

BTI 2012 | Sri Lanka Country Report

Status Index	1-10	5.85	# 58 of 128	
Political Transformation	1-10	4.88	# 78 of 128	➔
Economic Transformation	1-10	6.82	# 36 of 128	➔
Management Index	1-10	4.69	# 74 of 128	

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

This report is part of the Bertelsmann Stiftung's Transformation Index (BTI) 2012. The BTI is a global assessment of transition processes in which the state of democracy and market economy as well as the quality of political management in 128 transformation and developing countries are evaluated.

More on the BTI at <http://www.bti-project.org>

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Key Indicators

Population	mn.	20.9	HDI	0.691	GDP p.c.	\$	5078
Pop. growth ¹	% p.a.	0.9	HDI rank of 187	97	Gini Index		40.3
Life expectancy	years	75	UN Education Index	0.680	Poverty ³	%	29.1
Urban population	%	15.1	Gender inequality ²	0.419	Aid per capita	\$	34.7

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

Executive Summary

Sri Lanka's trajectory during the past two years has been marked by continuing economic development amidst some deterioration in political democracy. Foreign remittances rose 24% in 2010 to \$4.1 billion and countered deteriorating terms of trade, rising imports and the global recession. Despite an adverse trade balance in 2009, tariffs were rationalized and some controls were relaxed. Economic growth had slipped to 3.5% in 2009 but rose to about 8% in 2010 and is expected to remain at that level. The education level of the workforce remains high. Educational opportunities for women are excellent though there are considerable gender barriers to female engagement in society and the economy. Private property is relatively well-protected. On the other hand, there has been no significant reform of the overstuffed and relatively inefficient public sector and illegal siphoning of funds from state ventures has continued. The budget deficit is being reduced gradually and inflation seems well under control.

While the current government has undermined democracy in many ways, it realizes that its desire to stay in power and create a family dynasty is most likely to be met if it can develop the country and raise the people's standards of living. Thus the country's economic prospects look quite good (now that the civil war has ended) and the state appears to favor increased foreign investment.

The political picture is less hopeful. The military defeat of the separatist Liberation Tigers of Tamil Eelam (LTTE) in May 2009 removed a major danger to the state. On the other hand, the factors that pushed many Tamils to support the separatists have not yet been addressed. There is a need to rebuild the infrastructure in the north and east. More significantly, political democracy has been threatened by the concentration of power in the presidency. President Rajapaksa easily won re-election in January 2010 and his supporters won an overwhelming victory in the April 2010 elections to the legislature. With support from defectors, the ruling party has a two-thirds majority in parliament. The 18th Amendment to the Constitution (September 2010) gave the

president control over key appointments in the administration and the judiciary and removed the two-term limit on presidents. Criticism of the government is equated with disloyalty. Opposition news outlets are under siege, vulnerable to attacks by armed gangs. Electoral processes have continued but the contests have been lopsided partly due to open state support given to some groups. Criticism from the West has further stimulated linkages with China, Russia and Iran, who with Japan and India, have continued to support the Sri Lankan leadership.

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 dominated by the United National Party (UNP) and the Sri Lanka Freedom Party (SLFP). 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 met several obstacles. Political parties remained elite-dominated with minimal internal democratization. Ethnic tensions escalated, principally between the majority Sinhalese and minority Sri Lankan Tamils of the north and east. Sinhalese politicians implemented a number of policies that alienated many Sri Lankan Tamils, including the exclusion of most Tamil plantation workers in the central part of the country ("Up-Country Tamils") from citizenship in 1948, making Sinhala the only official language in 1956, and giving special constitutional recognition to Buddhism – the religion of most Sinhalese – in 1972. The largely Hindu Sri Lankan Tamils were further aggrieved by diminishing opportunities for state employment in the 1960s, and schemes intended to limit their access to some areas of university education in the 1970s. During the 1950s, Sri Lankan Tamil politicians 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 towards armed struggle. Faced with these challenges, as well as a short-lived insurgency among the Sinhalese youth in 1971, the state began to continually invoke a state of emergency, exerting greater control over the media and expanding the military forces. A new constitution in 1978 established a French-style presidential system and new anti-terrorist laws were enacted. Increasing attacks on state institutions and on the armed forces by Tamil militant groups in the 1980s and a pogrom against Tamil civilians in 1983 made matters worse. After an armed intervention by India in 1983, the proposal of a quasi-federal system 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 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 it 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 have emerged in the last 20 years, and have progressed from advocating a separate Muslim province to allying themselves with one or the other of the main parties. Despite these advances, the tendency of the ruling political group to accumulate power has resulted in some backsliding along the path of political transformation.

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 populist opposition to these changes continues.

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

Transformation Status

I. Political Transformation

1 | Stateness

Question
Score

The state's monopoly on the use of physical force was reinforced by the defeat of the armed forces of the LTTE on 17 May 2009 which ended an armed uprising that had lasted for over 25 years. De-mining and the search for caches of arms continue but the state is in control of all of Sri Lanka. However, in some areas of the north and east, state power is maintained only through state-supported paramilitary organizations that are beholden to the government.

Monopoly on the
use of force

9

All groups in Sri Lanka have legal access to citizenship. The military defeat of the LTTE left the Sri Lankan state without a viable challenger. On the other hand, many in the Tamil minority in the north seem to have reservations about accepting of Sri Lankan state. This may be indicated by the low polling (25% or lower) in the Jaffna Municipal Council elections (October 2009) and in polling in the Jaffna District in the presidential (January 2010) and parliamentary elections (April 2010) while the national poll average in the country was over 60%.

State identity

6

Still, the lack of poll data limits the conclusions that can be reached. When the Jaffna Municipal Council elections were held, about 12% of the electorate was displaced and unable to vote and the persistence of low polling in later elections might be influenced by the presence of military and paramilitary forces, although that factor did not result in low polling in Tamil majority areas in the eastern province. In the northern province Tamils clamor for a more devolved system and resent the various symbols of the predominantly Sinhalese Buddhist state (national flag and Sinhala language) being imposed on them. In short, they think of themselves as Tamil first and Sri Lankan second (if at all).

The state supports all major religions in Sri Lanka (Buddhism, Hinduism, Islam and Christianity) but the minister for religious affairs is entitled Minister for Buddha Sasana and Religious Affairs, reflecting the political power of the Buddhist majority. The constitution specifies that "The Republic of Sri Lanka shall give to

No interference of
religious dogmas

7

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. While clashes between religious groups seem to have declined and the state has begun to financially support the rebuilding of all religious places damaged during the civil war, there is also an attempt by the present government (working together with some among the Buddhist clergy and military) to strengthen Buddhist forces in the north east.

Sri Lanka has an effective administrative structure that provides basic health and education facilities to all areas. Central and provincial agencies provide power, water, housing and other basic facilities, and implement state policies such as those relating to fertilizer subsidies. In the north and the east, the end of violence in 2009 has led to a slow resumption of state services but much remains to be done.

Basic
administration
7

2 | Political Participation

Elections are regularly conducted on the basis of universal suffrage. The principle that those who win elections gain office is maintained but the opposition has restricted reach in terms of campaigning and access to media. State-owned media give privileged access to the incumbent. Election observers commented that the sixth presidential election, held on 26 January 2010, was the most violent election in 20 years. Alleged election irregularities during the presidential election included allegations of intimidation of voters and journalists, attacks on people participating at political campaign meetings and destruction of property of electoral rivals. The turnout of 74.5% of registered voters was relatively low for a Sri Lankan presidential election. The incumbent, United People’s Freedom Alliance (UPFA) candidate, Mahinda Rajapaksa, won with 58% of the valid votes – defeating 21 other candidates. The arrest and imprisonment of the main opposition presidential candidate (who won 40% of the vote) has cast a chill on democratic opposition. When Sri Lanka held general elections on 8 April 2010, irregularities in two areas led to re-polling on 20 April. Once again the opposition campaign faced restrictions and intimidation. Only 61% of registered voters went to the polls, – a lower participation rate than in previous parliamentary elections. The provincial and local elections in 2009 and 2010 were also won by the ruling UPFA (with the exception of one urban council election in Vavuniya). Polling ranged around 60% to 70% of the total registered voters except in the northern province where the figures were much lower.

Free and fair
elections
6

While classified as still sufficiently competitive and free, these polls were obviously on the brink of being grossly unfair. Therefore, Sri Lanka has clearly developed into a “borderline case” of minimalist democracy. Because of the drastic decline in election quality alone, the political system must be classified as highly defective.

The present government works to split the opposition and keep it weak, and it is already engaged in many schemes to try to ensure that it perpetuates its rule. For instance, it has sought to block certain parties being formed, the state media are used to vilify the opposition, and in many instances opposition rallies have been attacked (sometimes by security personnel).

Democratically elected officials have been able to implement their policies. There are no extra-constitutional veto powers. The president is the commander-in-chief of the armed forces and has been able to appoint his choices of chiefs for the army, navy, air force and police without question. Administrative officers are transferable and subject to political will. Legislators wield extensive influence with administrators in their constituency. However, local and provincially elected officials in the opposition are not assured of cooperation from state agencies in enforcing their policies and regulations unless they are political supporters of the government. The 18th Amendment to the Constitution enables the president to make a variety of appointments to administrative and judicial offices. There is concern that the immediate family of the president wields extensive influence in the polity through appointment to elective and non-elective office. The president and his immediate family in the country control much of the country's budget and no major change in policy or implementation in any ministry gets implemented if they oppose it. Broadly speaking, the only democratically elected representatives who have effective power to govern are the "First Family," rather than the representatives below them.

Effective power to govern

3

Under the laws relating to public security, the state can restrict public meetings of groups and this power has been increasingly used. Gangs attached to individual politicians intimidate voters, and opposition politicians participate in politics at personal risk. Opposition parties and civil society groups critical of the government continue to operate openly. However, civil society groups are increasingly under threat and are targeted in various ways (restrictions on organization and registration, searches, and audits). Most of those targeted also happen to be those who speak out in favor of minority groups and nonpartisan governance.

Association / assembly rights

5

The state controls significant portions of the news media, including major newspapers and state television. There are a few independent media outlets critical of the government, and those who do criticize the government are often targeted. Media houses have been attacked and many journalists have also been assaulted (with many fleeing abroad). Some criticism of the government in the English press is tolerated (as only about 10% of the population reads the English press) but criticism of the government in the vernacular media tends to be less tolerated.

Freedom of expression

5

3 | Rule of Law

The separation of powers has become increasingly limited. President Mahinda Rajapaksa won a second six-year term in January 2010 and is minister of defense, finance and planning, ports and aviation and highways. His coalition, the United People's Freedom Front (UPFF) won 144 of the 225 seats in the legislature in April 2010. Ninety-two of the legislators became part of the executive on appointment as ministers or deputy ministers. With the assistance of a few opposition defectors and minority parties, the ruling party can secure a two-thirds majority and it did so in September 2010 to approve the 18th Amendment to the Constitution which removed the two-term ceiling on the executive presidency and placed appointments to the Election Commission, the Public Service Commission, the National Police Commission, the Human Rights Commission of Sri Lanka, the Permanent Commission to Investigate Allegations of Bribery and Corruption, the Finance Commission and the Delimitation Commission in the hands of the president, subject only to consultations with five specified legislators.

Separation of
powers
4

The president is also empowered by the 18th Amendment to appoint the chief justice and the judges of the Supreme Court, the president and the judges of the Court of Appeal, members of the Judicial Service Commission (other than the chairman) and the attorney-general, auditor-general, the parliamentary commissioner for administration (or ombudsman), and the secretary-general of parliament subject to the same consultations. This represents a vast de jure expansion in presidential authority. Political interference in the operation of the administration is routine and recruitment to state agencies (except in the case of professionals such as doctors) is carried out almost entirely through political recommendations. There is less separation of power than ever before.

There is a well-organized legal system with a system of appellate courts and an active lawyers' association. However, political appointments to the bench (in all courts) and the intimidation and transfer of judges (mostly in the lower courts) have diminished the judiciary's independence. Corruption and political influence have undermined confidence in the judiciary. The judiciary is not empowered to rule on the constitutionality of legislation after it is enacted, though bills can be challenged before they become law.

Independent
judiciary
4

The 18th Amendment to the Constitution approved in September 2010 empowers the president to appoint judges to the Supreme Court and the Court of Appeal with minimal consultation. The right of the president to appoint the Judicial Services Commission (in charge of the appointment promotion, transfer and disciplinary action in relation to the lower judiciary) lays open the possibility of the further politicization of the judiciary.

Inefficiency, anomie and corruption are widespread at all levels of government, as is the impunity with which such practices and human rights violations are perpetrated. No high-ranking politician or public servant has been prosecuted for abuse of power while in office despite evidence that seemed to warrant prima facie cases. There is no practice relating to disclosure of financial interests while in office. The judiciary has ruled that the president cannot be prosecuted for abuses of power while in office.

Prosecution of
office abuse
4

Civil rights are guaranteed in the constitution and Sri Lanka has acceded to UN Conventions on Human Rights including the Convention Against Torture and the Optional Protocol to the Convention on the Elimination of all Forms of Discrimination Against Women. A ministry of child development and women's affairs has sponsored several programs.

Civil rights
3

On the other hand, in practice, civil rights have been restricted. At the conclusion of the civil war in May 2009, about 200,000 persons (mostly Tamils) were kept in restricted camps for questioning. After a campaign by civil rights advocates about 100,000 were released by December 2009, and most others by December 2010, but about 5,000 remain in state custody without trial. Allegations of extra-judicial killing by Sri Lankan forces during the last stages of the civil war have led to the appointment of a local Lessons Learnt and Reconciliation Commission and a UN panel of inquiry. Inquiries will continue in 2011, though Sri Lanka is unlikely to allow the UN panel to conduct investigations within the country. The presence of armed paramilitary forces limits civil rights in the Tamil areas of the north and east while to a lesser extent political gangs restrict expression of views in the Sinhala areas. The politicization of the judiciary and the police has led to a continued loss of confidence.

The defeat of the LTTE in May 2009 has freed the north and east from a militant regime that engaged in gross violations of civil rights although reports of disappearances continue to come from the north. The climate relating to the exercise of religious rights seems to have improved and campaigns criticizing discrimination against women receive state support. However, Sinhalese Buddhists tend to have their civil rights respected to a much higher degree than minorities (especially Tamils).

4 | Stability of Democratic Institutions

The victories of the ruling party in 2010 have led to an expansion of presidential power confirmed by the 18th Amendment to the Constitution which removed restrictions on the number of terms which an individual can serve as president and gave the president power to address the legislature periodically and appoint key officials including those in the judiciary. The ruling party also controls all

Performance of
democratic
institutions
3

provincial legislatures and virtually all local government organizations. Therefore, friction among institutions is minimal. On the other hand, there is limited vertical separation in policy-making and financing is insufficiently decentralized to lower tiers. Thus, the concentration of power at the presidential level has reduced the effectiveness of other democratic institutions. The best way to characterize the country under President Mahinda Rajapaksa is to say that it is more authoritarian than democratic. The defeat of the LTTE has made it even more so, as the regime seeks to use the popularity that has come with the military victory to try and lay foundations for a political dynasty.

The lack of survey data limits assessment. The last known survey for South Asia in 2005 indicated stronger support for democracy in Sri Lanka than in other countries of the region. Still, democratic procedures are widely regarded as the only means conferring legitimacy though they are often subverted in practice. Voters sometimes accept personal risks in order to cast ballots. The willingness of those in power to use the state apparatus to influence election results and to deny opportunities for political expression to their opponents could well have undermined faith in democracy. This might be reflected in lower rates of participation in elections at all levels.

Commitment to
democratic
institutions
3

5 | Political and Social Integration

The Sri Lankan party system is socially rooted and is able to articulate social interest. Multiple parties represent the major ethnic groups in the country and left wing views are represented by distinct parties. More than 20 parties were recognized by the Department of Elections as eligible to nominate lists for the parliamentary elections of 2010. However, about half of them contested as part of two broad coalitions that gained almost 90% of the votes. The two largest parties, the UNP and the ruling SLFP, are dominated by Sinhalese Buddhists and middle and upper class interests, and have historically been able to absorb adherents of smaller parties, including those who had supported Marxist groups. The two major parties agree on broad economic and social policies. Individual politicians seem comfortable in changing allegiance from one major party to the other. Polarization is low in terms of social policy. Nevertheless, there is considerable polarization between the two major parties on the one hand and the minority ethnic parties on the other although they form alliances of convenience. With large banks of voters loyal to the two major parties, voter volatility is moderate.

Party system
6

Party organization is undemocratic and centers on personalities and patronage. Party branches become active only at election time and act mostly to mobilize voters.

Religious interests such as groups of Buddhist monks and the Catholic Church are vocal, with Islamic and Hindu groups being less active. Given the strong representation of Sinhala Buddhists in power, minority religious groups have begun to accommodate to the status quo and there seem to be fewer overt clashes. With the rise of the service sector and the growth of manufacturing in free trade zones, trade union membership has continued to drop and currently includes only less than 20% of all workers. Many unions are affiliated with political parties. Employers' federations are influential in pushing economic reforms. There are many NGOs actively engaged in supporting poorer sections of society and in the creation of ethnic harmony, but the leadership is thin and NGOs dependent on foreign grants have come under attack as "foreign agents." The Rajapaksa government has gone out of its way to vilify independent associations whenever these associations have pointed to mal-governance. Numerous NGOs who want to work in the country have been refused permission and many groups have been forced to disband or operate at less than optimum levels because the government has curtailed their resource bases or refused to grant their personnel visas to enter or stay on in the country.

Interest groups
6

The 2005 survey on the State of Democracy in South Asia (the latest we have) concluded that support for democracy in Sri Lanka was higher than in any other country in the region at 86%. Support was stronger among the more educated and the urban dwellers and strong among minorities. There is no recent survey of support for democracy in Sri Lanka but some evidence of disillusionment is evident in the low poll (61%) for the 2010 parliamentary elections. However, there is no reason to doubt that people in Sri Lanka value their franchise and free and fair elections.

Approval of
democracy
n/a

There is no reliable survey data on inter-personal trust but extensive social networks exist in Sri Lanka. Many of them are based on religious affiliations and center on a temple, mosque or church. Social organizations in rural areas tend to concentrate on helping neighbors facing a crisis. In urban areas, the upper and middle classes participate in organizations such as the Lions Club, Jaycees and the Rotary Club. The poorer sections of urban society continue to work with religious leaders, often replicating rural patterns of organization. Trade unions have 1.5 million members but are concentrated in plantations and among urban wage earners. There have been some post-civil war efforts at promoting social cohesion in eastern Sri Lanka sponsored by the German organization, Deutsche Gesellschaft für Internationale Zusammenarbeit and the United Nations Development Program, but the results are difficult to quantify.

Social capital
5

II. Economic Transformation

6 | Level of Socioeconomic Development

Question
Score

Socioeconomic
barriers

6

Sri Lanka is now a middle-income country having reached a per capita GDP of \$2,000 in 2010 according to World Bank figures. It leads the region on the HDI (.76) and performs much better than comparable economies. Poverty as measured by the Household Income and Expenditure Survey declined from 15% in 2006/2007 to 7.6% in 2009 (these figures do not represent conditions in the northern and eastern provinces because they have been excluded from the survey). The latest World Bank estimate which has a different definition of poverty relates to 2002 and even according to those figures (37.6%), Sri Lanka's rate is better than that of Nepal, India and Pakistan. Despite the difficulties of the international recession and the continued rise in the prices of necessities, there is some evidence of expansion of opportunities partly due to the end of fighting in the north and east and to extensive investment in the southern province, the political base of President Rajapaksa. Sri Lanka's literacy rate of 90.6% leads the region. School attendance is high in all areas with no gender inequalities, although the quality of instruction varies greatly. Religion has no discernible impact on education except that the literacy rates of Muslim women are slightly lower than others. Safe drinking water and modern sanitation are available to only 65% of the workers living on plantations, although this represents a 50% rise in three years.

Evidence in the Household Income and Expenditure Survey of 2009 indicates that residents in the plantation sector (largely Tamil) have a poverty rate that is 50% above the national level and that the economic destruction caused by the civil war in the north and east – inhabited largely by Tamils – will take some years to repair. Interpersonal income inequalities remain high: the 2002 Gini Index stood at 41.1 and is likely to have risen to the upper forties by 2010. Civil conflict, inflation and poor infrastructure have slowed progress in rural areas despite overall growth rates of more than 6% in the economy in the last few years. 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. Men hold over 60% of employment in the organized sector and, on average, earn more than twice as much as women.

Economic indicators		2007	2008	2009	2010
GDP	\$ mn.	32351.2	40715.2	42068.0	49551.8
GDP growth	%	6.8	6.0	3.5	8.0
Inflation (CPI)	%	15.8	22.6	3.4	5.9
Unemployment	%	6.0	5.2	7.6	-
Foreign direct investment	% of GDP	1.9	1.8	1.0	1.0
Export growth	%	7.3	0.4	-12.3	5.8
Import growth	%	3.7	4.0	-9.6	13.0
Current account balance	\$ mn.	-1400.9	-3885.4	-214.7	-1418.4
Public debt	% of GDP	-	-	-	-
External debt	\$ mn.	14368.7	15614.8	17212.9	20452.2
Total debt service	\$ mn.	837.2	1231.8	1416.6	1444.6
Cash surplus or deficit	% of GDP	-6.5	-6.6	-	-
Tax revenue	% of GDP	14.2	13.3	-	-
Government consumption	% of GDP	15.3	16.2	17.6	15.6
Public expnd. on edu.	% of GDP	-	-	-	-
Public expnd. on health	% of GDP	4.3	4.1	4.0	-
R&D expenditure	% of GDP	-	-	-	-
Military expenditure	% of GDP	3.3	3.7	3.5	-

Sources: The World Bank, World Development Indicators 2011 | International Monetary Fund (IMF), World Economic Outlook 2011 | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database 2011.

7 | Organization of the Market and Competition

Market competition in Sri Lanka is stable. Discrimination against foreign investors is very low with up to 100% investment allowed in most industries and in a number of service activities, including banking, insurance, finance, construction, mass transportation, telecommunications and information technology, and petroleum distribution. However, (with some exceptions) foreign investment under \$1 million is prohibited in areas of retail trading and non-bank lending, and in some sectors, foreign investment exceeding 40% is subject to screening and approval. From 2011, start-up companies which invest between \$5,000 and \$10 million dollars in sectors to be specified will get a blanket five-year tax holiday. Outward investment in

Market-based
competition

8

equities was opened to individuals and corporations from January 2011 and from November 2010, foreign companies were permitted to open places of business in Sri Lanka, while foreigners on tour or business in Sri Lanka were permitted to open accounts in foreign currency. The top income tax rate is low at 35% and the top corporate tax rate which was 35.0% was reduced to 28% from 2011 (except for tobacco, alcohol and casinos which will rise to 40%). Firms in fisheries or who make seeds or planting material have been exempted from income tax for five years. Capital Gains Tax was abolished in Sri Lanka in 2002.

The only monopolies that exist are state-owned (e.g., energy, ports). The state controls some wages and prices, including the prices of petroleum, water, power, bus and rail fares. The state intervened in December 2010 to fix a maximum price on coconuts which are a key ingredient in Sri Lankan cuisine. Although the Consumer's Affairs Authority may investigate the effects on consumers of anti-competitive practices, 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 in the Colombo Stock Exchange, which may be reviewed by the Securities and Exchange Commission of Sri Lanka. A private firm's monopoly on the supply of bunker fuel ended with a Supreme Court decision in April 2009.

Anti-monopoly
policy
7

Sri Lanka has a relatively transparent and low tariff trade system. The average applied Most Favored Nation tariff was 11.5% in 2010, up from 9.8% in 2003. However, the proportion of duty-free lines has risen from 10% of the total in 2003 to 44.4% in 2010. Imports into Sri Lanka are also subject to a number of other charges: excise duty, Export Development Board Levy of 1% to 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. Sri Lanka applies policies to encourage exports of goods and services. They include a temporary importation for export processing scheme (TIEP), and a manufacture-in-bond scheme. Any enterprise located in an Export Processing Zone gets 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 2010 WTO Trade Policy Review is positive in its overall assessment. The limit on advance payments for imports was increased from \$10,000 to \$50,000 in November 2011.

Liberalization of
foreign trade
8

Sri Lanka's banking sector remained stable despite a global crisis due to early regulatory action taken to safeguard the banking system. The central bank has issued 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%. However, the Sri Lankan version of capital adequacy takes into account only the credit risk and there is no explicit charge for market risk. The 1996 amendment to the Basel Capital Accord with regard to market risk has not yet been incorporated in Sri Lanka and this is an area that needs attention. Nevertheless the banking system has public confidence and has been profitable despite a non-performing asset ratio of 15.3%. There were some highly publicized failures among the less regulated finance companies. Regulations permit 100% foreign control of banks, insurance companies, and stockbrokerages. Currently there are 26 commercial banks in operation in the country. Ten of these are locally incorporated and the rest are branches of foreign banks. Two of the local commercial banks are state-owned and they hold about 30% of banking sector assets. Many of the Sri Lankan banks are small and the practice of the state of borrowing from state banks has restricted their flexibility. There are ten merchant/investment banks and seven venture capital companies.

Banking system
8

By March 2010, the Colombo Stock Exchange had 232 listed companies and in response to the global economic crisis the All Share Price Index on 1 January 2011 was 6,635, rising 96.1% in the previous year to be the top performer in the world in 2010.

8 | Currency and Price Stability

Inflation as measured by the Colombo Consumer Price Index was 3.4% in 2009 but climbed slowly in 2010 to reach 6.9% in December 2010. It is likely to at least remain at that higher level in 2011 because of the end of the global recession, extensive floods in the central and eastern parts of the country early in the year and rising prices for petroleum. The change from double digit inflation in the previous years was also promoted by effective measures taken by the Central Bank of Sri Lanka which reduced the average weighted prime lending rate charged by commercial banks from 19% in January 2009 to just over 9% in January 2011. The projected budget deficit for 2011 is 6.8% of GDP, as against 8% in the previous year. The Sri Lankan rupee has held steady around 111 per dollar during the past year. Although the central bank is not operating independently of the government, its recent policies have not been used for political purposes and have helped to stabilize/reduce Sri Lanka's inflation.

Anti-inflation /
forex policy
7

Sri Lanka responded to the global economic recession by adopting a number of policies targeted to support export-oriented industries, and by increasing taxes on imports. The current accounts deficit which fell to -\$214 million in 2009 (the

Macrostability
7

revised figures make it about a surplus of \$80 million) from -\$3886 million in 2008 and is predicted to show a surplus of over \$800 million in 2010.

Foreign exchange reserves which fell to \$1.7 billion by December 2008, (equivalent to only 1.5 months of imports) rose to \$5 billion by January 2011. Both the external debt and the public debt rose faster than the rise in GDP and the debt–service ratio as a percentage of GNI rose to over 3.1% in 2009 but this is seen as manageable. Government consumption as a percentage of GDP fell in 2009 to 15.8% as compared to 16.2% in 2007 and the end of the civil war offers some potential for keeping the percentage of government consumption at this level despite pressure to institute new public welfare programs. It is unlikely that the WTO recommendation of reducing the budget deficit to 5% by 2011 will be attained but Sri Lanka’s policies have, on the whole, contributed to macrostability.

9 | Private Property

Property rights and acquisition are adequately secured in the industrial and service sectors. Land ownership and sale are safeguarded, although land registration procedures are cumbersome and subject to inordinate delays. Corruption and undue influence on the judiciary could restrict the enforcement of rights in specific cases. Private land ownership is limited to 50 acres per person. Foreign investors can purchase land. In parts of the country where state land is granted free to agricultural settlers, it is held in leasehold and is not legally disposable. While this measure was established to prevent forfeiture of land for debt, it has led to limited mobility for some farmers. One-hundred percent foreign ownership is permitted in most industrial and a number of service sector activities including banking, insurance, finance, construction, mass transportation, telecommunications and information technology, and petroleum distribution. There is no restriction on the repatriation of profits/dividends of foreign companies. 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 of 1995 implemented the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards and consequently, arbitral awards made abroad are enforceable in Sri Lanka, if the other party concerned is a state party to the same convention. Awards made in Sri Lanka are enforceable abroad, subject to the provisions of the Arbitration Act No. 11 of 1995.

While the regulatory requirements for the establishment of a new business are limited, the average time delay of 38 days is inordinate. Recent studies of regions

Property rights
8

Private enterprise
8

within Sri Lanka have identified several factors inhibiting the establishment of new enterprises, including unofficial “fees” and charges by public officials, the lack of a business-friendly attitude in the bureaucracy, and opaque and cumbersome procedures for business registration and licensing. The Rajapaksa government has rejected the further privatization of state enterprises, including state-owned banks, and electrical utilities. Instead, it seeks to retain ownership and management of these enterprises and to make them profitable. However, there are no plans to take over privately owned enterprises and recent changes liberalizing investment opportunities have provided more incentives for foreign investment.

10 | Welfare Regime

Sri Lanka’s HDI continues to be above that of many countries with higher per capita GDP because of its long-standing and comprehensive welfare programs. The Rajapaksa presidency has promoted a number of poverty alleviation programs. These include the Samurdhi subsidy program, a nutrition allowance program, dry rations for Internally Displaced Persons (IDPs), a Samurdhi social security program and a kerosene subsidy stamp program. These and some income generating schemes for the poor are estimated to cost \$90 million in 2011. The 2011 budget inaugurated provision of retirement benefits for those employed in the private sector and the self employed but this is expected to take a decade to mature.

Life expectancy at birth is 74 years – the highest in the region. Free health care has been implemented for over half a century but is challenged by financial constraints, with Sri Lanka falling behind Bhutan in public health expenditure as a percentage of GDP. The high incidence of malnutrition among children, the re-emergence of communicable diseases such as malaria and swine fever, and a demographic transition that has led to greater demand for care of the elderly are problems that need attention. Basic provision of education is comprehensive, with state or state-assisted schools providing education free from grade one to grade 12, but there is a shortage of teachers in foreign languages and in technical subjects. Tertiary education is not well funded. The rural population and most in the urban sector currently have no insurance coverage for natural disasters, disability and old age although a Samurdhi social security program has been launched to prevent poor families from falling into poverty due to childbirth and unexpected incidents such as deaths and hospitalization.

It is also important to note that the state’s welfare regime operates more efficiently for the majority community, partly because the government tends to support those who support it and a majority of Tamils do not support the Rajapaksa government. Many of the welfare programs that have been set up in the north east since the war ended have been funded by foreign governments and NGOs, not the government.

Social safety nets
6

Access to public services is open to all by law. There are however, inequalities in practice. The gender gap in educational enrollment or achievement is minimal, with literacy among females at 89.1% as opposed to 92.2 % for males and enrollments in primary and secondary levels comparable. However, men dominate the more lucrative levels of employment in both the public and private sectors and the average wage of females in the higher reaches of the formal sector is less than half that of men. There are regional and urban–rural disparities in the quality of the education system despite continuing efforts to develop magnet (Isuru) 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 severely limited in areas of conflict of the north and east, which has affected large numbers of minority Tamils and Muslims and some Sinhalese in the recent past and there has been little improvement in terms of minorities’ access to jobs (especially within the state system), although the government has tried to hire some Tamil policemen in the eastern province. Public officials often continue to demand that those who seek government services do so in Sinhala (the majority community’s language) and not Tamil.

Equal opportunity
6

11 | Economic Performance

The Sri Lankan economy could anticipate a very good performance in the coming years. The end of the global recession and the civil war led to a change in the growth rate from 3.5% in 2009 to about 8% in 2010. Consequently, the per capita PPP GDP which was \$4,778 in 2009 is expected to be well over \$5,000 in 2010. This rise was fuelled by improved agricultural production in rice, tea and other products and a revival of fisheries, although the production of rice will be adversely affected by the floods of early 2011. While garment exports are likely to grow more slowly due to the withdrawal of the GSP Plus market access benefit by the European Union in August 2010, the local market has continued to stimulate production. Tourism has begun to revive after the end of open conflict. A continued growth rate of around 8% is anticipated for the short term.

Output strength
8

Inflation as measured by the Colombo Consumer Price Index, which was 22.6% in 2008, was brought down to 3.4% in 2009 but climbed slowly in 2010 to reach 6.9% in December 2010 and is likely to remain in single digits in 2011.

Gross capital formation is projected to remain at the 25.3% reached in 2009 or to rise, but net FDI declined from 1.8% of GDP to 1% in 2009 and 2010 due to the global recession and lower rates of profitability. Sri Lanka responded in 2011 by reducing restrictions on foreign investment in certain sectors.

Unemployment (excluding the north) rose to 5.7% (5.3% in 2008) and while it should fall in 2011 due to extensive public projects, the statistics might not change

because the data for the war-torn north are likely to be included in the national figure for the first time in years in 2011. The rising commodity trade deficit is compensated for by a continuing inflow of private remittances (which increased 24% to \$4.1 billion in 2010) and multilateral loans.

Budget deficits held at under 7% 2006 – 2008 rose to 9.9% in 2009 and are being held at 8% in 2010 with the expectation that tax revenue (13.2% in 2008) will rise due to policies simplifying the tax system, rationalizing exemptions, improving tax compliance and strengthening tax administration. However, this is an area that needs attention if Sri Lanka is to control inflation, particularly because the economy remains vulnerable to the external shocks including a substantial rise in the price of oil.

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 inability of the politicized police to resist such actions by politically connected individuals worsens the situation. 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. New industries create environmental contaminants that pollute freshwater bodies. Environmental concerns tend to take a back seat to growth considerations. Ecologically sustainable growth gets only scant attention and is not reflected in the institutional framework.

Environmental
policy
5

The existing system of education at primary and secondary levels is comprehensive with gross enrollment at 100.2% at the primary level and 87% at the secondary level. Literacy is at 90.6% with female literacy at 89.1%. However, with total education expenses under 3% of GDP and with virtually all education run by the state, there are wide disparities in facilities between urban and rural areas. The government has begun to address this with a plan for 100 Isuru (magnet) schools but there is a long way to go. Facilities are poor in the war-torn north and east. Tertiary education continues to fall behind in quality. Private tertiary-education institutions provide post-secondary diplomas and link programs with foreign universities and the government has expressed support for new private tertiary institutions while continuing to expand the state structure. R&D expenditures are very low (0.17% of GDP in 2006). Modern infrastructure does not extend nationwide, but is limited to certain segments and enclaves such as major cities and modernized economic sectors.

Education policy /
R&D
5

Transformation Management

I. Level of Difficulty

In terms of structural constraints on the political process, the difficulty is medium. Sri Lanka does not have exploitable oil or coal resources. Continuing poverty in areas outside the Western Province, particularly in the plantations and in the north and the east, leaves sections of the poor excluded from the benefits of economic growth, and although current state policies are aimed at benefiting the rural poor, disparities between poor and rich seem to be rising. And, of course, there are the historical experiences of communal tensions and civil war which – also being the result of past political management (nation-building) – pose considerable structural constraints on the political process of democratic transformation.

Structural
constraints
6

On the other hand, Sri Lanka has a good geographical location, an educated labor force and a basic (though inadequate) system of internal transport. The incidence of pandemics is limited and the adverse impact of the 2005 tsunami was handled reasonably well. Much of the needed structural reform needed for an open economy has already been accomplished, with relatively broad consensus.

Civil society is only of limited use in overcoming Sri Lanka's structural constraints. Civil associations have taken an active role as guardians of civil and minority rights and have earned the increasing hostility of the government. Faith in democracy may have weakened in light of the various assaults conducted by the government on NGOs and the media over the past few years and the passage of the 18th Amendment. Patron–client ties are strong, and trust in state institutions is limited. There are numerous local religion-based organizations working on public welfare, but trade unions have been in decline.

Civil society
traditions
4

The end of the civil war in May 2009 has greatly reduced open conflict but it has left an ethnically divided citizenry and apprehension among many Tamils. The government's attempts to colonize the north east with transplanted Sinhalese settlers and the creation of army camps throughout former LTTE areas have led to concern among Tamils and Muslims and generated continued ill feeling among minorities. The establishment of new political structures that rebuild trust will be challenging in a context where the minority Muslim community is also increasingly conscious of its identity and where Christians feel threatened by the more militant

Conflict intensity
6

Buddhists. On the other hand, the coalition government at the center has representatives of all these groups and the prevailing rhetoric among those in power is the need for reconciliation.

However, the rhetoric of reconciliation needs to be matched with reconciliation on the ground.

II. Management Performance

14 | Steering Capability

President Rajapaksa's government has clear political, economic and social priorities and the capability to attain them. However, they do not necessarily coincide with the objectives of achieving normative democracy and a socially responsible market economy. On the political front, the objective of building a political stronghold was achieved through electoral success at the presidential and parliamentary elections. This was reinforced through the 18th Amendment to the Constitution that ended the restriction of a president to two terms in office and gave the president effective power to appoint those he wished to key positions including positions in the judiciary. On the socioeconomic front too, the priorities are clear. The southern province – a Rajapaksa power-base – has seen increased investment including the development of a new container port at Hambantota, financed with Chinese assistance. The president's philosophy, "Mahinda Chinthanaya," directs policy. It includes "Gama Neguma," a program to develop village infrastructure and rural opportunities, and Randora, a program of investment in infrastructure such as highways, power and irrigation primarily through more efficient and expanded use of state agencies. Privatization is explicitly ruled out and the importance of having a sound regulatory framework for public-private partnerships is emphasized.

Developing the south (especially in what is considered to be Rajapaksa country) is very much a strategic priority of the president. This, however, is done not to promote democracy and good governance (or due to a faith in free market economics) but because the regime believes development in certain areas of the country will allow the government to perpetuate its rule.

With freedom from dependence on coalition partners, the Rajapaksa government's agenda of economic reform has returned to its basic principles. The reform of tax laws and company regulations in 2006 – 2007 has been followed by the liberalization in rules for foreign investment (2009 – 2010). The main push is towards policies that favor the rural poor, including plans for pensions for workers in the informal sector and the control of the prices of basic foods and agricultural

Question
Score

Prioritization
5

Implementation
5

inputs. However, there is limited progress towards making the state sector less corrupt and more efficient. Economic inequality continues to grow.

On the political front, the push for greater control of power by the executive has been achieved through the 18th Amendment to the Constitution, the inducement of defections from the major opposition party and the imprisonment of the opposition candidate who won 40% of the vote at the 2009 presidential election.

Since the end of the war the government has had some success instituting a few big projects often using foreign aid (i.e., the Hambantota ports project and reconstructing some road networks). The government has appeared more competent in this regard than the previous one, although all this is done not to promote democracy and good and efficient governance or a market economy, but to perpetuate a family dynasty.

The political leadership's learning record is uneven. Learning processes are evident in newly launched economic programs that have been prepared by experts in state agencies including the central bank and draw upon best practices. In some instances, policies relating to loosening state controls over markets have resulted. Political learning is rather slow and incomplete, caused not by knowledge deficits but by the conflicting interests of powerful social groups and their political representatives, on whose support the government depends. Populist politics, and reluctance to embrace critical views inhibit progress in this field.

Policy learning
5

15 | Resource Efficiency

There has been some regression with regard to the efficient use of assets since the war escalated and the Rajapaksa family consolidated its control of the budget. The public sector is 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 transfers to undesirable locations. Auditing of state agencies is routine but there are continuing instances of leakages of state resources into private hands. Elected local and provincial assemblies have legally defined spheres of activity but do not have adequate financial resources. The budget deficit of 8% in 2011 is likely to lead to higher inflation in 2012.

Efficient use of
assets
4

Policy coordination through the administration is well-established; many central ministries have branches at the provincial level with coordination provided for by civil servants. On the other hand, this has undermined the scope of provincial and local governments due to limited vertical policy integration. The establishment of 61 separate ministries in the center has increased the scope for conflict, redundancies and friction although the increased centralization drive of the

Policy
coordination
5

presidency has ensured prioritization in some areas. In short, what often gets implemented is what the president and his family want implemented, but this has also led to more purposeful implementation of projects in some instances.

Corruption is deeply embedded at every level of the polity and administration. There is no prosecution of corrupt politicians in power. Public procurement systems are notoriously open to bribery and there is virtually no accountability of officeholders in terms of asset declarations and conflict of interest rules. State spending is audited, but party financing is not regulated. The media occasionally highlights glaring instances of questionable decisions. The president's family holds key positions of authority.

Anti-corruption
policy
5

16 | Consensus-Building

The two major parties (SLFP and UNP) agree on the long-term strategic goals of a market-based economy. However, the party in power, the SLFP, has placed greater emphasis on poverty eradication led by the public sector but within the framework of a market-based economy. Its leadership, represented by President Rajapaksa, has also proved willing to restrict democracy to crush opposition. This has led to reduced trust and cooperation. The Marxist JVP advocates state intervention in the economy, but its popular support has clearly dwindled. Minority Tamil and Muslim ethnic parties are primarily concerned about the protection of their constituents.

Consensus on goals
5

With the effective elimination of the LTTE after its military defeat, the major threat to democracy comes from the ruling party intent on keeping power after sweeping electoral successes in 2010. Under the Rajapaksa regime anti-democratic actors have been emboldened. The ruling party plans to hold provincial and local elections in March 2011 and its control over the media and the state apparatus is likely to give it a substantial victory, decimating the opposition. Indeed, relevant structures have now been instituted to disrupt free and fair elections and prevent the opposition mounting a strong challenge to the government. The military has not interfered in economic and political policy-making. Trade unions are weak except in a few sectors (e.g., power, transport, tea production). Under the current government anti-democratic actors have been emboldened. Given the president's immense popularity (mainly due to having vanquished the LTTE), there has been no reason to engage in major anti-democracy activities but relevant structures have now been instituted to disrupt free and fair elections and prevent the opposition mounting a strong challenge to the government. The executive–military nexus that took shape in recent times also does not bode well for democracy.

Anti-democratic
actors
5

The state has had some success moderating class conflict but that has been at the cost of escalating ethno-religious divisions. The major issue is the reconciliation of separatist Tamils of the north and east with the state. 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, are influenced by external events and have become more conscious of their identity and interests. The state has begun to fund the rebuilding of places of worship –irrespective of religion – that were damaged during the civil war. The establishment of a Ministry of National Languages and Social Integration in April 2010 marks some recognition of the importance of the ethno-linguistic divide in Sri Lanka, and the new ministry has put forward an ambitious plan to make the 1.2 million public servants trilingual (in Sinhala, Tamil and English).

Cleavage /
conflict
management
5

The political leadership does not make specific efforts to encourage the participation of civil society in the political process, but tries to manage civilian groups who seek to intervene in politics. Several journalists have been assaulted or disappeared during the review period. Intellectuals who criticize state policies do find outlets in the media but also find themselves under attack. Professional associations and interest groups are able to influence the state only in certain narrow areas.

Civil society
participation
4

The end of Sri Lanka's civil war (which is estimated to have resulted in 80,000 deaths) in May 2009 led to a debate on atrocities during the war and on charges of torture and executions by Sri Lankan armed forces during the concluding stages. Many of these charges were raised by the pro-rebel media which had not condemned rebel atrocities, but some video evidence of extra-judicial killings raised troubling questions. President Mahinda Rajapaksa appointed the eight-member Lessons Learnt and Reconciliation Commission (LLRC) in May 2010 to investigate whether any people, group, or institution bears any responsibilities for the conflict, and suggest measures to prevent such conflicts from happening in the future and to mete out restorative justice to the conflict-affected. This was seen by many international actors as a defensive measure. In June 2010 UN Secretary General Ban Ki-Moon appointed a three member panel of experts to probe human rights violations "during the final stages" of the civil war in Sri Lanka. The Sri Lankan government has refused to let the UN conduct an independent investigation in Sri Lanka and has offered merely to let the UN panel testify before the LLRC. This has created the impression that the government has no interest in seeking justice for crimes committed during the conflict, except in the case of crimes committed by the LTTE, and that the government would not allow an investigation into any atrocities by military and state personnel.

Reconciliation
2

In a broader context both the majority Sinhalese and the minority Tamils see themselves as victims of historical acts of injustice, the former during colonial

times and the latter in the period since independence. The continuing ethnic divide (which extends to a lesser extent to the Muslims) hinders progress toward reform goals.

17 | International Cooperation

The Sri Lankan state has worked successfully with the IMF and World Bank in the past decade and continues to do so. International actors have influenced state direction in economic policy, moderating populist influences in the last two years. World-Bank-financed projects are mostly in the area of education, irrigation, roads and healthcare and loans averaged over \$200 million a year in the four year period to June 2012. In June 2009 the IMF agreed to lend \$2.6 billion in the next two years and this enabled Sri Lanka to continue replenishing its reserves during the global recession.

Effective use of support

6

Sri Lanka's readiness to work with the West in development has become more limited due to Sri Lanka's refusal to link human rights issues with trade concessions and aid. This was what led to the end of GSP+ tariff concessions from the EU in August 2010 (with an estimated loss of \$150 million in trade annually).

On the other hand, Sri Lanka has developed stronger connections with China, which took over building of a new container port in Hambantota in the south and became Sri Lanka's major aid donor (displacing Japan). Russia and Iran have also stepped in as donors and India has pledged development assistance in the war-torn north. All of this denotes a move away from dependence on the West and fits well with the regime's efforts towards economic development without democratic evolution.

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

Credibility

6

It is less credible in its record on protection of human rights, press freedom and democracy. International NGOs are often seen by the Sri Lankan government as subversive forces.

Sri Lanka has excellent relations with its neighbors. Free trade agreements with India and Pakistan have significantly lowered tariff barriers and encouraged trade. Sri Lanka is a member of the regional body SAARC and continues to develop educational and economic links with its neighbors.

Regional cooperation

9

Strategic Outlook

There are two areas in which Sri Lanka's policies might be encouraged:

Economy: The Sri Lankan state has made continued progress toward a market economy and demonstrated its ability to deal with shocks including the recent global recession. Inflationary pressures have been kept under control, and due to substantial private individual remittances from the Middle East, the external current account is likely to have a surplus in spite of rising oil prices in 2011. Some steps have been taken towards greater legal public access to information, the publication of annual accounts of state enterprises and strengthening auditing and reporting procedures. Further transparency and efficiency in the legal and administrative framework will reduce the transaction costs of business enterprises and promote investment, but this is an area of progress.

Social Justice: Sri Lanka's emphasis on reducing rural poverty is a good start towards sustainable development. Sri Lanka has made good use of loans and grants offered by international bodies and friendly countries such as China, Japan, Russia, India and Iran to achieve progress but much remains to be done. Improving law and order, and ensuring better access to the judicial system should be part of this vision. Of equal importance is the improvement of education quality and access.

There are several areas in which policy changes are recommended:

Reconciliation: Ethnic reconciliation and a political settlement relating to the devolution of power is a key issue. The appointment of the Lessons Learnt and Reconciliation Commission by the Sri Lankan state has met with skepticism. Sri Lanka's refusal to let the UN Secretary General's panel investigate violations of human rights at the end of the civil war and its disputes with the EU on human rights guarantees have not inspired confidence among Sri Lanka's minorities. However, President Rajapaksa has a secure majority in the legislature and popular support among the majority, so is in a unique position to build a consensus on the issues of minority rights and devolution of power.

Political Democracy: The concentration of power in the Sri Lankan presidency has attenuated the independence of the judiciary and led to the increased politicization of the administration, the police and the armed forces. It is in the interests of all, including the ruling party, to give continuing media access to the opposition because the recent history of violence in Sri Lanka has suggested that the alternatives are not desirable. The international community should be prepared to deal with a country that experiences democratic regression in the near future as President Mahinda Rajapaksa's family seeks to further consolidate its power.

Environment: Environmental issues should be linked to sustainable development. The government needs to engage the private sector, NGOs, civil society and other stakeholders in

extensive talks to build a development policy consensus that pays greater attention to environmental concerns. Sixteen of Sri Lanka's coastal lagoons – that make up half of the country's wetlands – are classified as threatened. This is mostly due to development for tourism and recreational purposes, fisheries, fish farming, industrial development, unrestricted disposal of untreated sewage, large-scale sand mining and housing. Growing population pressure and some cultivation and clearing practices have led to enhanced vulnerability to natural disasters such as landslides and floods. Existing legal instruments need to be fully utilized and strengthened.