

Sri Lanka: Joint Staff Assessment of the Poverty Reduction Strategy Paper

The attached Joint Staff Assessment (JSA) of the Poverty Reduction Strategy Paper for Sri Lanka, prepared by the staffs of both the World Bank and IMF, was submitted with the member country's Poverty Reduction Strategy Paper (PRSP) or Interim PRSP (IPRSP) to the Executive Boards of the two institutions. A JSA evaluates the strengths and weaknesses of a country's poverty reduction objectives and strategies, and considers whether the PRSP or IPRSP provides a sound basis for concessional assistance from the Bank and Fund, as well as for debt relief under the Enhanced Heavily Indebted Poor Countries (HIPC) Debt Initiative. The Boards then decide whether the poverty reduction strategy merits such support.

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THE INTERNATIONAL DEVELOPMENT ASSOCIATION
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SRI LANKA

Joint Staff Assessment of the Poverty Reduction Strategy Paper

Prepared by the Staffs of the International Monetary Fund (IMF) and the
International Development Association (IDA)

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I. INTRODUCTION AND SUMMARY

1. Long-term growth in Sri Lanka, at an annual average rate of 5 percent in the 1990s, compares favorably to that in other countries in the region, but has been insufficient to reduce poverty adequately. Despite the country's substantial achievements in human development and the economy's external openness, several factors have impeded Sri Lanka's ability to realize its growth potential. The civil conflict that started in 1982 has not only disrupted economic activity but also made sustained implementation of economic reforms difficult. At the same time, poor infrastructure, a large and inefficient public sector and an overly restrictive regulatory environment have choked incentives for private investments. Thus, important challenges need to be addressed on the structural and institutional front.

2. The last year has witnessed sea changes in the political and policy environment. The peace talks—facilitated by Norway—and the lifting of the inter-regional trade embargo have begun to re-integrate the conflict areas with the rest of the island and have provided a tremendous impetus for domestic economic activity. At the same time, post-conflict related reconstruction needs have presented significant challenges. To set the framework for private-sector led growth, the new government has displayed a commitment to fiscal consolidation and structural reforms, while ensuring that adequate resources are made available for reconstruction needs. It is in this context that the Poverty Reduction Strategy Paper (PRSP) of the government of Sri Lanka, titled *Regaining Sri Lanka: Vision and Strategy for Accelerated Development*, was unveiled.

3. The PRSP lays out the vision and the medium term economic strategy. The goal is to accelerate growth and reduce poverty through private-sector led development. To achieve this, it focuses on a set of reforms geared toward reducing trade barriers and deregulation, particularly in banking, labor and land markets; training and reform of higher education to match employment opportunities with the requisite skills; improving connectivity through development of infrastructure—including roads, railways, and telecommunication—to expand access to markets; proposals in the area of human development and social protection to fight poverty, especially in the rural sector; and a commitment to developing monitoring mechanisms to track implementation and measure results.

4. The staffs consider that Sri Lanka's poverty reduction strategy (PRS) constitutes an adequate policy framework to increase growth and reduce poverty. However, its successful implementation will require more work in key areas, notably to (i) ensure continuity of the institutional arrangements laid out for PRS implementation (Annex 2, Part I) and strengthen the institutional capacity of various government departments for implementing, monitoring, and evaluating the PRS; (ii) prioritize a feasible set of actions from the long list of strategies listed in the Action Plans (Part III); (iii) align prioritization of policies with the requisite budgetary allocations through a more detailed costing exercise; (iv) implement a viable plan for expenditure tracking and poverty monitoring, (v) assess the poverty and social impact of the reform strategy including the proposed welfare reform; and (vi) assess the poverty situation of the North and East, and the reconstruction needs of this part of the country, and incorporate these into the strategy.

II. COUNTRY OWNERSHIP AND PARTICIPATION

5. **The extent of consultation that is embodied in Sri Lanka's PRSP "*Regaining Sri Lanka: Vision and Strategy for Accelerating Development*" is commendable, and is in fact one of the strengths of the document.** A large number of stakeholders including the government, academia, research organizations, nongovernment and community organizations, the private sector, trade unions, and donors were consulted at various stages of the document's preparation. In a sense, Sri Lanka preempted the PRSP process with consultations starting as early as 1998 to develop the Poverty Reduction Framework (PRF), which led to a deeper understanding of the causes and issues surrounding poverty. An extensive amount of technical work was also commissioned to fill in information gaps that surfaced during the consultation process. The Poverty Reduction Strategy (PRS), which commenced in 2001, came as a natural continuation of the PRF, with a focus on operationalizing the visions, strategies, and reforms. Parallel to the PRF and PRS process, the Government also engaged in consultations with communities in and around the areas of the country directly affected by conflict under the Relief, Rehabilitation, and Reconciliation (RRR) process to better understand the roots of the conflict, and develop appropriate strategies to assist these areas and facilitate peace. Drafts of both the PRS and RRR were posted on the internet to solicit comments from the public at large, and were presented in the first Donor Forum held in Colombo in June 2002, where these were strongly endorsed by the development partners.

6. After the election in December 2001, the new Government set about the task of defining its own economic program more precisely. This resulted in the publication of *Regaining Sri Lanka* (RSL), which was based on a more limited participatory process. RSL is a strong and aggressive proposal to remove the existing policy-induced and structural constraints that inhibit private sector activity in the way of changing the role of the State. It is to be emphasized that RSL is consistent with the thrust of the earlier draft of the PRS, but with a more accelerated and detailed implementation framework, and an elaborated monitoring and implementation mechanism. The results from consultations were used to revise and restructure the PRSP. The details of the consultative process are elaborated in Part II, Chapter 1 of the main text and summarized in Annex 1 of Part II.

7. **Consultation is an ongoing process, and in Sri Lanka this is well understood.** The authorities are putting in place mechanisms to maintain openness, strengthen implementation, and broaden participation. The Government has recently established a number of Steering Committees and Task Forces responsible for ensuring continued consultation and implementation of the PRSP. Looking ahead, the Government could strive to expand consultations with stakeholders in the North and East. In addition, it would be useful to strengthen ownership by seeking Parliament's endorsement of the PRSP.

III. POVERTY DIAGNOSTICS

8. **The PRSP presents a comprehensive description of the levels and trends of poverty, (as measured in terms of consumption expenditures) as well as its nonincome**

dimensions drawing on available data sources—primarily the Household Income and Expenditure Survey (HIES-1995–96) and Consumer Finance and Socioeconomic Survey (CFSS-1996–97), along with numerous secondary data sources like Demographic and Health Surveys and smaller sample surveys. The findings of the recent poverty assessment concluded by the World Bank (2001) are also integrated in the diagnostics. The staffs broadly agree that poverty increased during the first half of the nineties to affect more than 25 percent of the population; that it is a largely rural phenomenon with the incidence being acute among agricultural workers; and that there is concentration in certain relatively remote provinces and estates—these observations are reliable even though the data is nearly six years old. However, the analysis, particularly on poverty measurement and trends is hampered by the fact that the latest year covered by the surveys is 1996–97 and comparability is compromised by the use of two different surveys for 1995–96 and 1996–97.

9. **The nonincome dimensions and correlates of poverty are also analyzed adequately**—particularly in the areas of education, nutritional indicators, and employment by sectors in so far as data allows. A preliminary attempt has also been made to present the poverty picture in the North and the East, drawing on secondary sources and small localized surveys. The limitations on information for these areas reflect conflict-related restrictions on data gathering. The staffs also agree with the broad categories of the determinants of poverty explored, ranging from inadequate growth or problems in the quality of education, to issues like armed conflict and incomplete decentralization. However, the overly broad discussion is not always grounded in data, which makes it hard to clearly quantify the major impediments to poverty reduction. This in turn makes it hard to link diagnostics and analyses to the setting of policy priorities.

10. **Ongoing dialogue with the government is geared toward addressing some of the above-mentioned concerns.** A poverty map is proposed by the World Bank to aid more in-depth examination of the key determinants of poverty and deprivation, particularly along locational characteristics. The monitoring component will also incorporate improvements in the frequency and comparability of surveys. Finally, a special study of the North East will help determine the baseline poverty diagnostics, which can then be integrated with the national surveys in the future.

11. **While many policy reforms have been outlined in the PRSP, a mechanism to monitor and assess their impact is largely lacking.** It is difficult to judge a priori whether these reforms will reduce poverty or have their intended impact – even indirectly from household surveys since information available so far is quite dated. In this context, using the national household data that will become available in July 2003, as well as other data sources to analyze the poverty and social impact of reforms remains a critical exercise for the future.

12. **Finally, on the methodology of poverty measurement, the staffs would like to highlight a few issues.** First, two sets of poverty lines are used in the PRSP for each of the two household surveys. There is a lack of clarity on whether the poverty lines *across different surveys* (HIES and CFSES) are comparable, and on the methodology adopted for updating the poverty line to compare poverty levels across different years of the HIES survey

(1990–91 and 95–96). Second, while using a lower and a higher poverty line can be justified by the need to explore the robustness of measures or to distinguish between the levels of poverty, it will be useful in that case to clarify what each poverty line defines. Rationalizing the poverty lines in terms of what they signify will be important for the government to move towards adopting an official poverty line (or lines) and formalizing a methodology for using and updating these lines that ensures compatible poverty trends in the future. This exercise should be underpinned by working towards survey instruments that are comparable across years, to ensure consistency of measures.

IV. POLICY AGENDA IN THE PRSP

13. **The main tenet of the PRSP is to “regain Sri Lanka” by accelerating growth and reducing poverty through private-sector led development.** This marks a clear departure from the previous unsustainable policies of “redistribution and transfers” to alleviate poverty. To meet its aims, the PRSP outlines six core areas – providing a supportive macroeconomic environment, reducing conflict-related poverty, creating opportunities for pro-poor growth, investing in people, and improving governance and empowerment. The action plan matrices (Annex 5 of Part II and Part III) list specific policies in these areas. Staffs believe that strong implementation of the general strategy and policies described in the PRSP could generate broad-based growth and reduce poverty.

A. Macroeconomic Framework and the Structural Agenda

14. **The PRSP presents an ambitious framework of accelerating growth and maintaining macroeconomic stability.** While a stated goal is to achieve a growth rate of 8-10 percent in the long term, the macroeconomic framework envisages growth to average around 6½ percent over the medium term (1 percent higher than the average growth during the 1990s—a period of intense civil conflict—and lower than the 4-5 percentage points average increase in growth rates in other post-conflict cases). This outlook relies critically on *peace*—vital to strengthening business and consumer confidence, expanding sectors severely affected by the conflict, such as internal trade, tourism and commercial fishing, and reintegrating the North and East to the overall economy; *fiscal consolidation*—key to achieve stability since government debt amounts to more than 100 percent of GDP, and to free resources for the private sector; and *deep structural reforms*—necessary to increase overall productivity and growth. With reconstruction related imports, the external current account deficit is expected to widen over the medium term. The external position, however, would strengthen as a result of reasonably strong capital inflows and concessional financing. Since the growth rates on which the macroeconomic framework is based are above Sri Lanka’s past experience, the risks to this baseline scenario cannot be ignored, and while staffs believe that these growth rates are within reach, the PRSP lacks alternative frameworks or contingency policies. Notably, the PRSP does not include an assessment of how the upcoming elimination of textile quotas will affect Sri Lanka’s economic growth or the poor. For this reason, staffs encourage the Government to develop an alternative, lower growth scenario and design contingency plans that fully reflect the envisaged risks.

15. **Identifying the sources of growth** is critical to make the link between growth and poverty. The PRSP makes a start in this direction by outlining detailed action plans for raising the productivity in *priority sectors*, like agriculture, fisheries, tourism, apparel, and tea industry. While staffs endorse the action plans, links between these sectors and poverty-related outcomes need to be fully analyzed, which would be critical for prioritizing policies that promote pro-poor growth.

16. **The PRSP recognizes that fiscal consolidation is essential for achieving growth and macroeconomic stability.** Owing to the large stock of debt, interest payments currently account for almost one-third of all spending and are higher than capital spending. The PRSP envisages a significant reduction in the deficit (to about 4 percent of GDP over the medium term) through a combination of increase in revenue by broadening the tax base and improving tax administration, a rationalization and reorientation of expenditures, including a reduction in defense spending, and a shift in financing from costly domestic debt to concessional foreign funds. As a result, by 2006 the interest bill is projected to decline to 5½ percent of GDP from the current level of 7½ percent of GDP, and capital spending to reach 7 percent of GDP from its present level of 3½ percent of GDP. Social spending is projected to remain stable over the medium term, reflecting better targeting of welfare benefits (resulting in savings of about 1 percent of GDP) and a doubling of capital expenditures in health and education. While the envisaged deficit reduction is critical to restore fiscal sustainability, the strategy to achieve this will need to be updated periodically, particularly given the sensitivity of interest payments to changing market conditions and other compositional changes in spending needed after the introduction of a medium term expenditure framework.

17. **The lack of a medium term expenditure framework (MTEF) has made the costing of PRSP initiatives difficult.** The PRSP provides only capital cost estimates for priority investment projects that are expected to be financed mainly by donors (Annex 6). However, this costing estimate is incomplete, as details of the recurrent spending needs and the cost of those projects that are not expected to be financed by donors are not included. The development of a MTEF, which the government plans to have in place by mid-year (aided by a public expenditure review in progress), is key to a more in-depth costing of the PRSP, thereby helping to undertake pro-poor budget allocations over time. Once the MTEF is completed, staffs expect that expenditure priorities identified in the PRSP will be more accurately reflected in the medium-term budgets. Donors will need to facilitate this process by providing medium-term commitments of their support.

18. **Moving forward, devising an integrated and effective public expenditure management system is critical for better development and poverty outcomes.** This entails improving public accounts system, strengthening expenditure planning and its alignment with budgetary processes as well as expenditure execution, monitoring and oversight mechanisms. To start this process, the Government has recently prepared a draft Public Finance Act (PFA) which when finalized and enacted will fill the important gaps that exist on the basic legal framework for budgeting, public expenditure management, and financial accountability.

19. **Structural reforms are critical to create an enabling environment for high growth; the PRSP puts forward a progressive agenda for such reforms.** The focus is on reducing state dominance of the economy through restructuring and privatization; on strengthening the banking sector, particularly restructuring the insolvent Peoples Bank; and reforming the labor laws to increase labor market flexibility. Staffs welcome the emphasis on these areas.

20. **To tackle the problem of inefficiency of state owned enterprises (SOEs) and to mobilize resources, the Government is committed to continue restructuring state enterprises, including through privatization.** Notably, the recently enacted *Electricity Reform Bill* paves the way for the unbundling of the power sector into separate generation, transmission and distribution companies, and opening up the sector to the private sector (power sector reform is supported by the Asian Development Bank (ADB) and Japan Bank for International Cooperation (JBIC)). The government has also privatized several state owned enterprises, including the bus companies, parts of the telecom company, and opened private sector participation in areas, such as ports.

21. **Similarly, there is ongoing effort to strengthen the financial sector, particularly restructuring the state-owned banks.** The staffs welcome the envisaged divestment of People's Bank that controls 25 percent of the deposits of the entire banking system, and for which previous attempts at recapitalization have resulted in failure, a continued increase in nonperforming loans, insider lending, and accumulated losses. Preparatory steps, such as enacting an asset management company law, are underway. Staffs reiterate the need for a fully transparent process, with sufficient safeguards to preserve the integrity of the restructured bank. For the other state bank—Bank of Ceylon—a business action plan to fully commercialize its activities is being implemented. In other areas of the financial sector similar steps are being taken, for example, the insurance company is now in the final stages of privatization.

22. **In the labor market, recent amendments to the labor laws are a step in the right direction.** The staffs, however, are also of the view that, in addition to the implementation of these amendments, a systematic overhaul of the overly restrictive labor laws will be key to securing high long-term growth and employment. The PRSP, however, does not provide a time bound set of measures in this area, which is admittedly politically sensitive.

23. **Staffs also welcome broader measures to improve the enabling regulatory environment for private activity,** including steps to move towards a uniform and transparent system of corporate tax structure, and to reform the regulatory environment for market *entry and exit* by amending the Companies Act and the bankruptcy legislation. Also, to strengthen the efficiency of tax administration and improve customer service, the government plans to establish a modern revenue authority. On trade policy, the PRSP also stresses the critical importance of a liberal *regime* to enhance domestic competition and increase exports. Accordingly, the Government is committed to reducing tariff protection, including the rationalization of high protection currently afforded to agricultural products. The liberalization of trade in agriculture, however, should be linked to land reform, and this

link is missing from the PRSP. For the sake of predictability, staffs would urge the announcement of a schedule for tariff reform leading to the stated medium-term objective of a stable, low and uniform import tariff rate regime.

24. **The Government is committed to reducing the state's involvement in commercial activities and redefining its role and focusing on providing "public" goods and services and using public resources effectively for poverty reduction.** To this end, the Government sees the urgent need for improved governance—to reform public administration and expenditure management, improve transparency, accountability, and continue decentralization. However, implementation plans for achieving the stated goals remain outstanding. Staffs strongly encourage the government to establish, in the near term, viable institutional mechanisms for advancing and implementing the governance agenda particularly in the area of civil service reform and public expenditure management.

B. Sectoral Policies

25. **The thrust of the sectoral policies underpinning the PRSP is adequate, but requires prioritization.** While the matrix that provides detailed action plans by sector represents a good start, there is need for further refinement in terms of specificity and timing. The first annual PRSP progress report will need to incorporate these refinements and incorporate the missing elements particularly in the areas of governance and quality of service delivery.

26. **The PRSP identifies revitalizing the rural economy as an integral part of pro-poor growth.** It rightly focuses on areas like rural connectivity, land markets, water resource management, rural electrification, import tariff policy and productivity of nonplantation agriculture. On tariff policy, the PRSP recognizes that the high rates of tariff protection for food crops penalize the rural poor, a vast majority of whom are net food consumers. It also recognizes the need to develop market oriented pricing policies to improve the incentive environment for agriculture, and to relax restrictions on the inflow of seed, plant, and planting material.

27. **However, there appears to be some disconnect between the agricultural sector issues and approach for improving its productivity** described in the main text in Chapter 5 of Part II, and the Action Plan matrix indicated in Section V of Part III. For instance, while the main text advocates private sector driven productivity improvements, the action plan appears to advocate continued state interventions. The action plan will also benefit from refinements to address important systemic issues, like improving linkages between agencies at the federal and provincial levels and making leading institutions like Department of Agriculture (DOA) more responsive to the sector's demands. While the results of the Community Driven Development (CDD) pilot initiative currently undertaken in the Mahaweli area show CDD to be a viable approach for rural development, such initiatives are not incorporated in the PRSP. Finally, it would be useful for the action plan to prioritize the specific actions for the short and medium term.

28. **The PRSP adequately stresses the importance of promoting private sector development.** In addition to the liberalization of the domestic economy and strengthening of the enabling environment mentioned above there is significant focus on building infrastructure—roads, ports, railways and IT to improve market access—and reforming labor and land markets. Preparations are also underway to promote efficient land use by establishing clear property rights, and modernizing the institutional and legal framework. The latter would involve removing restrictions related to the sale, leasing, transfer and mortgaging of rural land, and divesting state-owned urban land to promote efficient use of urban land as well as raise resources. *Outstanding challenges in infrastructure* are in its management and sustainability, and the removal of counterproductive regulations that thwart private sector participation.

29. Within the ambit of private sector development, particularly for promoting pro-poor growth, the PRSP rightly recognizes **Small and Medium Enterprises (SMEs) as an important strategic sector**, accounting for as much as 36 percent of industrial employment and 20 percent of value added in the manufacturing sector. Access to long-term credit and connectivity, which are pre-requisites for productivity growth and expansion of SMEs, are both likely to be enhanced by the broad policies adopted in the PRSP. Fiscal consolidation and debt reduction should increase resources available for lending to SMEs; improving transport and IT connectivity will increase their access to markets and information. The completed SME White Paper envisions increased competitiveness of the sector through lower tariff protection, deregulation, and increased access to global markets; it also emphasizes the need for an education system that promotes an innovative entrepreneurial culture, and the importance of collecting SME data for future policy formulation. Some recommendations, such as the R&D voucher system, SME industrial parks and other state interventions will need to be evaluated from the view of efficiency and sustainability.

30. **In the education sector, the staffs find the policy recommendations and strategic directions to be positive and progressive.** In school education, there is a welcome emphasis on quality and equity, through school-based management, increased stakeholder participation and involvement of the private sector. At the tertiary level the focus is on increasing supply and relevance to the labor market—by increasing institutional autonomy, encouraging private sector involvement, particularly in training and technical education, and investing in quality assurance. At the same time, there is not enough in the way of *concrete action plans* in some key areas like decentralizing school management, promoting public-private partnerships in schooling and seeking private investment in training and technical education. Decentralization should be envisaged in the context of the overall framework of political devolution, which has been incomplete in Sri Lanka till date. Effective delivery of education services will require defining the role of the provinces and devolved institutions in school administration and teacher deployment, as well as combating politicization and corruption. On the whole for this sector, translating the progressive vision into an implementation framework remains a fundamental weakness.

31. **In developing a health strategy, the PRSP rightly assigns the highest priority on addressing the health concerns of the poor** by focusing on public health issues, targeting

services to meet the needs of disadvantaged groups, and rationalizing the use of health care funding. The sector *strategy* recognizes the need for a coherent policy framework for redefining the role of the public and private sectors in health care provision, and for the mechanisms for effective regulation. The decision of the Government to adopt a national health sector program approach is seen as an encouraging development towards enhancing the financial sustainability of the health system, while protecting equity of access and quality of care. That said, the health sector *priority actions* need to be organized and sequenced within a consistent sector plan, with well-defined objectives, outcome and output indicators and activities. Although general indication is provided of the existing and new programs to be financed between 2002 and 2006, the health programs need to be defined strategically, in function of achieving clear and measurable targets. The *financing* plans for specific programs should follow the preparation of a health sector plan that costs and assesses different options for reform.

32. **Finally, in the area of social protection, the staffs strongly endorse the Government's commitment to rationalize all social welfare programs, and to de-politicize and improve the targeting of Samurdhi** (largely a cash transfer program) in particular, based on the recently enacted Welfare Reform Act. The reform process involves setting objective criteria for selection of beneficiaries of Samurdhi through means-testing, credible enforcement of these criteria, and the concomitant development of a complete database of beneficiaries to track entry into and exit from the program. These reforms are expected to engender better targeting with lower rates of exclusion of deserving beneficiaries. If successfully implemented, the program's impact as a social protection against shocks will be greatly enhanced. An outstanding challenge in the area of social protection is the development and implementation of pension reforms.

V. TARGETS, INDICATORS, AND MONITORING

33. **The PRSP describes Sri Lanka's position vis-à-vis the Millennium Development Goals.** For many of these goals, e.g., enrollment rates in primary education, infant and maternal mortality, the country has made substantial progress. However, considerable challenges remain in other areas—income poverty, child malnutrition, disease control (especially HIV, TB and malaria) and the *quality* of health and education services. Further work needs to be done in the area of monitoring, which includes the choice of key indicators, definition of baselines and target setting to reflect the objectives and constraints in relevant sectors and facilitate costing based on targets. This process would need to be underpinned by further analytical work to identify the linkages between policy, output and outcome indicators. The PRSP acknowledges these weaknesses.

34. **Staffs consider the framework of monitoring and evaluation presented as a useful start.** However there is much work ahead in data collection, analysis and its linkages with policy, and the monitoring of inputs, outputs and outcomes. The immediate challenges lie in improving existing surveys—the aforementioned HIES and CFSES—by regularizing their periodicity, synchronizing their timing, and strengthening of some modules to track indicators of income generation, employment, and well being. An integral part of poverty

monitoring and impact is also the *participatory component* to assess access and consumer satisfaction with service delivery. While the PRSP acknowledges its importance, regularizing this remains an outstanding concern.

35. **The PRSP is silent on institutionalizing a public expenditure tracking system** that can help to evaluate whether targeted spending in areas like public infrastructure, social sectors, and anti-poverty programs is reaching the intended beneficiaries. A positive development in the context of the Samurdhi cash transfer program is the proposed in-built system to track indicators of poverty to monitor movement of beneficiaries in and out of the program. However, a broader expenditure tracking system linked to the intermediate output indicators that reflect the impact of public investments is necessary and an outstanding challenge.

36. **Though the PRSP provides a comprehensive picture of the patterns and determinants of poverty, further work is warranted to monitor and assess the impact of current and future policies on the poor** that is likely to vary across heterogeneous groups (examples include the land and labor policies envisaged in the PRSP). The existing HIES may provide some answers; additionally, other data sources like the Demographic and Health Survey (DHS) could be tailored to monitor the impact of specific policies. One concern is the low frequency (currently once every 5 years) of both the HIES and the DHS. As part of strengthening the monitoring and evaluation component, data sources could be reviewed to ensure that relevant information is generated to support the goals of the poverty monitoring and evaluation exercise.

37. **Poverty diagnostics for the conflict-ridden region of North-East is currently inadequate but with the peace accord and post-conflict reconstruction efforts, an opportunity now arises to improve the availability of data.** A special study of this region is currently being proposed by the World Bank. The HIES and other surveys will need to be representative of this region, and the current HIES on the ground appears to have accomplished this goal. Similarly, the PRSP—and the budget—largely excludes the large costs of reconstruction.

38. Finally, and perhaps most crucial, are the institutional arrangements to coordinate the monitoring and evaluation exercise and promote incentives for its use in policy and budgetary decision-making. **The PRSP provides a detailed overview of the institutional arrangements for monitoring.** An immediate concern would be to enhance capacity of the Department of Census and Statistics (DCS) to be able to conduct the HIES survey at intervals of 2-3 years (currently, the DCS and the Central Bank alternate in fielding two similar surveys—the HIES and the CFSES—which is both inefficient and raises problems of comparability). Once the DCS is empowered with sole responsibility, it will help rationalize the poverty monitoring system along the dimensions described above, and improve capacity and prospects for developing a multipurpose household survey (like the Living Standards Measurement Survey) to deepen poverty diagnostics and monitoring.

VI. RISKS AND CHALLENGES

39. **There are several risks that could derail the strategy laid out in the PRSP. These include risks related to implementation, political uncertainties, and the impact of exogenous factors. Several mitigation strategies are being adopted, which will help address some of these risks.**

40. **Political risks:** The first and foremost risk is associated with the peace process. While the length of current ceasefire is unprecedented, which is highly encouraging, there may still be risks of fallout resulting in reversals on many policy fronts. Over the medium-term, there is also the issue of how smoothly the demobilization of forces on both sides is carried out. Second, the political uncertainty arising from the President and the Government belonging to opposing parties, as the former is vested with powers to dismiss the Government and call for elections. This poses a threat to the political feasibility of reform implementation, including its predictability and continuity.

41. **Implementation risks:** First, the program implies a significant reduction in the role of the state, and there may be political resistance to such reforms. Even when accepted, this is a formidable list of reforms that is well beyond the recent performance level of the public sector. Second, the development of institutional capacity for expenditure tracking and implementation could be slow. Lastly, while the peace dividends are substantial, there are also challenges. Implementation of the government's policies and reforms will need to be flexible such that neither peace nor the country's long-term growth is jeopardized.

42. **Exogenous/external shocks:** There is a risk that the growth path envisaged in the macroeconomic framework may prove optimistic—that risks to the outlook have been underestimated and the effect of peace on growth overestimated. Moreover, the global recession imposes constraints particularly on export growth. The impending Middle East situation might reduce tourism and worker remittances – both significant sources of revenue – and hurt the recovery of the economy, just as both sectors have been recovering. In addition, the exchange rate could come under intense downward pressures, while higher oil prices, by raising the cost of living, could be a source of public discontent.

43. **Mitigation strategies:** Several mitigation strategies are being adopted. First, a major communications program is being developed with support from the World Bank to present and explain the reform program to the people, which should enhance support for reforms. In addition, a major program of technical assistance for the reform process has recently been approved by the World Bank, which should boost capacity for implementation. The IMF, World Bank, and DFID will also consider support to the monitoring and evaluation capacity building effort. The political risks are harder to mitigate, but should be tractable so long as the Government retains the confidence of Parliament, and successful implementation of reforms and negotiation of the peace process are the best guarantees of this. For the peace process, there is every indication of commitment of both sides, and the best prospect to support this is the demonstration of the benefits of peace. Thus the Bank and others will be providing early support for reconstruction efforts as part of this strategy. Finally, the external

shocks require strengthening the foreign reserve position, which would include appealing for external assistance in this regard during the forthcoming Financing Conference for Sri Lanka in Tokyo in June.

VII. CONCLUSION

44. **The staffs consider that Sri Lanka's PRSP constitutes an adequate framework for the overarching objective of enhancing growth and poverty reduction.** The PRSP is the result of strong country ownership and an extensive consultation process. However, the Joint Staff Assessment identifies some gaps that would need further work. **It is recommended that the first annual progress report include the following:** (a) an update of the macroeconomic framework—including a lower-growth case scenario and an analysis of risks—aligned to a detailed costing of the PRSP reform agenda, and a prioritization of policies; (b) addressing critical issues in the governance agenda especially in the area of civil service reform, transparency, and decentralization; (c) a selection of indicators and baselines to monitor the implementation of the PRSP and setting up an expenditure tracking system; (d) a preliminary assessment of the impact of policies on the poor and disadvantaged groups; and (e) completing the assessment of the poverty situation and reconstruction needs of the North and East.

45. The staffs of the IMF and World Bank consider that the poverty reduction strategy presented in Sri Lanka's PRSP provides a satisfactory basis for World Bank and Fund concessional assistance. The Staffs recommend that the respective Executive Directors of the World Bank and IMF reach the same conclusion.