a system of user fees for health services which did not have considerable impact on government expenditure reduction. This included only a small fee based on the income of the patient which was self-reported. Hence, the user charges at the time represented only about 1 percent of the total health expenditure (by 1950 according to the administrative reports) which did not impose a burden on the patients nor did it provide relief to government expenses. The user charges were abolished in 1950. Health expenditure at the time was borne mainly by the government. However, after the peak expenditure in 1971 as in the education expenditure it had kept quite low through out and it had been below 2 percent of GDP and even closer to 1 percent of GDP in several years of early 1980s. The favorable economic conditions in the plantation sector facilitated the provision of welfare services including health from the tax revenue until the 1960s. With the population growth in the 1960s and 1970s health services had to be expanded but slow economic growth and resource constraints in later years hampered the growth of the health sectors particularly in quality terms due to the reduction of public expenditure on health (de Silva 2004).

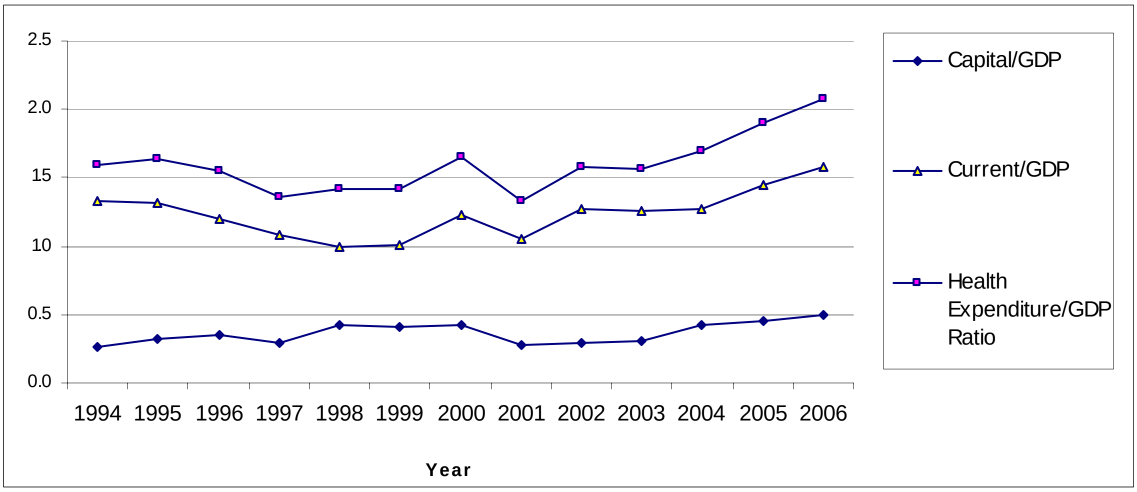
Figure 5: Public Expenditure on Health since independence to 2006



Source: Graphed from data obtained from Economic Progress of Independent Sri Lanka, CB

Taking a closer look at the recent past, figure 5 shows that public health expenditure remained at approximately 1.5 percent of GDP. However, since 2003 there is an increasing trend in total public health expenditure.

Figure 6: Public Health Expenditure from year 1994 to 2006



Source: Data from various issues of Central Bank Annual Reports

With economic liberalization, the private sector has had the opportunity to invest in the health sector. In addition, allowing medical officers to take on private practices after duty hours helped to further strengthen this change (de Silva 2004). In total for 2003 while the public source of funding is around 43 percent of the total health financing, the private sources financed 57 percent. In 2004, public funds accounted for 49 percent while the private financing accounted to 51 percent of the total health financing. In GDP terms, while the government financing has been only 1.7 percent and 2.0 percent for 2003 and 2004 respectively, the private financing has been 2.2 percent and 2.0 percent respectively. Government funds mainly consisted of central government revenues and donor assisted external resources. Other government sources such as the President's Fund, Employees' Trust Fund (ETF) and the Provincial Councils revenues contributed to an insignificant amount. The private expenditure funding sources were mostly household out of pocket spending in addition to the private sector employers, commercial health insurance and NGOs' own sources of funding (Institute of Policy Studies of Sri Lanka 2007).

It is true that the country has been facing problems on the welfare front due to the high defence expenditures of the ongoing war. This has mainly prevented the diversion of resources to education and health sectors. Nevertheless, the rapid demographic transition that is taking place has opened up an opportunity for the country to improve the quality of both education and health. The low population growth which was partly an outcome of effective family planning has resulted in a lower proportion of children in the population. This rapid decline started in the late 1990s. Due to this decline of the younger population it will not require additional investment in education and health in terms of increasing the number of schools and teachers and pre-natal and post-natal health services. As is highlighted by Kelegama (2006), now is the high time to grab this opportunity, since this reduction in the child dependency ratio will be offset by the increase in old-age dependents and as per the predictions it is to be completely offset by 2036. However, as the book highlights, the danger is that the government, faced with a high fiscal burden, will tend to use the opportunity to reduce the expenditure on education and health. Instead it should be geared to improve the quality of the both with the same level of investment (Kelegama 2006; Sanderatna 2000).

Humanitarian Effects of the Civil Conflict

More than two decades long, the civil conflict has caused immense losses to the country in economic as well as humanitarian terms. The impressive performances of human development at the macro-level overshadow the disparities at regional level. More than anything, the losses in the war-torn areas are often unaccounted.

Some estimated data show that 2.5 million people lived in areas of direct military activity. About 65,000 people have been killed, about 800,000 were internally displaced, including 172,000 in refugee camps, and another 700,000 have left the country. There are about 30,000 war widows and about 300,000 displaced children in the North and East (The World Bank 2004).

Table 32: Selected Human Development Indicators 2001

Indicator	**North & East**	**Sri Lanka**
Child malnutrition (%)	46.2	29.4
Infant mortality/ 1,000	30	12
Maternal mortality/ 100,000	81	23
Literacy (%)	68.3 (a)	90.1
School drop out (%)	15	4
Per-capita income (2000)	Rs 37,206	Rs 63,000

(a) Batticaloa district only
Primary Source: WHO and DCS
Secondary Source: The World Bank (2004)

Table 32 shows the disparities existing in the selected indicators of human development for the country and the North and East which are the major war affected areas.

Social Protection Schemes

Successive governments of Sri Lanka have followed numerous policies and programmes aimed at reducing poverty and improving the living standards of its people. To supplement these policies, they have implemented a number of welfare programmes (transfer programmes) such as the *Janasaviya* Programme (1989-1994), the *Samurdhi* Programme (since 1995) and various food subsidy programmes. Moreover, there are other social welfare programmes such as social security for disabled soldiers, social welfare for Internally Displaced People (IDPs), Relief and Recovery programmes, midday meal programme for children at school, social assistance to vulnerable groups like the elderly, women headed households and disabled people, nutrition supplement programme (*Triposha*) for mothers and children. Altogether these welfare programmes including the *Samurdhi* programme consumed about 1 percent of GDP in 2003 (The World Bank 2007)

(i) Food Subsidies and Food Stamps

In Sri Lanka, the first large scale food subsidy programme was initiated in 1942 during the Second World War to ensure adequate food distribution and continued until the 1970s as part of the states welfare programme. This programme initially gave universal coverage to households without means testing. However, due to high fiscal costs (accounting for nearly 20 percent of the government's current expenditure), tax-payers were taken out of the scheme in the early 1970's and also the quantity of rice under the ration was halved. Moreover, in the late 1970s, the number of beneficiaries was significantly reduced (to about 50 percent of the population) by limiting the free food ration only to those families whose income fell below a particular cut-off point. It was the principal anti-poverty measure in the post-independence era until it was abandoned in 1977 (Jayasuriya 2004).

In late 1979 the Food Ration Programme was replaced with a Food Stamp Programme. The advantage of the new scheme was that the size of the entitlement was fixed in nominal terms (in Rupees) and hence it was easy to maintain a stable budget.[11] However, the non-indexing of food stamps to the cost of living index resulted in the real value of the food stamps declining significantly over time, and thus contributing only very little to the household income of recipients.

(ii) Janasaviya

The *Janasaviya* Programme (JSP) was started in 1989. It had the dual objectives of short-term income-supplementation and long-term employment creation of low income households. The selected households were expected to participate in the programme for two years. During this period, an allowance of Rs 2,500 per month was provided to each household, half of which was to be used for consumption purposes while the balance was for investment in a self-employment venture.[12] At the end of the two years, the income-supplement component could be withdrawn and invested in some self-employment activity to enhance household income. Due to high costs, the JSP was operated only in a

[11] In the Food subsidy scheme it is the quantum of the commodity which is fixed. Thus, rise in commodity prices would lead to fiscal/budgetary problems.
[12] The amount for investment was saved in a bank account in the name of the recipient/participant, and could be withdrawn at the end of the two years.

few selected regions. Moreover, evidence showed that many self-employment activities created under the JSP were not sustained due to various reasons such as lack of skills/training and marketing difficulties. JSP continued until 1995, when it was replaced by the *Samurdhi* programme by the then newly-elected government.

(iii) Samurdhi

The *Samurdhi* Programme has been the single largest welfare programme for the poor in Sri Lanka since its inception in 1995. It covers nearly 2 million households in the country. *Samurdhi* has three main components: (i) the income transfer component, which includes consumption and social insurance support for families whose monthly income is below Rs 1500;[13] (ii) Community development through investment in economic and social infrastructure, agriculture, nutrition, etc.; and (iii) The savings-credit (microfinance) scheme aimed at providing financial services to the poor through a series of *Samurdhi* Banks that have been set-up in almost all the districts in the country. All these strategies come under the main objectives of the government in adopting both short-term strategies in reducing vulnerability of the poor and long-term strategies in assisting them to eventually move out of poverty. The government's short-term strategies are based on poverty cushioning methodologies such as income support, social insurance and social development programs. Under long-term strategies it aims to address the core issues of poverty alleviation by using methods such as empowerment, social mobilization and integrated rural development (Gunathilake *et al* 1997).

Table 33: Deciding the different subsidy values

Number of members in the family	**Value of the allowance card (Rs)**
6 or more	1500
3 or more	900
2	525
1	375
Janasaviya families	415
Families whose income level has improved due to empowerment but still actively contributing to the *Samurdhi* Programme	210

Source: Ministry of Samurdhi and Poverty Alleviation (2007)

The beneficiary households are selected based on the monthly level of income they earn. If the household earns an income below Rs 1,500 per month, it is identified as a beneficiary household. All the income sources of a household are considered when identifying them as beneficiaries and the amount varies according the number of members in a family. In addition, special recognition is given to the families with disabled or with elderly people. The worth of the income transfer the household receives varies from Rs 210 to Rs 1, 500, as shown in table 33.

In 2006, a number of important changes were made to the *Samurdhi* subsidy programme, as pledged in the election manifesto of the President. Accordingly, the *Samurdhi* subsidy/benefit was increased by 50 percent from 2006 for all the beneficiary groups

[13] In 2006, the government spent about Rs 10,586 million on *Samurdhi* income transfer according to the Central Bank of Sri Lanka (2006). The amount of transfer received by the selected households depends on the household income and the family size.

except for the earlier *Jansaviya* group (which now receives an additional Rs 15 for the increase of insurance deduction). The benefits before and after this change in 2006 for various groups are presented in table 34. As shown, a household that received benefits worth Rs 1000 a month before the changes would receive Rs 1500 a month with the changes introduced in 2006. A characteristic feature of the programme is that it is being carried out throughout the country, regardless of area or sector of residence. In addition, it should be understood that the amounts for compulsory savings, social insurance and housing fund are deducted from the total monthly benefit, according to the amount of total monthly benefit as shown in the table. What the beneficiaries get to their hand are the commodity stamp and the money stamp.

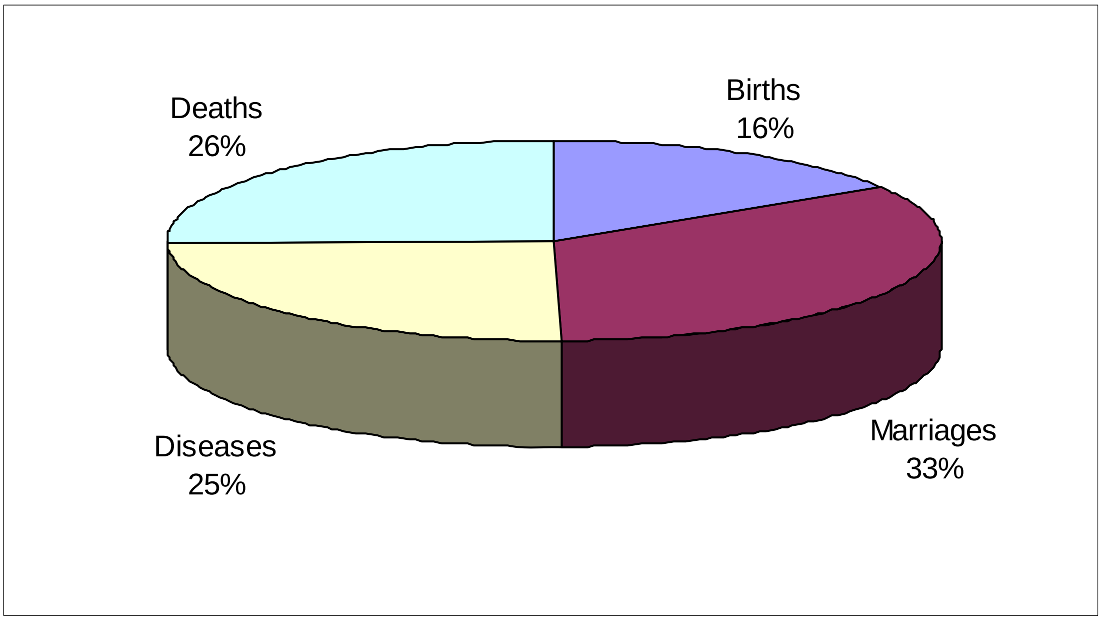
Table 34: Changes to *Samurdhi* Benefits Before and After 2006

	Total Monthly Benefit (Rs.)	**Breakdown of Monthly Benefit**				
		Commodity Stamp (Rs.)	**Money Stamp (Rs.)**	**Compulsory Savings (Rs.)**	**Social Insurance (Rs.)**	**Housing Fund (Rs.)**
Before	1000	400	360	200	30	10
2006	1500	605	540	300	45	10
Before	600	250	210	100	30	10
2006	900	380	315	150	45	10
Before	350	340	-	-	-	10
2006	525	515	-	-	-	10
Before	250	240	-	-	-	10
2006	375	365	-	-	-	10
Before	400	360[a]	-	-	30	10
2006	415	360[a]	-	-	45	10
Before	140	100[a]	-	-	30	10
2006	210	155[a]	-	-	45	10

Notes: a: For commodity purchase or to be converted into money.
Primary Source: Department of the Commissioner General of Samurdhi.
Secondary Source: Institute of Policy Studies of Sri Lanka (2006)

The *Samurdhi* social security programme (or the insurance programme) has been established with the objective of helping poor households to reduce their vulnerability at times of various life cycle events. This programme covers four types of events, mainly child birth, marriage, hospitalization and death. Figure 7 shows the shares of total claims made by *Samurdhi* beneficiaries for each of the four types of events during the year 2005. As indicated, marriages have accounted for the highest share of claims during 2005, accounting for about 33 percent out of the total number of claims.

Figure 7: Share of Total Insurance Claims in 2005

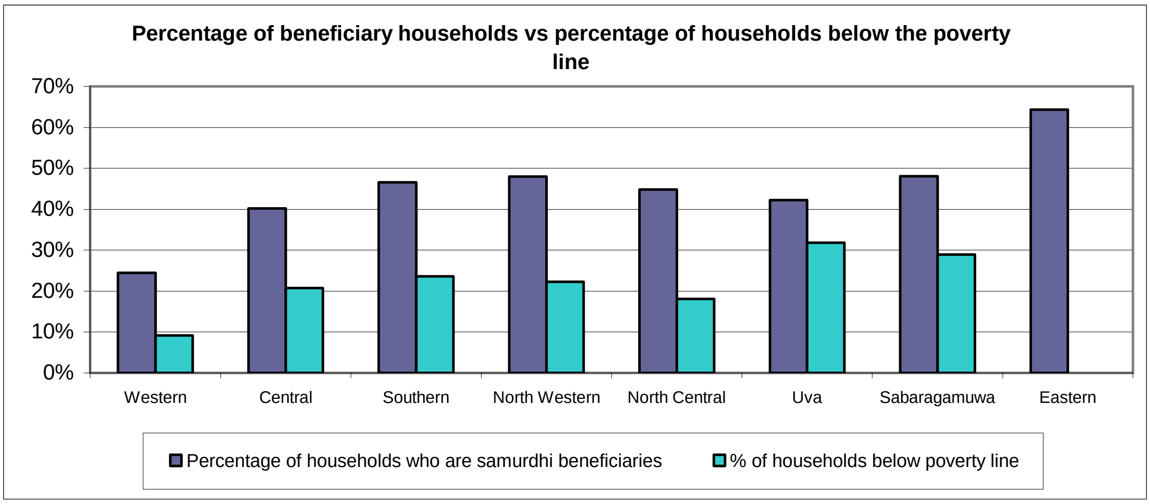


Source: Calculated from Ministry of Samurdhi and Poverty Alleviation (2007)

As can be seen from figure 8, the percentage of beneficiaries is much higher than the percentage of poor households, in almost all the provinces. In total, according to the World Bank (2007) 45 percent of the population receives the *Samurdhi* transfers which accounts to about 2 million families. This indicates that a considerable proportion of non-poor are benefiting from *Samurdhi* income subsidies. Particularly, in the Western, North Central, North Western and Southern provinces, the proportion of *Samurdhi* beneficiaries is almost twice the share of the poor. Poor targeting is the major setback of the programme. According to the World Bank (2007), there are wide variations between the Divisional Secretariat (DS) division level poverty estimates and the distribution of *Samurdhi* beneficiaries across the DS divisions. In addition to poor targeting the *Samurdhi* programme suffers from a number of problems such as corruption and politicization of the selection process. This can be explained by the huge number of beneficiaries identified as needy, being about 2 million households, which is approximately closer to 41 percent of the households in the country, while the percentage of poor households are estimated to be only about 19 percent.[14]

[14] Based on the official poverty line of the DCS

Figure 8: Percentage of Beneficiary Households versus Percentage of Households Below the Poverty Line (by province)



Notes: The percentage of poor households is based on the estimates of the DCS using the Official Poverty Line (real per capita monthly total consumption expenditure of Rs. 1423 in 2002) whereas the Samurdhi beneficiary households are those with a total (household) income of less than Rs. 1500 a month (based on the estimates of the DCGS for 2005).
Primary Source: Based on poverty and demographic statistics from DCS and DCGS.
Secondary Source: Institute of Policy Studies of Sri Lanka (2006)

The prevailing situation stresses the need for improving the targeting of the *Samurdhi* subsidy programme. This would help to reduce the unnecessary expenditures of the government and will make more resources available for efficient service delivery to the most needed. The government in this sense now is trying to have a participatory approach in beneficiary targeting which in future will help to improve proper targeting.

Impact on household welfare by Samurdhi programme

According to a study of Glinskaya (2000), the *Samurdhi* programme has an equalizing impact on welfare distribution in the country. The gini coefficient of income inequality (expenditure inequality) with *Samurdhi* is 0.531 (0.309) and the counterfactual without *Samurdhi* transfer is 0.544 (0.320). *Samurdhi* reduces income inequality (expenditure inequality) by 2 (3) percent. Moreover, the study points out that on average 14 percent of the total household food expenditure of the beneficiary households is covered by the *Samurdhi* food consumption grant. Moreover, it shows that the impact on the welfare of households from the lowest quintiles is larger then on higher-income households. This is evident by the fact that about 21 percent of the total food expenditures of the lowest quintile households are being covered by the *Samurdhi* food stamp grant, while in the case of households from the second income quintile only 12 percent of total food expenditure is covered by the *Samurdhi* food stamp grant. Moreover, the study finds out that the impact on consumption of the richest 60 percent of the population is even smaller ranging from 8 to 1 percent of the value of total food consumption. The results are shown in table 36.

Table 36: *Samurdhi* food transfer as a share of household food expenditure

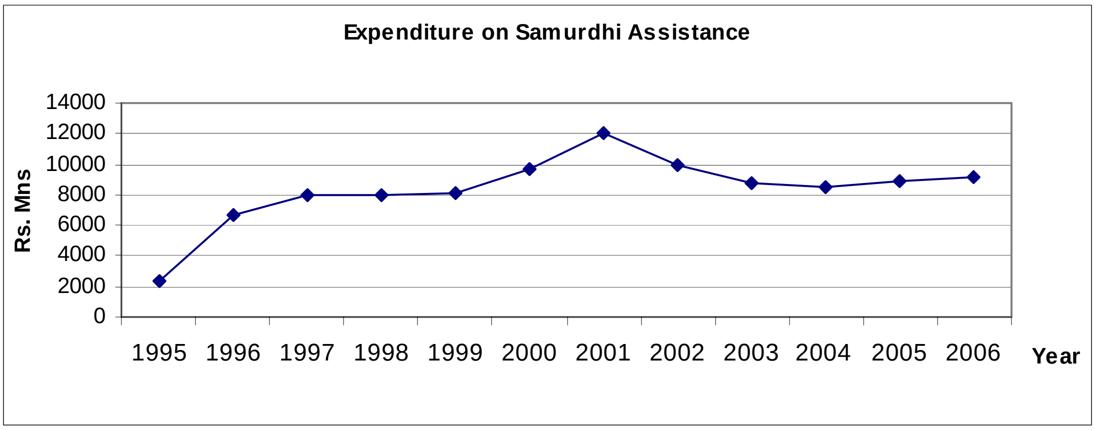
Quintile	**1 (Lowest)**	**2**	**3**	**4**	**5 (Highest)**	**Total**
Conditional on being a recipient	21	13	10	9	8	14
Unconditional	14	7	4	3	1	6
Applying compulsory deductions						
Conditional on being a recipient	18	10	8	7	7	11
Unconditional	11	5	3	2	1	5

Primary Source: Calculations based on 1999/2000 Sri Lanka Integrated Survey
Secondary Source: Glinskaya (2000)

Spending Trends for Social Protection

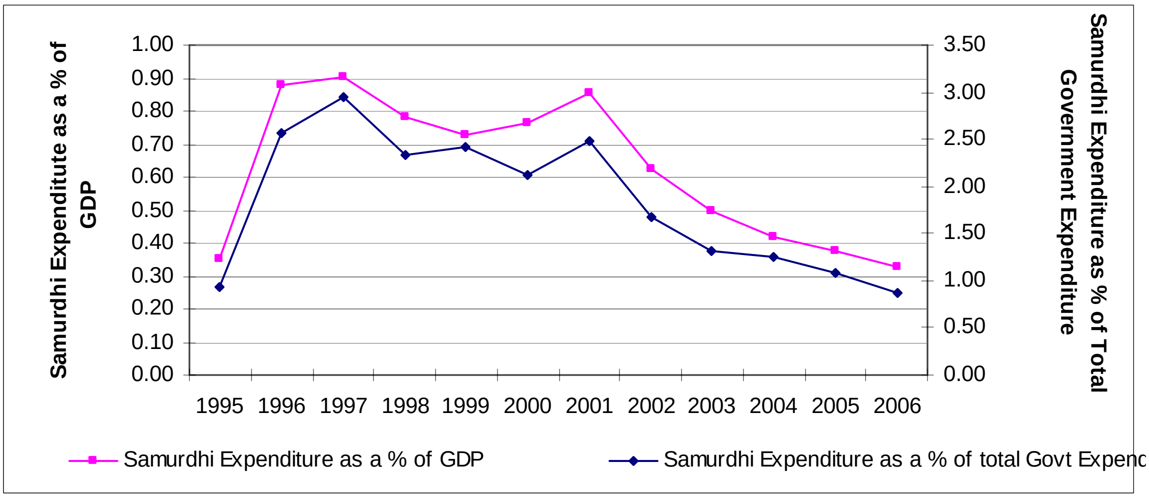
Figure 9 shows the trend in public sector spending on the *Samurdhi* scheme since its inception. It started low at about Rs 2.3 billion by 1995 and reached the peak of over Rs 12 billion by 2001. Since then due to the fiscal austerity at the time, the successive governments were forced to reduce the expenses on *Samurdhi*. Hence, from 2001 until 2004, the expenditure on *Samurdhi* was on a declining trend and even came down close to Rs 8.5 billion. Nevertheless, after 2004 it has been increasing. By the end of 2005, it increased to a figure close to Rs. 9 billion, which reflects a change in policy towards more welfare based approach.

Figure 9: Expenditure on *Samurdhi* Subsidy (Rs. Mn.)



Note: The Samurdhi assistance figures are available only upto 31-07-2006 and it is Rs. 5305.3 Million. From this the calculated figure for the year appear as Rs. 9094.8 million
Source: Ministry of Samurdhi and Poverty Alleviation (2007)

Figure 10: Expenditure on Samurdhi Subsidy (as percentage of GDP and government expenditure)



Note: The Samurdhi assistance figures are available only upto 31-07-2006 and it is Rs. 5305.3 Million. From this the calculated figure for the year appear as Rs. 9094.8
Source: Ministry of Samurdhi and Poverty Alleviation (2007) and Central Bank, Annual Reports, various issues

Figure 10 shows how the expenditure on the *Samurdhi* subsidy as a percentage of GDP and as a percentage of total government expenditure has changed over the period 1995-2006. The expenditure on the *Samurdhi* subsidy as a percentage of GDP and total government expenditure also shows a similar trend to figure 9. Since 2001, the figure shows the clear decline of the *Samurdhi* subsidy expenditure as a percentage of GDP and as a percentage of total government expenditure. By 2006 it reached a low figure closer to 0.3 percent of the GDP while it moved closer to 1 percent of the total government expenditure.

Other Key Welfare Programmes

There are a number of welfare programmes at present in addition to *Samurdhi*, some of which are overlapping and administered by different departments. The largest is the Public Assistance programme which is being administered by different provincial governments. The target group is specific vulnerable groups such as poor among the elderly and disabled, families without breadwinners, destitute women and orphans. The average monthly grant is about Rs 135 which is lower than the *Samurdhi* grant and in 2005 there were 365,000 families receiving the grant. There is another separate social welfare programme operating for the IDPs in the conflict affected areas which provide assistance in the form of cash and dry rations.

The *Triposha* nutrition supplement programme is a significant targeted programme for pregnant and lactating mothers, and children of age 6-59 months from poor families. There were 580,000 beneficiary families in 2005. There are also other nutrition programmes. One is carried out by the *Samurdhi* division and Ministry of Health which provides a basket of food items to pregnant and lactating mothers of poor families, infant milk subsidy by the *Samurdhi* Ministry. In addition, the Ministry of Health has another nutrition supplement programme different from *Triposha* in some areas. There is also the School Midday Meal programme implemented in selected schools (The World Bank 2007).

Retirement Schemes

The retirement schemes available in Sri Lanka consists of a combination of fully funded or PAYGO (Pay-As-You-Go) schemes. Though these schemes cover both formal and informal sector workers, the coverage is only about 25 percent of the working age population. According to the Department of Census and Statistics of Sri Lanka (2007), in 2006 formal sector employment was only 38 percent while informal sector employment was as high as 62 percent. The absence of a universal or means tested pension had left a large segment of the population in the country without a formal security cover in old age (Gaminiratne 2007).

(i) Employees' Provident Fund (EPF)

The EPF is the largest retirement savings scheme in the country. It was established in 1958 by the Employees' Provident Fund Act, No. 15 of 1958, as a means of providing formal sector workers some sort of an income security in retirement. At the time, it was established as the second best alternative for a pension scheme, since the formal sector at the time was small in size and a large proportion of the population was not in formal employment. Now the EPF is a mandatory, contributory scheme which covers the employees of the private sector.

The employers and the workers have to make joint payroll contributions at the rates of 12 percent and 8 percent of earnings respectively. The employer is also responsible for the registration of the worker and remits the contributions. The worker can withdraw the accumulated amount as a lump sum at retirement. The statutory age of retirement is 55 years for men and 50 years for women. However, the worker can choose to extend contributions to the EPF if he works even after this age. A major disadvantage of the system is that it does not offer any pension benefit, or any option for workers to convert the lump-sum into annuities or pensions (Eriyagama and Rannan-Eliya 2003a; Gaminiratne 2007).

The principal custodian and investment manager of the fund is the Central Bank. By the end of 2001, the EPF had coverage of about 65 percent of the eligible population, which represents about 1.9 million active accounts out of 2.9 million eligible formal private sector workers. As the casual and contract workers are steadily increasing evasion, non-payment is going to become a huge problem to be addressed in future. The remaining 35 percent are not covered. In terms of coverage, gender bias can be observed with 70 percent of the covered being men (see table 38) (Gaminiratne 2007).

As studies show, the EPF has several deficiencies in ensuring the social security of its target group. Though the primary objective of the EPF scheme is to ensure that those working in the formal sector have some form of income security in their old age, the deficiencies explained below create doubts as to whether it is able to achieve its objective. One major deficiency is the lack of a pension or any periodic income after retirement according to the way the scheme is designed. Since the scheme does not offer such, the members have only the option of obtaining the lump-sum amount at retirement. Furthermore even if we assume that the members are able to obtain at no cost actuarially-fair annuities to invest their lump-sum in, the replacement income will be only 20-45 percent of the average wage for the most of the workers. Moreover, it will decline as the individual gets older in retirement. Further, the age an average person starts working make the contributions time too low to derive benefits after retirement. The situation is worse for women if they temporarily withdraw from the labour force for reasons of child birth and rearing, which often happens in Sri Lanka (Eriyagama and Rannan-Eliya 2003a).

(ii) Public Service Pension Scheme (PSPS)

The PSPS is a mandatory but non-contributory scheme for public sector workers, financed from general taxation. The scheme was closed in 2002-2003 for new entrants but had to restart again by 2004. All permanent public workers are eligible for the scheme. In 2003 there had been 750,000 workers eligible which amounts to 10.5 percent of the labour force of the country and the coverage of those eligible is 100 percent. The PSPS is supplemented by a mandatory contributory survivors and disability plan or the Widow's and Orphan's Pension Scheme (WOP). In 2002, the scheme had made payments to 400,000 pensioners out of which 100,000 had been widows.

The retirement income is estimated based on the final salary and the years of service. The minimum retirement age is 55 years and the mandatory age of retirement is 60, with an extension possible after this only under specific circumstances depending on the case. For a person to qualify for the pension rights, a 10 year minimum service is required, which will bring in an entitlement of 40 percent of the final salary. An individual with a service of 30 years can retire with 90 percent of the final salary. The percentage of the retirement income is quite satisfactory owing to the pension formula, compared to many countries (Gaminiratne 2007).

Even though the PSPS is a non-contributory scheme financed from taxation, due to the absence of a formal index linking pensions to prices or wage growth, the value in real terms has eroded over the time, deteriorating the standard of living of many public sector pensioners. Though the government had taken steps several times to increase the real value the adjustments have been ad hoc and mostly below the rate of inflation. Moreover, the better characteristics of the PSPS replacement formula are being offset by the comparatively low salaries in the public sector. As mentioned in Gaminiratne (2007), in 2002, about 77 percent of the civil servants earned less than Rs 5,000 which pulled them into the second lowest income quintile relative to the whole population. Moreover, 92 percent earned less than Rs 6,000 and 99 percent earned less than Rs 10,000. Accordingly, the average pension had been Rs 6,500 while the median payment had been closer to Rs 5,500 in 2002.

(iii) Voluntary Schemes (Farmers, Fishermen and Self-Employed Scheme)

To provide social security for the workers outside the formal sector, these schemes were established by Acts of Parliament in 1987, 1990 and 1996 respectively. Depending on the age of the enrolment the workers have to make contributions for a minimum number of years to qualify for the pension. If the age of enrolment is older, then even though the number of years of contributions is lower the annual payments are higher.

In addition to the standard old age pension, additional benefits such as provision of survivor's pension and death gratuity for the spouse on the death of the member and provision of disability benefits on the occasion of partial or permanent disablement are provided. The scheme covers about 80 percent of the all informal sector workers in the economy. Nevertheless, despite the benefits and encouragement by the administration such as provision of grace periods to repay the outstanding contributions, the default rates are quite high.

The Farmers' Pension and Social Security Benefit Scheme is administered by the Agricultural and Agrarian Insurance Board (AAIB). The targeted farmers are both female and male Sri Lankan citizens whose main source of subsistence is agriculture. Eligibility is primarily based on the type of crops cultivated, age and non-entitlement to other benefit schemes. The rate of contribution is specified by the government gazette. There are two methods: a farmer can pay on a regular basis until reaching vesting age; or on a discounted basis as a one-off payment made in the year of enrolment, with no subsequent payments required (Eriyagama and Rannan-Eliya 2003a).

The scheme has two main components: a pension scheme which aims to provide old-age income security and a social security benefit scheme which is to provide group insurance in the event of trouble. This has a disability benefit, disablement gratuity and death gratuity.

This scheme receives income from: a government contribution to the fund which was provided during 1987-1990, contributions from members, interest and investment income on its fund balances and miscellaneous income including grants for specific projects. At the establishment, out of the promised amount of Rs 750 million over 10 years, by 1990 only Rs 173 million was being advanced. The contributions from the members accounted for 49.5 percent of income for the scheme from 1996-2001 and the interest and investment income had been 50.5 percent of total income for the same period (Eriyagama and Rannan-Eliya 2003a).

The Farmer's Scheme had covered about 65 percent of the farming population which accounts for 675,000 in terms of number of members out of 1.9 million estimated eligible farming population in 2002. Out of the enrolled, 33 percent are women while 66 percent are men.

The Fishermen's Pension and Social Security Benefit Scheme is also administered by the AAIB. The scheme covers both fishermen who are engaged in marine fisheries as well as inland fishing. Eligibility depends on the age, ownership of certain assets and non-membership of other similar benefits and pension schemes. Similar to the Farmers' scheme, there are two methods of payments either on a regular basis or discounted basis. This scheme also has two main components: a pension scheme and a social security benefit component. The income of the fund is mainly received from member contributions and interest earned from investment in treasury bills. In addition, since its inception the state has allocated an annual subsidy of Rs 1.5 million to the scheme, which is meant for the administrative expenses of the scheme (Eriyagama and Rannan-Eliya 2003a).

The Fishermen's Scheme had covered about 79 percent of the fishermen community, which accounts to about 48,000 members out of an estimated fishermen community of 61,000 in 2002 and the enrolled were mainly men.

The management and the administration of the Pension and Social Security Benefit Scheme for the Self-Employed are vested with the Sri Lanka Social Security Board. Only certain types of workers are eligible for the scheme and this depends on the age, income, non-membership of other similar benefits and pension schemes. Though initially by the 1996 Act, self-employed persons with an annual income not exceeding Rs 36,000 were made eligible for the scheme, an amendment in 1999 substituted that with persons not liable to pay income tax as eligible. The members can pay the contributions either on a regular basis or as a lump-sum. As with earlier schemes this also has pension benefits as well as social security benefits. The scheme is funded from a government subsidy of Rs 28.6 million (initially pledged to be Rs 100 million), member contributions and interest and other income from investments (Eriyagama and Rannan-Eliya 2003b).

The coverage of the Self-Employed Pension Scheme is about 8 percent out of the eligible self-employed population which accounts to about 65,000 self-employed workers out of 815,000 by 2002. The high rate of defaults which amounts to about 30 percent of the enrolled has reduced the effectiveness of coverage to about 5 percent (Gaminiratne 2007).

All these informal pension schemes face the same problem of losing value in real terms with inflation. This is mainly because, as already mentioned above, the pension payments are not index linked to inflation and hence, retirement income becomes inadequate at retirement (Gaminiratne 2007).

Table 37: Eligibility and Coverage by Scheme for Retirement Schemes

	Membership (000's)	**Eligible Workers (000's)**	**Coverage (as a % of eligible)**	**Effective Coverage (as a % of eligible)**	**Effective Coverage (as a % of WAP)**
EPF	1900	2900	65	65	16
PSPS	750	750	100	100	6
Farmers	675	1900	36	18	-
Fishermen	48	61	79	39	0
Self-Employed	75	815	8	4	0
Total	**3438**	**6416**	**54**	**47**	**25**

Notes: 1. Effective coverage factors default rate
2. WAP- Working Age Population (15-65 years)
Primary Source: LFS, CFS, SLIS survey data (2000, 1997, 2001)
Secondary Source: Gaminiratne (2007)

Table 38: Breakdown of Eligibility Participants by Gender

	Male	**Female**
EPF	70%	30%
PSPS	64%	36%
Farmers'	67%	33%
Fishermen's	100%	0%
Self-Employed	77%	23%
Total	**67%**	**33%**

Primary Source: Derived from LFS 2000 (all quarters)
Secondary Source: Gaminiratne (2007)

Excluding the North and East, the working age population of Sri Lanka was about 12 million in 2002. Out of this, 54 percent are eligible for one of the above retirement schemes which accounts to about 6.2-6.4 million workers out of the working age population. Out of this eligible group, the coverage approximates to 36 percent of the working age population which makes up the number of enrolees to 3.5 million. However, the effective coverage is much lower than that due to the high default rates, which was estimated by a sample survey analysis to lie between 50-70 percent of those enrolled. Hence, by 2002, the effective coverage had been only about 25 percent of the working age population which makes the active contributors to only 2.8-3.0 million of those enrolled (Gaminiratne 2007).

C) The Politics of Development, Welfare Provisioning and Poverty Eradication

Sri Lanka, among many developing countries, has long been recognized as a country pursuing social democracy with welfare state ideals of equality and justice, which are the characters of the developed industrialized countries. Since independence, the welfare state ideology was promoted in the country by the successive governments in power. However, it was a severe strain for a developing country with a non-industrialized, partially modernized economy. This is one reason for the collapse of the welfare state in the later years of the 1970s. Further, the welfare state ideology was rejected by the neo-liberal post-1977 era politics of the country. The post-1977 policies of non-interventionist open market economy principles did not provide much room for the egalitarian welfare state ideology. The new policies led to privatization of many public services and the welfare sector was downgraded severely (Jayasuriya 2000).

Since then, throughout the last few decades, there has been a shift in the focus of welfare policies. Until the 1970s the emphasis had been more on state-managed approaches with a commitment to universal provision of basic needs and services. However, in the 1980s the state focus shifted from 'universalism' to more of a 'targeted' approach. The *Janasaviya* programme is such an effort of the time. It was later replaced by the *Samurdhi* programme. In addition, there was a change in the emphasis to 'workfare' type of approaches that seek to permanently raise the income capacity of the poor by raising their productivity and promoting self-employment (rather than providing income or food transfers to low-income households).

The present stream of thinking on welfare policies moves ahead with understanding the fact that social policies cannot be formulated without having a solid foundation of economic polices. Hence, they have showed the interest to humanize capitalism or in other words to have structural adjustment with a 'human face' (Jayasuriya 2000).

However, there has been a strong domestic political commitment since the post-independence era for social welfare. Even at time when governments have been suffering from high fiscal constraints/deficits and rising defence expenditure and debt service payments, the governments still continued to support the welfare policies and provide priority. The high priority given to welfare policies, in terms of expenditures and in terms of achievements, especially for education, health and poverty alleviation has often been a political motive in the recent history. This can in turn be attributed to the country's competitive and democratic political system, in which the political parties tended to persuade the voters by promises of a better welfare package.

This has been a consequence of the political environment since independence. The welfare services were more affordable soon after the independence due to high export earnings at the time from commodity exports. The government was able to tap resources from the well functioning plantation sector at the time by taxing highly the export plantation crops, to finance the welfare programmes. The initial governments were willing to provide welfare support to gain the support from its base of voters.

With the evolution of such a system there has been high resistance from people, at times when the governments try to cut down welfare measures when the cost of provision rises. One example is the resignation of the then prime minister due to public pressure, with the unavoidable increase of the rice price in 1953, after the government became unable to provide rice at a subsidized price. Historical occurrences have led the people to consider social welfare as an absolute right. Ever since, welfare politics played a major role in Sri Lankan politics and the elections are often a competition of a series of promises on welfare by the competing parties (Kelegama 2006). However, this has allowed a period of social welfare provision, even with stringent budgetary policies. It is this strong political will and commitment and the social milieu that largely contributed to the success of remaining welfare policies carried out by the successive governments over several decades. Particularly, in the case of education, the cultural and social factors in Sri Lanka, which place a huge importance on children’s education by households, even by the rural poor households have also urged the initiation and continuation of various government educational policies/programmes (Tilakaratna 2006).

Various external agents including multilateral organizations such as the World Bank and ADB and many other donor agencies have also contributed to the success of some of these policies/programmes under social welfare. Especially the World Bank provided its supportive hand to the Ministry of Education in upgrading the quality of education material. In addition, there are several other programmes supported by the World Bank which helps to improve the welfare of the citizens of the country. One such programme is the *Gemi Diriya* programme which is for the community development and livelihood development. It is a novel approach, unlike other livelihood programmes; *Gemi Diriya* aims not only at the generation of livelihoods activities but also sustainability of these livelihoods. It is designed to raise income and improve wellbeing of rural communities by building and sustaining village level institutions and transferring resources and decision making responsibilities to village communities. In addition there are many other institutions which are mostly international non-governmental organizations (INGOs) which help to raise the welfare status of the citizens. One such significant attempt is in the microfinance sector. The National Development Trust Fund (NDTF) which was established by the Government of Sri Lanka is an example in the microfinance sector which acts in collaboration with many donors. It was established with assistance from the World Bank and Federal Republic of Germany and serves as the apex lending institution for poverty alleviation programs. NDTF operates through a network of over two hundred Partner Organizations (POs) around the country that act as intermediaries between the NDTF and the beneficiaries who are poor households. The NDTF carries out three main projects supported by ADB. The Rural Financial Sector Development Project (RFSDP) of ADB is one of these projects.

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