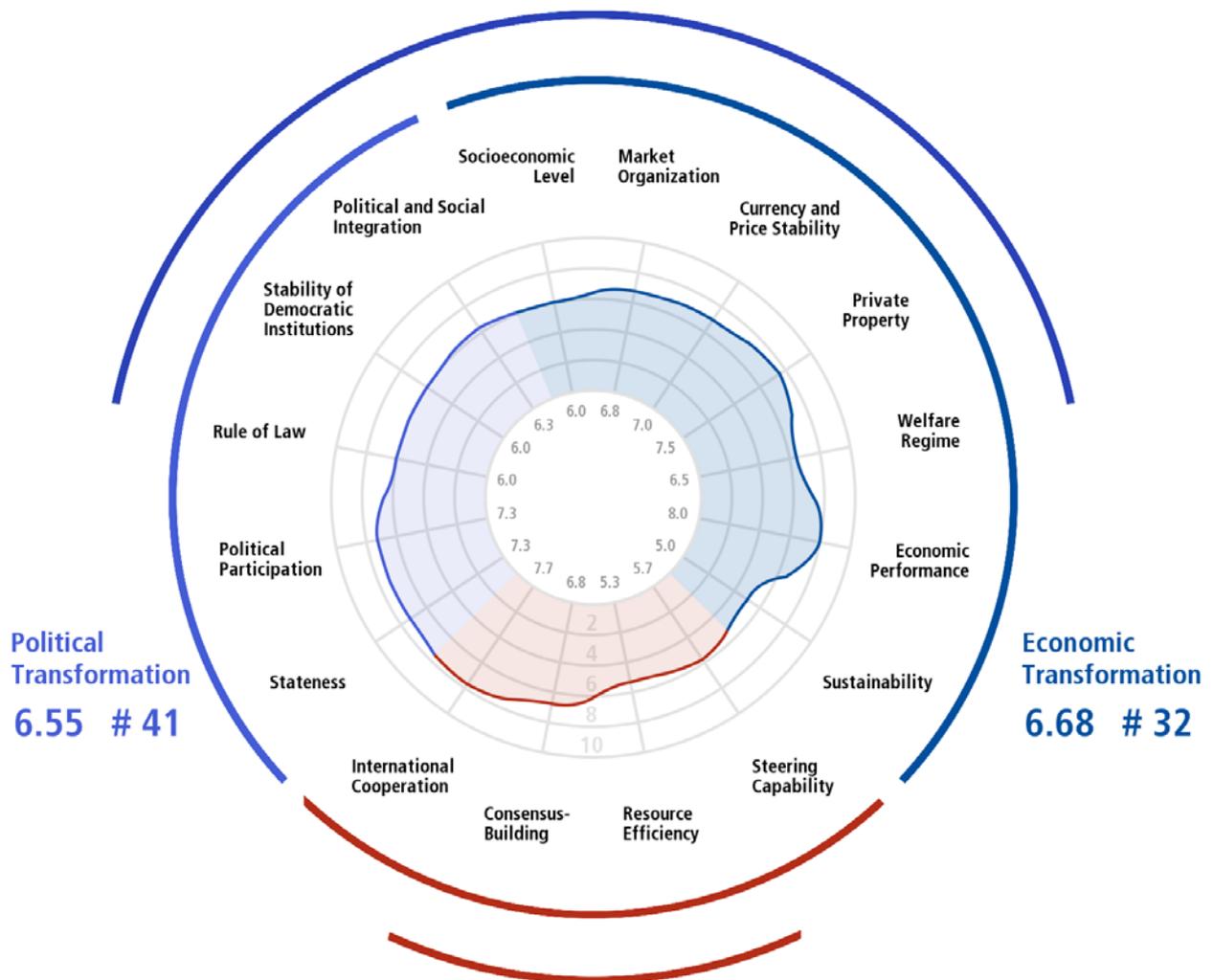


Sri Lanka

Status Index

6.61 # 33

on 1-10 scale out of 129



Political Transformation
6.55 # 41

Economic Transformation
6.68 # 32

Governance Index

5.60 # 43

on 1-10 scale out of 129

This report is part of the Bertelsmann Stiftung's Transformation Index (BTI) 2018. It covers the period from February 1, 2015 to January 31, 2017. The BTI assesses the transformation toward democracy and a market economy as well as the quality of political management in 129 countries. More on the BTI at <http://www.bti-project.org>.

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Key Indicators

Population	M	21.2	HDI	0.766	GDP p.c., PPP \$	12316
Pop. growth ¹	% p.a.	1.1	HDI rank of 188	73	Gini Index	39.2
Life expectancy	years	75.0	UN Education Index	0.769	Poverty ³	% 16.1
Urban population	%	18.4	Gender inequality ²	0.386	Aid per capita \$	20.4

Sources (as of October 2017): The World Bank, World Development Indicators 2017 | UNDP, Human Development Report 2016. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$3.20 a day at 2011 international prices.

Executive Summary

The period under review covers the first two years of Sri Lanka's new coalition government, following the unexpected defeat of President Rajapaksa in January 2015. The new government led by President Maithripala Sirisena has taken several steps to counteract the erosion of democracy that occurred under his predecessor. The Nineteenth Amendment to the constitution in 2015 decreed that the president must obtain the approval of a Constitutional Council, containing representatives of the opposition, to appoint Supreme Court judges and members of key bodies like the Elections Commission and the Judicial Services Commission. The president was also prohibited from dissolving a newly elected parliament without its consent for four and a half years. Leading political parties representing all ethnic and religious groups within the Sri Lankan state accepted the principle of a negotiated political settlement. The Right of Access to Information Act enacted in 2016 enables better review of state action, while the establishment of an Office of Missing Persons was a constructive first step in investigating the circumstances under which past extra-legal disappearances occurred. Nevertheless, there remains much to be done. In January 2017, a Consultation Task Force on Reconciliation Mechanisms (CTFRM) appointed by the prime minister reported on further changes to the constitution including greater devolution of power to reconcile the Tamil minority. Though there continues to be resistance within the governing coalition to some of these proposals. There is continuing tension between the two major parties in the coalition government. Local and regional government elections have been postponed, ostensibly till proposals to reform the system are agreed.

On the economic front, Sri Lanka has seen continued development with a 4.8% economic growth rate in 2016 with a similar rate projected for 2017. Foreign reserves fell from \$9 billion in August 2014 to \$6 billion in December 2015 to \$5.4 billion in January 2017. Remittances from expatriated Sri Lankan workers remained steady. Meanwhile, tourism continued to boom with the number of tourists visiting Sri Lanka rising from 1.0 million in 2012 to 1.5 million in 2014 to 2 million in 2016. The inflation rate is under 4% and the unemployment rate remained under 5%. Public debt is 76% of GDP. The basic literacy level of the workforce remains high. Educational

opportunities for women are excellent, although there are considerable gender barriers to female engagement in society and the economy, and the female participation rate in the workforce remains stuck at under 35%. One might note, however, that the informal sector accounts for 60% of all economic activity and that the sector is often omitted in statistics. Private property is relatively well-protected although there are barriers to the foreign ownership of companies in some sectors as well as constraints on foreign property ownership. The public sector remains overstaffed and relatively inefficient despite some moves toward public-private partnerships. The budget deficit is gradually being reduced by more efficient tax collection procedures, and the extension of the scope and rate of the value-added tax. There are signs of greater investment in education. However, there are regional disparities in economic development and foreign trade is impeded by para-tariffs.

The change of government in early 2015 was also accompanied by a realignment of Sri Lanka's foreign relations. Continuing economic links with China, Russia and Iran are now complemented by better relations with India and the West.

History and Characteristics of Transformation

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

However, the political transformation to a third world democracy has met with several obstacles. Political parties remained elite-dominated with minimal internal democratization. The establishment of a French-style presidential system in 1978 provided opportunities for the centralization of political power which reached its apogee in the period 2005 to 2014. However, in reaction to this, a constitutional amendment enacted in 2015 has restricted presidential power and further amendments to the constitution on the same lines are under consideration.

Additionally, ethnic tensions escalated after 1948, principally between the majority Sinhalese and minority Sri Lankan Tamils of the north and east. Sinhalese politicians implemented a number of policies that alienated many Sri Lankan Tamils. Examples of such measures are the exclusion of most Tamil plantation workers in the central part of the country ("Up-Country Tamils") from citizenship in 1948, making Sinhala the only official language in 1956, and giving special constitutional recognition to Buddhism – the religion of most Sinhalese – in 1972. The largely Hindu Sri Lankan Tamils were further aggrieved by diminishing opportunities for state employment in the 1960s, and schemes intended to limit their access to some areas of university education in the 1970s. During the 1950s, Sri Lankan Tamil politicians demanded a federal system, and in the 1970s began a campaign for a separate state.

In the late 1970s, the more radicalized Tamil youth moved toward armed struggle. Faced with these challenges, as well as a short-lived insurgency among the Sinhalese youth in 1971, the state began to continually invoke a state of emergency, exerting greater control over the media and expanding the military forces. New anti-terrorist laws were enacted. Increasing attacks on state institutions and on the armed forces by Tamil militant groups in the 1980s and a pogrom against Tamil civilians in 1983 made matters worse. An offer of a quasi-federal system following Indian armed intervention in 1987 failed to resolve the issue. By the late 1980s, the state faced twin armed insurrections, one by Tamil separatist groups and another by Sinhalese Marxists. It was able to crush the latter in 1989, but the Liberation Tigers of Tamil Eelam (LTTE), which emerged as the dominant Tamil rebel group, controlled parts of the north and east of Sri Lanka and fought a civil war that lasted for 26 years until the LTTE was militarily defeated in May 2009. A basic problem in post-war reconciliation is reaching a consensus on arrangements to reconcile the minority Tamils of the north and east.

Meanwhile, reforms permitted most Up-Country Tamils to gain citizenship rights in the 1980s and Up-Country Tamil political parties currently participate in mainstream politics. Muslim political parties that had emerged in the last 20 years, and had advocated a separate Muslim province have begun to ally themselves with one or the other of the main parties.

The economic transformation has been more promising. The British left Sri Lanka with a colonial economy in which the state depended on the plantation sector for much of its revenue. Sri Lankan politicians maintained the well-developed health care system that they inherited, and they vastly expanded secondary education. On the other hand, they also inherited a weak industrial sector and had to make heavy investments in agriculture to reduce the country's dependence on food imports. A development model of import substitution and of economic development through public sector companies was attempted until 1977. From then on, market-oriented reforms were gradually adopted. Successive governments of different political hues have pursued privatization, public sector reforms and the liberalization of trade and capital movements, although there were some moves toward a more protectionist economy between 2005 and 2015. The new government is open to more trade liberalization and export-oriented growth, but populist opposition to such policies continues.

The BTI combines text analysis and numerical assessments. The score for each question is provided below its respective title. The scale ranges from 1 (worst) to 10 (best).

Transformation Status

I. Political Transformation

1 | Stateness

The state's monopoly on the use of physical force is unchallenged. However, there is a heightened level of security in parts of the north and east with some violent incidents. In April 2014, the Sri Lankan military shot dead three alleged Tamil nationalists in Nedunkerni (Vavuniya District). In October 2016, two Tamil students were shot dead by the police at a checkpoint in Kokuvil (Jaffna District). Five policemen were arrested in relation to the second incident.

All groups in Sri Lanka have legal access to political rights. The current political leadership of the Tamil minority in the north and east, as represented by centrally located elected representatives, has publicly accepted the Sri Lankan state while campaigning for more devolution of power. While the memories of the separatist war will take time to recede, the debate has largely shifted to devolution and reducing the involvement of military forces in minority areas. The rhetoric by Buddhist nationalists against Muslim and Christian minorities has been toned down though it has not ended. Overall, the policy of reconciliation with minorities supported by the new government has had a significant impact. The recommendations of the Consultation Task Force on Reconciliation Mechanisms appointed by the new government have become the basis for discussion on potential constitutional changes and disputes are now about the nature and extent of changes in the political structure.

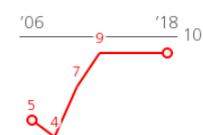
The constitution specifies that "The Republic of Sri Lanka shall give to Buddhism the foremost place," although it also safeguards freedom to have or adopt a religion of one's choice and the freedom to teach and practice one's religion in public or private. State funds support Sri Lanka's four major religions (Buddhism, Hinduism, Islam and Christianity).

While the current coalition government includes people who have supported Buddhist nationalists, it is openly supportive of religious diversity. Constitutional

Question
Score

Monopoly on the
use of force

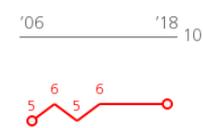
9



1

State identity

6



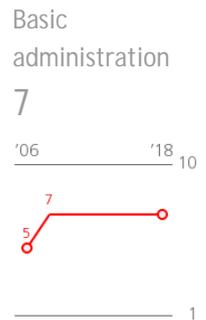
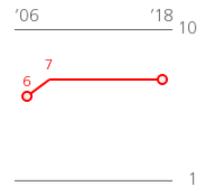
1

No interference of
religious dogmas

7

reform proposals in 2016 included a suggestion to move toward a more secular state. A poll in late 2016 indicates that while over 75% of the Sinhalese majority community support retaining the clause, which provides for the special status of Buddhism in the constitution, more than 75% of the Tamil and Muslim minority oppose it. This explains the majoritarian mindset of many of the country’s leading politicians.

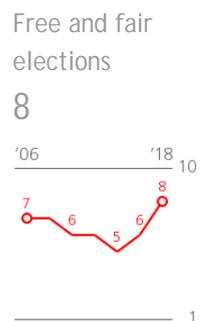
Sri Lanka has an effective administrative structure that provides basic health care and educational facilities to all regions. National and provincial agencies provide power, water, housing and other basic facilities, and implement such state policies. By 2015, 95% of people had access to an improved water source and 95% to sanitation. However, due to historical and political influences, there is an imbalance in the provision state facilities in health care and education in various areas.



2 | Political Participation

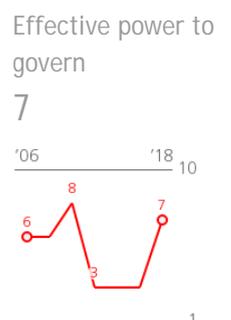
Elections are regularly conducted on the basis of universal suffrage through multiparty contests.

The opposition has limited access to state-owned media. However, non-state controlled media are often openly critical of the government. A survey in October 2015 indicated that most Sri Lankans agreed that the Sri Lankan media is completely free to criticize the government. The election management agency is professional. Registration and vote counting mechanisms are fair. Polling centers are located in accessible places.



The 2015 presidential election, which unseated an incumbent of 10 years’ standing who had misused the state apparatus to influence voters and the subsequent parliamentary election have reinforced confidence in the electoral process. However, the postponement of local and provincial elections, ostensibly to reform the electoral system has led to some skepticism.

Democratically elected officials have been able to implement their policies. There are no extra-constitutional veto powers but the military and the Buddhist establishment have influential voices. For instance, leaders of the Buddhist clergy have insisted that the constitution should retain a clause that protects the special social status of Buddhism and are likely to have their way. Administrative officers are subject to political pressure, and may be subject to transfers to less desirable locations if they resist such pressures. Legislators wield extensive influence over administrators in their constituencies and receive financial allocations from the national government for minor projects.



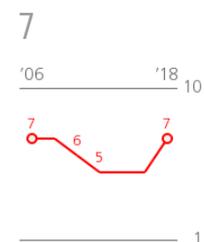
Opposition parties and civil society groups critical of the government continued to operate relatively openly, and, since January 2015, the government has allowed greater association and assembly rights. Public protest gatherings are organized by opposition groups in all areas. Travel restrictions on foreign passport holders to the former civil war areas in the north were removed in early 2016. Nevertheless, under the laws relating to public security, the state can prevent groups from meeting in public, a power that inhibits the exercise of free association in the north where there is a large military presence. Journalists and civil society leaders anticipate surveillance in “high security” areas close to army encampments in the north.

There is widespread satisfaction on the level of media freedom in December 2015 with 67.7% of Sri Lankans agreeing (with 27.9% strongly agreeing) that the Sri Lankan media is completely free to criticize the government, a considerable increase from 51.7% in March 2015 and 39.2% in 2014. A Right of Access to Information Act was enacted in June 2016. While the state controls some major media outlets, there is scope for the expression of a diverse range of opinions. For instance, access has been restored to online news outlets including those controlled from overseas. Many sensitive topics including the occupation of private land by the military are reported on openly, unlike under the previous regime. Open threats to journalists have become rare and several people suspected of killing journalists under the former administration have been arrested. However, the scope for free exchange of opinions seems more restricted in parts of the north where there is a heavy presence of security forces. For instance, the state has prevented some private stations from using the transmission tower newly constructed in the north of the country, while open criticism of the military remains rare.

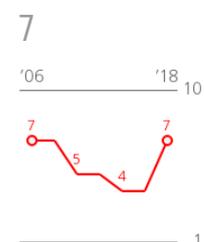
3 | Rule of Law

The Nineteenth Amendment to the constitution approved in 2015 circumscribed the power of the president in a number of ways. It reduced presidential influence over the judiciary and the administration by restricting the hitherto virtually unfettered power of the president to appoint a number of public officeholders, including judges of the Supreme Court and the Court of Appeal, the attorney-general, the auditor-general and the inspector-general of police. These appointments, as well as those to the Election Commission, the Public Service Commission, the National Police Commission, the Human Rights Commission, the Commission to Investigate Allegations of Bribery or Corruption, and the Delimitation Commission, can now be made by the president only upon the recommendation of a Constitutional Council, which includes representatives of both the government and the opposition. The amendment also reduced the term of the president from six years to five, and limited presidents to a maximum of two terms. In addition, the president was prohibited from dissolving parliament without its consent for four and a half years after the date of

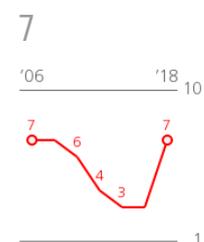
Association /
assembly rights



Freedom of
expression



Separation of
powers



the last parliamentary election. These de jure changes have been accompanied by an improved de facto separation of powers, and more effective checks and balances.

The judiciary is rebuilding its reputation after years of subservience to the executive. The legal profession is influential. The president's power to appoint judges to the Supreme Court and the Court of Appeal has been subjected to approval by a Constitutional Council after the Nineteenth Amendment to the constitution in 2015. This amendment also subjected the right of the president to appoint members the Judicial Services Commission (which administers appointments, promotions, transfers and disciplinary action among the lower levels of judiciary) to the same process. The judiciary is not empowered to rule on the constitutionality of legislation after it is enacted, although bills can be challenged before they become law.

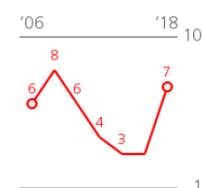
While the judiciary has become less susceptible to executive control, it has continued to experience challenges in ensuring accountability of politicians and officials in power, and in enforcing regulations that impact on economically powerful interests. The lower levels of the judiciary especially could use more training.

The current government is a coalition of parties including those that were part of the former regime. A number of public officials of the previous administration have been subject to legal prosecution since early 2015. These prosecutions have slowly made their way through the law courts under established laws and procedures. While allegations of corruption of public officials and politicians who have been in power since early 2015 have received wide publicity, there have been no prosecutions of such individuals. However, obstacles to illegal activities (e.g., corruption) have become much more substantial. A survey in October 2015, indicated that more Sri Lankans (49.6%) felt that the government was committed to eradicating corruption compared to the previous survey conducted in March 2015 (43.9%)

The law specifies protection of civil rights but long delays in the court system limit the effectiveness of the judiciary in addressing grievances. In the north and east, while the situation has improved, Tamils are occasionally subject to abuse by officials, and the denial of to personal privacy and liberty. They have limited recourse in these situations. Threats, intimidation and violence carried out against Christians have declined in the last two years but intimidation of Muslims by Buddhist groups continue to be reported sporadically. Prosecutions of police abuses and hate crimes in the last two years have sent a positive message. Allegations of torture have declined steeply but in 2016 there were still over 200 such allegations. Same-sex acts are criminalized under the penal code. The state has proposed a procedure by which transgender people could change the gender on their documents after a report from a mental health professional but there is scant evidence that this is in use. The legal establishment in 2016 of an Office of Missing Persons as an investigative agency to help family members trace the fate of thousands of persons who "disappeared" in the past is a positive step.

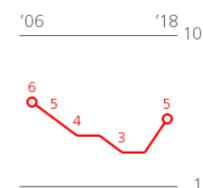
Independent judiciary

7



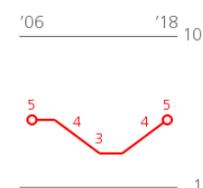
Prosecution of office abuse

5



Civil rights

5



4 | Stability of Democratic Institutions

The institutional structure remains insufficiently decentralized. Proposals to amend the constitution to devolve more powers to the provincial councils have been met with resistance. The postponement of local and regional elections till 2017 has led to negative reactions. In a survey in October 2015, only 37.3% of Sri Lankans stated that they could have an influence over national decision-making while nearly 46% stated that they could not. However, despite political differences within the ruling coalition, the central legislature and the elected presidency have functioned much more democratically than in previous years. On the other hand, political differences within the central administration, and between the center and provinces have made implementation of policy more challenging.

This assessment is hindered by a lack of survey data. The Nineteenth Amendment to the constitution approved in 2015 was designed in part to reduce the powers of the elected president and support democracy. While there is active discussion on constitutional reform, all proposals presented to the legislature are based on democratic institutions. All major political parties, interest groups and civil society organizations profess a commitment to democracy.

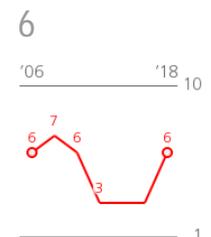
On the other hand, populist agitation against state policy led by opposition political parties, which resulted in demonstrations and violence (as in the case of agitation against the agreement with a Chinese firm on the port of Hambantota), could indicate some readiness to operate outside traditional democratic institutions.

5 | Political and Social Integration

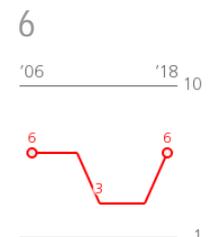
Overall, party organization is undemocratic, and is dependent on personalities and patronage. The Sri Lanka Freedom Party (SLFP) is the junior partner in the coalition government and currently the second largest party in Sri Lanka. The SLFP is torn between supporters of Maithripala Sirisena, the current president, and Mahinda Rajapaksa, the former president. The latter group has organized itself as an informal legislative group under the title of “Joint Opposition.” The Sri Lanka Podujana Peramuna (Sri Lanka People’s Front) was formed in November 2016 to provide a political organization for this group if and when they formally leave the SLFP.

With the increasing acceptance of a single Sri Lankan state by all major political parties, political polarization has abated somewhat. However, there are major differences on the devolution of political power between the major parties, and the parties representing the Tamil minority in the north and east. The latter gained around 5% of the vote in the 2015 elections to parliament.

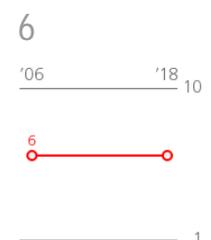
Performance of democratic institutions



Commitment to democratic institutions



Party system



Nineteen political parties are represented in the legislature and over 40 other groups are registered as political parties. However, political party fragmentation is more limited than these statistics suggest. In the 2015 elections to parliament, two coalitions led by the two major parties the United National Party and the SLFP gained 89% of the vote.

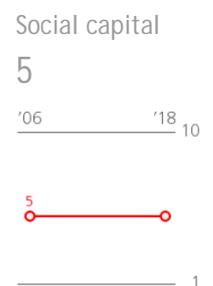
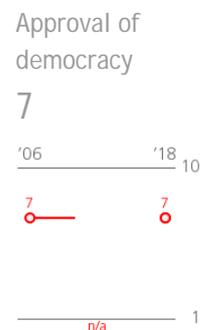
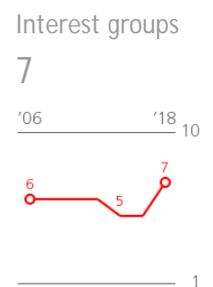
Voter volatility is high as evidenced in the drop in the percentage of votes gained by SLFP presidential candidate from 57.9% in 2010 to 47.6% in 2015.

Sri Lanka’s Buddhist groups have been the most vocal and influential in the country. However, the new government has sought to be more even handed in the treatment of religious and ethnic minorities. Although extremist Sinhalese Buddhist views are occasionally articulated at the local level there is a more active conversation on ethnic reconciliation. Trade union membership is low (less than 10% of all workers), but labor unions are particularly powerful in urban areas and in the plantations. Numerous NGOs are actively engaged in assisting poorer sections of society and the new government is much more open to their activity than the former government which pursued restrictive policies. Prominent actors associated with civil society organizations now serve on government commissions (i.e., bribery, police and judicial commissions). The entire civil society environment is starkly different from what groups experienced during the Mahinda Rajapaksa years.

A survey in October 2015 indicated that 55% of respondents were satisfied with the level of democracy in the country while 16% expressed dissatisfaction. The level of satisfaction was higher among ethnic minorities than in the majority community. The 77.7% voter participation in the multiparty general elections of August 2015 may be an indication of a stronger faith in democratic institutions.

However, the lack of survey data makes it difficult to estimate public satisfaction relating to the functioning of democratic institutions.

The absence of survey data makes an estimate difficult. There are active local and national self-help organizations based on religious affiliations. Local non-denominational organizations are sometimes active on the village level. The level of trust seems to be based more on cultural and professional affinities than on citizenship.



II. Economic Transformation

6 | Level of Socioeconomic Development

Sri Lanka is a middle-income country whose per capita GNI (Atlas method) rose from \$2,260 in 2010 to \$3,800 in 2015. From a 2009 base of \$4,778, the PPP GDP per capita rose to \$9,738 in 2013 before reaching \$11,739 in 2015. In 2014, Sri Lanka led the region in the HDI (0.757) and ranked 73 out of 187 countries. In 2012, the World Bank estimated the proportion of people living on less than \$3.10 a day (PPP) was 14.6% (the best result in South Asia). However, regional disparities remain. A World Bank study released in February 2016 recorded that the poverty rate remains high in three districts affected by the civil war (Kilinochchi, Mannar and Mulaithivu) and in a rural district (Moneragala) in the south. Similarly, poverty in the plantation areas largely inhabited by the Tamil minority remains above the national norm, but there has been some progress in reducing it. There are also large numbers of poor in urban areas.

Sri Lanka's youth literacy rate (ages 15-24) of 98% leads the region. School attendance is high in all areas, with no gender inequalities, although the quality of instruction varies greatly across urban and rural areas. Religion has no discernible impact on education except that the literacy rate for Muslim women is slightly lower than average. The percentage of the population with access to clean water was 96% in 2015 and the percentage with access to sanitation was 95%.

However, interpersonal income inequalities remain high: the 2012 Gini Index stood at 39.2 up from 36.4 in 2010. Investments in infrastructure (major roads and ports) in recent years have yet to pay commensurate dividends. Low child mortality and high female higher education levels have not translated into greater equity in economic participation and more decision-making power for women although the country's standing in the Gender Inequality Index improved from 0.370 in 2014 from 0.402 in 2012 and 0.412 in 2010. The percentage of females in the total labor force was 33.5% in 2014 having barely shifted from 32.0% in 2004.

Question
Score

Socioeconomic
barriers

6

'06 '18 10



1

Economic indicators		2013	2014	2015	2016
GDP	\$ M	74317.8	79356.5	80612.0	81321.9
GDP growth	%	3.4	5.0	4.8	4.4
Inflation (CPI)	%	6.9	3.3	0.9	3.7
Unemployment	%	4.4	4.4	4.7	5.0
Foreign direct investment	% of GDP	1.3	1.1	0.8	1.1
Export growth	%	6.6	4.3	4.7	-0.7
Import growth	%	-1.5	9.6	10.6	7.9
Current account balance	\$ M	-2540.6	-1987.7	-2008.5	-
Public debt	% of GDP	70.8	71.3	77.6	79.3
External debt	\$ M	39313.9	42262.8	43925.2	46607.9
Total debt service	\$ M	2048.1	6355.7	3412.2	3150.9
Net lending/borrowing	% of GDP	-5.3	-5.6	-7.6	-
Tax revenue	% of GDP	10.5	10.1	12.4	-
Government consumption	% of GDP	7.8	8.4	9.0	8.6
Public education spending	% of GDP	1.6	1.9	2.2	-
Public health spending	% of GDP	2.1	2.0	-	-
R&D expenditure	% of GDP	0.1	-	-	-
Military expenditure	% of GDP	2.2	2.4	2.6	2.4

Sources (as of October 2017): The World Bank, World Development Indicators | International Monetary Fund (IMF), World Economic Outlook | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database.

7 | Organization of the Market and Competition

The government allows 100% foreign investment in any commercial, trading or industrial activity other than a few regulated sectors such as air transportation, coastal shipping, large-scale mechanized gemstone mining, lotteries and the military hardware which are all subject to approval by relevant government agencies. Foreign ownership in excess of 40% must be approved on a case-by-case basis in certain areas such as the production for export of goods subject to international quotas, growing and primary processing of tea, rubber and coconut, timber-based industries using local timber, mass communications and deep-sea fishing. Foreign investment is not

Market-based competition

7



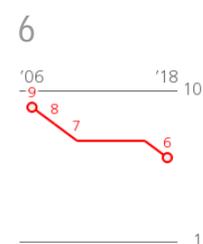
permitted in non-bank money lending, pawn-brokering, retail trade with capital investments of less than \$1 million, and coastal fishing.

There are no plans to take over privately owned enterprises. Administered pricing keeps the cost of energy low and extends to several basic foodstuffs. The currency is linked to the U.S. dollar but is allowed to float within limits. It has been estimated that the informal sector represents almost 60% of the Sri Lankan economy. An economic census conducted by Sri Lanka's Department of Census and Statistics in 2013-14 indicated that over three fifths of businesses in the informal sector were managed by single individuals and that only a fourth of such businesses (excluding state run enterprises) were located in urban areas. Local entry barriers to such enterprises are minimal.

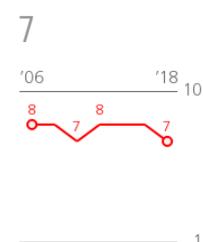
Two hundred state-owned businesses (e.g., energy, ports) have monopolistic control over many areas of the economy. A report from the state Census Department estimates that employment in central government, provincial government, statutory bodies and state enterprises grew by 30% to 1.1 million between 2006 and 2016. The state controls some wages and prices, including the price of petroleum, water, power and bus and rail fares. Although the Consumer Affairs Authority may investigate the effect of anti-competitive practices on consumers, Sri Lanka's law does not empower it to investigate the existence of monopolies or to examine mergers or acquisitions that have already taken place. Pre-merger notifications are not mandatory. Therefore, investigations of mergers may only be undertaken for utilities which fall under the purview of the Public Utilities Commission, or for companies listed on the Colombo Stock Exchange, which may be reviewed by the Securities and Exchange Commission of Sri Lanka.

Sri Lanka, a member of WTO since 1995, has a relatively official low-tariff trade system. The average weighted tariff was 6.7% in 2012. However, imports into Sri Lanka are also subject to a number of other charges: excise duty, Export Development Board Levy between 1% and 35%, value-added tax of 12% (VAT), Social Responsibility Levy (1%), the Ports and Airports Development Levy of 5% (PAL), the Nation Building Tax (3%), and port handling charges. Excise duties are levied on tobacco products, oil products, aerated water, liquor, beer, motor vehicles and certain household electrical items. These para-tariffs make Sri Lanka a protectionist country. Incentives for export include a temporary importation for export processing scheme (TIEP), and a manufacture-in-bond scheme. Enterprises located in export processing zone benefit from tax holidays, duty-free imports and concessionary land prices. Exporters of non-traditional goods exporting at least 80% of their production also enjoy a number of tax concessions, including a preferential income tax rate on profits from these exports, and a tax holiday. Export duties are levied on vein quartz and an export tax is levied on cashew nuts, raw hides, metal scrap, natural rubber, coconut products and tea. The 2015 merchandise trade-to-GDP ratio was 35.9 (down from 41.8 in 2013) which indicates a declining integration into world markets. The 2017

Anti-monopoly policy



Liberalization of foreign trade



budget projects the abolition of the export tax on about 200 products, which could signal a slight move toward more market-based trade.

Sri Lanka's banking sector remained stable with banks' capital-to-assets ratio at 8.2 in 2015. The central bank has a format for the publication of audited accounts and for the quarterly and annual publication of financial statements. The total risk-weighted ratio required is 10% and the core capital ratio is 5%. The banking system has public confidence and has been profitable. However, Sri Lanka's definition of capital adequacy only takes credit risk into account and there is no explicit charge for market risk. Furthermore, the former government used state-owned and private banks for local borrowing and financing of state enterprises (with banks often persuaded to conform to the government's interests rather than their own). The non-performing asset ratio declined from 5.6% in 2013 to 4.2% in 2014 and 3.0% in 2016. Regulations permit 100% foreign control of banks, insurance companies and stock brokerages. Currently there are 25 commercial banks in operation in the country. Two of the local commercial banks are state-owned, holding around 30% of banking sector assets. Many Sri Lankan banks are small.

By September 2016, the Colombo Stock Exchange listed 295 companies with a capitalization of \$18.8 billion. The All Share Price Index fell 6.2% in 2015 to \$6,895 on 1 January 2016, and fell again by 9.2% to \$6,228 by the end of the year.

8 | Currency and Price Stability

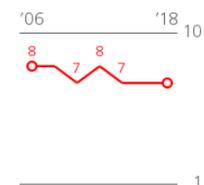
Inflation, as measured by the Colombo Consumer Price Index, was 6.9% in 2013 and fell to 3.3% in 2014 and to 0.9% in 2015. Despite the fiscal stimulus in 2015 (the election year), core inflation in 2016 was around 4% but began to rise in early 2017.

During the year, the value of the rupee against the U.S. dollar declined gradually, with the rupee slipping to LKR 150 to \$1 in January 2017. Foreign direct investment remains below 2% of GDP. Selling of government bonds by foreign investors in the four months up to 15 February 2017 led to a capital outflow of over \$750 million. Although the central bank does not operate independently of the government, its policies have not been overtly political.

Public debt as a percentage of GDP held steady at 76% in 2015. The year 2016 saw some progress toward more efficiency in revenue collection. Government consumption in 2015 had been only 8.8% of the country's GDP. Despite some opposition, the government pushed through an increase in the rate of value-added tax (VAT) from 11% to 15%. Although some items were exempted from VAT, the increase together with greater efficiencies in collecting revenue, is predicted to reduce the annual government budget deficit from 7.4% of GDP in 2015 to 5.4% in 2016. The state also began to examine losses in over 200 state-owned enterprises, many of which are inefficiently run or (like the Ceylon Electricity Board and the Ceylon

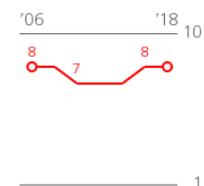
Banking system

7



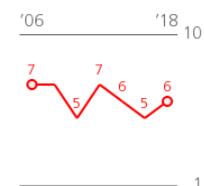
Anti-inflation / forex policy

8



Macrostability

6



Petroleum Corporation) are burdened with prices set by the state at below cost levels. The loss-making Mihin Airlines, set up by the previous administration, was absorbed into the national carrier, Sri Lankan Airlines. The government has begun reviewing offers for a 49% share in the management and control of Sri Lankan Airlines. The 2017 budget approved in December 2016 envisages more public-private partnerships. Foreign private investment remained at a low level and the outflow of foreign capital resulted in a fall of foreign reserves by 11% in 2015. The current account balance was \$1.2 billion in 2016 and this was an improvement on 2015. Sri Lanka received a three-year extended fund facility of \$1.5 billion from the International Monetary Fund and long-term loan of \$2.4 billion from the Asian Development Bank which would be disbursed over the next three years. These should finance continued public investment in 2016 to 2019.

9 | Private Property

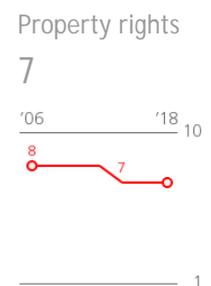
Property and acquisition rights are adequately secured in the industrial and service sectors. Ownership and sale of land are safeguarded, although land registration procedures remain cumbersome and subject to inordinate delays (nine procedures and 51 days). In January 2015, the new president initiated a process to restore private property occupied by the armed forces, and about 2,000 acres have been restored over the past two years. However, in the north, the armed forces continue to hold onto much former private property.

Corruption and undue influence over the judiciary could restrict the enforcement of rights in specific cases. Private land ownership is limited to 50 acres per person.

There is no restriction on the repatriation of profits or dividends of foreign companies although certain sectors of the economy are barred to foreign investors. Remittance of management fees, royalties and licensing fees are also permitted for companies with majority foreign investment approved under Section 17 of the Board of Investment (BOI) Act. Stock market investments can be remitted without prior approval from the central bank. Investment returns can be remitted in any convertible currency at the market rate while foreign investors may invest in foreign currency-denominated bonds.

The Arbitration Act No. 11 passed in 1995 implemented the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards meaning that arbitral awards made abroad are enforceable in Sri Lanka (and vice versa) if the counterpart is based in a signatory state.

The regulatory requirements for the establishment of new businesses are limited and the World Bank estimates that the average time to establish a new business was less than 10 days in 2015, in contrast to 13 days in 2014. This is the fastest in the region. Factors inhibiting the establishment of new enterprises include unofficial charges by



Private enterprise

8

public officials, low-level hostility from the bureaucracy and cumbersome procedures for business registration. The new government has sought to reduce regulations that impede investment.

The private sector plays an important role in the economy, especially in finance, internet technology, the production of clothing and tea, and tourism. The government allows 100% foreign investment in any commercial, trading or industrial activity other than a few regulated sectors. It has expressed a greater commitment to public-private partnerships, which could take over some state-owned enterprises.

10 | Welfare Regime

Sri Lanka's HDI remains higher than that of many countries with higher per capita GDP because of its long-standing and comprehensive welfare programs. The state has promoted a number of poverty alleviation programs. These include the Samurdhi program subsidy (increased in the 2015 budget), a nutrition allowance program and social security and pension programs. The new regime has increased the poverty allowance paid to poor senior citizens and added a new nutrition allowance at childbirth.

Life expectancy at birth has risen marginally from 74.1 in 2012 to 74.8 in 2014. Prior to 2015, however, state investment was focused more closely on infrastructure than on strengthening social safety nets. State welfare expenditure on health care as a percentage of GDP, for example, was low at 2.0% in 2014 and increased only marginally in 2015.

Basic provision of education is comprehensive, with state or state-assisted schools providing education free from grade 1 to grade 12, but there is a shortage of teachers in foreign languages and in technical subjects. Tertiary education is not well funded. State funding for education has risen substantially in 2016. The rural population and the majority of those in urban areas currently have no insurance coverage for natural disasters.

The emergence of a coalition government with strong minority support in 2015 has opened up the likelihood of a more equitable distribution of state benefits to all groups, including the Tamils in the north and east but statistical evidence of progress is scarce.

Access to public services is open to all by law. There are however, inequalities in practice. The gender gap in educational enrollment or is minimal with the Gender Parity Index at 1.0 in primary education, 1.1 in secondary and 1.5 in tertiary. However, men dominate the more lucrative levels of employment in both the public and private sectors and, while females with comparable qualifications and experience



Social safety nets



Equal opportunity



receive similar wages in the higher reaches of the public sector, the average wages and incomes of female workers is substantially less than that of males.

There are regional and urban-rural disparities in the quality of the education system despite continuing efforts to develop magnet schools. Access to financial resources is limited for the poorer sectors of society, despite the state's encouragement of micro-lending. Access to opportunity has been somewhat limited in areas of former conflict in the north and east. This has affected the Tamil minority as well as Muslims and some Sinhalese in the north and east. While there has been some effort to provide minorities with better access to jobs (especially within the state system) since 2015, the data on outcomes is not available.

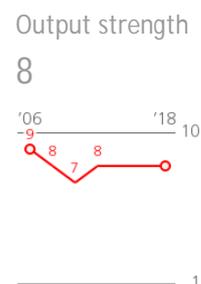
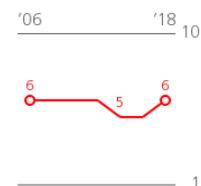
11 | Economic Performance

The Sri Lankan economy has performed well in recent years. The end of both the global recession and the civil war led to a positive GDP growth rate which peaked at 8.2% in 2011. After falling to 3.4% in 2013, the 2013 growth rate stabilized at 4.8% in 2014 and remained at 4.8% in 2015. Per capita GDP (PPP) rose to \$11,739 in 2015 from \$8,390 in 2010. The International Monetary Fund estimate for GDP growth (as of December 2016) was 4.8% for 2017. Growth had been fueled by major state-sponsored construction projects; improved yields for rice, tea and other products; and a revival of fisheries (2010-2014). In the past year, however, tea production declined slightly and adverse weather is likely to limit rice yields in 2017.

Exports (including apparel and light manufactures) grew with overall exports rising by 4.3% in 2014 and 4.7% in 2015. Figures for 2016 seem to show a decline in exports following a slowdown in world trade. In the last few years, imports rose steadily by 9.6% in 2014 and 10.6% in 2015, despite the decline in the price of oil imports between 2014 and 2015, but recorded a fall in 2016. Exports currently pay for less than 60% of imports. The trade gap was covered by remittances from Sri Lankans working abroad and increased revenue in the tourism industry (which has expanded by double digits in the last few years). However, these earnings are dependent on external factors and, in view of the need to service the high external debt, the trade deficit needs to be narrowed.

Inflation, as measured by the Consumer Price Index, was a negligible 0.9% in 2015 after 6.9% in 2013 and 3.4% in 2013. It is estimated to rise to 4% in 2016 and slightly more in 2017. Increases in commercial and non-concessionary borrowings from external sources in recent years will increase the country's debt payment burden in the near future. The current external debt is around \$65 billion.

Gross capital formation as a percentage of the GDP was 30.1% in 2015 down slightly from 32% in 2014 and 33.2% in 2012. More troubling is the low rate of net foreign direct investment which was a dismal 0.8% in 2015, down from an already low 1.1%



in 2014 and 1.3% in 2013. Signs of capital flight in late 2016 indicate that the situation is unlikely to improve in the near future. However, the 2017 budget approved in December 2016 has some measures designed to encourage private foreign investment.

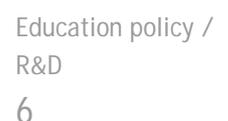
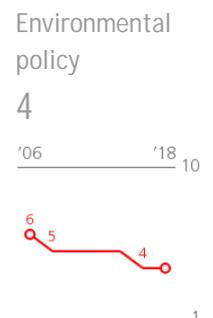
Tax revenue as a percentage of GDP has been low in recent years (10.4% in 2012) but the government pushed through an increase in the rate of value-added tax (VAT) from 11% to 15% in late 2016. Although health care, housing and a number of essential foods were exempted from VAT, the increase, together with greater efficiencies in collecting tax revenue, is predicted to increase the percentage of tax revenue and reduce the annual government budget deficit from 7.4% of GDP in 2015 to 5.4% in 2016.

Unemployment was at 4.6% in 2014 (4.4% in 2013). Females made up 53% of the working-age population in 2014 but only 33.5% of the employed population, a figure that has remained virtually unchanged for years.

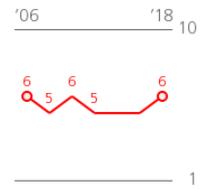
12 | Sustainability

The encroachment of natural reserves and continued deforestation (despite logging restrictions imposed in 1999) has resulted in soil erosion and other adverse effects on biodiversity. The provision of free water for agriculture has contributed to high usage. Air and water pollution has worsened in urban areas and development pressures have also led to the reclamation of estuarial, lagoon and marsh waters, and the unrestricted disposal of untreated sewage, leading to major pollution problems. Recycling of garbage in urban areas is inadequate. Industries create environmental contaminants that pollute freshwater bodies. Environmental concerns have tended to take a back seat to growth considerations. However, following a pledge given at the Climate Change Summit in Paris in 2015, the Ministry of Mahaweli Development and Environment inaugurated a program to develop 10,000 environmentally friendly villages. On paper, Sri Lanka has national policies on the environment (2003), wetlands (2005) and biosafety (2005), but they often remain unenforced due to political pressure or personal influence. There have been some efforts to promote reforestation, awareness of the importance of protecting the environment and recycling rates. However, the impact of these efforts is not yet evident.

The existing system of education is comprehensive, with gross enrollment at 101.3% at the primary level (2014) and 99.7% at the secondary level (2013). Female enrolment at all levels is higher than corresponding male enrolment. The adult literacy rate (16 and over) is 93% (2012). Total public expenditure on education was a low 1.6% of GDP in 2013. The allocation was sharply increased to 5.4% of GDP in 2016 and is likely to be 4.1% in 2017. Virtually all education is run by the state, and there are wide disparities in facilities between urban and rural areas. Tertiary education, with a gross enrolment of just over 20% continues to fall behind in quality.



Private tertiary institutions provide post-secondary diplomas and link programs with foreign universities. The government has supported the expansion of private sector tertiary education linked to foreign institutions while also continuing to enlarge the state structure. However, it has met with some populist opposition especially in respect of the establishment of a private medical college. R&D expenditures are particularly low (0.1% of GDP in 2013).



Governance

I. Level of Difficulty

Sri Lanka has a good geographical location and a literate labor force. The basic (though inadequate) system of transport has been improved in recent years with considerable investment in ports, airports and roads. Improved water supply has greatly reduced the incidence of pandemics. Welfare policies have reduced extreme poverty though there is still much to be done, particularly in the north and east, rural and plantation areas, and in growing urban centers.

On the other hand, Sri Lanka currently has an aging population with the percentage of people over 60 years of age projected to rise from the current rate of 12% to 16% in 2020 and 29% by 2050. Sri Lanka does not have exploitable oil or coal resources. Recent historical experiences of communal tensions and civil war pose considerable structural constraints on the political process of democratic transformation.

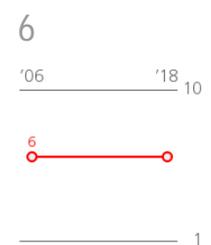
Sri Lanka enjoys a long civil society tradition, reaching back to colonial and, arguably, even pre-colonial times. Civil associations have taken an active role as guardians of civil and minority rights. At the same time, however, decades of armed conflict have prevented the emergence of strong, civil society associations that cut across ethnic cleavages and provide bridging (instead of bounding) social capital.

While the lack of survey data prevents definitive assertions, traditions of civil society seem to be marginally stronger than in 2016. In fact, in the past two years, the freedom of the media has expanded and the increased penetration of electronic devices (estimated to cover 30% of the population) has led to a growth in social media. NGOs appear to have become more active.

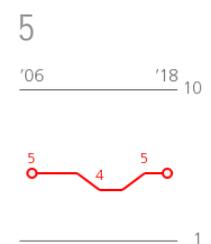
Nevertheless, the patronage system remains strong, and trust in state institutions is limited. There are numerous local religious organizations that work in the fields of public welfare and advocacy, but trade unions have been in decline.

Tensions and fears among ethnic and religious minorities have fallen considerably over the past two years. The incidence of violence based on ethnic and religious differences were far fewer over the last two years than before 2015. However, some 100 incidents of local violations of religious freedoms against Muslims were reported in 2016 and a slightly lower number recorded in relation to Christians. Unlike in the

Structural
constraints



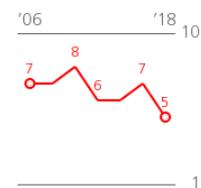
Civil society
traditions



Conflict intensity

5

recent past, however, the state condemned such actions and occasionally intervened to resolve conflicts between religious minorities and the Buddhist majority. The number of violent incidents among the Tamil minority population in the north declined sharply over the last two years and, when incidents occurred, the media reported on them compelling state agencies and politicians to respond. On the other hand, political leaders continue to mobilize ethnic and religious cleavages and, with the growth in the use of social media, there is a potential for populist movements to form against elite policies.



II. Governance Performance

14 | Steering Capability

Since early 2015, the new government has begun to pay more attention to long-term strategic priorities. In the political sphere, the Nineteenth Amendment to the constitution's reduction in presidential power and the development of proposals for further constitutional reform in late 2016 have begun to address issues relating to the development of a more democratic and decentralized power structure. Proposals for constitutional reform were drafted after inputs from both expert and special-interest groups. On the economic front, there is greater attention to long-term consequences of state expenditure and foreign borrowing. There is far more readiness to reduce state control over areas of the economy (based on an analysis of the growth in unprofitable state-owned enterprises in the previous decade), although privatization has proceeded slowly. Economic pressures have rendered the state more vulnerable to pressure from international lenders such as the IMF.

On the other hand, the broad socioeconomic priorities of the government do not differ substantially from those of its predecessor. Investment in infrastructural projects such as ports and highways continued to take precedence over increased funding of health care and education. However, this is also due to evidence-based planning because, after coming into power, the new political leaders realized that low-interest loans from China were available for specific infrastructure projects, while funds for the enhancement of human capacities from institutions like the World Bank and IMF involved specific conditions. However, the coalition of ethnic groups and political parties supporting the new regime is less politically cohesive than that which buttressed the previous government, while some members of the previous regime participating in the new government will be less likely to support changes in the status-quo. Therefore, new long-term initiatives are often subject to interminable political negotiations.

Question
Score

Prioritization

6



Political disputes within the coalition government have hampered implementation of policy in the last two years. Ministers belonging to the two major parties (UNP and SLFP) have tended to place different emphases on policies with a view to political advantage. The large size of the cabinet (45 ministers with some ministries under the prime minister and a few under the president) has dissipated responsibility for policy implementation. This difficulty is recognized but an attempt to set up a super-ministry responsible for the coordination and implementation of policy has met with widespread opposition. In particular, members of the SLFP members have opposed the creation of a super-ministry, arguing that it is a means of enhancing the powers of the UNP prime minister vis-a-vis the SLFP president. Moreover, while the UNP has a strong representation in central government, the party is in a minority in the Provincial Councils, where elections have not been held since the change of government.

On the other hand, there is general agreement on the need to implement more market-friendly policies. The government has to take account of populist opposition among the majority community to plans for greater devolution of power.

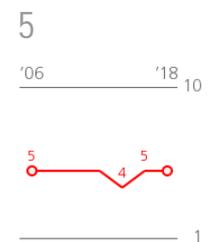
The government's demonstrated ability in policy learning has shown improvement but changes in policy evaluation, and the adoption of good practices and expert advice have been limited by political tensions between the political parties of the governing coalition as well as realities on the ground. Thus, for example, there is greater recognition of the need to provide a political accommodation for the Tamil minority and some minor changes were made. For example, civilian (rather than military) governors were appointed and an Office of Missing Persons was established. However, there has been no progress on the formal devolution of power to the provinces.

On the other hand, there is evidence of flexibility in the change from criticism of borrowing from China (as pursued by the previous government) with a gradual return to negotiating more loans from China once it became clear that there were no other sources of large-scale borrowing for major infrastructural initiatives. Also, recognition of the need to limit budget deficits and to make state-owned enterprises profitable have led to action.

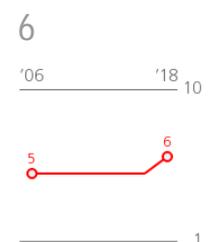
15 | Resource Efficiency

The public sector continues to be overstaffed and the appointment of new public officials is politicized with the exception of a minority of specialized professionals such as doctors. Once appointed, public officials are protected in their positions, though they can be subject to transfer to undesirable locations. Salary raises for public servants, stemming from political considerations and perks paid to politicians (i.e., being provided with duty-free vehicles) despite the rising debt, suggest continuing problems. On the other hand, under pressure from international lending agencies such

Implementation



Policy learning



Efficient use of assets

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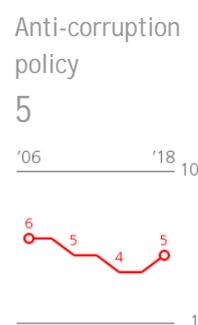
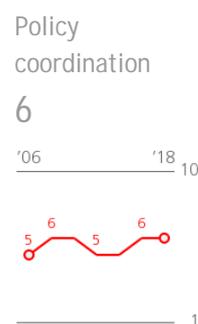
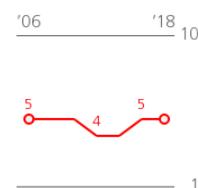
as the IMF, the government has commenced the process of reviewing state-owned corporations from the viewpoint of economic returns despite some foot dragging by members of the coalition government.

Auditing of state agencies is routine but there are continuing instances of state resources falling into private hands. The budget deficit has fallen from 7.4% of GDP in 2015 to 5.4% in 2016. Meanwhile, the increase in the rate of value-added tax (VAT) from 11% to 15% in late 2016 and greater efficiencies in collecting revenue are predicted to further reduce the budget deficit in 2017. However, external debt has grown substantially in the last few years and foreign loan repayments will come to \$4.5 billion in 2017, to be followed by another \$4 billion in 2018.

Elected local and provincial assemblies have legally defined spheres of activity but do not have adequate financial resources. The press plays an important role in monitoring the use of resources. Despite the prevalence of corruption, the administrative structure does provide a mechanism to deliver services across the country.

Many central ministries have branches at the provincial level with coordination provided by civil servants. However, policy coordination between the 51 central ministries, and between central ministries and local authorities has been challenging. An effort in 2016 to empower the Ministry of National Policy and Economic Affairs currently under the prime minister to coordinate national development activity led to a storm of opposition on the ground, as it would undermine the authority of the other ministers and Provincial Councils. However, it also illustrates the need for greater coordination in the implementation of government policy. The Sri Lankan administrative structure requires further reform to ensure transparency and equity in the implementation of policy.

The current government took over in January 2015 with a pledge to end corruption. However, the sale of some government bonds by the central bank led to the enrichment of a private corporation and, while probably legal, this has led to public accusations of improper behavior. The government’s proposal to hire sports utility vehicles, which would be issued free to 58 legislators assigned for district development work, faced much criticism. On the other hand, it is worth noting that the press has become freer since the change of regime in 2015 and that the scale of corruption might have moderately reduced at least at the higher levels. Unfortunately, while there has been much publicity on the extent of corruption within the previous government and instances of missing funds, prosecution of public officials accused of corruption identified has proceeded slowly. There is widespread belief that corruption continues to be embedded in the administration. Public procurement systems are open to bribery and there is virtually no accountability of officeholders in the form of asset declarations or conflict of interest rules. State spending is audited, but party financing is not regulated. Media questioning of the allocation of public funds and state contracts has become a valuable corrective influence. The Right of



Access to Information Act, approved in 2016, could become a valuable tool to counter corruption.

16 | Consensus-Building

Following President Rajapaksa's defeat in January 2015, all major groups, including many of his erstwhile supporters, advocate the restoration of democratic norms. The military has kept out of politics, while religious leaders of all faiths have expressed support for democratic values. The leading Tamil minority party, the Tamil National Alliance, is committed to negotiating political changes through a democratic framework. The leaders of Muslim political groups have also continued to be committed to a democratic structure.

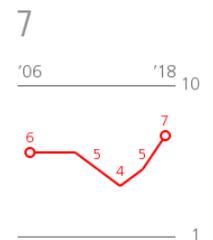
The two major parties (SLFP and UNP) agree on the long-term strategic goals of poverty alleviation through state welfare and subsidies within a market-based economy. The UNP is more vocal in its support of the market economy but currently depends on the parliamentary support of the SLFP which is more favorable to retaining state-owned enterprises and para-tariffs that protect local manufacturers. The Marxist party JVP advocates state intervention in the economy, but its popular support has dwindled considerably. In terms of economic policy, minority Tamil and Muslim ethnic parties are primarily concerned with protecting the interests of their respective groups.

There is no armed resistance to the elected government either at the local or national level. The military has not interfered in economic and political policy-making. Trade unions are weak in all but a handful of sectors (e.g., power, transport, tea production).

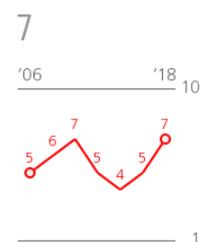
The new government has made considerable progress in fostering democracy allowing the media to freely criticize state policy and enacting the Right of Access to Information Act in 2016. However, criticism of the military in the media is rare. Furthermore, in the wake of populist agitation against the government, such as in the case of the lease of Hambantota port to a Chinese corporation, there has been some evidence of a readiness to use force to counter protests. Also, particularly in the Tamil north, strict security measures enforced by the police and armed forces could be seen as alienating some actors from the democratic process. Constitutional revisions that provide greater safeguards for human rights, which would have strengthened loyalty to the democratic political process, have been delayed. Overall, however, the situation has improved greatly in the past two years.

The major challenge is reconciliation between Tamils and the state. The appointment of a civilian to succeed a former military officer as governor of the Tamil-majority Northern Province, the gradual return of land appropriated by the armed forces, as well as the establishment of an Office of Missing Persons can be seen as preliminary steps toward this aim. Other steps such as the signing of the national anthem in Tamil

Consensus on goals



Anti-democratic actors



Cleavage / conflict management

7

and providing more housing for Tamil refugees have been favorably viewed by the Tamil leadership, which has pledged to work with the government toward a new political structure.

The prime minister led a process of consultation through parliamentary committees which resulted in recommendations for a new constitution. However, there seems to be opposition within the coalition government to the further devolution of powers and much will depend on whether a consensus for constitutional change can be built in the coming years. There is also a need for closure on investigations relating to civilian casualties in the closing phase of the civil war in 2009.

The Up-Country Tamils in the central part of Sri Lanka also see themselves as an economically oppressed group. Muslims, who make up almost 8% of the population, have become fearful of assaults on their identity and interests by majority Buddhists. There are some political groups that seek to gain advantage by continuing to attack Muslims and Christians. Though physical attacks on mosques and churches have declined after the new government chartered a more inclusive policy. Nevertheless, the governing coalition contains elements that have little sympathy for minority concerns

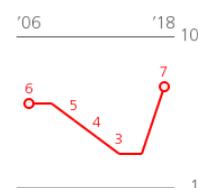
The state has been partially successful in moderating class conflict and the post-January 2015 government has continued efforts to assist the poor by reducing state-imposed maximum prices on several foodstuffs.

This is an area that has seen major changes. Professional associations (such as the Bar Association), intellectuals and media professionals critical of state policies have become much freer to express their views without fear for their lives. Thus, the setting of policy agendas is now shared with some sections of civil society. In certain instances, for example in constitutional reform proposals, the input of civil society was actively sought. In the north, student groups are more vocal and active, and cooperatives of fishermen and women’s groups operate more boldly than they did under the previous government. On the other hand, civil society participation appears to me more limited in areas such as decision-making and policy implementation. The Right of Access to Information Act does provide greater scope for the media to monitor performance but such monitoring is not formally supported by state agencies.

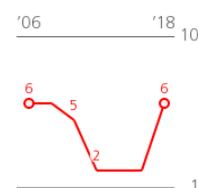
The death toll in Sri Lanka’s civil war is estimated to have been 80,000. The end of hostilities in May 2009 led to debate about atrocities during the war and allegations of extra-legal actions against Sri Lankan armed forces during the concluding stages. The eight-member Lessons Learned and Reconciliation Commission (LLRC) appointed by the Sri Lankan government in May 2010 to investigate responsibility for the war, and suggest measures for restorative justice and conflict prevention was criticized by international actors as a defensive measure. The LLRC report released in December 2011 suggested the safeguarding of political and linguistic rights,



Civil society participation
7



Reconciliation
6



inclusion of minorities in development processes and compensation for injury or loss of life. Progress in implementing these recommendations has been very slow.

However, the change of government in early 2015 has strengthened the reconciliation process, with the new regime accepting the recommendations of the LLRC and promising to work with Tamil political leaders who command a majority in the Northern Province's legislature. A Consultation Task Force on Reconciliation Mechanisms appointed by the prime minister recommended in January 2017 that both local and international judges should be appointed to a court that would investigate allegations of war crimes relating to the civil war. This is what the Tamil minority leaders have requested and what the United Nations has recommended. However, in the past, the president has been opposed to the participation of international judges in such a panel. This difference within the ruling coalition could hamper reconciliation efforts.

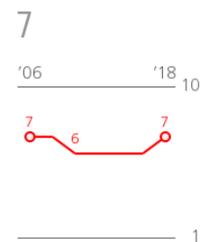
The establishment, in February 2017, of a new party, the Tamil United Freedom Party, has been interpreted positively by the press. The Tamil United Freedom Party proposes to work within the Sri Lankan state structure, and is led by a former rebel army commander and a former SLFP deputy minister of the previous government.

17 | International Cooperation

The pattern of external assistance has continued the transition begun a decade ago when Sri Lanka moved from reliance on the West to increasing reliance on new lenders such as China and India as well as international agencies such as the IMF and World Bank. Some \$6 billion in Chinese loans have been used primarily for infrastructure projects (such as ports and roads) and the newer projects (unlike the ill-conceived projects in Hambantota port and Mattala airport) seem to have potential for a favorable economic return. Indian investment has largely been directed to housing and oil exploration. World Bank-financed projects are mostly in the areas of education, irrigation, roads and health care, with loans averaging over \$300 million per year in the four-year period to December 2016. The IMF approved a three-year \$1.5 billion loan in November 2016.

All indications are that the new government is open to developing a long-term strategy using external advice and assistance. World Bank assistance has been sought to improve competitiveness of export enterprises. The readiness to examine the financial viability of state-owned enterprises (with technical assistance from the IMF) and to more closely appraise projects on financial viability criteria are welcome moves.

Effective use of support



The Sri Lankan state is seen as a credible partner by multilateral lending organizations such as the World Bank because of its performance in development projects.

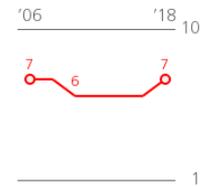
The readiness with which the new government has engaged international organizations in addressing human rights concerns has changed state attitudes toward externally funded institutions within the country. They are no longer subject to vilification by state actors. International NGOs are now seen by the Sri Lankan government as partners in development. Sri Lanka's credibility on press freedom has improved substantially in the past two years.

Sri Lanka has good relations with its neighbors. Though increased Chinese investment in infrastructure projects in the last few years and the sale of an 80% share of the southern port of Hambantota to a Chinese company has caused concern within the Indian government and has provoked public protests in Sri Lanka. Sri Lanka's efforts to protect domestic fishing rights in its coastal waters has also led to some clashes with the southern Indian State of Tamil Nadu. There remains considerable concern regarding Tamil Nadu's attitude toward Sri Lanka's refusal to offer meaningful devolution to the Tamil minority in the north and east. On the whole, Sri Lanka's relations with neighboring India have improved recently. In 2015, Sri Lanka signed an agreement with India to cooperate on the peaceful use of nuclear energy and on another agreement which envisages cooperation in a variety of cultural fields including performing arts, libraries and archives, publications and professional exchange.

Sri Lanka also has excellent relations with other South Asian countries such as Pakistan and Bangladesh. Despite Sri Lanka's membership in the South Asian Free Trade Association, only 9% of Sri Lanka's trade is with other South Asian countries. However, in 2015, India was Sri Lanka's biggest trading partner followed by the European Union and the United States. Sri Lanka is also a member of the Asia Pacific Trade Agreement (APTA). Furthermore, the seven member countries of the APTA at a ministerial council session in January 2017 agreed on a further reduction in preferential tariffs. On January 11, 2017, the European Union's executive proposed that the bloc reinstates a trade concession to Sri Lanka as an incentive to the government to promote human rights and good governance.

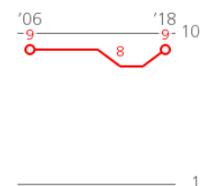
Credibility

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Regional cooperation

9



Strategic Outlook

The Sri Lankan state has made further progress toward a market economy. Inflationary pressures have been kept under control. Continuing private remittances from expatriated workers (over \$7 billion in 2016) and the growth in the tourism industry (over 2 million tourists arrived in 2016) have helped to alleviate the current account deficit. Nevertheless, there are substantial economic challenges, including the repayment of foreign debt and interest, which will total around \$4 billion a year for the next few years. Ensuring export growth is crucial if the country is to finance imports of consumer and durable goods. There are signs that the state is moving from export levies to other sources of revenue, such as increased VAT, but more work remains to be done to reduce transaction costs for businesses and promote investment.

Sri Lanka's emphasis on reducing rural poverty is a good start toward sustainable development. Sri Lanka has made efforts to reduce burdens for the very poor but some of the mechanisms used, such as fixing maximum retail prices, distort the market. Also, the Gini Index for Sri Lanka remains high.

Moreover, policies promoting more open markets (and global trade) need to be developed with caution because of the growth in populist and anti-foreign sentiment in the country, as evidenced by the recent agitation against the lease of a port to a Chinese company in late 2016 and early 2017.

There are several other areas in which policy changes are recommended: reconciliation, political democracy, demographic trends and environmental protection.

Ethnic reconciliation and a political settlement on devolution of power remain key issues. The recommendations of the Consultation Task Force on Reconciliation Mechanisms appointed by the new government have become the basis for discussion on constitutional changes among the stakeholders. Politicians in power need to look beyond their political differences to build a consensus on the issues of minority rights and devolution.

The new government has taken some steps toward promoting the independence of the judiciary and protecting human rights. It needs to reinforce this by ensuring that the postponed local and provincial elections are held as soon as possible in 2017, and by ensuring fairness at the polls.

While Sri Lanka currently has a demographic bonus due to the high proportion of the population that is of working age, an aging population is increasing the dependency ratio. Studies have indicated a current shortage of labor in construction and agriculture. Greater efforts are required to increase female participation in the workforce, provide better training and enhance resources for the care of the elderly.

Environmental issues should be linked to sustainable development. In 2015, the new government pledged to protect 21,800 acres of mangrove swamps at a cost of \$3 million over the next five

years. However, some 4,000 acres of wetland have already been destroyed due to development activities. Additionally, while there is increased awareness of rising sea levels, state and private investment in vulnerable coastal areas continues. Growing population pressure, and certain cultivation and clearing practices have resulted in greater exposure to natural disasters such as landslides and floods. Existing legal instruments need to be fully utilized and strengthened, and there needs to be more comprehensive evaluations of environmental implications of development projects.