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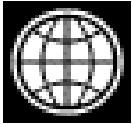
# **Sri Lanka**

## **Strengthening Social Protection**

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Human Development Unit  
South Asia Region

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## **CURRENCY AND EQUIVALENT**

Exchange Rate = Annual Average, 2006

Currency Unit = Rupees (Rs.)

US\$1 = Rs. 100.499

### **FISCAL YEAR**

January 1 – December 31

### **ABBREVIATIONS AND ACRONYMS**

A/L	Advanced Level
ALMAO	All Lanka Mutual Assurance Organization
CEPA	Center for Poverty Analysis
CIMO	Integral Quality and Modernization Program
CSPS	Civil Service Pension Scheme
DC	Defined Contribution
DCS	Department of Census and Statistics
DB	Defined Benefit
EPF	Employees' Provident Fund
ETF	Employees Trust Fund
GCE	General Certificate of Education
GDP	Gross Domestic Product
HIES	Household Income and Expenditure Survey
HRMIS	Human Resources Management Information System
ICA	Investment Climate Assessment
IDP	Internally Displaced Person
ILO	International Labour Organization
LTTE	Liberation Tigers of Tamil Eelam
NGO	Non-Governmental Organization
OECD	Organization for Economic Cooperation and Development
O/L	Ordinary Level
PMTF	Proxy Means Test Formula
SLIS	Sri Lanka Integrated Survey
SP	Social Protection
SSSTF	Samurdhi Social Security Trust Fund
TEWA	Termination of Employment of Workman Act
UCEP	Underprivileged Children's Education Program
UI	Unemployment Insurance
UNICEF	United Nations Children Fund

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# CONTENTS

<b>EXECUTIVE SUMMARY</b> .....	<b>i</b>
<b>1. POVERTY AND VULNERABILITY</b> .....	<b>1</b>
1.1 GROWTH, INEQUALITY AND POVERTY.....	1
1.2 SOURCES OF RISK.....	3
Aggregate Shocks.....	4
Individual-Specific Risks.....	5
1.3 POVERTY PROFILE.....	6
Regional Poverty.....	8
Children.....	8
The Poor and Vulnerable Among the Working Age Population.....	11
The elderly.....	13
<b>2. ENHANCING EMPLOYMENT OPPORTUNITIES AND EMPLOYABILITY</b> .....	<b>14</b>
2.1 KEY LABOR MARKET TRENDS AND OUTCOMES.....	15
2.2 LABOR MARKET INSTITUTIONS: IMPACT ON EQUITY AND GROWTH.....	16
Severance Pay.....	16
Wage Setting Institutions.....	20
Civil Sector Hiring Policies.....	21
2.3 ENHANCING LABOR SUPPLY BY INCREASING EDUCATION AND TRAINING OF THE POOR.....	24
2.4 POLICY OPTIONS.....	28
Reforming Labor Market Institutions: Moving from Job to Worker Protection.....	30
Improving Access to Education and Training.....	32
<b>3. IMPROVING SOCIAL INSURANCE</b> .....	<b>34</b>
3.1 FORMAL SOCIAL INSURANCE SCHEMES.....	35
Old Age Income Support through Pensions.....	35
Disability and Survivors Insurance.....	37
Unemployment Insurance.....	38
3.2 SCHEMES FOR THE INFORMAL SECTOR.....	38
Pensions.....	38
Disability and Survivors Insurance.....	39
Unemployment.....	40
Cross Cutting Issues.....	40
3.3 POLICY OPTIONS.....	41
Improving the Coverage and Efficiency of Formal Sector Schemes.....	41
Developing a coherent approach to the risks of death, disability, and ill health.....	44
Building Blocks of Unemployment Insurance System Adapted to Sri Lanka.....	44
Improving Coverage and Efficiency of Informal Sector Schemes.....	46
<b>4. COPING WITH RISK: SOCIAL SAFETY NETS</b> .....	<b>49</b>
4.1 OVERVIEW OF SOCIAL SAFETY NET INTERVENTIONS.....	49
4.2 INCOME TRANSFER PROGRAMS.....	52
The Samurdhi Program.....	52
Income Support for Disabled.....	57

4.3	COPING WITH LARGE-SCALE DISASTERS, DROUGHTS, AND DISPLACEMENT .....	59
4.4	REFORMING SAFETY NETS .....	61
	(a) Reforming the Samurdhi System: Addressing Chronic Poverty.....	61
	(b) Options for Helping the Poor Escape Poverty.....	65
	(c) Helping the Poor Cope with Vulnerability .....	67
<b>5.</b>	<b>CONCLUSIONS AND RECOMMENDATIONS .....</b>	<b>71</b>
5.1	SUMMARY OF ANALYTICAL FINDINGS.....	71
5.2	GAPS IN KNOWLEDGE .....	75
5.3	POLICY DIRECTIONS.....	75
	<b>BIBLIOGRAPHY .....</b>	<b>80</b>
	<b>ANNEXES.....</b>	<b>88</b>

## Boxes

Box 1.1:	Definition of poverty and vulnerability .....	8
Box 1.2:	Life cycle effects of child malnutrition .....	11
Box 2.1:	Helping job-seekers to be placed in the private sector .....	24
Box 2.2:	Training for the informal sector: The Jua Kali experience, Kenya .....	30
Box 2.3:	A proactive approach to small- and medium-size enterprise support.....	31
Box 2.4:	Bangladesh: underprivileged children’s education program (UCEP) .....	33
Box 3.1:	Examples of informal social security schemes in Sri Lanka .....	40
Box 4.1:	The voluntary sector.....	51
Box 4.2:	How much money will it take to move people out of poverty through income transfers?.....	56
Box 4.3:	Developing a proxy means test formula .....	64
Box 4.4:	Community participation in targeting welfare benefits-Sri Lanka’s experience with Janasaviya... 65	
Box 4.5:	Conditional cash transfers as a way to improve school attendance, health and nutrition of the poor .....	66
Box 4.6:	Combining public works with financial services .....	67
Box 4.7:	Key design elements of a successful workfare program .....	69
Box 4.8:	Emergency labor redeployment project.....	70

## Figures

Figure 1.1:	Growth of GDP and GDP per capita, 1991-2003 (in percent).....	1
Figure 1.2:	Change in consumption expenditure by quintile, 1980-2002 (per adult equivalent, in %) .....	2
Figure 1.3:	Index of real GDP change by province, 1996-2003 (in percent).....	3
Figure 1.4:	Incidence of poverty by sector, 1990/91-2002 .....	3
Figure 1.5:	Demographic ageing, Sri Lanka and world regional averages (percentage of population over 60 years old, 2000-2050).....	5
Figure 1.6:	Employment losses in tsunami-affected districts .....	6
Figure 1.7:	Income and expenditure by province.....	9
Figure 1.8:	Children with low weight for age (percent).....	11
Figure 1.9:	Formal and informal employment, 1997-2003 (in million).....	12
Figure 1.10:	Share of unemployment by income decile, 2002.....	13
Figure 2.1:	Labor force participation rate, total and by gender, 1994-2003 .....	15
Figure 2.2:	Employment by type of job, 1992-2003 (in million).....	15
Figure 2.3:	Unemployment rate by age group.....	15
Figure 2.4:	Unemployment rate by education .....	16
Figure 2.5:	Job creation and job destruction flows .....	19

Figure 2.6: Number of firms by size, 2000-03 .....	19
Figure 2.7: Employment growth of firms (deviations from the common growth trend), 1995-2003 .....	19
Figure 2.8: Coverage of TEWA by income quintiles (in percent, 2000) .....	20
Figure 2.9: Education by sector of employment .....	25
Figure 2.10: Reasons for not attending school, in percent (for those who have dropped out) .....	25
Figure 2.11: Children in communities with poor school resources, by expenditure quintile (percent of total) .....	25
Figure 2.12: Education and training received by disabled, 2003 (by type of disability, in percent) .....	27
Figure 4.1: Expenditures of the Ministry of Samurdhi and the Ministry of Social Welfare (percent of GDP) .....	52
Figure 4.2: International comparison of social assistance expenditure (percent of GDP), 1996-2003 .....	53
Figure 4.3: Growing outreach of the Samurdhi program .....	55
Figure 4.4: District allocations for Samurdhi income transfers .....	58

## Tables

Table 1.1: Vulnerability to shocks by members of microfinance institutions, 2004 .....	6
Table 1.2: Reproductive health indicators by socio-economic groups, 2000 .....	7
Table 1.3: Probit estimates of the probability that a household is poor, 2002 .....	10
Table 2.1: Job flow dynamics, 2001/02 and 2002/03 .....	18
Table 2.2: Estimation of earnings function (per hour take-home and total pay), 2000 .....	22
Table 2.3: Analyses on gender-wage/earnings differentials .....	23
Table 2.4: Analyses on ethnicity-based wage/earnings differentials .....	23
Table 2.5: International comparison of intergenerational schooling correlations .....	27
Table 2.6: Summary of impact evaluations of active labor market programs .....	29
Table 3.1: Nominal, actual and potential coverage of formal old age schemes, 2002 .....	36
Table 3.2: Options for old age income support schemes by redistribution, required pre-funding, and risk allocation .....	43
Table 4.1: Social safety nets expenditures, 2000-04 (Rs. Million) .....	50
Table 4.2: Samurdhi eligibility criteria .....	54
Table 4.3: Samurdhi recipients by category of allowance, and of 2002 .....	55
Table 4.4: Samurdhi program, deductions of compulsory payments (Rs.) .....	56
Table 4.5: Public works organized in tsunami-affected areas, 2005 .....	61
Table 5.1: Summary of social protection programs, key issues, and proposed policies .....	73

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## EXECUTIVE SUMMARY

*“... given the near universality of market failures in poor countries, it should be possible, with a combination of careful research and good thinking, to identify opportunities for redirecting resources to poorer people who are in a position to make very good use of them.”*

*World Development Report 2006*

1. **Sri Lanka’s accomplishments in the area of social policy surpass most developing countries.** Sri Lanka has made stellar progress on the millennium development goals: the country has already attained universal primary education and completion and has achieved gender parity at primary and secondary education levels. Sri Lanka’s child and infant mortality rates are unusually low relative to other developing countries, and also compare favorably with some middle income countries. While challenges remain—particularly in improving the quality of education services, tackling persistent child malnutrition, and addressing regional disparities in social outcomes—Sri Lanka’s accomplishments are remarkable for a developing country, particularly one that has endured a 20 year civil conflict (World Bank 2005a).

2. **Sri Lanka’s performance on poverty reduction has been more modest.** Almost a quarter of Sri Lankan population is poor, with poverty concentrated in rural areas. Despite average annual economic growth of 4.5 percent in the last decade (1994-2003), the decline in poverty has been modest, dampened by growing inequality.<sup>1</sup> If inequality had not increased, poverty reduction would have been more than 5 fold higher. That said, given its much higher level of income, poverty rates in Sri Lanka are still much lower than for most South Asian countries (World Bank 2005a) and while inequality is much higher than most countries in the region, it is far lower than for many Latin American countries (World Bank 2006).

3. **Aside from poverty (low income), Sri Lankans also face considerable vulnerability to income shocks.** The poor, with few assets and limited access to markets, are often the hardest hit, but income shocks can also drive many non-poor into poverty. Results from a recent survey, consistent with results from other South Asian countries, show that the major *individual* risks faced by Sri Lankan households are sickness, disability and death of a family member and unemployment, and the main *community-wide (aggregate)* shocks include drought, crop failure, and other natural disasters (the most recent and disastrous being the tsunami).<sup>2</sup> Moreover, Sri Lanka has one of the most rapidly aging populations in South Asia. Over the next 25 years, the share of the population over 60 will double from about 10 to 20 percent and this demographic trend will have an aggregate impact on the economy,

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<sup>1</sup> Gini Index of per capita consumption expenditures, a measure of inequality, increased from 0.32 to 0.40 over the period 1990/91 to 2000.

<sup>2</sup> The microfinance survey found that over a twelve month period, over a half of households experienced significant income shocks, with 21 percent of households being exposed to sickness, injury and death, 16 percent to unemployment, 23 percent to natural calamities, and 18 percent to crop failures in Sri Lanka is amongst the highest in the region, it is lower than found in many countries of Latin America.

potentially changing patterns of labor force participation and the composition of health care, and imposing a strain on traditional and formal income support systems.<sup>3</sup>

4. **There are several poor and vulnerable groups deserving attention.** Among *children*, these groups include those living in large families (the poverty incidence of households with 3 children is 57 percent above the national average and of households with 4 or more children is more than double the national average), disabled children and child workers/street children, children affected by the conflict (child soldiers), children who drop out from school (though their numbers are very small relative to other South Asian countries), and malnourished children. Among *working age adults*, the most poor and vulnerable are informal sector workers living in remote and infrastructure poor areas (particularly uneducated, casual and own-account workers), unemployed youth from low income families, displaced due to the civil conflict or natural disasters, and the disabled. Among *the elderly*, only the oldest face above-average poverty rates (the incidence of poverty among households with member over 80 years old is 10 percent above the national average), but rapid aging of the population may lead to strains in the traditional and formal income support systems and contribute to future vulnerability among the elderly.

5. **Sri Lanka is committed to promoting equitable growth and has instituted several social protection programs.** A fairly extensive social protection system comprises three main components: (i) *employment protection and promotion*: labor legislation, unions, collective bargaining and related institutions, and training/retraining of workers; (ii) *social security/insurance programs*: pensions, disability, survivor insurance (coupled with universal health coverage); and (iii) *safety nets*, or protection of last resort: mainly cash transfers and social welfare and care services. Informal networks, including those relying on migration and remittances, continue to have an important role in helping people weather chronic poverty and income shocks, but the viability of such networks given urbanization and aging is in question; and evidence suggests that informal arrangements are not able to provide protection against community wide shocks.<sup>4</sup>

6. **This report reviews Sri Lanka's social protection programs and proposes strategic options for enhancing their role in promoting growth with equity.** Well designed social protection (SP) systems can help address poverty and inequality through redistribution, and mitigate risks and facilitate employment opportunities, thus contributing to both growth and equity goals.<sup>5</sup> The report first identifies the poor and vulnerable (chapter 1) and then reviews and evaluates employment protection and promotion policies and programs (chapter 2), social security/insurance schemes (chapter 3), and safety net programs (chapter 4) and proposes policy options. The concluding chapter summarizes key analytical findings and presents a unified policy framework to improve social protection. The report relies mainly on extensive existing literature from Sri Lanka and international researchers. The remaining part of this section

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<sup>3</sup> While more evidence on income shocks is merited, risks facing Sri Lankan households are not dissimilar to those affecting other households in South Asian region. Recent evidence on income risks in such diverse countries as Afghanistan, India (Andhra Pradesh) and Maldives suggest that health and disability shocks are amongst the most important income shocks (in terms of frequency and lost income) faced by households in these countries (World Bank 2005b, 2005c, 2005d). And South Asian countries are highly prone to natural disasters, as the most recent earthquake in Pakistan bears witness.

<sup>4</sup> See Townsend (1994), Morduch (1995, 2002), Ravallion and Chauduri (1997), and Munshi and Rosenzweig (2005) for evidence on informal support networks in promoting consumption smoothing.

<sup>5</sup> See World Bank (2001) for a description of how social protection issues are addressed by the social risk management framework, and World Bank (2005e) for a discussion of how equity contributes to growth. Note that social risk management approach categorizes mechanisms into three categories: (i) those that reduce social risks (for example, reduce the probability of becoming unemployed or sick); (ii) those that mitigate social risk (for example, reduce the impact of unemployment or sickness); and (iii) those applied in response to the undesirable event—coping mechanisms (for example, social assistance).

summarizes the main issues and policy options. (The main results of the poverty and vulnerability chapter have been detailed in paragraphs 2-4 above.)

## **I. Sri Lanka's Social Protection System**

7. As in most countries, Sri Lanka's social protection system has three main elements: employment protection and promotion; social security/insurance, and safety nets. Its coverage is much more extensive than in other South Asian countries, with up to a third of the workforce covered in case of employment protection and social security, and about 40 percent of households covered in the case of the largest safety net (cash benefit) program. Social protection expenditures amounted to approximately 3 percent of GDP in 2004 (2 percent for pensions and 1 percent for safety nets)—but the large implicit debt of the pension system (estimated at 60 percent of GDP) means that the above costs underestimate the full fiscal costs of the social protection system.

### **1. Employment Protection and Promotion**

8. **Sri Lanka is to be commended for providing basic protection of core labor standards—albeit to formal sector workers.** Sri Lanka has ratified eight ILO conventions on core labor standards, including the right to collective bargaining and freedom of association. Tripartite mechanisms for social dialogue have been in place for a long time and trade unions, employers and the government interact collectively to resolve critical issues in industrial relations, e.g., wages and other disputes. While the problem of child labor (street children and child soldiers) remains, strong child focused policies (e.g., inclusive education system and employment protection) have led to one of the lowest rates of out of school children (and incidence of child labor) in all of South Asia. Gender discrimination in wages is present—women earn less than men, as a result of productivity differences, but also because of other non-economic factors—but there is no evidence of ethnicity-based differences in earnings.

### **Key Issues**

9. **However, Sri Lanka's labor market institutions provide excessive job protection for formal sector workers.** Sri Lanka's severance pay (TEWA) system is one of the most restrictive severance pay systems in the world (for example, a Sri Lankan worker with 20 years of experience is awarded by a severance pay of 39 monthly wages vs. average of 16 in other Asian countries and 6 in OECD countries), and the process of separation requires prior approval by the Labor Commissioner and is thus non-transparent and arbitrary. Wage setting institutions have also considerably raised the returns of public sector workers and 'protected' private sector workers (covered under the TEWA) relative to informal sector workers. Adding to perverse labor market incentives (and contributing to government over-staffing) are patronage-based appointments to the civil service.

10. **Excessive job security leads to lower productivity and exclusion of vulnerable workers from formal sector jobs.** Labor market institutions that encourage worker voice can help reduce discriminatory practices, enhance work place health, safety, and training—improving equity and productivity of covered workers.<sup>6</sup> However, international evidence suggests that excessive protection to incumbent workers ('or insiders') can reduce the reallocation of labor required to enhance economic productivity. It is perhaps not surprising, then, that job flow rates in Sri Lanka are far lower than those found in developed, transition and other developing countries (in early 2000s, Sri Lanka's job creation rate was 8 percent and job destruction rate was 4 percent, vastly lagging behind the average job creation

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<sup>6</sup> For an extensive survey on the literature of the economic and employment impact of unions and collective bargaining see Aidt and Tzannatos (2000), based on OECD experience, and World Bank (2005) and Nickell and Layard (1997), based on experience of other countries.

rate of 14 percent and job destruction rate of 11 percent in selected 17 developed, transition and developing countries, see chapter 2). Moreover, international evidence shows that restrictive employment protection legislation, like the TEWA, reduces job prospects of vulnerable groups (or ‘outsiders’) e.g., women, youth, and informal workers, as observed in Sri Lanka.<sup>7</sup> Thus excessive protection of workers has not only efficiency costs, but also results in exclusion of vulnerable groups from the labor market.

**11. Wage setting institutions increase wages of formal sector workers relative to informal sector workers.** There is compelling evidence that wage setting institutions (unions and collective bargaining, tripartite pay commissions) have created an artificial gap between better-paying jobs in the public and the “protected” private sector, and low-paying jobs in the “unprotected” private sector. Empirical analysis shows that public and formal private sector jobs command an important wage premium which cannot be explained by the productive characteristics of the workers. Other things equal, returns of public sector workers are 14 percent more, and returns of the ‘protected’ private sector workers (covered under the TEWA) are 11-12 percent more than returns of informal sector workers. In addition, public sector workers enjoy other benefits such as tax exemption, job security and non-contributory pensions. Unions are also more likely to be active in this sector, compelling greater compliance with protective labor legislation and engaging in collective bargaining. However, women earn less than men, as a result of productivity differences but also because of other factors, such as discrimination. On the positive side, there is no evidence of ethnicity-based differences in earnings (with few exceptions, studies show statistically insignificant differences in earnings, once differences in observable characteristics of individuals are accounted for).

**12. Recent evidence supports that high unemployment is linked to the queuing and institutional hypotheses for labor market rigidities.**<sup>8</sup> The civil service wage premium attracts job-seekers to queue and thus generates unemployment. Similarly, the wage premium of TEWA-covered jobs increases costs and reduces labor demand. Note that TEWA-covered jobs also carry non-wage costs—the expected costs of layoffs (if explicitly acknowledged at the time of the contract, the expected costs of layoff should reduce wages, and so the amount of the wage premium of the TEWA jobs underestimates the additional costs borne by employers). Adding to perverse labor market incentives (and contributing to government over-staffing) are patronage-based appointments to the civil service as a way of obtaining political support or fulfill promises, with insufficient private job creation often used as a rationale (in the 2005 Budget announcement, for example, 30,000 graduates were recruited and 40,000 temporary staff were made permanent).

**13. Informal sector workers have lower education levels which reduce their labor market prospects—a result, in part, of high dropouts among children from poor families.** Many school dropouts can only qualify for unskilled occupations, the occupations which are paid the lowest and which are associated with the highest poverty incidence. In 1999/2000, 7 percent of 5–14 year olds did not attend school. Dropouts occur both because poor families cannot afford schooling costs and because the expected benefits of schooling for children from poor families are low. Direct and opportunity costs of schooling of poor families are relatively higher because by sending children to school, the sacrifice in terms of foregone work at home and direct costs of schooling are higher than the sacrifice of non-poor families. Expected returns of schooling for poor children are lower because their schooling is of lower quality and because they lack the social networks which would enable them accessing higher paying jobs.

**14. Sri Lanka has few passive or active labor market programs, with scope for piloting new approaches.** Publicly administered and provided *active* labor market programs (job counseling,

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<sup>7</sup> See, for example, OECD (1999) and Elmeskov, Martin and Scarpetta (1999) for the impact of strict limitations on terminations of employees.

<sup>8</sup> We are referring to the findings of Rama (2003), World Bank (1999), and Heltberg and Vodopivec (2004).

information, training, wage subsidies) exist on a very small scale in Sri Lanka, and their effectiveness is not known. Indeed, this is quite positive as Sri Lanka can design and develop programs based on an evaluation of both domestic interventions and international experience. Evidence from OECD countries suggests that publicly provided programs are often very costly and ineffective, with job counseling/search and job information being the exception. Well targeted programs to vulnerable groups can also be effective, but their cost needs to be carefully controlled. Evidence from developing countries suggests that privately provided, but publicly regulated training programs work best to link job seekers to jobs. The Government is considering the introduction of a *passive* labor market program: a formal unemployment insurance (UI) system, modeled largely on an OECD model. However, international evidence suggests that unemployment benefits need to be much more simply designed if implemented in low income countries (World Bank 2003). Sri Lanka is also addressing unemployment among youth by preparing a national action youth plan for implementation in the coming year.

### ***Policy Options***

15. Strong economic growth, a sound investment climate, and high quality education systems are critical for improving employment, productivity and wages for all workers. However, well functioning labor market institutions that balance job and worker protection also importantly contribute to favorable labor market outcomes.

16. **Reducing excessive job security for formal sector workers will not only enhance productivity, but also improve job prospects for vulnerable groups.** The costly protection of formal sector *jobs* via excessive termination benefits could be gradually reduced to international norms. In particular, it would be important for policy makers to reconsider maintaining the exceedingly high costs of separation and the discretionary power of the Labor Commissioner for granting permission for layoffs. Avoiding direct government interference in wage setting (apart from setting of minimum wages) would also reduce labor costs. Ad-hoc recruitment of unemployed graduates should also be reconsidered, as it reduces incentives for youth to take non-government jobs. Reducing excessive protection for ‘insiders’ could, in tandem with other economic reforms, promote job flows, and hence higher economic productivity. Increasing access to formal sector jobs (with greater access to basic workers rights and social security—see next section) for ‘outsiders’ or less educated and marginalized workers would also promote equity and contribute to a reduction in labor market duality.

17. **Replacing ‘job’ protection with ‘worker’ social protection programs can promote market efficiency and helps allay the political costs of reform.** Reducing job protection for formal sector workers is politically difficult, to say the least, and often meets with stiff resistance from ‘insiders’ because it increases the prospects of layoffs and dismissals from previously protected jobs. Yet, many countries have taken this difficult step. Promoting social dialogue and negotiating solutions acceptable to all stakeholders have been critically important for fostering change. Ensuring protection of *basic* workers rights is also essential. Moreover, the introduction of well designed, cost-effective active and passive labor market programs that provide more efficient protection to workers in the long run (in lieu of protection of jobs) and that help allaying the short term political costs of reforms has proved instrumental in achieving this policy shift (for example, in Eastern European countries).<sup>9</sup> Once in place, active and

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<sup>9</sup> During the early transition of Eastern European countries, reductions in job protection were accompanied by the active and passive programs to ease restructuring/layoffs. While the programs were initially generous and increased fiscal costs, their generosity was significantly reduced over time, as the goals of the restructuring agenda were met, though reducing entitlements was difficult (see Vodopivec, Wörgötter and Raju 2005). That said, it should be noted that too generous worker protection programs can also impede effective functioning of the labor market, and these programs also need to be cost effective in design (World Bank 2000).

passive programs also facilitate restructuring efforts and thus promote dynamic efficiency. Sri Lanka is already taking steps to create a more explicit ‘worker’ protection system to support less stringent protection of jobs, but a key challenge will be to adapt these programs to the fiscal and administrative capacity of the country. In this respect:

- **The unemployment insurance program will need to be adapted to Sri Lankan context.** This program could potentially lay the foundation for a more efficient protection of formal workers and ease the political costs of reducing job protection, but its design, costs, and administration will need to be modified from a standard OECD model and adapted to the Sri Lankan context (see social insurance section below).
- **Active measures to enhance skills/employability of lower income workers should be piloted, prior to scaling up.** Strengthening cost-effective programs (e.g. job counseling/information) and providing informal sector workers better access to well designed and affordable training through demand driven, private sector based approaches could bring greater equity and productivity gains. Programs specifically targeted to women, youth, disabled, and the poor living in remote rural areas could also be piloted (for youth and disabled these pilots should be based on the recommendations of national action plans).

## 2. Social insurance

18. **Sri Lanka provides the most extensive social security (pensions, disability, survivor and health) coverage in South Asia.** The provision of social security is largely tied to participation in the formal sector, although since the 1990s, a new public sponsored scheme reaches a significant number of farmers and fishermen, despite its voluntary nature. Together, these programs cover a third of the population, much more than any other South Asian country. Aside from pensions, these workers are offered disability and survivor insurance as part of their benefit package. Coverage for medical expenses/drugs to cope against catastrophic health shocks is provided through a universal health insurance scheme that is not tied to scheme membership, although formal sector workers have added benefits.

### *Key Issues*

19. **Nevertheless, the coverage of current schemes is limited and their administration and financial sustainability could be considerably strengthened.** *First*, there are large gaps in coverage, with the vast majority of informal sector workers lacking coverage and considerable evasion among those in the formal sector. Two thirds of the labor force remains without insurance for life’s major risks in the face of dramatic demographic ageing trends. *Second*, pensions provide some consumption smoothing over the life cycle only for civil servants, but not for workers participating in other retirement schemes. The Employees’ Provident Fund provides insufficient benefits due to low investment returns, a low pensionable age, and the lump sum payout that does not offer longevity insurance (for outliving one’s savings). *Third*, the fiscal sustainability of these schemes is questionable. At 2 percent of GDP, Sri Lanka has the highest pension spending on civil service pensions in the region, and preliminary estimates indicate that the pension system faces an unfunded liability on the order 60 percent of GDP. Although the EPF is a defined contribution scheme which is self-financing by definition, it, too, depends on government financial capacity because practically the entire EPF portfolio consists of government

paper.<sup>10</sup> And *fourth*, pension programs have weak administration and regulation, and limited portability of benefits (pension rights that are not transferable across jobs) constrains labor mobility.

20. **Two publicly sponsored programs offer social security for informal sector workers, but face similar and even more complex challenges.** Farmers, fishermen and self-employed are the main groups served by these programs. Because these workers do not earn regular wages, their contributions and benefits are set in flat nominal terms and both are steadily eroded by inflation. Minimum pensions have been increased by fiat. In the long run, the relationship between the assets and the liabilities in these two schemes may lead to broken promises, a massive bailout, or both. Administrative costs are high, eating into members' contributions, and investments are once again concentrated in government paper.

21. **Informal sector workers also participate in quasi-formal group arrangements for death benefits.** There exist a large number of self-help associations that have traditionally provided funeral assistance or death benevolence benefits, and they have recently been joined by a few non-governmental organizations. However, the benefit levels of these schemes are set ad hoc and are not indexed to inflation, the financial sustainability of schemes is not known, and their regulation and administration are likely to be weak.

22. **As noted above, a formal unemployment insurance (UI) system is being considered and workfare programs—a safety net cum unemployment insurance program for informal sector workers—are largely ad hoc.** The government has formulated several OECD type proposals for unemployment insurance programs, but this scheme will be geared to formal sector workers. To provide income support for the workers in the informal sector, *workfare schemes* exist on an ad-hoc basis, but Sri Lanka does not have a permanent workfare scheme (offering low wages to target the most vulnerable able bodied workers) that can be scaled up to help informal sector workers earn benefits in times of unemployment caused by layoffs or natural disasters, and scaled down when these emergencies are passed (a well-known example of such a scheme is provided in Argentina).

### *Policy Options*

23. **Social insurance institutions could substantially improve their services, as well as expand their coverage and scope, and financial solvency.** In the short run, important gradual reforms include:

- **Improvements in the functioning of old age income support schemes, and consideration of possibilities to expand coverage to the informal sector.** In the case of the civil service scheme, these measures include gradually reducing target replacement rates (pension benefits as a share of individual's wages) and introducing employees' contributions, increasing retirement ages in Employees' Provident Fund and approved retirement schemes, and improving the linkage of benefits to contributions (or introducing fully contributory schemes) rather than specifying nominal benefits and contributions in schemes covering informal sector workers. Moreover, with regard to death and disability insurance, public policy objectives should be clarified with a view to reducing arbitrary differences and inequities between workers. Once again, political economy considerations will be important, especially in case when benefits are affected. However, many countries have addressed this issue by introduced changes very gradually, with several options, including grandfathering, available to workers impacted by the change (e.g., India, Russia).
- **Adaptation of the proposed unemployment insurance scheme and a consideration of workfare** to address unemployment shocks. The proposed UI system will need to be adapted to

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<sup>10</sup> In the defined contribution scheme, the stream of contributions and the returns on ensuing investments determine pension benefits; in a defined benefit scheme, pension benefits are determined by a specific, predetermined formula (and thus benefits are usually only loosely linked to contributions).

Sri Lanka's fiscal and administrative capacity. For example, the elimination of personalized monitoring of continuing eligibility conditions and a much simplified benefit and administration structure would render it more appropriate for a low income country. For informal sector workers, particularly the poor, a workfare program might be considered which can be self-targeted to the able bodied poor. However, its costs will need to be assessed and administrative arrangements developed to ensure self-targeting and the program piloted, prior to scaling up.

- For all schemes, **information systems (record keeping, forecasting) need to be upgraded and supervision improved.** Funded schemes also need to strengthen fund management and regulation, and consider diversification of their investment options.

24. **A longer-term strategy is to create a seamless, unified framework for formal and informal sector workers, covering old age, disability, survivor and unemployment risks.** Social security (old age, death, disability) should be based on a defined contribution scheme (or with contributions strongly linked to benefits) with parameters set so as to produce a target replacement rate. This would allow for complete portability of benefits (individuals would not lose accumulated benefit when they move jobs, easing labor mobility) and increase economies of scale in administration (e.g., record keeping) and avoid the creation of new liabilities. Death and disability insurance, fairly priced based on actuarial results, could be purchased for members of this scheme. Annuitization of benefit (the conversion of a lump-sum benefit into a stream of benefits paid in regular intervals) after retirement could also be made possible. Similarly, a funded severance portion of the system could be added and integrated into the unemployment insurance (UI) program, with UI benefits being funded by withdrawals from both individual saving accounts as well as from the solidarity fund, the latter being financed by pooled contributions of workers and their employers. This approach offers advantages not only in terms extension of coverage, but also greater labor mobility and financial solvency. *A unified system would need to be designed carefully, and would only be implemented gradually once improvements in regulation and administration of current programs are achieved. Increased formalization of the economy would complement expansion in coverage.*

### 3. Social Safety Nets

25. **Sri Lanka has put in place an extensive social safety net system to address chronic poverty.** The safety net system comprises Samurdhi, the main program cash transfer program to address chronic poverty, and disability payments. In addition, the system provides limited social welfare and care services; and disaster relief to all affected persons on the basis of the impact and injuries suffered. Relief programs are also in place to assist families cope with income loss associated with drought. The Government and private response to the recent Tsunami was exceptional, with special cash transfer and other programs implemented to help affected families cope with the disaster.

26. **The safety system could be better designed to serve its objectives.** Specific areas where the safety net system could be strengthened include:

- **The targeting, the level of benefit and work incentives of the Samurdhi program could be improved.** The program is poorly targeted, with a low level of benefits, and limited exit provisions. Since its introduction in 1995, the income transfer component of the program utilizes the bulk of resources and has the widest outreach. At the end of 2002, a total of 1.9 million families or 41 percent of the population received the income transfer (Central Bank of Sri Lanka 2003). While the allocation of funds at the central level is relatively equitable, much of the mistargeting occurs due to the lack of explicit targeting criteria at the local level. Moreover, reflecting a decrease of beneficiaries and an erosion of nominally fixed benefit levels, program expenditures declined from 0.9 percent of GDP in 2001 to 0.4 percent of GDP in 2004. It's

welfare impact is minimal—for example, in 2000 on average it amounted to less than 15 percent of total household food expenditure. Thus, as currently designed, the program provides inadequate assistance to the poor. It also does not adequately help the poor escape poverty (e.g. through investment in their human capital).

- **The disability program does not reach all poor disabled people.** The second largest income transfer program, *cash compensation for disability*, is primarily focused on the disabled soldiers injured in the conflict, leaving other disabled groups under-covered (survey data show that only 41 percent of the disabled receive any sort of income transfer, including the disability allowance, from the government). Program expenditures have increased steadily over the years, reaching approximately 0.2 percent of GDP in 2004. The combined spending on the two main cash transfer programs is thus about 0.6 percent of GDP—generally consistent, or even higher than countries in the region. It has to be stressed that disability payments are a limited way of supporting the disabled poor, and that a more comprehensive approach to disability is needed that addresses prevention and enables the disabled to integrate better into society.
- **Social welfare and care services exist, but provide limited coverage.** Social welfare and care services are an essential complement to cash programs, addressing social risks (e.g. alcohol and drug abuse, orphan hood, protection of legal rights), particularly for the poor. Currently services are provided publicly and through non-governmental organizations, but the coverage is small and their impact is not well known.
- **Relief programs could be strengthened in their ability to support affected populations.** Displaced persons are also eligible for rehabilitation assistance for permanent settlement but fiscal constraints limit program coverage. The relief for the displaced (in the form of food assistance) during drought conditions is insufficient to meet basic nutrition needs.

### *Policy Options*

27. **The equity objectives of the safety net should be strengthened, but the program could also benefit by focusing on alleviating vulnerabilities and promoting growth.** Policy options include:

- **Revamping existing social assistance/cash transfer programs to target the poor.** The ongoing reform—aiming to increase the amount of support within existing budget through better targeting—is an important initiative, and similar reforms have been successfully introduced in many countries around the world (e.g., Armenia, Mexico). Introducing a proxy means testing targeting formula will improve objectivity and transparency. Eligibility could also be validated via community participation. Because inflation has strongly eroded the real value of benefits, current benefits should at least be maintained in real terms and continually adjusted for inflation.<sup>11</sup> But higher benefits may create work disincentives (poverty traps), so suitable exit/incentive clauses from the program need to be designed (e.g., workfare to improve community infrastructure, which can act as a work test for able bodied poor), and continual eligibility frequently monitored. Once disability is included as a criterion for receiving Samurdhi benefits, it would be possible to consider the option of folding disability transfers into Samurdhi, or at least ensure consistency across the two main cash transfer programs as a first step. Similar coordination on benefit and eligibility could be developed for other cash transfer programs, so that over time a consolidated cash transfer system could be developed, allowing an increase in benefits (within fiscal envelope and with attention to work incentives) and enhancing administrative and targeting efficiency.

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<sup>11</sup> Perhaps the original 1996 values could be restored, which would roughly double 2004 benefit levels.

- **Strengthening incentives to help the poor escape poverty.** The safety net program could be designed to help the poor participate in human development and income earning programs, and improve their access to skill development. The Samurdhi reform could be strengthened by using cash transfers providing incentives to improve school enrollment and reduce dropouts, and also to help the poorest participate in nutrition based programs, thus confronting child malnutrition. Helping the poor access micro-finance and training will also assist poor people to exit the safety net (successful examples include Mexico, Brazil, and Turkey).
- **Upgrading programs to address individual vulnerabilities.** Strengthening existing social welfare and care services for vulnerable groups are critical for addressing individual vulnerabilities. While these services can be outsourced to private providers/NGOs, the government agencies need to shape policy, set standards of care, license providers, and regulate the provision of services. Strengthening and mainstreaming disability is also important to address the special needs of this vulnerable group. The implementation of the national disability action plan will require considerable coordinated efforts across a number of agencies, both public and private, to raise awareness/reduce stigma of disability, strengthen prevention of disability, and promote the inclusion of disabled in socio-economic activities.
- **And community wide vulnerabilities.** As noted above, to address *disaster/drought relief*, the government could develop a package of interventions: cash/livelihood grants, workfare, and social welfare and care services, ready to be scaled up in case of disasters. Relief for *conflict affected groups and areas* could be strengthened by helping demobilized soldiers to reintegrate into civil society, by attending the special needs of children and youths affected by the conflict, and by rehabilitating schools, roads and essential infrastructure through public works.

## II. Main Conclusions

28. **Sri Lanka’s social protection system provides extensive coverage, but could still be strengthened to better support growth and equity.** The wide range of social protection programs indicates the Government’s commitment to promote growth with equity. However, the system could be much more effective. Many vulnerable groups are not covered, and conversely, some non-vulnerable groups are included. Aside from equity issues, the programs also create inefficiencies that can constrain growth. For example, pension programs are fiscally unaffordable and limit labor mobility, employment protection institutions impede job flows, and safety nets are not linked to improving training and job prospects for the poor.

29. **The report outlines strategic directions for reforming social protection programs to improve equity and facilitate economic growth.** Examples of such “double dividend” policies are discussed for all three areas of social protection:

- By opening “good” jobs to underprivileged informal sector workers, improved labor market policies would not only level the playing field for these workers but also facilitate the fulfillment of their potential, thereby enhancing the productive potential of the whole economy.
- By enabling widespread risk pooling, social insurance not only helps preserve the wellbeing of individuals but also avoids the use of costly self-insurance such as accumulating assets as a form of precautionary savings, and allows individuals to engage in more productive and higher risk/return production.
- By linking cash transfers to investment in human development of children and enhancing income opportunities for the poor, social safety nets not only reduce poverty and vulnerability but also

enhance opportunities of the poor, thus helping the poor *and* making the economy more productive.

**30. Moving forward in this direction will require attention to the following areas: the financing of social protection, program administration and garnering broad based support for reforms.**

**Ensuring adequate and fiscally sustainable funding for the social protection programs.** Social protection spending in Sri Lanka is skewed towards higher income groups both in the case of safety net programs (e.g., Samurdhi) and in social insurance (e.g., pensions). The proposed Samurdhi reforms, as well as social insurance proposals of this report, would not only help to correct these imbalances, but they would also help keeping public expenditures on these programs in check. In particular, improved targeting under the proposed Samurdhi reform will create ample room for increasing benefit per recipient — the level of which has been strongly eroded because the amount per beneficiary has been nominally fixed — without necessarily increasing the overall spending level. Over the long term, to ensure fiscal sustainability the country will need to reduce spending on pension schemes for civil servants (and the scheme’s large implicit debt burden) and link pension benefits strongly to contributions. Moreover, public expenditures may also be re-directed towards (potentially subsidized) insurance coverage of the poor and towards adequately funded and efficiently targeted safety net programs. Overall spending for safety nets in developed countries peaks at about 2 percent of GDP (World Bank 2005e) and could serve as upper bound target expenditure for safety net programs for Sri Lanka, including cash transfers and social welfare services. Some flexibility and set aside in safety net spending may be needed to respond to social protection needs stemming from emergencies, such as natural disasters.

**Strengthening capacity to administer programs is critical for program implementation.** Although social protection reforms may bring strong efficiency gains and may promise to improve welfare of the poor, such reforms are technically demanding and, therefore, the capacity of the country to design and implement such reforms need to be developed. Social protection reforms are difficult to design because they require meticulous attention to adequacy, incentives, fiscal costs, and monitoring and evaluation, and because they often have to be coordinated across different areas (ranging from social protection to financial markets, fiscal management, education, and health), and because local circumstances need to be carefully accounted for.

**Appropriately accounting for political economy considerations is vital for ensuring successful adoption of proposed changes.** Social protection reforms are politically difficult because many groups prefer the status quo. For example, current beneficiaries of strong employment protection—incumbent workers and their unions—may oppose any reduction of job protection as they consider alternatives, such as unemployment insurance, inappropriate; existing beneficiaries of Samurdhi may oppose reforms because they do not wish to lose eligibility if a more transparent method of selection is adopted. And because potential beneficiaries are often without adequate political representation (informal sector workers, or the poor who are excluded from safety net programs, for example), and because the benefits of reforms often accrue only in the long run (such as in reforms of old age income support), social protection reforms need to be coupled with adequate attention to political economy of reform.

## Summary of Social Protection Policy Options

<b>I. EMPLOYMENT PROTECTION AND PROMOTION: Enhancing opportunity</b>	
Employment Protection and Promotion	<ul style="list-style-type: none"> <li>• Create a more equitable and efficient employment protection program by reducing excessive <i>job</i> protection (reducing termination benefits and discretionary powers for layoffs, avoiding excessive interference in wage setting mechanisms, phasing out ad hoc civil service recruitment practices) and strengthening protection of basic rights and social protection of <i>workers</i></li> </ul>
	<ul style="list-style-type: none"> <li>• Consider cost effective active labor programs, e.g. job counseling and information, and demand driven training programs for vulnerable, disadvantaged workers (incorporating employment options for youth and disabled from respective national action plans)</li> </ul>
<b>II. SOCIAL INSURANCE: Promoting Security</b>	
Social security: old age, disability and survivor	<ul style="list-style-type: none"> <li>• Improve the adequacy and fiscal sustainability of formal social security schemes (e.g. gradually reducing target benefits, increasing retirement age, increasing employee contributions and strengthening their links to benefits, improving record keeping/forecasting, strengthening fund management, and developing sound investment options)</li> <li>• Explore possibilities to expand the coverage of formal social security schemes to the informal sector, including potential subsidization of the very poor</li> </ul>
Unemployment insurance/workfare	<ul style="list-style-type: none"> <li>• Introduce a modified version of the UI system by eliminating personalized monitoring of beneficiaries and simplifying benefit and administrative procedures, consistent with Sri Lanka's income level, labor market conditions, and administrative capacity</li> <li>• Strengthen self-targeted workfare programs to help individuals cope with unemployment that can be scaled up during seasonal downturns, droughts, and other natural disasters</li> </ul>
All social security/insurance	<ul style="list-style-type: none"> <li>• Over the long term, under appropriate pre- conditions, explore options for creating an integrated social security system, based on a defined contribution scheme (or with contributions strongly linked to benefits) with parameters set so as to produce a target replacement rate, to allow portability of benefit, and to increase economies of scale in administration (e.g. record keeping), and to avoid the creation of new liabilities.</li> </ul>
<b>III. SOCIAL SAFETY NETS: Enhancing Equity</b>	
Samurdhi program, civil-conflict related programs, flood and drought relief, other safety net programs	<p>(1) <i>Address chronic poverty:</i></p> <ul style="list-style-type: none"> <li>• Improve targeting of the program by introducing proxy means testing, and avoid poverty traps by introducing exit /incentive policies (e.g. workfare)</li> <li>• Increase benefit level, without compromising work incentives and fiscal sustainability</li> <li>• Improve fiscal, administrative and targeting efficiency by gradual consolidation of disability and other cash payments under the Samurdhi program</li> </ul> <p>(2) <i>Help the poor escape poverty:</i></p> <ul style="list-style-type: none"> <li>• Consider conditional cash transfers to reduce school non-attendance and child malnutrition</li> <li>• Promote access of to poor through skill development and access to micro-finance</li> </ul> <p>(3) <i>Address individual vulnerabilities:</i></p> <ul style="list-style-type: none"> <li>• Strengthen delivery social welfare and care services through public private partnerships</li> <li>• Implement national disability policy focusing on raising awareness/reducing stigma, preventing disability, and including disabled people in socio-economic activity)</li> </ul> <p>(4) <i>Address aggregate vulnerability:</i></p> <ul style="list-style-type: none"> <li>• Develop a package of interventions: cash/livelihood grants, workfare, and social welfare and care services, to be scaled up in case of disasters</li> <li>• Strengthen relief for <i>conflict affected groups</i> and areas by helping demobilized soldiers to reintegrate into civil society, by attending the special needs of children and youths affected by the conflict, and by rehabilitating schools, roads and essential infrastructure through public works.</li> </ul>

# 1. POVERTY AND VULNERABILITY

*“I cannot think of earning even the minimum for my family to survive if I do not go in search of work like this from place to place.”*

*P.H. Sirisena, a 41 year old casual laborer in Kegalle district*

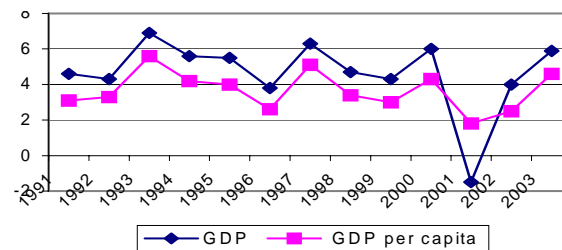
1. As a natural starting point for designing an effective social protection system, this chapter reviews growth, inequality and poverty trends, identifies key sources of risk, and profiles the most important poor and vulnerable groups.<sup>12</sup> The chapter finds that a large proportion of households in Sri Lanka live in poverty (with low levels of income), and these and many other individuals are also vulnerable to income shocks (or variance in income) resulting from individual specific shocks, such as sickness, loss of employment, or more community wide shocks, such as natural disasters and the civil conflict. Across the life cycle, the chapter uses a mix of poverty estimates and more qualitative evidence to identify the poorest and most vulnerable groups as *children*: child workers, children living in large families and disabled children; *working age adults*: informal sector workers (particularly uneducated, casual and own-account workers), unemployed youth, farmers and others affected by natural disasters, internally displaced persons, and the disabled; and the oldest among *the elderly*. While precise estimates of vulnerability are not undertaken in this report, the poor, those without any human and physical assets, are likely to be the most vulnerable and hardest hit by income shocks.

2. This chapter begins by describing the macro picture in Sri Lanka in terms of trends in economic growth, inequality and poverty. Then the chapter describes the main risks and identifies chief poor and vulnerable groups in society. The following chapters of the report draw on the findings of this chapter to discuss formal and informal social protection programs aimed at reducing poverty and vulnerability in Sri Lanka, and evaluate their ability to protect the poor.

## 1.1 Growth, Inequality and Poverty

3. **Sri Lanka’s economy has been steadily growing over the last few decades.** The average yearly GDP growth in the last decade (1994-2003) averaged at 4.5 percent (with a large drop in 2001—Figure 1.1). Trend in GDP per capita has a similar pattern and grew steadily since 1990s. Compared to other countries in the region, Sri Lanka’s GDP growth was average—it equaled the rate of growth of Nepal, lagged behind India’s average growth rate of 5.8 percent, and exceeded the Pakistan’s a average growth rate of 3.6 percent (the comparison refers to 1990-2003).

**Figure 1.1: Growth of GDP and GDP per capita, 1991-2003 (in percent)**

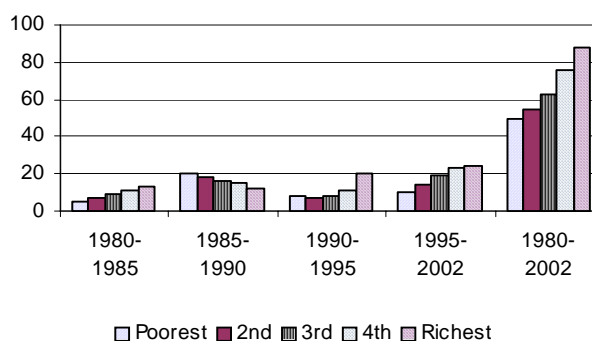


*Source: Central Bank of Sri Lanka, Annual Report (various issues).*

<sup>12</sup> Guidelines about building social protection systems are provided by World Bank (2000) and World Bank (2002a).

4. **Economic growth raised incomes, but inequality increased.** The per capita consumption of richer segments of the population grew much faster than income of the poorer segments (Figure 1.2). A recent study (Gunatilaka 2005) showed that higher per capita consumption of the lower and middle income classes is associated with their improvements in educational attainment. The same study also found that while increases of per capita consumption were associated with improvements in infrastructure access (telephones, electricity and roads) across all points of distribution, these associations were particularly strong for middle income groups.<sup>13</sup> The unequal growth of per capita consumption is reflected also in the strong increase of Gini coefficients both at the national as well as sectoral level. The Gini increased from 0.32 to 0.40 and now exceeds all other countries South Asia with the exception of Nepal.<sup>14</sup>

**Figure 1.2: Change in consumption expenditure by quintile, 1980-2002 (per adult equivalent, in %)**



*Source:* Gunatilaka (2005) based on Dept. of Census and Statistics' LFSS data for 1980 and 1985 and HIES data for 1990, 1995 and 2002. *Notes:* Nominal values deflated using temporal and spatial price indices constructed with the Country Product Dummy Method. Northern and Eastern Provinces excluded from the analysis due to non-availability of data.

5. **Unequal growth across provinces contributed to the increase of inequality.** That national inequality of per capita consumption increased can be partially explained by the unequal growth of output across provinces. As shown in Figure 1.3, index of GDP change between 1996 and 2003 varies tremendously across provinces (earlier data is not available). Output growth was the highest in Western and Southern, and, interestingly, also in Eastern and Northern provinces, where the increase was about 45-50 percent; in contrast, in several provinces output in this period increased only by up to 20 percent, and Sabaragamuwa faced a reduction of output.<sup>15</sup>

6. **Moderate growth and growing inequality resulted in a modest reduction of poverty.** Although Sri Lanka's poor do not live in the destitution encountered elsewhere in South Asia, significant poverty and vulnerability remain. After an increase in the early 1990s, poverty declined from 29 percent in 1995/6 to 23 percent in 2002 (Figure 1.4). Compared to other countries in the region, in the 1990s Pakistan reduced poverty more slowly, and Bangladesh and India more quickly (World Bank 2005a).<sup>16</sup> In Sri Lanka, a significant proportion of the population lives just above the poverty line and small declines in income can make them vulnerable to poverty.<sup>17</sup>

<sup>13</sup> Gunatilaka's (2005) regression-based decomposition of per capita consumption inequality shows that the contribution of education and infrastructure to inequality increased over the years, and that changes in these characteristics are responsible for the lion's share of the inequality increase, particularly between 1995 and 2002. In contrast, spatial and demographic factors, contributed relatively little.

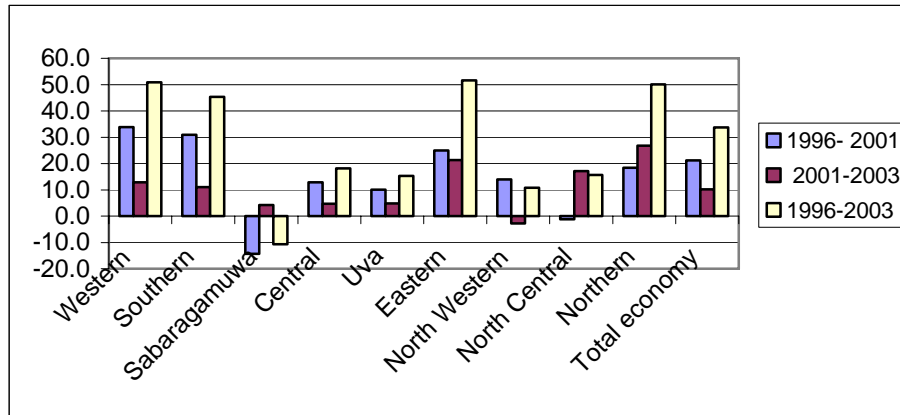
<sup>14</sup> The inequalities in the region, however, are still vastly lower than in Latin America (for example, Brazil's Gini coefficient of income inequality was 59), and also lower than in some East Asian countries (in early 2000s, for example, Gini coefficient of income inequality in was Thailand 43 (World Bank's World Development indicators, data refer to early 2000s).

<sup>15</sup> These results also show that the cease-fire agreement of February 2002 spurred economic growth primarily in the conflict zone itself (note the large increases of output in the Northern, Eastern, and North Central Provinces in 2001-2003 period)—the result which hints at the vast potential economic dividends of the lasting, full-fledged peace.

<sup>16</sup> Note that these trends are based on the poverty headcounts calculated from national poverty lines.

<sup>17</sup> Raising the poverty line by 20 percent in 1995/96 increased poverty incidence by 56 percent (Gunewardena 2000).

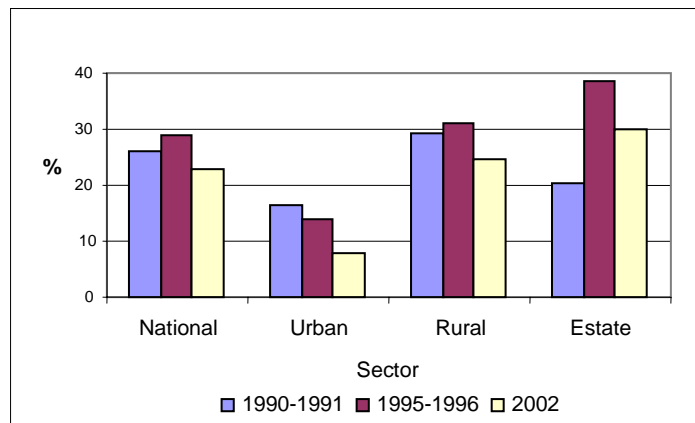
**Figure 1.3: Index of real GDP change by province, 1996-2003 (in percent)**



Source: Own calculation based on Government's Secretariat for Coordinating the Peace Process, "Impact of the Ceasefire Agreement on Regional Economic Growth in Sri Lanka."

7. **Assuming constant inequality, the same economic growth would have significantly reduced poverty.** If a household's per capita consumption increased at the average national rate of 29 percent, simulations show that economic growth would have reduced poverty by more than 15 percent nationally, and by 12 and 18 percent in urban and rural areas, respectively (Narayan and Yoshida 2004). In contrast, because of growing inequality, the true reduction in poverty was only 3 percent nationally (8 and 5 percent in urban and rural areas, respectively).

**Figure 1.4: Incidence of poverty by sector, 1990/91-2002**



Source: Narayan and Yoshida (2004).

## 1.2 Sources of Risk

8. **Aside from low income, Sri Lankan households experience variance in income as a result of income risks** (uncertain events that can damage well-being). Some of these risks affect specific individuals (idiosyncratic risks), and others affect whole communities (community-wide or covariate risks).<sup>18</sup> Common idiosyncratic risks include sickness/accident or death and loss of employment, and common covariate risks include natural calamities, drought and crop failure. Such shocks reduce household income and may force the whole communities into poverty, transiently or permanently. While considerable work needs to be done to ascertain the sources and impact of vulnerability, evidence from a 2004 survey of members of microfinance institutions in Sri Lanka confirms the importance of these shocks to households. During 12 months prior to survey, over a half of households experienced

<sup>18</sup> *Idiosyncratic risk* affects a specific individual or household in a way unrelated to the risk of other individuals or households, in contrast to *covariate risks* which typically affect entire communities or regions. Inter-household risk-sharing is possible to address idiosyncratic risks, depend on availability of inter-household networks; in contrast, covariate risks make risk-sharing within a community difficult if not impossible.

significant income shocks (Tilakaratna and Wickramasingha 2005).<sup>19</sup> The results from the survey are consistent with evidence on income shocks from other South Asian countries and regions (World Bank 2005b, 2005c, and 2005d).

### **Aggregate Shocks**

9. **Sri Lankan households are prone to climactic shocks and natural disasters.** While the tsunami of December 2004 is no doubt the largest natural disaster to affect Sri Lanka in recent times, other natural hazards also affect Sri Lanka. For the 1948—1992 period, Zubair et al (2005) report 27 major episodes of drought and 24 of floods, as well as 17 landslides and 10 cyclones. Moreover, the high density of people in the wet parts of the island converts into a larger number of persons vulnerable to floods and landslides (Ralapanawa and Zubair 2003). The above-mentioned microfinance survey found that during the course of a year, 23 percent of households experienced income shocks due to natural calamities and 18 percent due to crop failures.

- **Landslides are localized to seven districts in the central massifs** (Badulla, Ratnapura, Matale, Kegalle, Nuwara Eliya, Kandy and parts of Kalutara). The frequency of landslide occurrences has been increasing each year, the likely causes being changes in land use due to rapid urbanization (Ralapanawa and Zubair 2003).
- **Drought is the most significant hazard in terms of people affected and the needed relief** (Ralapanawa and Zubair 2003). While Sri Lanka receives on average 1,800 mm of rainfall annually, it is distributed unevenly over the year and over the land so that a large part of the island is drought-prone particularly during the subsidiary rainy season.

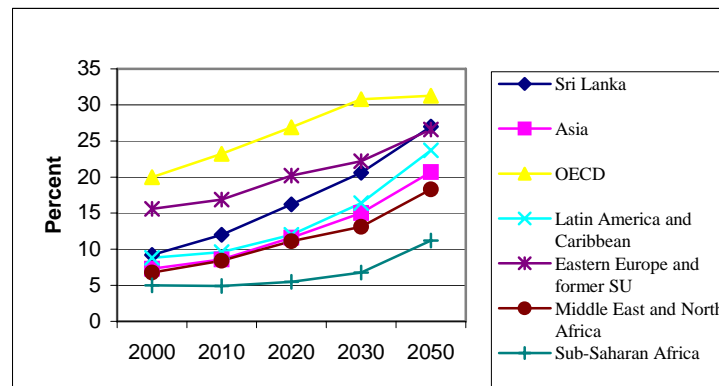
10. **The on-going civil conflict in the North and East of Sri Lanka is also a major social calamity for the country.** About 2.5 million people lived in areas of military activity, of which up to 700,000 left the country and about 800,000 did not return to their homes as of 2002 (World Bank, 2002b). An estimated 65,000 persons were killed during the conflict and several hundred thousand have been displaced.

11. **Being one of the fastest aging countries in the world, Sri Lanka must also get prepared to face the challenge of population aging.** Over the next 25 years, the share of the population over 60 will double from about 10 to 20 percent (Figure 1.5), a process that unfolded over the course of a century in France and 75 years in the United States. This unprecedented speed of ageing is driven by a rapid decline of fertility coupled by a strong increase of life expectancy, which, over last 40 years, occurred much faster than in the rest of the world.

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<sup>19</sup> This study was conducted before the tsunami that hit Sri Lanka's coastline on December 26, 2004.

**Figure 1.5: Demographic ageing, Sri Lanka and world regional averages (percentage of population over 60 years old, 2000-2050)**



Source: World Bank demographic projections.

### Individual-Specific Risks

12. **Sickness, injury, and death are the main shocks affecting Sri Lankan households.** The above-mentioned microfinance survey found that a large share of respondents (21 percent) experienced sickness, injury and death shock over the study period (Table 1.1). While all individuals are subject to health shocks, the health outcomes are particularly poor for low income groups (see reproductive health indicators and outcomes in Table 1.2).<sup>20</sup> According to Aturupane (1999), the poor are especially vulnerable to three types of *communicable diseases*: (i) respiratory infections, where prevalence is high among urban poor, particularly due to air pollution; (ii) mosquito-borne illnesses like malaria, filaria, and dengue fever, due to low quality of the housing of the poor, unhygienic garbage accumulation and disposal, and under-nutrition; and (iii) water-borne diseases like cholera, dysentery and diarrhea, because the poor lack access to clean drinking water and safe sanitation. Moreover, Aturupane reports that *non-communicable diseases* (cardiovascular, diabetes, tuberculosis) are among the leading causes of morbidity and mortality among poor individuals in Sri Lanka, partly because they are less aware of the importance of early detection and possibilities of effective treatment for diseases like cancer and heart disease. This result is consistent with other studies of risk and vulnerability in South Asia.

13. **Unemployment was the next most frequent shock affecting households.** Over a twelve month period, nearly 16 percent of the surveyed households experienced unemployment that resulted in significant income shock (Table 1.1). While the incidence of unemployment among the respondents of the reported microfinance survey was disproportionately high (unemployment rate declined strongly from nearly 16 percent in 1990 to 8.2 percent in the fourth quarter of 2004), Sri Lanka's unemployment rate, together with Pakistan's 8.3 percent rate in 2002, is amongst the highest in the region.<sup>21</sup> Apart from the labor market constraints (see chapter 2), aggregate shocks also contribute to unemployment. For example, Senaka-Arachchi (1998) reports that droughts—mainly affecting dry zone farmers cultivating paddy and chena—cause large losses of employment and therefore income. Displacement suffered by populations

<sup>20</sup> Sri Lanka's achievements in health are much better than in other countries at a comparable level of development, partly because many health care services are offered to the poor and the rich alike. In the area of reproductive health, for example, indicators of the services received (such as immunization coverage, percentage who received antenatal and postnatal care) show remarkably equal access to health care across socio economic quintiles (see Table 2.2).

<sup>21</sup> According to ILO Labor Statistics; available at <http://laborsta.ilo.org/>.

from the conflict and natural disasters is another cause of unemployment. According to UNCHR, 342,000 persons were displaced by the recent tsunami, with virtually all of them (97 percent) suffering from the loss of employment, property and other assets. Moreover, an estimated 200,000 jobs were lost in fishing and rural industries, tourism, and agriculture (World Bank 2005h), with some of the worst affected districts (Galle, Hambantota, and Matara) being among the poorest ones (Figure 1.6).

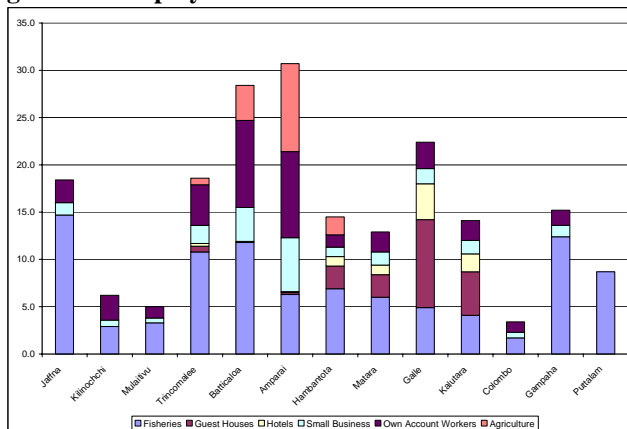
**Table 1.1: Vulnerability to shocks by members of microfinance institutions, 2004**

Nature of Risk	Type of risk	No. of Households	Percentage
Sickness/Accident/Death	Idiosyncratic	306	20.7
Employment Related	Idiosyncratic	232	15.7
Indebtedness	Idiosyncratic	185	12.5
Marriage/Child Birth	Idiosyncratic	96	6.5
Other Personal Problems	Idiosyncratic	30	1.4
Natural Calamities	Covariate	335	22.6
Crop Failure	Covariate	271	18.3
Social Calamities	Covariate	48	3.1
Others	-	154	10.4

Source: Adapted from Tilakaratna and Wickramasingha (2005), data from Microfinance Survey 2004, administered to 1,480 households whose members participate in microfinance institutions.

14. **Death and disability risks have been exacerbated by the conflict and natural disasters** (particularly the recent tsunami). According to the Census of population of 2001, the share of disabled (with intellectual, mobility, psychiatric, hearing, or speech disabilities) in population was 1.6 percent (Mendis 2004). As noted, the on-going conflict in the North-east has contributed significantly to disability and death in that region, particularly for the poor. While 8 percent of households in the North-East had a member killed in the conflict, this share was nearly double for the poorest quintile of households (World Bank, 2002b). The recent tsunami and other natural disasters (see below) have also contributed to disability and to the loss of life. Aside from physical disability, many individuals and households affected by the conflict and natural disasters are also prone to psycho-social distress, which also limits their ability to function as productive members of society.

**Figure 1.6: Employment losses in tsunami-affected districts**



Source: World Bank (2005h).

### 1.3 Poverty Profile

15. **Who are the poor and vulnerable in Sri Lanka?** To identify the poor, the following section relies on the national consumption threshold definition of poverty. The vulnerable are those either above

or below the threshold who are likely to suffer a decline in wellbeing, including falling into poverty, as the result of an income shock (see Box 1.1 for the definition of poverty and vulnerability). Having few resources and facing limited access to credit and insurance markets, the poor are often the hardest hit by adverse shocks, so poverty and vulnerability are intrinsically linked. This chapter thus does not undertake a formal analysis of vulnerability—an important gap that needs to be addressed in future analysis—and mainly relies on qualitative and quantitative evidence to identify the poor and vulnerable groups.

**Table 1.2: Reproductive health indicators by socio-economic groups, 2000**

	Socio -economic quintile					Poor / Rich ratio
	Poorest	Second	Third	Fourth	Richest	
<b>Pre- and post-natal care (percent)</b>						
Pregnant women who received measles immunization	85.8	88.9	89.6	90.6	89.5	0.96
Pregnant women who received tetanus immunization	93.9	95.2	96.3	96.2	97.6	0.96
Pregnant women who received domiciliary ante natal care	80.2	83.7	87.9	90.1	81.6	0.98
Pregnant women who received iron tablets	92.4	96.5	94.4	97.8	98.0	0.94
Women who received domiciliary post natal care	75.4	77.9	75.6	80.2	76.7	0.98
Prevalence of breast feeding %	98.6	99.2	98.4	99.7	99.0	0.99
Women who were aware of symptoms of pregnancy complications %	68.0	71.8	77.6	85.3	85.4	0.8
Home delivery %	5.0	2.5	1.2	0.4	0.0	5/0
Mother with body mass index <18 %	37.8	30.2	22.0	18.3	13.5	2.8
<b>Infant health and mortality indicators</b>						
Prevalence of low birth weight %	19.4	21.2	16.2	14.6	11.3	1.7
Prevalence of stunting (Ht/Age) %	25.1	23.1	12.0	9.9	4.3	5.8
Prevalence of wasting (Wt/Age) %	19.6	19.3	14.6	11.7	10.4	1.9
Prevalence of under weight (Wt/ age) %	44.3	40.5	30.7	22.0	13.5	3.3
Infant Mortality Rate /1000 LB	26.8	22.8	18.3	16.7	14.6	1.8
<b>Memorandum items</b>						
Women who ever attended school %	83.5	92.9	96.6	98.7	99.2	0.84
Age at first birth	21.0	20.0	22.0	23.0	25.0	0.84
Mean ideal number of children	3.2	3.0	2.9	2.7	2.6	1.23
Total Fertility Rate	2.43	2.04	2.0	1.97	1.61	1.5

*Source:* The World Bank (2005i), based on the 2000 Demographic and Health Survey.

*Note:* The distribution by socio -economic quintiles is based on a wealth index. This index is the composite score which reflects the presence of selected consumer items (such as radio, television, and car), the quality of dwelling (such as flooring materials, type of drinking water, toilet facilities), and some other household characteristics.

### **Box 1.1: Definition of poverty and vulnerability**

There are different definitions and measures of poverty—ranging from income poverty (absolute or relative poverty lines) and social exclusion, to poverty defined by capabilities of individuals. Sen’s capabilities approach defines poverty as not being able to do certain things, lacking capabilities to function or lacking “the substantive freedoms [a person] enjoys to lead the kind of life he or she values” (Sen, 1999). The World Development Report of 2000 defines poverty as “unacceptable deprivation in wellbeing.” The dominant approach in measuring poverty is by income, using a threshold income per capita as the poverty line (Ravallion 1998). Poverty is typically measured using an absolute poverty line. In Sri Lanka, the official poverty line in 2002 was Rs. 1423, corresponding to the per-capita consumption expenditure providing nutritional intake of 2030 kilocalories (Department of Census and Statistics 2004a).

Vulnerability refers to the relationship between poverty, risk and efforts to manage risk (Alwang, Siegel and Jorgensen 2001). One definition of vulnerability is “the possibility of suffering a decline in wellbeing, in particular a fall under some minimum benchmark or poverty threshold [where] the fall is brought about by shocks against which protection is either costly or not possible” (Duclos 2002). It is therefore the “expected welfare loss above socially accepted norm, which is caused by uncertain events and the lack of appropriate risk management instruments” (World Bank, 2002). Vulnerability has multiple dimensions including consumption, health, physical wellbeing, social capital, and insecurity of old age (World Bank, 2002). An interesting paper, applying innovative empirical measurement of vulnerability, is Christiaensen and Subbarao (2005). Cross-sectional methodology is provided by Chaudhuri, Jalan and Suryahadi (2002).

### **Regional Poverty**

16. **Rural areas and estate sectors have higher poverty rates than urban sectors.** Urban areas have a poverty rate of 7.9 percent, almost a third of the national poverty rate (22.7 percent). In contrast, poverty rates in rural (24.6 percent) and estate sectors (30.0 percent) are much higher than the national poverty rate (see Table A1.1 in Annex 1.1 for poverty statistics by province). Moreover, over the recent years rural and estate areas have realized a smaller decline in poverty than urban areas. In contrast to urban areas, where the incidence of poverty since 1990 has been strongly and steadily reduced, rural areas and particularly the estate sector witnessed not only a slower reduction of poverty but also an increase of poverty in the first half of the 1990s (Figure 1.4).

17. **North and Eastern provinces have poverty rates that are likely higher than in the rest of the country** (no data exist the 1985-1996 period). This disparity is evident at every level; average income levels are lower in the Northern and Eastern provinces than in any of the others, while average expenditure in the North is similar to that in the poorest provinces, and that of the East to middle-level provinces (Figure 1.7).<sup>22</sup> The distribution of income within these provinces is similar to that of the rest of the country. Thus, with lower average incomes, and a similar income distribution, it is likely that the incidence of absolute poverty is higher in these provinces.

### **Children**

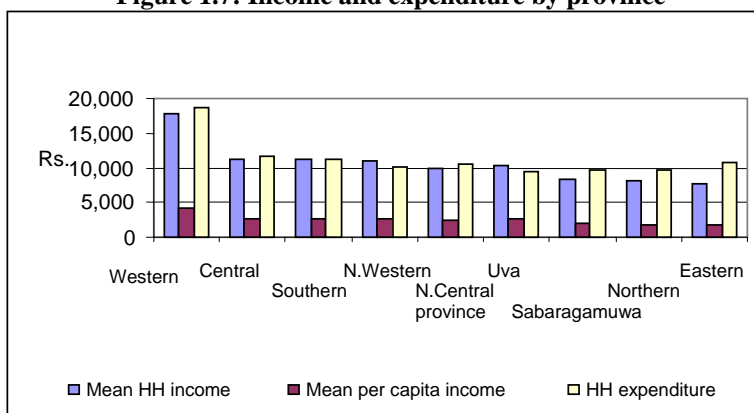
18. **Children in large families are particularly prone to poverty.** The incidence of poverty is particularly high in households with many children, the pattern shared by urban, rural, and estate sectors. For example, the poverty of households with 2 children is 27 percent (about equal to the national

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<sup>22</sup> Note that while the data for the North and the East are from an HIES conducted during the six months September 2002 to February 2003, the data for the rest of the country are from the HIES conducted from January to December 2002.

average), but poverty incidence for households with 3 children is 38 percent and for those with 4 or more children it is 51 percent, nearly double the national average (Table A1.1). Note that more than over 30 percent of all poor in Sri Lanka live in households having 3 or more children. Multivariate analysis also shows that other things equal, the presence of additional child increases the likelihood that the household is poor (Table 1.3). Of particular concern are the following groups, several of which may well be overlapping. Poverty among children, which leads to poor human development outcomes, can lead to vicious cycle of poverty.

**Figure 1.7: Income and expenditure by province**



Source: Household Income and Expenditure Survey (HIES) 2002, Basic Information at District Level, Department of Census and Statistics (2004b), and Results of the Household and Income Expenditure Survey conducted in Northern and Eastern Province (HIES-NE) 2002/2003, both available at [www.statistics.gov.lk](http://www.statistics.gov.lk)

19. **The school attendance of poor children is hindered by high direct and indirect costs of schooling.** As substantiated in chapter 2, high direct costs of schooling (fees, etc.), the presence of large number of young children, and being in the poorest expenditure quintile negatively affect school attendance. Disabilities also reduce enrollments, particularly for girls (see chapter 2).

20. **Many children who do not attend school work—though the incidence of child labor in Sri Lanka is much lower than in other South Asian countries.** In 2000, around 25,000 children aged between 10 and 14 were economically active in Sri Lanka (DCS 1999), with majority (90 percent) of them being located in rural areas. These children work either as paid employees, in family enterprises or farms without payment, or on their own account. Overall there are about 38,000 children school-age children who do not attend school, with majority of these children being girls (56 percent). The majority of children not attending school are poor. It should be noted that the incidence of child labor is very low in Sri Lanka relative to other South Asian countries, but needs to be addressed nonetheless. Recent data show that 2 percent of children were economically active in Sri Lanka, in comparison to 27.8 percent in Bangladesh, 12 percent in India, 15 percent in Pakistan, 51 percent in Bhutan, and 42 percent in Nepal (data from ILO Labor statistics).

21. **Children in the conflict areas may not attend school as they face the risks of being recruited as soldiers.** As of September 2005, UNICEF (2005) reported that the number of children (those below 18 years) recruited as LTTE soldiers was 5,198. Some were recruited when they were as young as 9 years, about one third were 11-13 years old, and about one half of them were 15-17 years old (UNICEF 2005). While the majority returned home or was released, UNICEF reports that in September 2005, 1,284 (two thirds boys) were still being held as soldiers. These children are also more likely to suffer disability from land mines and other impact of armed struggle.

**Table 1.3: Probit estimates of the probability that a household is poor, 2002**

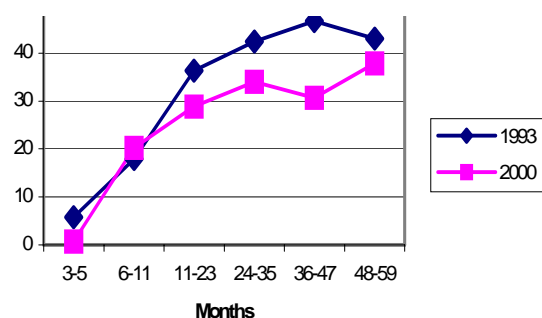
	Coefficient	Robust z statistic
<b>Household characteristics</b>		
Presence of elderly	<b>-0.07</b>	-2.2
Family member abroad	<b>-0.34</b>	-6.2
Presence of a child or children	<b>0.19</b>	6.2
Receiving domestic remittance	<b>-0.18</b>	-2.8
Receiving foreign remittance	<b>-0.50</b>	-5.8
Receiving pension payment	<b>-0.82</b>	-8.9
Receiving disability payment	<b>0.39</b>	5.2
None employed	0.13	1.9
Two or more employed	<b>-0.25</b>	-8.0
One unemployed	-0.02	-0.6
Two or more unemployed	<b>0.20</b>	3.6
Household size of 4-6 members	<b>0.49</b>	13.7
Household size more than 6 members	<b>1.00</b>	22.7
Located in the rural sector	<b>0.72</b>	16.4
Located in the estate sector	<b>0.49</b>	7.2
At least one formal sector worker	<b>-0.42</b>	-9.5
At least one informal sector worker	<b>0.35</b>	11.1
<b>Characteristics of the household head</b>		
Male	0.05	1.0
Unemployed	-0.05	-0.6
Inactive	0.01	0.2
Completed 5 grade or less	<b>0.82</b>	15.7
Completed 6-9 grades	<b>0.41</b>	7.9
Completed A/L & above	<b>-0.42</b>	-4.0
Single	0.01	0.3
Separated	0.03	0.3

*Source:* Own computations based on HIES 2002 data.

*Notes:* Significance of coefficients of 5 percent or more is reported in bold. The coefficients represent deviations from the reference household: a small household (3 members or less), with no presence of elderly, having no family member abroad, with no children, receiving no domestic or foreign remittance and no pension payments, having one employed and no unemployed workers, located in the urban sector, and with an employed, married female household head, possessing O/L and above but not A/L education. Number of observations is 17,066.

22. **Malnourished children have increased risk of sickness and their development of cognitive skills is hindered.** Although severe malnutrition is low in Sri Lanka, among children below 5 years nearly one third are underweight and more than ten percent suffer from malnutrition, which places Sri Lanka below the outcomes of countries with similar per capita national income (World Bank 2005a). While growth of children in Sri Lanka is satisfactory during the first 4 to 6 months of infancy, there is a strong deterioration of growth later on, particularly during sixth to 23rd month, and the deterioration continues during the rest of the first four years of life (Figure 1.8). Evidence shows that child malnutrition increases vulnerability of children to infections and mortality. Malnutrition can also limit the acquisition of cognitive and psychosocial skills at young ages, hinder educational attainment, and reduce employment prospects (see Box 1.2). The causes of malnutrition in Sri Lanka are not fully understood. Some factors include inappropriate breast feeding, poor complementary feeding practices or a combination of the two (de Silva 2001).

**Figure 1.8: Children with low weight for age**  
(percent)



### Box 1.2: Life cycle effects of child malnutrition

Evidence shows that child malnutrition affects mortality, cognitive and psychosocial skills in the young age as well as later outcomes related to education and labor market:

- Malnourished children are susceptible to infections, leading to further malnutrition and affecting school attendance and thus learning. Another consequence is increased mortality—about one-half of all deaths in developing countries in children under five are due to the interaction between malnutrition and common infections such as diarrhea, respiratory infections, and measles.
- Motor and mental development is also affected negatively by poor nutrition. For example, iodine deficiency and anemia cause poor cognitive development, particularly in children under two.
- Evidence also shows that unhealthy children do not perform well in school, as they enter school later and perform more poorly on cognitive achievement tests.
- Early childhood human capital has important effects on adult productivities, both directly through health status over the life cycle and indirectly through schooling.

Source: Behrman et al, 2004.

### The Poor and Vulnerable Among the Working Age Population

23. **Poverty disproportionately affects informal sector workers, comprising in 2003 nearly two thirds of all workers.** The incidence of poverty among households with at least one informal sector worker is much above the national average, exceeding it by 60 percent in urban areas, by 40 percent in rural areas, and by 7 percent in the estate sector (Table A1.1).<sup>23</sup> Households with informal sector workers represent more than half of all households (45 percent of all households in urban areas, 50 percent in rural areas, and 90 percent in the estate sector), and these households account for more than 70 percent of the poor. Multivariate analysis also shows that other things equal, the presence of at least one informal sector worker significantly increases the likelihood that the household is poor, and that the presence of at least one formal sector worker significantly reduces this likelihood (see Table 1.3). Note that the informal sector workers are a diverse group of comprising casual workers, own account workers and unpaid family

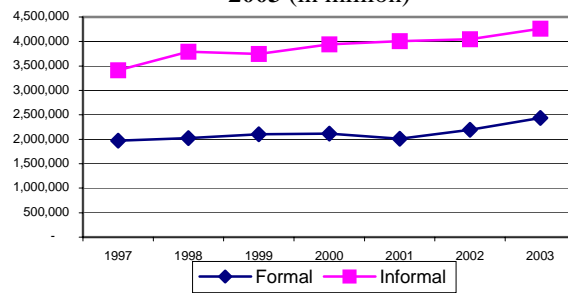
<sup>23</sup> Poverty analysis is based on household income and expenditure surveys and the definition of the informal sector workers deviate somewhat from the one in the analysis based on labor force survey data.

workers, and that since 1997, its proportion in comparison to formal sector workers stayed roughly constant (Figure 1.9).<sup>24</sup> In contrast to the formal sector workers who enjoy income security, better occupation health and safety, and fringe benefits such as job security, pensions, paid holidays, informal sector workers are faced with low income security and informal terms and conditions of work. Informal sector workers are also much less educated, which partly explains their higher poverty incidence.<sup>25</sup> Judged by their long working hours, male own account and casual workers are particularly in the precarious position (Arunatilke 2005a reports that in 2003, 26 percent of them worked longer than 60 hours per week).

**24. The incidence of poverty increases with the number of unemployed in the household.** The

incidence of poverty of households with one unemployed is higher than the national average by 2 percentage points, and the incidence of poverty of households with two or more is higher by 13 percentage points (Table A1.1). Similarly, in the context of multivariate analysis, while the presence of one unemployed is not associated with higher probability of unemployment, the presence of two or more unemployed is (similarly, the presence of two employed workers is associated with lower likelihood of poverty than just of one employed worker)—see Table A1.1. While unemployment signals a loss in income, it is also a source of major social costs. Sri Lanka was twice confronted with a large-scale unrest of Sinhalese youth from the rural South, many of them unemployed. Especially the second insurgency from 1987—1991 brought the country to the verge of collapse and left nearly 40,000—60,000 dead or missing, most of them youth (Hettige, Mayer, and Salih 2004).

**Figure 1.9: Formal and informal employment, 1997-2003 (in million)**



**25. The incidence of unemployment is slightly ‘U shaped’ relative to income** (as suggested by Rama 2003). The unemployed are those who can afford to stay out of the labor force and those with worse job opportunities.<sup>26</sup> The distribution of unemployment by household income has one peak at low income level, the one associated with “involuntary unemployment”—inability to find any kind of job, and a second peak at high income levels, reflecting unemployment as a choice while searching for a “good” job (Figure 1.10). The unemployment rate is the highest among the youth, women, and highly educated (particularly those with A/L level education).

**26. The disabled are particularly vulnerable to poor employment prospects.** Few disabled work. According to a survey of the Ministry of Social Welfare (2003), in 2003 16 percent of persons with disability worked (22 percent of men and only 8 percent of women). Employment rates among disabled varied from an extremely low 1 percent for persons with intellectual disability and 7 percent for those

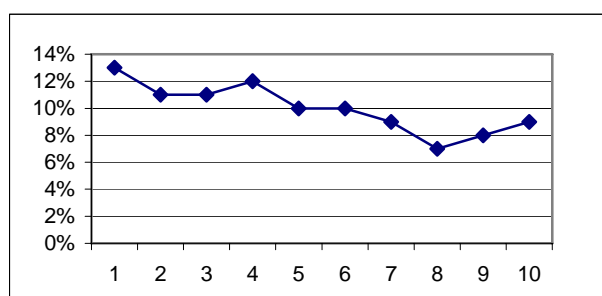
<sup>24</sup> To be able to analyze informality using labor force survey data, informal workers are defined as own account workers, unpaid family workers and those private sector workers who are paid daily (this operational definition may underestimate the number of informal workers, as some informal sector workers may be paid weekly or monthly). Note that informal workers are predominantly engaged in agriculture, fishing, and livestock rearing, as well as in petty trade, other small commerce, and industry and service occupations.

<sup>25</sup> As shown in Table 2.3, higher education is strongly associated with lower risk of poverty, the finding confirmed also in multivariate analysis (household head possessing A/L level of education of above is shown to be negatively associated with poverty of the household, other things equal).

<sup>26</sup> Affordability factors are suggested by Arunatilake (2005a), who shows that in comparison to employed workers, unemployed are more likely to come from a family with fewer children and possessing more assets and less likely to be a household head. Arunatilake also points to the opportunity factors—residing in Western province and in a community with better infrastructure—in influencing the unemployment status.

with psychiatric disability to a high of 26 percent for those with mobility disability. Of those employed, 32 percent were self-employed, 29 percent were in public employment, and only 13 percent in the formal private sector. For most employed, personal income was below US\$1 per day, varying from 43 percent for those with visual disability to 88 percent with speech disability. In general, the incidence of poverty among households receiving disability payments (after disability payments are accounted for) is 52 percent above the national average. The lack of participation of disabled in society may be the result of stigma. According to the above survey, only 33 percent went out with the rest of the family. Many disabled had never been to a wedding nor taken part in community activities and festivals. However, poor employment status also likely reflects a lack of mobility. Many disabled are constrained in their mobility. The same survey found that only 35 percent of individuals who felt that a tricycle or wheelchair would be of use to them had such devices. A large proportion of disabled also have limited access to basic aids to correct sensory disabilities. Only 24 percent of those who felt the need for a hearing aid had been able to get them.

**Figure 1.10: Share of unemployment by income decile, 2002**



Source: Arunatilake (2005a)

## The elderly

27. **While the elderly tend to be better off compared to other population groups, some older groups remain vulnerable to poverty.** As shown in Table A1.1, the poverty rate has an inverse U shaped relationship with age. Poverty declines with age till the 55-64 group, and then gradually increases with age (the incidence of poverty among households with member over 80 years old is 10 percent above the national average). Our results show that pension payments are associated with lower likelihood of poverty of the household where the recipients reside. Most elderly currently rely on the family for income support—though only two thirds prefer this arrangement<sup>27</sup>—but growing urbanization and break up of traditional values may erode this support (World Bank, 1994). Family support may not always be costless. There may well be some discrimination against elderly (as found by Kochar, 2005, in Pakistan, for example). The elderly may also be vulnerable in the future, although it is likely that they will adjust their labor supply or savings to adjust for aging. Nannayakkara (2004) found that the labor force participation rate of males age 60-64 has fallen by about 20 percent in the last two decades, a pattern reminiscent of the OECD trends over the last 40 years. Public policies such as increased retirement age can ameliorate, but not reverse these long term trends. Households may not save more in preparation for this unprecedented period of population aging. High discount rates or myopic behavior may prevail. For example, a recent survey found that only 16 percent of Sri Lankan elderly had planned for their old age.

<sup>27</sup> Hinting at possible future changes in family support is the preferred living arrangement found by Rajan et al (2005). They report that although 90 percent of elderly Sri Lankans presently live with their children, this is the preferred arrangement only for 65 percent of them (21 percent would prefer to live alone or with the spouse, 11 percent in old age homes, and 3 percent with relatives or friends).

## 2. ENHANCING EMPLOYMENT OPPORTUNITIES AND EMPLOYABILITY

*“We are one happy family, but you want that some of us to lose jobs. That’s why we hate you.”*

*A representative of an interest group in Sri Lanka speaking to representatives of an international agency*

28. Labor is typically the most important and often the only assets of the poor. **Some of the most effective policies of helping individuals to manage social risk thus consist of promoting job creation, ensuring equality in access to jobs, and helping the poor and vulnerable to acquire appropriate skills.** This chapter evaluates these policies for Sri Lanka, focusing on labor market institutions (severance pay, wage setting, civil service hiring), education programs, and micro-finance institutions. In doing so, it centers its attention upon several of the groups identified in Chapter 1 as the most poor and vulnerable, the groups whose labor market prospects are the most bleak and uncertain: the subset of informal sector workers who are pushed into informal sector by circumstances beyond their control, often living in remote and infrastructure poor areas; the children of these workers, who are facing a vicious circle of poverty; the unemployed youth; and the disabled. The chapter also discusses the prevalence of wage discrimination among various population groups.

29. **The chapter finds that Sri Lanka’s labor market is affected by a counterproductive duality between formal and informal employment.** Labor market institutions provide generous wages and protect the rights of insiders (of workers employed in the formal sector), and, consistent with international experience, the high level of protection adversely affects job growth, contributes to informal employment, and increases unemployment among youth and marginalized groups. The limited education of informal sector workers and their location in poorer rural areas also reduce their access to better paying formal sector jobs. And by lowering expected returns from schooling, restricted formal sector job opportunities also appear to reduce schooling participation of the poor, creating a cadre of less educated workers, with lower formal job prospects, thus perpetuating a vicious cycle of poverty. Thus the chapter concludes that more efficient labor market institutions—that provide essential but reduced protection—not only help promote growth, but somewhat paradoxically, also help improve employment prospects of informal sector workers, women, youth and other marginalized groups. Given the political difficulty of instituting such reforms, the chapter notes that reducing job protection should be complemented by appropriate social protection policies—the ones that help workers insure against unemployment, as well as addresses their training needs.

30. The chapter is organized as follows. To set the stage, the first section summarizes labor market trends and outcomes. The second section analyzes the impact of labor market institutions, focusing on employment protection legislation, wage setting, and civil service hiring policies. The third section examines the labor supply, focusing on education and training as determinants of the quality of labor force. The last section concludes by drawing policy implications.

## 2.1 Key Labor Market Trends and Outcomes

31. **Labor force growth has been aligned with population growth, so participation in Sri Lanka has remained stagnant despite economic growth.** From 1994 to 2003, the labor force grew at an annual average rate of 2.9%, in line with the increase in the working age population. Labor force participation rates remained constant—about 55 percent—over this time, but varied widely across population groups (Figure 2.1). The male participation rate (76 percent) was more than twice that of women (35 percent). Participation by age had a familiar inverse U shape, with participation rates lower for young and old relative to prime age adults. The participation rate was highest in the estate sector, followed by rural and urban participation rates.

32. **The structure of employment—particularly the large share of informal sector employment—has remained constant.** During 1997-2003, the distribution of workers among public sector employees, formal private sector employees, informal private sector employees, own-account workers and unpaid family workers has remained constant (Figure 2.2). The share of informal workers in total employment has also remained stable at about 65 percent. (Characteristics of informal sector workers and the unemployed are described in chapter 1.)

33. **Unemployment rates have declined by almost half in recent years, but remain very high among particular groups—women and youth.** As noted in the previous chapter, unemployment rate declined strongly from nearly 16 percent in 1990 to 8.2 percent in the fourth quarter of 2004. Unemployment rate varies widely across sub-population groups, and it is particularly high among the females, youth and the more educated. In 2003, female unemployment rate (13 percent) was slightly more than twice that of the male rate (6 percent). By age group, unemployment rate is highest in the 15-19 age group followed by that in the 20-29 age group (Figure 2.3). Close to one-third and one-fifth of the individuals in the 15-19 and 20-29 age groups are unemployed, respectively. In all other age groups, the unemployment rates are less than 5 percent.

Figure 2.1: Labor force participation rate, total and by gender, 1994-2003

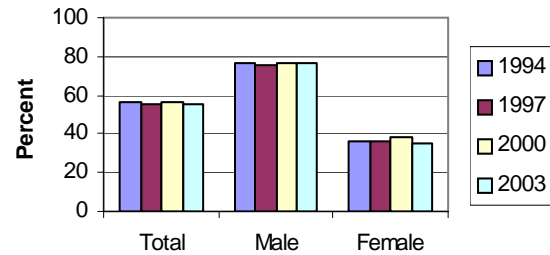
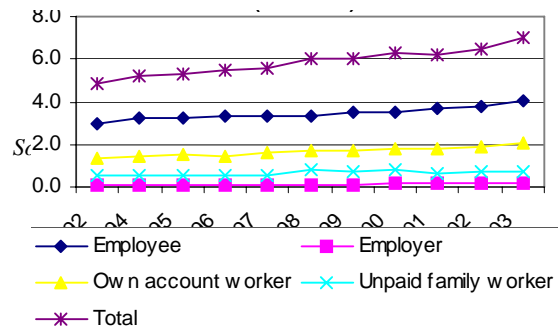
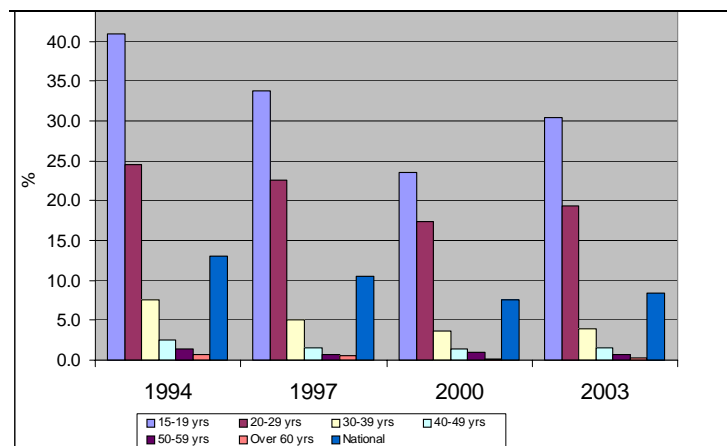


Figure 2.2: Employment by type of job, 1992-2003 (in million)



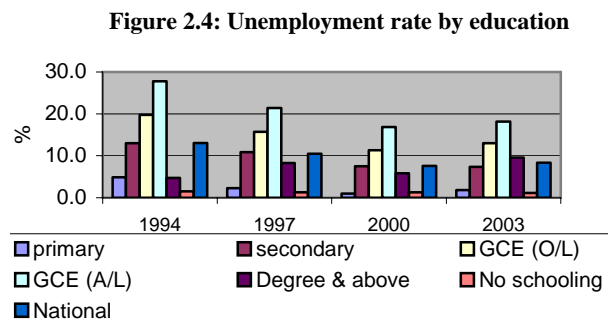
Source: Own calculations based on LFS data.

Figure 2.3: Unemployment rate by age group



Source: Computations based on LFS.

34. **Unemployment rates are highest for the well educated.** By level of education, unemployment rate is highest for the A/L qualified (18 percent in 2003), followed by that for O/L qualified (13 percent in 2003) individuals. In comparison, for individuals with below a primary level education, the unemployment rates are far below the national average (see Figure 2.4).



35. **Real earnings have increased for all, but estate sector workers lagged behind.** During 1992-2002, real earnings increased at the annual growth rates of 1.5 percent for median and 2.6 percent for mean earnings. Growth of real earnings was shared by men and women, as well as by urban and rural workers—but the real growth of estate sector workers was lagging behind and stagnated in real terms (Heltberg and Vodopivec, 2004).

36. **In 2003, average wages in public sector exceeded those in formal and informal private sector in almost all occupations** (Arunatilake 2005a). While informal sector workers were paid more than worker in the formal private sector in occupations at the upper end of the ladder, they were paid about equal or less at the lower-end occupations. This suggests a large wage premium of public sector jobs that offer also additional non-wage benefits (job security, extensive holidays, and, on average, low effort required at the job). By law formal sector employees also enjoy other types of benefits such as paid leave days and job security. On the other end of the ladder are informal sector workers who do not enjoy any of the above fringe benefits.

## 2.2 Labor Market Institutions: Impact on Equity and Growth

37. The demand for labor depends critically on overall growth in output. However, growing evidence suggests that labor market institutions—laws, unions, collective bargaining, core labor standards) can impact the demand for labor, particularly for vulnerable groups. While basic protection of worker rights (e.g., worker safety or contract violations) improves welfare and productivity, excessive protection that raises the costs of firing workers (e.g., severance) can paradoxically increase hiring costs and reduce employment opportunities for many labor force participants (particularly those with less skills) and hinder job creation. We therefore turn to evaluating three main employment protection institutions: severance pay system embodied in the Termination of Employment of Workman Act (TEWA), the wage setting mechanism, and civil service hiring practices. We examine how these institutions affect the demand for labor and thus influence labor market outcomes.<sup>28</sup>

### Severance Pay

38. **Sri Lanka's severance pay system—embodied in the Termination of Employment of Workman Act (TEWA) of 1971—is one of the costliest and most restrictive severance pay systems in the world.** The TEWA requires employers with more than 14 workers to seek the authorization of the

<sup>28</sup> In line with its focus on social policies, Sri Lanka has devoted significant attention to worker protection. For example, extensive legislation covers different aspects of working conditions and the government has ratified eight ILO conventions on core labor standards (although some weaknesses in monitoring and enforcement of labor standards need to be addressed). Tripartite mechanisms for social dialogue have been in place for a long time and trade unions, employers and the government interact and collectively resolve critical issues in industrial relations in the labor market.

Commissioner of Labor for intended layoffs. It not only requires that employers pay high compensation to laid off workers, but its discretionary nature and lengthy procedures further restrict the ability of employers to lay off workers. By ex-ante determining the amount of severance pay, the recently introduced formulas somewhat reduced arbitrariness, but payments remain well above international norms (employment protection legislation is described in Annex 2.1).

39. **Sri Lankan severance pay system, by limiting access to “good” jobs and by reducing job creation, is likely to hurt vulnerable groups and reduce productivity of firms.** This report empirically documents that TEWA regulations influence firms in two ways.<sup>29</sup> First, job creation and job destruction flows of formal sector firms in Sri Lanka are unusually low by international standards, a trait that can undoubtedly partly be explained by restrictive employment protection legislation. Second, the growth pattern of firms in the neighborhood of 15 workers is peculiar, with firms with 15 workers recording exceptionally large changes both when shrinking and when growing. As a consequence, formal sector employment is likely lower, reducing the size of higher productivity formal sector firms and limiting access to “good” jobs to one of the most vulnerable groups—informal sector workers, and firms’ ability to introduce technological innovations is lower, reducing their productivity.

40. **Sri Lanka’s low intensity of job flows is likely the consequence of its restrictive TEWA system.** In early 2000s, job creation exceeded job destruction, with the average job creation rate of 7.9 percent and the job destruction rate of 4.1 percent.<sup>30</sup> The resulting average gross job reallocation rate (the sum of jobs which disappeared in shrinking firms and those which were generated in expanding firms) was 12 percent, and excess job reallocation rate (a measure of the “job turnover”) was 8.3 percent. Job flow of for temporary workers, quite expectedly, strongly exceeded job flows of permanent workers (see Table 2.1). International comparison presented in Figure 2.5 shows that in each dimension, job flow rates of other countries vastly exceed job flow rates of Sri Lanka (note that the comparison includes a range of developed, transition and developing countries). While job flows can be low because of several other factors (exposure to macroeconomic and trade shocks, for example), compelling international evidence suggests that restrictive employment protection legislation, like TEWA, is the major contributing factor (see, for example, Haltiwanger and Vodopivec 2002).

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<sup>29</sup> In addition, labor regulations were identified as one of the most important obstacles to investment climate perceived by urban enterprises in Sri Lanka (Asian Development Bank and World Bank 2005).

<sup>30</sup> Consistent with Davis and Haltiwanger (1999), job creation is defined as the sum of increases in employment in all firms that expanded in a particular year, and job destruction as a sum of employment losses in firms that contracted in the particular year. We also use two summary job flow measures: job reallocation (the sum of job creation and job destruction) and excess job reallocation (the difference between the job reallocation and net employment growth).

**Table 2.1: Job flow dynamics, 2001/02 and 2002/03**

	2001/02			2002/03		
	Total	Permanent	Temporary	Total	Permanent	Temporary
<b>Rate of job creation and destruction (percent)</b>						
Job creation	8.2	8.2	13.5	7.6	6.2	39.3
Job destruction	3.9	3.9	6.3	4.4	4.4	6.6
Job reallocation	12.1	12.1	19.8	12.0	10.6	46.0
Excess job reallocation	7.7	7.8	12.5	8.8	8.9	13.3
<b>Memorandum items</b>						
Employment	160,167	153,814	6,353	165,337	156,502	8,835
Number of firms		418			426	

*Source:* Own computations based on 2003 urban ICA data.

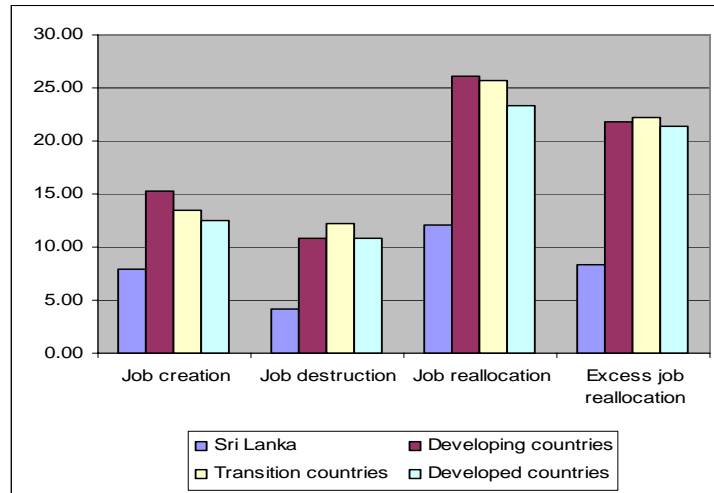
41. **TEWA explains the irregular size distribution of firms and limited growth of firms with 15 workers.** If the TEWA is creating adverse consequence for firms, they must be trying to avoid it. One way to do is by keeping their workforce below 15, thus benefiting from the TEWA exclusion. The Employees' Provident Fund data shown in Figure 2.6 indicates that each distribution of firms in 2000-03 has "a kink" at the size 14.<sup>31</sup> While the number of firms falls monotonically with the size of the firm for the firms larger than 10, there is an irregularity at the size 14, with the number of firms of this size being about the same as the number of firms of the size 13, followed again with a reduced number of firms of the size 15. Moreover, Figure 2.7 shows that to take advantage of the TEWA exclusion, firms of size 15 are shrinking more intensely than firms smaller or larger (and, since they have already passed the critical threshold, growing firms of this size are exceeding the intensity of growth of their immediate neighbors).<sup>32</sup> In other words, the firm size of 15 is found to be particularly "unstable", and the firm size of 14 particularly stable.

42. **Sri Lanka's depressed low job flows, relative to other countries, have potentially adverse implications for productivity growth.** It has long been recognized that in a well-functioning market economy, there is large scale, ongoing reallocation of inputs and outputs across individual producers. Recent empirical evidence shows that this reallocation contributes significantly to aggregate productivity growth (for a survey of this area, see Davis and Haltiwanger 1999). Caballero and Hammour (2000) also show that constrained labor markets may create a host of inefficiencies in the process of "creative destruction"—the process that is an important part of normal functioning of market economies.

<sup>31</sup> While Employees' Provident Fund (EPF) provides an extremely rich database on the firm-level number of workers—all registered firms are required to pay contributions for their permanent workers—the data is not free of problems. Above all, firms report only workers for whom EPF contributions are paid. If for whatever reason such contributions are not paid, the true number of workers of the firm deviates from the number reported to the EPF—the deviation which figures prominently particularly when computing growth rates. To improve reliability of the data, in the analysis of the growth of firms we therefore excluded firms with less than 10 workers (either in current or previous year), as well as firms with growth rates in the current year (positive or negative) exceeding 20 percent, as such large changes almost certainly reflected reporting inaccuracies.

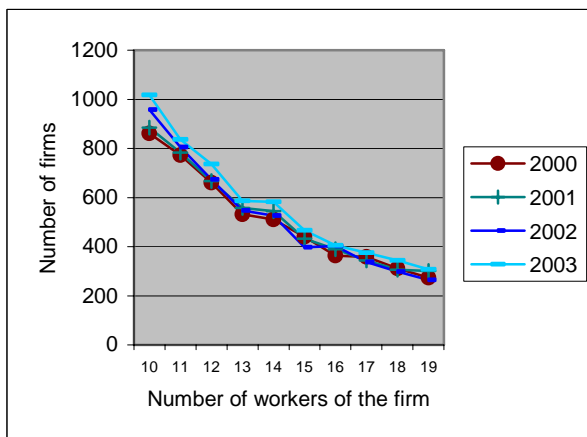
<sup>32</sup> Figure 2.7 plots the coefficients—size-specific dummies—in the following two regressions. For each year during 1996-2003, we grouped firms into a growing and shrinking group and then regressed growth (reduction) rates on firm size and year dummy variables. All size-specific dummies—reflecting deviations from the common growth trend—were found statistically significant.

**Figure 2.5: Job creation and job destruction flows**

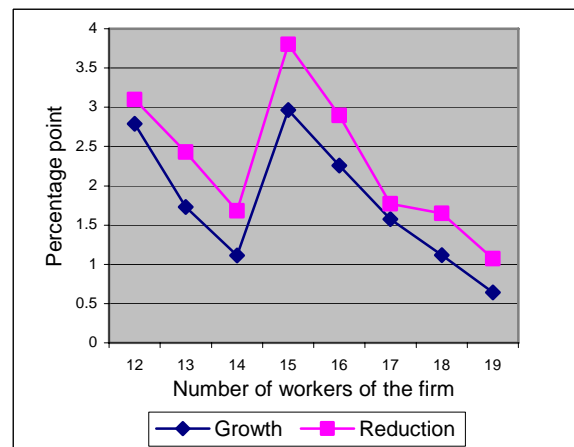


*Source:* own estimates for Sri Lanka, based on ICA 2003 urban survey (average for 2001/02 and 2002/03), World Bank (2005j) for other countries. Transition countries (total economy): Estonia: 1997-2000. Hungary: 1994-2000. Latvia: 1994-1999. Romania: 1994-2000. Slovenia: 1992-2000. Developed countries: West Germany 1978-1999, USA 1989-1997, Italy: 1988-1993, UK 1987-1998, Portugal 1984-1994, Finland 1989-1998, France 1991-1996, Canada 1985-1997, Denmark 1982-1994, Netherlands 1994-1997. Developing countries: Argentina 1997-2001, Mexico 1987-2000.

**Figure 2.6: Number of firms by size, 2000-03**



**Figure 2.7: Employment growth of firms (deviations from the common growth trend), 1995-2003**



*Source:* Own computation based on EPF data, 1995-2003 (based on the panel of firms consisting of 34,655 firms in 1995 and 50,748 firms in 2003).

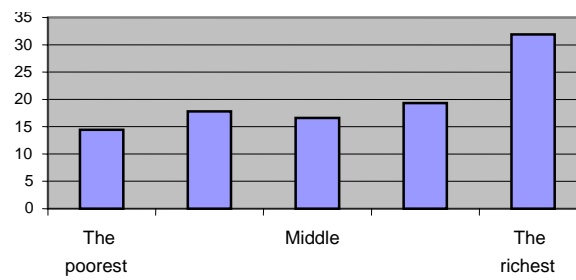
43. **International evidence shows that restrictive employment protection legislation, like TEWA, also reduces job prospects of women, youth and elderly—as observed in Sri Lanka.** There is growing and abundant evidence that strict employment protection reduces employment, particularly of women, young people and older workers, and that it hinders technological innovations (for a recent survey of such effects, see Vodopivec 2004 and Heltberg and Vodopivec 2004). And in India, protective worker legislation hurts precisely the most vulnerable groups.<sup>33</sup> The poor employment prospects of young

<sup>33</sup> Besley and Burgess (2004) show that legislation introduced in the name of equity can hurt precisely the group it is intended to protect. They found that pro-worker labor regulations reduced manufacturing output and employment

people and women may well be explained by restrictions on firing, which in turn hinder job creation. In short, large firing costs contribute to the emergence of dual labor markets, with well protected formal sector workers (which tend to be predominantly prime-age males) contrasted by much less protected informal sector workers and the unemployed.

44. **TEWA also likely reduces prospects of hiring informal sector workers who lack the opportunity to influence legislation.** While formal sector workers have a strong formal representation via trade unions, informal sector workers have been without an effective voice and their interests have therefore not been adequately represented when setting up the regulatory framework. The evidence about the TEWA coverage is consistent with this interpretation, showing that the workers covered by the TEWA are among the better-off segment of population. As shown in Figure 2.8, in 1999/2000 nearly one third of workers covered by the TEWA came from the richest quintile of population; in contrast, the rest of population was covered less than proportionally, with the lowest coverage in the poorest quintile.<sup>34</sup>

**Figure 2.8: Coverage of TEWA by income quintiles** (in percent, 2000)



Source: Heltberg and Vodopivec (2004), based on SLIS data.

### Wage Setting Institutions

45. **Pay Commissions, Tripartite Wages Boards and Collective Bargaining institutions play an important role in establishing wage levels.** There is a three-tier wage-setting structure: the public sector, the formal ('protected') private sector and the informal ('unprotected') sector. Public sector wages are governed by two key mechanisms: periodic recommendations by government-appointed pay commissions, and adjustments by the Cabinet in the cost of living allowance. Formal private sector wages are determined via tripartite Wages Boards (which determine minimum wages) and via collective bargaining between unions and the employers represented by the Employers Federation of Ceylon.

46. **Wage setting institutions increase wages of formal sector workers relative to informal sector workers.** There is compelling evidence that wage setting institutions have created an artificial gap between better-paying jobs in the public and the "protected" private sector and low-paying jobs in the "unprotected" private sector. Empirical analysis shows that public and formal private sector jobs command an important wage premium which cannot be explained by the productive characteristics of the workers. Other things equal, returns of public sector workers are 14 percent more, and returns of the 'protected' private sector workers are 11-12 percent more than returns of informal sector workers (see regression results in Table 2.2, taken from Heltberg and Vodopivec, 2004).<sup>35</sup> In addition, public sector

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and increased agricultural output (because investment shifted into farming) and increased urban poverty. And the effects were large: each pro-worker regulatory amendment, on average reduced registered manufacturing employment by 7 percent and daily employment in manufacturing by 29 percent.

<sup>34</sup> The TEWA system is likely to create other adverse consequences for businesses, many of which also affect workers in those firms. Among others, due to the TEWA, firms lack the flexibility to redeploy workers within the firm and to hire workers during a TEWA inquiry, and they may try to outsource parts of their business operations so as to circumvent the TEWA (Ranaraja, 2005).

<sup>35</sup> The analysis does not account for possible selection bias resulting from workers choosing the sector of employment—according to Rama (2003), however, accounting for the selection into public sector jobs has not altered significantly the estimates of earnings function returns.

workers enjoy other benefits such as tax exemption, job security and non-contributory pensions. Separate regressions (not presented here) show that the earnings premium tends to be concentrated at the lower education levels, including workers with GCE O/L level, the result consistent with findings of Rodrigo and Munasinghe (undated) who found that the pay advantage of civil service workers over their private sector counterparts applies particularly to lower level occupations. Note that formal private sector (represented in the table under the “TEWA job”) denotes workers in firms employing more than 14 workers which are therefore liable to the employment protection legislation under the TEWA (see above) and hence proxies the private sector ‘protected’ by legislation.<sup>36</sup> Unions are also more likely to be active in this sector, compelling greater compliance with protective labor legislation and engaging in collective bargaining. The largest premium (36-44 percent) is for military employment, probably reflecting the inherent risk factor in such employment.

47. **Women earn less than men, as a result of productivity differences but also because of other factors, such as discrimination.** There is substantial evidence of the presence of gender-based discrimination (see Table 2.3). Both Aturupane (1996) and Ajwad and Kurululasuriya (2002) found that discrimination in the labor market rather than differences in productive characteristics accounted for a large fraction of the gender-wage differential—which may be the result of discrimination or other institutional rigidities in hiring women.<sup>37</sup> Meanwhile, in a time-series analysis of the gender-wage gap in the agricultural sector during the period 1979-1998, Gunatilaka and Hewarathna (2002) show a persistent and stable gap between male and female wages for the same task in the tea, coconut and paddy sectors.

48. **On the positive side, there is no evidence of ethnicity-based differences in earnings.** With few exceptions, studies summarized in Table 2.4 show statistically insignificant differences in earnings, once differences in observable characteristics of individuals are accounted for.

### Civil Sector Hiring Policies

49. **Wage setting institutions and civil service recruitment practices have been advanced as reasons explaining high unemployment,** particularly among young people. Several hypotheses have been advanced to explain unemployment. The *unrealistic wage expectations* hypothesis maintains that more educated workers seek jobs which would pay them more than the market is willing to pay, perhaps because workers possess the wrong set of skills (or there is a skills mismatch, see World Bank 1999). The other two hypotheses assume that there exist “good” and “bad” jobs in Sri Lanka. The *queueing hypothesis* argues that the unemployed wait for an opportunity to take a job in the civil service which is known for offering stable jobs with generous fringe benefits (including pensions), and for requiring low work effort. Similarly, the *institutional hypothesis* maintains that unemployment arises because job creation of the “protected” private sector is hindered by high labor costs created by costly employment protection legislation and strong bargaining power of workers under conditions of virtually complete job security.

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<sup>36</sup> The protected sector denoted by the variable “TEWA job” also includes BOI firms. Although there few unions in this sector, workers in BOI firms producing for the export market usually enjoy better terms and conditions of work than informal sector workers, partially due to the concerns of international buyers and the implementation of social compliance contracts.

<sup>37</sup> In contrast, Gunewardena (2002) found that the OLS methodology used by the other two studies tended to overestimate the extent of discrimination. Having corrected for the omitted variable bias of the OLS methodology, she found that even though returns to education for women were higher than for men, initial disadvantages were so great that favorable returns were insufficient to eliminate the gender gap.

**Table 2.2: Estimation of earnings function (per hour take-home and total pay), 2000**

	Take-home pay per hour (log)	Total pay including benefits per hour (log)
Public sector job	0.137** (4.15)	0.144 (4.41)**
TEWA job	0.106 (2.91)**	0.120 (3.35)**
Military job	0.356 (7.28)**	0.437 (9.06)**
Grade 1-4	-0.025 (0.12)	-0.004 (0.02)
Grade 5-9	-0.000 (0.00)	0.027 (0.14)
GCE O/L	0.091 (0.46)	0.139 (0.71)
GCE A/L	0.353 (1.78)	0.370 (1.89)
Degree and above	0.677 (3.34)**	0.681 (3.40)**
Rural dummy	-0.171 (5.99)**	-0.165 (5.83)**
Estate dummy	0.050 (0.53)	0.032 (0.34)
Age	0.047 (7.33)**	0.047 (7.35)**
Age squared	-0.000 (5.65)**	-0.000 (5.74)**
Male	0.125 (4.62)	0.126 (4.74)**
Constant	1.972 (8.58)**	1.989 (8.77)**
Observations	3187	3188
R-squared	0.19	0.20

Source: Heltberg and Vodopivec (2004) based on Sri Lanka Integrated Survey (SLIS).

Notes: 'Total pay' includes other payments such as tips and bonuses, and 'Take-home pay' does not include such payments. Pension benefits are not included in either definition. Province dummies are included in both regression. Absolute value of t-statistics in parentheses. \* significant at 5%; \*\* significant at 1%.

**Table 2.3: Analyses on gender-wage/earnings differentials**

Study	Aturupane (1996)	Ajwad & Kurukulasuriya (2002)	Gunewardena (2002)	Gunatilaka and Hewarathna (2002)
Key results	61 percent of earnings differential between sexes not explained by differential endowments of personal characteristics.	Hourly wage premium for males 15% Conditional gender wage differentials 16%, 5%, 16% and for Sinhalese, Tamils, and Moors when male wage structure assumed to be true. More than 95 % of the gap not explained by productivity related characteristics.	Gender difference in log of earnings reduced from 0.45 in 1985/86 to 0.31 in 1990/91. Although returns to education were higher for women than for men in 1990/91, initial disadvantages so great that favorable returns insufficient to eliminate gender gap.	Persistent and stable gender wage differential for male and female workers in same task.
Method	Oaxaca Decomposition using OLS	Blinder-Oaxaca Decomposition using OLS and quantile regressions	OLS regression corrected for omitted variable bias using a fixed effects approach.	Time series analysis using stationarity tests and cointegration.
Period	1994	1999/2000	1985, 1991	1979-1998

*Note:* The above findings need to be qualified by the fact that estimating the impact of discrimination on wages is complicated by the fact that many endogenous factors affect labor market outcomes. For example, the decision to pursue education may be affected by discrimination itself, with the discriminated group either having lower school attainments due to discrimination at that level, or having high school attainment because of over-education to compensate for the difference in wages due to discrimination (Ajwad and Kurukulasuriya 2002).

**Table 2.4: Analyses on ethnicity-based wage/earnings differentials**

Study	Aturupane (1996)	Ajwad & Kurukulasuriya (2002)	Gunewardena (2002)
Key results	Men: Sri Lankan Tamils earned 9.2%, Indian Tamils 19% and Muslims 10% less than Sinhalese men. Results not significant. Women: Sri Lankan Tamils earned 11%, Indian Tamils 2.9% and Muslims 17% less than Sinhalese women. Results not statistically significant.	Tamils earn 7% more and Moors 2.5% less than Sinhalese, results not statistically significant.	1985/86: Men: Sri Lankan Tamils earn 4.9% more, Indian Tamils earn 4.7% less than Sinhalese men. Results not statistically significant. Women: Sri Lankan Tamils earn 14.3% more (statistically significant), Indian Tamils earn 13.7% more (not statistically significant) than Sinhalese women.
Method	Oaxaca Decomposition using OLS	Blinder-Oaxaca Decomposition using OLS and quantile regressions	OLS regression corrected for omitted variable bias using a fixed effects approach.
Period	1994	1999/2000	1985, 1991

*Note:* same as under Table 2.3.

50. **Recent evidence supports the queuing and institutional hypotheses linked to labor market rigidities.**<sup>38</sup> As shown above, the regression analysis confirmed the existence of a positive public sector premium relative to the private sector, other things equal, as well as the wage premium of TEWA-

<sup>38</sup> We are referring to the findings of Rama (2003), World Bank (1999), and Heltberg and Vodopivec (2004).

protected jobs over other private sector jobs. By implication, the civil service wage premium attracts job-seekers to queue and thus generates unemployment. Similarly, the wage premium of TEWA-covered jobs increases costs and reduces labor demand. Note that TEWA-covered jobs also carry non-wage costs—the expected costs of layoffs (if explicitly acknowledged at the time of the contract, the expected costs of layoff should reduce wages, and so the amount of the wage premium of the TEWA jobs underestimates the additional costs borne by employers).

51. **Government ad-hoc recruitment policies also contribute their share to unemployment (via queuing).** Above evidence about the wage premium shows that queuing for public sector jobs has made good sense—and that perhaps the appeal of public sector jobs is also the reason for the poor success of job subsidy programs (see Box 2.1). Adding to perverse labor market incentives (and contributing to government overstaffing) are patronage-based appointments to the civil service as a way of obtaining political support or fulfill promises, with insufficient private job creation often used as an excuse. Political motivation of regular large scale recruitments is evident from the fact that such recruitments often mirror electoral cycles. In the 2005 Budget announcement, for example, 30,000 graduates were recruited and 40,000 temporary staff were made permanent. Note that with 14 percent of the labor force employed in Government (18 percent if semi-government is included) in the 1990s, Sri Lanka had one of the largest bureaucracies in the region. According to the World Bank (1998), Sri Lanka had 3.9 civil servants per 100 population compared to the average of 2.6 per 100 population in Asia. Moreover, during 1998-02 the number of employees of the Central Government increased by 23 percent (from 354 to 436 thousand), strongly exceeding corresponding increases of the population and labor force (which were 6 and 9 percent, respectively—Sri Lanka DCS, 1998 and 2002).

#### **Box 2.1: Helping job-seekers to be placed in the private sector**

The Distance Education Modernization Project, launched in December 2003, has been seeking to place young workers who finished A-level but failed to enter universities to the private sector (subsidizing their pay by Rs. 4,000 for the first nine months of employment). With not much success.

Since December 2003, 36,000 youngsters applied, and the project solicited 2,554 job offers from 184 private sector firms. After interviewing 16,481 of candidates, firms offered jobs to 1,273 of them. But by August 2005, only 432 students have actually accepted these offers. And students often had second thoughts about taking these jobs. For example, a leading private sector manufacturing firm accepted 37 candidates (after interviewing over 300 of them), but after they were given an orientation at the factory, the candidates sent a letter announcing collective withdrawal just a few days before the agreed upon date for starting a job.

*Source:* Management of Distance Education Modernization Project, Ministry of Education.

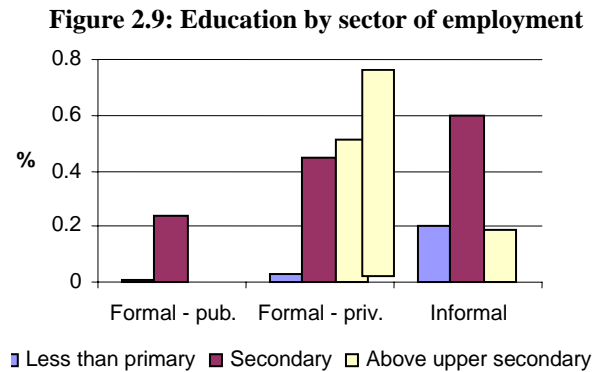
### **2.3 Enhancing Labor Supply by Increasing Education and Training of the Poor**

52. The above discussion has largely focused on the constraints imposed by labor market institutions on the demand for labor. We now turn to a brief discussion of education and training as determinants of the quality of the labor supply (for a comprehensive discussion education in Sri Lanka, see World Bank 2005f).

53. **Workers are pushed to informal sector by lack of human capital, poverty, and distance to markets.** Given that informal sector workers are disproportionately poor and that significant inequities follow the formal-informal split, a natural question arises—why do people choose such jobs? Is this option primarily a matter of ability and personal preference, or are there specific circumstances outside the control of individuals that influence such decisions? In a background paper for this study, Arunatilake

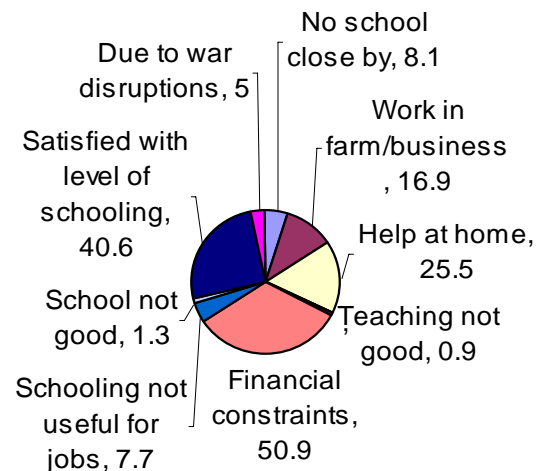
(2005a) shows that informal sector workers are over-represented in communities with higher unemployment rates and in provinces other than Western province and the North/East. Many of them are pushed in the informal sector by large distance from commercial sectors, the lack of adequate community infrastructure (access to roads and electricity), and by poverty which limits their investment opportunities (including investment in schooling and health). Arunatilake thus shows that the lack of equal opportunities underlies the decision to enter the informal sector.

54. **Informal sector workers are much less educated, which partly explains their higher poverty incidence.** The share of workers with less than primary education and with secondary education in the informal sector is much higher, and the share of workers with the above-secondary education is much lower than in the comparator sectors—public sector and formal private sector (Figure 2.9). And as shown in the previous chapter, lower education is strongly associated with higher risk of poverty.



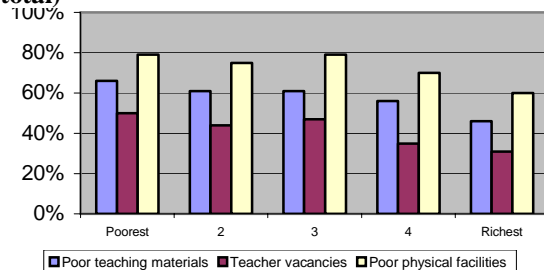
55. **Informal sector workers include many individuals who dropped out of school because of high costs of schooling and because of low perceived benefits of education.** According to SLIS survey, 7 percent of all 5 – 14 year olds did not attend school. More than half of these children did not attend school because of financial constraints, 17 percent because they had to work on the farm or in business, and 26 percent because they had to help at home (Figure 2.10). Moreover, 41 percent of respondents stated that they were satisfied with the level of schooling and 7 percent that additional schooling was not useful for finding a job.

**Figure 2.10: Reasons for not attending school, in percent (for those who have dropped out)**



56. **The regression analysis confirms that poverty affects school attendance.** Being in the poorest expenditure quintile, the presence of large number of young children, and direct costs of schooling, on both essential school materials and on private tuition, were all found to negatively affect school attendance (Arunatilake 2005b). Arunatilake’s results also suggest that lower attendance is associated with lower expected benefits from schooling for children from poor families. She found that school quality (as proxied by unfilled teacher vacancies) negatively influenced school attendance, and schools catering the poor are known to be given less resources (see Figure 2.11). Moreover, the importance of the occupation of the household head for school attendance suggests that household characteristics may influence the expected benefits of schooling (and

**Figure 2.11: Children in communities with poor school resources, by expenditure quintile (percent of total)**



Source: SLIS 1999/2000. Note: Percentages do not add up to 100, since more than one reason could be cited

of job search), as parents with more influential positions and thus better social networks may affect the returns of education by increasing the chances of accessing higher paying jobs.<sup>39</sup> This finding is strengthened by the fact that socio-cultural factors, such as ethnicity of the father, also affect schooling behavior (Arunatilaka 2005b).

57. **The low education of informal sector workers reduces education prospects of their children, despite universal access to education.** For this reason, **intergenerational schooling mobility is low** in Sri Lanka by international comparison—reflecting in part institutional constraints that result in limited job opportunities. Intergenerational economic mobility is an important indicator of social and economic progress made across generations. Comparing the educational attainment across three generations, Ranasinghe (2004a) finds that an additional year of parental education for the older generation implies an increase of nearly 0.6 years of schooling for children, in comparison to only about 0.3 years for the youngest generation (Table 2.5). The comparatively low intergenerational mobility in Sri Lanka could be due to the children of poorly educated parents having high out of pocket costs, or the high opportunity costs involved in sending children to school, or low expected returns from education, including low opportunities for employment. Findings that are consistent with the results noted in the last two paragraphs.

58. **Informal sector workers living in rural areas have limited access to ‘second chance’ offered by training.** The challenges of training as a tool to give workers a “second chance” seem to be very similar to the challenges of education. In its comprehensive evaluation of Sri Lanka’s training, World Bank (2005f) shows that training is an effective labor market tool, as it reduces job search times and increases earnings. In its analysis of training participation, the study finds that (i) parental schooling positively influences children’s training decisions, (ii) the probability of getting training in the Western Province is higher than in all other provinces, and (iii) the probability of training, especially of formal training, is strongly correlated with level of schooling attainment (as individuals with higher levels of education also tend to benefit more from training). This analysis implies that members of poor families have worse access to training, and suggests that reducing regional inequalities in access to training as an important priority. These constraints are likely to be also important for poor unemployed youth and the disabled.

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<sup>39</sup> Both Arunatilake (2005b) and Ranasinghe and Hartog (2002) find that children of fathers with professional or administrative (managerial) occupations have a much higher probability of staying in school and completing higher level of education than children of fathers of lower level occupations.

**Table 2.5: International comparison of intergenerational schooling correlations**

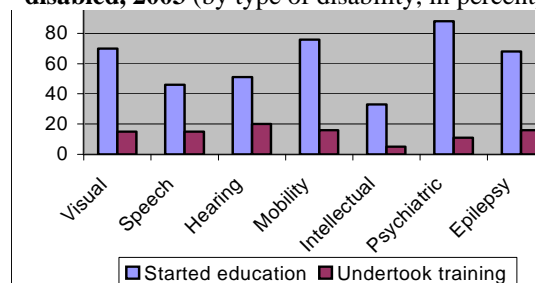
Country/year	Source	Father-Son	Mother-Daughter	Father-Daughter	Mother-Son	Year of Birth
<b>Sri Lanka</b> (18+ year olds)	Ranasinghe (2004)					
	Older and younger generations pooled	0.52	0.54	—	—	1920-1981
	Older generation only	0.51	0.48	—	—	1920-1981
	Younger generation only	0.42	0.46	—	—	1945-1981
<b>US</b> (20-30 year olds)	Couch & Dunn [1997]	0.418	0.431	0.402	0.423	1954-1964
<b>Germany</b> (19-26 year olds)	Couch & Dunn [1997]	0.237	0.391	0.016	0.097	1958-1965
<b>Malaysia</b> (8-50 year olds)	Lillard & Willis [1994]	0.194	0.358	0.226	0.239	1938-1980
<b>Mexico</b> (23-69 year olds)	Binder & Woodruff [1999]	0.488	—	0.517	—	1925-1971
<b>South Africa</b> (16-65 year olds)	Hertz[2001]	0.408	0.42	—	—	1928-1977
<b>Panama</b> (18+ year olds)	Heckman & Hotz [1986]	0.57	—	—	0.75	1965-1983
<b>Israel</b> (22 + year olds)	Beenstock [2002]	0.2928	0.3427	0.3479	0.2678	1953-1973

Source: Ranasinghe (2004a).

**59. Disability also reduces school participation, particularly for girls, and despite their special needs, few disabled have received any training.**

At present disabled children can attend government schools either through the inclusion in ordinary classrooms or in special education units attached to ordinary schools. Those who cannot or do not want to fit into either of these streams, attend special schools run by NGOs and the private sector. However, according to 2003 survey, a large share (39 percent) of disabled had never started schooling, ranging from 12 percent for persons with psychiatric disability, 24 percent for those with mobility disability, to 67 percent in the case of those with a intellectual disability (Ministry of Social Welfare 2003, see Figure 2.12). Disabled female children were found far less likely to go to school than disabled male children. Moreover, children with disability have high school attrition rates. Minor vision and hearing disability can result in children being out of school, or dropping out. For example, only 24 percent of those who felt that a hearing aid would improve their hearing had been able to receive them. Disabled also face difficulties in their access to training — despite their special needs, in 2003 only 5-20 percent have undertook a training program, with the percentage ranging from 5 percent for persons with intellectual, to 15 percent for those with visual and speech disability and 20 percent for hearing disability (Ministry of Social Welfare 2003, see Figure 2.12).<sup>40</sup>

**Figure 2.12: Education and training received by disabled, 2003 (by type of disability, in percent)**



Source: Ministry of Social Welfare (2003).

<sup>40</sup> According to 2002 labor force survey, 13 percent of working-age population reported having received training (World Bank 2005f).

60. **The Ministry of Labor has developed active labor market programs, but their impact is not well known.** A review of current programs and piloting of new programs is warranted (paying special attention to youth, women and disabled) to arrive at the appropriate scope and the national strategy.<sup>41</sup> Findings from industrialized countries on the effectiveness of such programs from developed countries suggest that training programs can be costly and ineffective (see, for example, Betcherman et al, 2004, and their summary in Table 2.6). On the positive, side, most programs also appear to work best under conditions of economic growth (as currently the case in Sri Lanka). But findings from industrialized countries about the impacts of these programs may not apply to developing countries, which are characterized by a much larger informal labor markets and weaker capacity to implement programs. Evidence from less industrialized countries suggests that outsourcing programs to the private sector may be most effective, with potential use of vouchers to help ensure that private information is maximized in matching suppliers of training with those seeking training, with the Government setting the standards and regulating the sector (see Box 2.2 for such experience in Kenya in Sub-Saharan Africa, and Box 2.3 for a successful approach to public private partnerships in Mexico).

## 2.4 Policy Options

61. **Labor market institutions that help protect basic rights of workers can improve equity and efficiency.** However, the above analysis shows that consistent with international evidence, excessive protection embodied **labor market institutions and practices in Sri Lanka—severance pay, wage setting institutions, and the civil service hiring process—have adversely affected equity, productivity and economic growth.** They have (i) hindered job creation and raised returns of privileged groups, thereby worsening labor market outcomes of vulnerable groups, including limiting their access to “good” jobs; (ii) constrained the restructuring and investment capacity of businesses; (iii) and via generating perverse incentives of “waiting” for public sector jobs, they have contributed to unemployment. Consequently, they contributed to the high share of informal sector employment—which critically affects poverty— and to high unemployment among young people, particularly women.<sup>42</sup> Moreover, employability (the capacity of individuals influencing their labor market success) of the poor also suffers because of important inequalities in access to education and training. While economic growth will be the main driver of job growth and poverty reduction, the role of efficient labor market institutions in ensuring a more equitable growth in jobs is also an important one. To move in this direction, two key areas need to be addressed: (i) reducing job protection in favor of worker protection, and (ii) enhancing access to training/skills for informal sector workers and youth to improve their job prospects (addressing school participation via demand side interventions is relegated to chapter 4).

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<sup>41</sup> To assist the Sri Lankan government in the preparation of a National Action Plan on youth employment and to improve the country’s capacity to address youth employment issues, the World Bank, together with the ILO, in 2004 launched a special 2-year initiative under the UN-sponsored “Youth Employment Network.” Under this initiative, conceptual foundations for the National Action Plan will be prepared, partly based on new studies in the areas of employment creation, employability, entrepreneurship, and equal opportunity have been commissioned. Among others, these studies will look at the institutional factors affecting employment creation and the effectiveness of active labor market programs, focusing on the youth. The World Bank is also preparing a survey investigating factors that are instrumental for a successful school-to-work transition, perhaps the most important transition for the youth.

<sup>42</sup> An important implication of restrained demand for labor is migration. In 2003 there were more than a million Sri Lankans working abroad, with females accounting for up to 60 percent (Sri Lanka Bureau of Foreign Employment 2004). While the analysis of migration is beyond the scope of the report, its opposing effects are worth mentioning: while migration provides productive opportunities for many Sri Lankans and contributes to increased consumption of migrant households, it also brings a host of problems both for migrants and for their families. For example, data from the SLIS 1999/00 show that children with a migrant parent have lower educational attainment and worse health status than other children. The absence of the mother, in particular, is seen as affecting the stability of the family and the welfare of the children (Ranasinghe 2004b).

**Table 2.6: Summary of impact evaluations of active labor market programs**

<b>Intervention</b>	<b>Summary of overall impact</b>	<b>Comments</b>
Job search assistance	Generally positive impacts on employment and earnings in developed and transition countries. Costs relatively low so cost-benefit ratio usually positive. Very little evidence for developing countries	Programs have most positive impacts when economy good. In developing countries, questions about coverage and effectiveness of these services, given informal LMs.
Training for unemployed	Positive impacts on employment but no overall effect on earnings in developed countries. Positive on both in transition countries. Evaluations in developing countries not positive (but few studies). More information on costs needed.	Program effectiveness benefits from on-the-job training and employer involvement. Women often seem to benefit more than men. Programs have most success when economy good.
Retraining for workers in mass layoffs	Often no positive impact on employment and earnings but there are exceptions. Very little evidence for transition and developing countries.	Better results may be achieved with integrated training and employment services.
Training for youth	Very negative impacts on employment and earnings in developed countries. Positive impacts in developing countries (Latin America), though few studies. No evidence from transition countries.	Youth employment problems more effectively addressed through earlier, education-related interventions. Training most effective when combined with other employment, basic education, and social services. Successful programs require intensive services and, thus, are costly.
Wage/employment subsidies	Overall negative impacts on employment and earnings in developed and transition countries. Very little evidence in developing countries.	Recent evaluations in developed countries more favorable (e.g., welfare-to-work programs). Programs may be more effective when combined with training. Deadweight and substitution effects likely important but often not fully assessed.
Public works	Overall negative impacts on employment and earnings in developed and transition countries. Very little evidence on LM impacts in developing countries, despite widespread use.	Can be effective as a short-term safety net for the poor but generally not as program to improve future LM prospects.
Micro-enterprise /self-employment assistance	Not enough LM-oriented evaluations to determine overall employment and earnings impacts.	Very low take-up. Some evidence of positive impacts for older, better-educated individuals. Results likely better when technical and advisory services accompany financial aid.

*Source:* Betcherman, Olivas and Dar (2004).

*Note:* Based on the findings of 152 rigorous impact evaluation studies.

### **Box 2.2: Training for the informal sector: The Jua Kali experience, Kenya**

The successful Kenyan Jua Kali project sought to provide training for about 25,000 informal sector manufacturing workers. A key feature of the project was a successful voucher program, enabling informal sector workers to purchase the training they wanted from any registered training provider.

Several important lessons emerged. First, the use of a voucher mechanism enabled the project to stimulate demand for training, technology, and management and marketing consultation among micro and small enterprises. A supply response was generated and a training market established to address the needs of micro enterprises. Second, an unexpected impact of the voucher training program was the emergence of skilled craftsmen as the leading providers of training. The strong preference of Jua Kali workers for training by master craftspersons was reflected in the fact that 85 percent of all vouchers were used for the services of master craftspersons, and only 15 percent for private and public training institutions. The training by master craftspersons was well adapted to entrepreneurs' need for short, practical training. The project strongly increased the demand for craftspersons training. And third, the experience of the project underscores the importance of appropriate management arrangement: a project for the private sectors is best managed by the private sector with government playing a facilitating role.

The following general features should be taken into account when governments seek to facilitate training for an informal economy:

- Demand for training among micro and small enterprises in the informal sector is likely to be low and need developing in order to demonstrate the benefits of skills development.
- Informal sector associations can help to raise awareness of skills shortages among members, as well as addressing other shared needs.
- Training for the informal sector differs from the formal sector in its preference for merging technical skills with business management skills and in delivering courses with a flexible schedule.
- Training must have immediate application, since the poor cannot afford long periods of training before seeing a payoff. Evaluating competencies achieved through training is important to ensure quality.

*Sources:* Johanson and Van Adams (2004) and World Bank (2005k)

### **Reforming Labor Market Institutions: Moving from Job to Worker Protection**

62. **Considerations about the reduction of the generosity of severance pay.** The March 2005 formula increased the already exceedingly high employers' costs of severance pay, and the discretionary power of the Labor Commissioner has been preserved. In the light of international experience, these two aspects need to be reexamined, if Sri Lanka is to become a more dynamic economy. Options to be evaluated include (note that along with these measures, complementary measures to compensate for changes in risk bearing would have to be carefully sequenced, particularly the introduction of unemployment insurance — see below):

- Reducing the factor of generosity for each year of service as well as the maximum payment, thus aligning better the generosity of severance pay with international practice.
- Allowing individual layoffs without notifying the Commissioner, and retaining the requirement of notification only in cases of mass layoffs (as widely practiced internationally)—there is no need to retain the discretion after the compensation formula has been introduced.
- Avoidance of charging “double-compensation” to employers (TEWA payments could be reduced by the amount of gratuity paid to laid off workers).
- Excluding the coverage of worker incompetence under the TEWA.

### **Box 2.3: A proactive approach to small- and medium-size enterprise support**

The Integral Quality and Modernization Program (CIMO—now renamed as PAC), established in 1988, has been effective in reaching small and medium-size enterprises and assisting them to upgrade worker skills, improve quality, and raise productivity. Set up as a pilot project to provide subsidized training, CIMO evolved when it became apparent that lack of training was only one factor contributing to low productivity. By 2000 CIMO was providing a package of training and industrial extension services to over 80,000 enterprises each year and training 200,000 employees. Private sector interest has grown. More than 300 business associations now participate in CIMO, up from 72 in 1988.

All states and the Federal District of Mexico have at least one CIMO unit, each staffed by 3 or 4 promoters. Most units are housed in business associations that contribute office and support infrastructure. The promoters organize workshops on training and technical assistance services, identify potential local and regional training suppliers and consulting agents, and actively seek out enterprises to deliver assistance on a cost-sharing basis. They work with enterprises to conduct an initial evaluation of the firm, as the basis for training programs and other consulting assistance. CIMO is expanding in two directions: assisting enterprises with specific sectoral needs, and providing an integrated package of services, including information on technology, new production processes, quality control techniques, and marketing as well as subsidized training.

Evaluations found that CIMO had been effective in improving the performance of targeted companies. Compared to a control group, CIMO firms increased investments in worker training, had higher rates of capacity utilization, and were more likely to adopt quality control practices. These improved outcomes were associated with increased productivity. Evaluations found CIMO-PAC to be a cost-effective way of assisting small and medium-size enterprises. Other performance indicators were: increased profitability, sales, capacity utilization, wage and employment growth, reduced labor turnover, absenteeism, and rejection rates for products. The most dramatic impacts were among micro and small firms.

*Source:* World Bank (2005k).

63. **Avoiding direct government interference in wage setting (except minimum wages).** The effects found by the report—the premium paid to formal sector workers—should be further studied, primarily by trying to disentangle the effects of wage setting from the effects of constrained access to formal sector jobs imposed by the TEWA. The government should restrict its involvement in wage setting to the determination of minimum wages as a partner under the tripartite minimum wage setting mechanism. It should not directly interfere in private sector wage setting, even in the form of “recommended” wage increases, as they, too, may introduce distortions in wage setting.

64. **Reforming civil service recruitment practices** Ad-hoc government recruitment of unemployed graduates is counterproductive, as it reduces incentives for youth to take non-government jobs. Commitment to recruit according to preset long-term schedules would re-orient young job seekers to search for jobs outside the public sector, increasing the pool of talents available to employers and ultimately improving overall capacity of the economy.

65. **Developing explicit social protection (or worker) measures to complement reduced protection of jobs.** International experience shows that reducing the protection of jobs will have to be simultaneously supported by the enhancing other parts of social protection, for example, by introducing an explicit protection system of workers in the form of unemployment insurance (Vodopivec 2004). Explicit worker protection arrangements would help preserve the welfare of workers and thus help reducing the opposition to job protection reforms. Such arrangements were successfully introduced in Eastern European countries when they reformed their employment protection legislation. And irreversibility of reforms needs to be assured, so that the newly introduced unemployment insurance does

not become yet another benefit for already privileged formal sector workers without commensurate changes in the job protection system.

66. **Promoting a social dialogue to engage all stakeholders in the decision making process.** Even so, some workers may not consider the provision of worker protection, such as unemployment insurance, appropriate. Promoting a social dialog on these issues is necessary, and reforms will undoubtedly be a lengthy process. Adding to the complexity of the task is the fact that reforming employment protection legislation is technically demanding, because reforms have to be coordinated across different areas and attuned to local circumstances (see the discussion of the introduction of the unemployment insurance system in chapter 3).

## **Improving Access to Education and Training**

67. **Improving access to training and other services for informal sector workers and unemployed vulnerable groups.** The participation of the informal sector workers, the unemployed and other vulnerable groups in active labor market programs (ALMP)—such as training, job search assistance, self-employment programs, is called for, and international evidence on the effectiveness of such measures should be taken into account. Preference should be given to programs that are cost effective (e.g., job search and information assistance, including job matching services via JobsNet network, and job counseling). Programs may need to be directed at particular regions (such as the North East), and cater also to women, youth, and disabled individuals. Outsourcing programs to the private sector is likely to be most effective, with potential use of vouchers to help ensure that private information is maximized in the matching supplier to demand. To maximize their usefulness, a careful analysis and piloting of such programs is called to arrive at the appropriate scope and the national strategy.<sup>43</sup> Moreover, the access of people with disability to training programs should be strengthened, among others by expanding the range of training programs, providing additional training to the trainers, the development and use of sign language, and the use of community-based rehabilitation approach.

68. **Ensuring access of poor children and youth to education and/or well designed training programs.** As noted, avoiding low skill levels requires increased participation of children in school and reducing their dropouts. These issues have already been addressed in an earlier report World Bank (2005f). However, from a social protection perspective, one option is to defray the costs of education of the poorest children by, for example, providing safety nets contingent on school participation (see more discussion and international experience in chapter 4). Innovative approaches to tailor schooling and training around the needs of the working children, or children who have dropped out of school, may also be needed (see Box 2.4 on an innovative program in Bangladesh program).

69. **Linking the participation of the poor in skill development programs to their participation in social protection programs**—in unemployment insurance programs, micro-finance, and (for able bodied) in workfare. Ensuring participation in these programs may help ensure the poor escape poverty

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<sup>43</sup> To assist the Sri Lankan government in the preparation of a National Action Plan on youth employment and to improve the country's capacity to address youth employment issues, the World Bank, together with the ILO, in 2004 launched a special 2-year initiative under the UN-sponsored "Youth Employment Network." Under this initiative, conceptual foundations for the National Action Plan will be prepared, partly based on new studies in the areas of employment creation, employability, entrepreneurship, and equal opportunity have been commissioned. Among others, these studies will look at the institutional factors affecting employment creation and the effectiveness of active labor market programs, focusing on the youth. The World Bank is also preparing a survey investigating factors that are instrumental for a successful school-to-work transition, perhaps the most important transition for the youth.

(see chapter 4). This is the practice in most OECD countries where unemployment benefit claims are contingent on participation in training programs.

**Box 2.4: Bangladesh: underprivileged children's education program (UCEP)**

UCEP, established in the early 1970s as a non-government organization, seeks to raise the living standards of poor urban children and their families in Bangladesh. It focuses on the target group of working street children and aims to provide them with skills to enhance their employability in the local labor market, often in the informal sector. In 1997, it had 30 general schools for non-formal basic education working on three shifts per day in four major cities, with total enrollment of 18,300. UCEP has extraordinarily high completion and employment rates for its graduates, both averaging about 95 percent.

UCEP's program can be divided into three stages. The first stage is accelerated non-formal basic education starting at age 10 or 11. Basic education up to grade 8 is covered in about four to four-and-a-half years. About half the graduates from the non-formal basic education program are admitted into vocational training. The second stage consists of fundamental skills training, which lasts from six months to two years. And the third stage is placement in employment, and follow-up on the job.

Factors that have contributed to making UCEP successful include:

- Providing students with a solid base of general education.
- Focusing on the proper target group, i.e., those with "blue collar working aspirations", those who intend to enter the labor force after training as semi-skilled workers.
- Continuous linkages with industry to ensure that trainees are trained in the knowledge, skills and attitudes sought by employers, and that employers are aware of the competencies of UCEP graduates.
- Focus on acquisition of skills and competencies through highly structured, supervised individual "hands-on" instructions (rather than being driven by credentials and certificates).
- Rigorous follow-up of each graduate in terms of employment, earnings and performance on the job.

*Source:* World Bank (2005k).

### 3. IMPROVING SOCIAL INSURANCE

*"It is of great value because when you grow old and cannot work your fields, you know there is a permanent payment that you can bank on every month."*

*Gange Elison, a 63 year old small farmer, talking about the Farmers' pension scheme*

70. This chapter examines how social insurance in Sri Lanka can be improved in order to reduce vulnerabilities related to old age, injury, disability, death, and unemployment.<sup>44</sup> It thus focuses on the group identified in chapter 1 as one of the most poor and vulnerable: informal sector workers, left out not only from old age, but often also from disability and death insurance. The chapter also addresses the needs of workers who are currently covered by formal schemes but their benefits are inadequate and/or the schemes may be financially unsustainable. The fact that Sri Lanka has one of the most rapidly aging populations renders the discussion of these issues a particular urgency and importance.

71. In high income countries, social insurance schemes provide old age, survivor and disability pensions, unemployment benefits and often, health services. Sri Lanka also has some of these programs and offers the most extensive social security (pensions, disability, survivor and health) coverage in South Asia. The provision of social security is largely tied to participation in the formal sector, although since the 1990s, a new public sponsored scheme reaches a significant number of farmers and fishermen, despite its voluntary nature. Together, these programs cover a third of the population, much more than any other South Asian country. But as described below, these programs are limited in terms of both adequacy and sustainability, resulting in a dual challenge: to address the shortcomings of existing schemes and to find ways of expanding coverage to the informal sector workers. The chapter finds that the coverage of existing formal and informal insurance schemes could be increased, and their financial efficiency improved, if certain changes were made to their design, administration and regulation. Coverage expansion would need to be phased in order to take into account administrative complexity of programs. Finally, expansion of social insurance coverage is closely linked to the level of formality in the labor market, and labor market and other reforms to increase formality will be critical complements. The expansion of this system would also reduce burden on the safety net.

72. This chapter is divided into four sections that address the risks of old age, disability, death and unemployment in Sri Lanka. The first section briefly reviews existing schemes for formal sector workers, with a focus on areas where improvement is needed. The next section looks at schemes that are available

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<sup>44</sup> By providing insurance against a series of risks including unemployment, illness, disability and longevity, social insurance schemes can both foster equity and enhance economic growth. While the equity enhancing aspects of insurance are clear, insurance can also help to promote growth. For example, insurance allows individuals to avoid "dynamic poverty traps" whereby uninsured shocks drive households into chronic poverty (Ravallion 2003), avoid costly forms of consumption smoothing such as borrowing or removing children from education (Chetty and Looney 2005), and allow households to channel their savings to more productive activities (Rosenzweig and Wolpin 1993).

to informal sector workers and the population at large. The last section provides recommendations for improving the efficiency of existing formal and informal insurance schemes.

### **3.1 Formal Social Insurance Schemes**

73. **Sri Lanka provides the most extensive social security (pensions, disability, survivor and health) coverage in South Asia.** The provision of social security is largely tied to participation in the formal sector, although since the 1990s, a new public sponsored scheme reaches a significant number of farmers and fishermen, despite its voluntary nature. Together, these programs cover a third of the population, much more than any other South Asian country. Aside from pensions, these workers are offered disability and survivor insurance as part of their benefit package.

#### **Old Age Income Support through Pensions**

74. **Sri Lanka has four programs providing income support for old age, but all have major shortcomings.** Three of these—the Employees Provident Fund (along with the “approved” private funds that operate under the same rules), the Civil Service Pension Scheme (CSPS), and the two voluntary schemes for informal sector workers—are directed at those households with some capacity to save for the long term. The fourth is a broad social assistance program—Samurdhi (discussed in detail in the next chapter) that includes among its beneficiaries also households with elderly members. Studies of Sri Lanka’s pension sector (most done by local researchers) find that these programs have shortcomings in meeting at least one of the two key criteria for success—adequacy and sustainability. These problems must be addressed before policymakers can confront the final challenge, namely to extend coverage of these programs to the majority of the population.

75. **The pension system (exception civil servants) does not allow consumption smoothing over the lifecycle** (Gaminiratne et al 2004). Their budget financed, defined benefit pension is the only annuity available in Sri Lanka. The target benefit levels are high relative to pre-retirement incomes and retirement can take place at the early age of 55. In contrast, members of the EPF scheme tend to have insufficient balances as investment returns trail the growth of their own incomes and retirement ages have not adjusted to increased longevity (Eriyagama and Rannan-Eliya 2003a). Even were the balance to be sufficient, the lump sum payout does not provide longevity insurance. In fact, survey data suggest that most retirees distribute their balance among children in what may be seen as an implicit intergenerational contract. Similarly, members of the Farmers and Fishermen and Self-employed pension funds are promised future benefits in nominal terms. As a result, the real value of their future pension income depends on inflation rates and possible ad hoc adjustments of nominal benefits and is, therefore, unpredictable (Eriyagama and Rannan-Eliya, 2003b and 2003c). Finally, elderly covered by the Samurdhi program (the general social assistance scheme) are exposed, as are other individuals, to the weaknesses of the program—small benefits and serious inclusion and exclusion errors (see the discussion of Samurdhi in chapter 4).

76. **There are large gaps in pension coverage of the population.** The combined coverage of the EPFO, CSPS and the two informal sector schemes comes to about one quarter of the working age population and around a third of the labor force (Table 3.1). The latter schemes covering farmers, fishermen and the self-employed that meet certain criteria were created as a policy response to low coverage and the programs have indeed led to improvement in this regard (particularly the coverage of the farmers’ and fishermen’s schemes is high for an informal sector scheme).

77. **Labor mobility is also inhibited by the existing pension system.** There is no mechanism for shifting accrued pension wealth between the different kinds of scheme. Civil servants moving to the

private sector stand to lose much of their pension wealth due to the rules of the defined-benefit scheme. Also, pension rights from the self-employed, farmers and fishermen are not portable.

**Table 3.1: Nominal, actual and potential coverage of formal old age schemes, 2002**

Scheme and year of introduction	Coverage			Share in working age population (percent)	
	Nominal (thousands)	Actual (thousands)	Actual coverage rate (percent)	Nominally covered	Actually covered
Civil service pension scheme	880	880	100	6.5	6.5
<i>Mandatory schemes</i>					
Employees' provident fund (1958)	3,000	1,900	63	22.1	14.0
Approved private provident funds	n.a.	165	n.a.	n.a.	1.0
Other private pension schemes	n.a.	61	n.a.	n.a.	0.5
<i>Voluntary schemes</i>					
Farmers' pension scheme	2200	607	28	18.1	5.0
Fishermen's pension scheme	55	43	78	0.3	0.3
Self-employed pension scheme	950	47	5	7.7	0.4
<b>TOTAL</b>	<b>7,085</b>	<b>3,703</b>	<b>52</b>	<b>52.5</b>	<b>27.7</b>

Source: Adapted from Gaminiratne et al (2004).

78. **The pension system is also fiscally unsustainable.** A recent estimate put the CSPS liability at around 60 percent of GDP, for example.<sup>45</sup> Relatively generous pensions for civil servants are not funded (as nominally in the case of the EPF), resulting in a huge liability and contributing to current fiscal deficits. The *sustainability* of the CSPS thus depends on the overall fiscal situation and eventually on cuts in other parts of the budget since there are no funds backing these liabilities.<sup>46</sup> Note that at close to two percent of GDP and more than 10 percent of government revenues, Sri Lanka ranks among the highest spenders among developing countries on civil service pensions (and spending is expected to grow as the civil service continues to age and the average duration of retirement for public sector workers increases).

79. **Although the EPF is a defined contribution arrangement which is in principle self-financing it, too, is dependent on government financial capacity.** Practically the entire EPF portfolio consists of government debt. If the government reacts to the presence of this captive credit by increasing its spending proportionately, the EPF reserves are effectively spent each year and the practice simply shifts the burden of the aging population onto taxpayers responsible for paying off the public debt. While the mechanism is more subtle, the current investment regime for this 'fully-funded' scheme may not contribute much to sustainability at a broader level. Moreover, the impact of the accumulated balances of the EPF on national savings is also questionable for the same reason.

<sup>45</sup> See Palacios (2005).

<sup>46</sup> A reform introducing a contributory, defined benefit scheme in 2003 has not been implemented and is currently the subject of legal disputes.

## Disability and Survivors Insurance

80. **The Sri Lankan disability and survivor insurance consists of a patchwork of ad hoc programs not arising from a coherent national strategy.**<sup>47</sup> Although the risks of disability and death are significant (see chapter 1), the system leaves many individuals uninsured, particularly the poor.<sup>48</sup> The ad hoc nature of these schemes also does not facilitate labor mobility. To our knowledge there are no data available on the incidence of death and disability among the members of these programs, much less an actuarial assessment of their finances. The major programs and key issues are described below.

81. **In Sri Lanka, disability and survivor benefits of public sector workers are tied directly to coverage in the pension system and are provided as defined benefits.** This is a typical arrangement in many countries, even in countries where retirement savings scheme is defined contribution (Demarco and Gruschka 2004). The government thus insures disability and survivor risks for public sector workers, although the value of the benefit may be eroded in time due to the lack of indexation. Because of the long civil conflict, spending on this part of the government pension system is higher than what is typically observed in other countries.

82. **Workers in the formal private sector are covered for death and permanent disability through lump sum payments of the Employees Trust Fund (ETF).** Financed from an employer contribution of 3 per cent of wage, the death benefits are set at 10 times the monthly average wage of the member during the final three months of coverage up to 50,000 rupees (this benefit is in addition to the balance that is received by the designated survivor).<sup>49</sup> Permanent disability triggers a payment of up to 24 times the average monthly salary of the last three months prior to the accident up to 150,000 rupees, along with withdrawal of balance. The scheme covers accidents that result in loss of limb or vision, 30 types of industrial disease and, since 1993, paralysis. Self-employed and foreign workers can also join subject to a minimum contribution of 150 rupees per month.

83. **While insurance benefits of this type help members absorb income shocks, its financing is not transparent.** Aside from death and disability, ETF contributions cover five additional benefits including three health related benefits (heart surgery, hospitalization, and intra-ocular transplants), as well as an education and a housing benefit. It is not clear whether the premium that is paid for these self-insured benefits bears any relation to an actuarially determined premium, although it appears unlikely. An alternative approach would be to cost out the fair price of the insurance and to purchase a group policy in the same way that is prevalent in the Latin American DC pension schemes.<sup>50</sup> Finally, integrating the EPF/ETF both administratively (currently there are parallel recordkeeping systems) and in terms of the benefits may be worth considering. The group insurance that could be purchased, for example, could take

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<sup>47</sup> A National Policy on Disabilities was approved in July 2003 by Sri Lanka's Council of Ministers. This statement encompasses a much wider scope than insurance and includes labor market and education issues. For a discussion, see Mendis (2004).

<sup>48</sup> Major illness or accident have been shown to result in a major reduction in short term consumption (for example, Gertler and Gruber 2002), and death of a breadwinner may send their spouses and orphans into a permanent state of destitution. Moreover, in contrast to the risk of outliving one's savings in old age, the risk of morbidity or mortality are higher among the poor.

<sup>49</sup> Employees' Trust Fund Board, Benefits and Services Handbook. Available at [http://www.lanka.net/etf/member\\_services.htm](http://www.lanka.net/etf/member_services.htm).

<sup>50</sup> The policy would insure the difference between the balance in an individual's account at the time of the event and the pre-specified annuity payment. The fair premium would be a function of the disability and mortality rates of the group as well as the investment returns, and prevailing discount rates. See Demarco and Grushka (2004). This costing is most straightforward in the case of death and permanent disability as both are easy to monitor given the narrow definition of disability.

into account the balances in both accounts since members withdraw both in the case of either death or disability.

## Unemployment Insurance

84. **To address unemployment risks, Sri Lanka is considering an introduction of an unemployment insurance (UI) system, but its introduction should be carefully considered.** Recognizing the need to make labor market more flexible, Sri Lanka has started to reform its inefficient and excessive job protection legislation (see Annex 2.1). For political economy reasons, reducing the protection of jobs can only succeed if other parts of social protection are strengthened. This fact has been duly recognized in Sri Lanka. To provide additional benefits to laid-off workers, the government is thus determined to introduce a more explicit protection scheme via unemployment insurance. This reform would be the first step in moving from the policy of protecting jobs to protecting workers. But while introducing this scheme is positive from the transparency and efficiency perspective (bringing worker protection and reducing job protection), it will most likely impose additional costs via increased payroll contributions from both employers and workers.

85. **Since 2003 the government has formulated several proposals of a UI system, mostly reflecting design parameters of such systems in OECD countries.** While proposals vary, under most variants program eligibility and coverage coincides with eligibility to and coverage of TEWA compensation. The proposed replacement rate is 50 percent (that is, the level of compensation is to equal 50 percent of the wage the beneficiaries received in their last job), and the proposed maximum duration of benefits varies from 12 to 24 months. Several financing options have been proposed, most relying on additional contributions on employers and workers. Proposal have differed about the implementation agency of the program (EPF and ETF have been suggested), and employment services are to be provided by the JobsNet network.

86. **However, the introduction of the standard, OECD-type of UI system requires certain conditions which are not met in Sri Lanka** (see Vodopivec 2006). First, *weak administrative capacity* renders personalized monitoring of benefit eligibility under a standard UI program infeasible (ineffective and prone to corruption). In addition to requiring a benefit payment network, the implementation of the UI system requires extensive and sophisticated information about fulfillment of both starting and above all, continuing eligibility requirements that current administrative capacity cannot support. Second, the *large informal sector* provides abundant opportunities for undeclared paid work and thus makes monitoring of such incomes difficult and ineffective. Moreover, eligibility monitoring is more demanding and costly also because Sri Lanka's administrative database may not allow cross-checking of the benefit receipt which are used in developed countries. Ineffective monitoring would produce more disincentives and misuses than a similar program in developed countries: benefit recipients may not be looking hard for a job or failing to take a job if opportunities arise, and they may actually be working while receiving the benefit. Third, there are other aspects—such as *high political risk and environment prone to corruption*—that may jeopardize the implementation of standard, full-fledged UI system.

### 3.2 Schemes for the informal sector

#### *Pensions*

87. **Pension schemes for informal workers help address some coverage gaps, but also lead to unfunded liabilities.** Because the benefits under these schemes are determined in nominal terms, the size of that liability depends largely on future rates of inflation. It is worth noting that the parameters of the original scheme have been changed on an ad hoc basis in a way that has consistently increased the liability. In addition, government has not contributed to the fund as was originally planned (and as

required by law). In short, there is significant potential for a future liability to emerge as political pressure to raise benefits combined with government's desire to defer its own payments increase the actuarial deficit of the scheme.

### **Disability and Survivors Insurance**

88. **Members of the pension scheme for informal sector—farmers, fishermen, and self-employed—are also covered by partial and total disablement and death insurance.** The benefit is paid as a lump sum and is defined in nominal terms, thus resulting in a declining real benefit level, unless ad hoc adjustments are made. Under these circumstances, it is not possible to ascertain the actuarially fair premium (premium that adequately reflects the risk involved) that would have to be charged for the prescribed level of benefits and determine the long run sustainability of the scheme.

89. **That there is latent demand for insurance against the above risks is evidenced by the number of non-governmental organizations that offer such products.** For example, self help associations have traditionally provided funeral assistance or death benevolence benefits. These contribution-based informal micro-insurance schemes that assist at the event of a death in the family have indemnities either through lump-sum payments and/or in kind. They account for a large proportion (nearly 30 percent) of all non-governmental and community-based organizations (see chapter 4).

90. **A few non-governmental organizations have ventured recently into the field of micro-insurance for social protection** (see Box 3.1). They appear to have adopted innovative approaches to provide cover in the event of death, disability, ill-health, maternity care and family calamities. Networking among other microfinance organizations and re-insuring with national and international insurance providers are methods used to both expand membership and secure finances. However, the regulatory environment for these initiatives remains exceedingly weak, being identical to the one for microcredit (see chapter 4).

91. **The Samurdhi Social Security Trust Fund (SSSTF) is yet another source of coverage.** The scheme is financed through deductions from the income transfer at source and is not a conventional social insurance program. While mandatory contributions reduce the size of the income transfer and minimize its impact on consumption, the social security appears to be operating relatively well and seems to help reduce the vulnerability of the poor. There are also plans to further develop the scheme by offering additional insurance products such as education insurance, old age pensions, and medical insurance. Proposed reforms of the Samurdhi Program as envisaged by the passage of the Welfare Benefits Act are likely to de-link the social security trust fund from the income transfer component, so that it becomes a truly contributory scheme.

### **Box 3.1: Examples of informal social security schemes in Sri Lanka**

The 2003 mapping of informal sector social security schemes by the Institute for Participatory Interaction in Development notes four such initiatives: the Yasiru micro-insurance scheme, the micro-insurance facility of the Women's Development Foundation, Hambantota, Sanasa's All Lanka Mutual Assurance Organization (ALMAO) and the *Diriya Matha Rakshana* (Courageous Mothers' Insurance) of the National Forum of People's Organization.

Yasiru was originally based on the funeral society concept and in fact came into existence when the civil disturbances in southern Sri Lanka in 1989 placed existing funeral assistance societies under tremendous pressure. It began initially with a re-insurance facility from the State Insurance Corporation and is currently re-insured with Interpolis of the Netherlands. It has established partnerships with other networks of NGOs and CBOs including the Small fishermen's Federation. Membership of the scheme stood at 7000 in March 2003, a phenomenal increase from 2500 in December 2002. Well-represented in the Southern, Uva and Western Provinces, the organization has recently begun work in the Northern and Eastern Provinces.

ALMAO is established as an incorporated company with legal status. Its capital is contributed by the parent organization, Sanasa and funeral assistance organizations in addition to shares worth Rs. 100 each bought by members. In addition to death and disability coverage it also has a savings and credit insurance component. The *Diriya Matha Rakshana* is an innovative social protection scheme which provides services to female street vendors in the suburban city of Moratuwa. The scheme is based on a reinsurance program arranged with the Insurance Corporation.

*Source:* Institute for Participatory Interaction in Development (2003).

**The SSSTF offers nominal insurance to poor households.** Under the scheme, households receiving Rs. 1000, 500 and 250 as income transfers contribute Rs. 25 each month to the insurance fund. Insurance can be claimed in the following circumstances: death of any family member (Rs. 5000), marriage of one child (Rs. 3000), birth of first child (Rs. 2000), and sickness (Rs. 50 per hospitalized day up to a maximum of Rs. 1500 for a year). By 2000, about 11 percent of beneficiaries covered by the scheme have claimed insurance, amounting to roughly Rs. 355 million.<sup>51</sup> However, the actuarial soundness, adequacy, and financial viability and effectiveness of this scheme are not well known.

### **Unemployment**

92. **Workfare schemes also exist in an ad-hoc basis to provide employment for low wage workers.** As described in chapter 4, during the recent tsunami many NGOs operated public works schemes to help provide employment for affected groups. Sri Lanka, however, does not have a permanent workfare scheme to help informal sector workers in times of unemployment from layoffs or as a result of natural disasters. These schemes provide labor intensive low skill jobs for the poorest unemployed, self targeted through the payment of low wages. Many countries have extensive workfare, such as Argentina, and Bangladesh and most recently India. International experience shows that one of the key design elements for making these programs pro-poor is to use very low wages to self-target to the poorest workers. Workfare programs have also been used as a work test for cash transfer schemes, with social assistance benefits provided contingent on work (see chapter 4 for discussion).

### **Cross Cutting Issues**

93. **Existing formal and informal social security schemes in Sri Lanka suffer from the lack of coordination, problems of fiscal sustainability, gaps in coverage and weak administration.** Some of

<sup>51</sup> This figure excludes the districts of the Eastern Province where the program began only in 1998.

these problems cut across programs and would ideally be addressed in tandem. For example, coordination of the administration of various programs would be based on harmonized recordkeeping systems. Actuarial capacity, which is largely absent in the different institutions that oversee programs, could be developed and applied to all programs (for example, generating financial projections of the civil service pension scheme as well as of the retirement schemes for informal sector workers, or the calculation of the cost of insuring EPF members for death benefits). As argued below, there may also be merit in searching for strategies that lead to a convergence of systems for formal and informal sector workers. At present, however, extending coverage of formal schemes without reforming them would only expand these problems. Nevertheless, access to social protection beyond the formal sector workers is clearly an objective. Like formal sector schemes, informal sector social security programs are financially unsustainable, with poor recordkeeping, regulation and supervision, and with limited capability of estimating financial liabilities.

### **3.3 Policy Options**

94. As noted above, insuring individuals against income loss from unemployment, disability, death of family member, and old age can facilitate consumption smoothing and improve welfare, and also support economic growth. The main directions of reform in the social insurance that supports this objective are: (1) reforming formal system to render them financially sustainable and well administered, so as to be able to expand their coverage to the informal sector, (2) making current informal sector schemes more efficient, so as to allow them to expand their coverage to a larger group, and (3) undertaking these reforms so as to eventually create a seamless insurance system that covers both formal and informal sector workers. However, this expansion will need to be phased, initiated based on a thorough assessment of current experience, and piloted first for schemes where moral hazard is lower (life, pensions), and whose administration is less complex. The expansion of social insurance coverage is closely linked to the level of formality in the labor market. Thus, reforms in the labor market (noted in the previous chapter) and in other areas (such as tax policies) that help increase the coverage of the formal sector will be critical.

#### **Improving the Coverage and Efficiency of Formal Sector Schemes**

##### **Pensions**

95. **A number of studies have made it clear that there is ample room to improve formal income support schemes on two fronts, adequacy and sustainability.** There are a number of concrete, incremental steps that could be taken within the existing framework to begin to address both issues. In the case of the CSPS:

- Civil service target replacement rates could be gradually reduced, calculated on the basis of a longer earnings base and subsequently adjusted for inflation. Contributions from employees could be introduced.
- A strategy for prefunding the remaining liability could be developed.
- Improved administrative recordkeeping could be introduced (perhaps as part of an overall HRMIS strategy).

For the EPF and approved schemes:

- Retirement ages could be gradually increased to reflect longevity gains.
- EPF fund management could be outsourced and investment policy could shift toward greater diversification including foreign investment.
- Private pension supervision could be developed with a view toward improving the quality of the approved funds and expanding the role of the private sector.
- Recordkeeping systems could be upgraded and service improved.
- Alternative minimum annuitization strategies could be considered.

97. Partial reforms along these lines are themselves a major challenge. A more holistic approach however, is to reconsider the entire framework—one that has evolved in different directions for different parts of the population for historical reasons. Indeed, there is little rationale for differences in replacement rate targets, funding strategies and other key elements of the different formal sector schemes.

98. **As a starting point of a reform, policymakers should determine realistic target levels of income support for the elderly** both as a minimum (safety net) as well as in comparison to the consumption levels in active years (the consumption smoothing function of income support). This target represents the objective of the system in terms of adequacy and is a subjective choice in each country. The international experience is diverse with OECD pension systems replacing as anywhere between 35 and 80 percent of pre-retirement earnings (Whitehouse, 2007). Because pension systems often have redistributive objectives, targeted replacement rates for lower income workers are generally higher, and for high income workers generally lower. In the case of informal sector workers, targets may have to be defined differently, but nevertheless, in a way that is meaningful from an adequacy perspective. For example, the voluntary scheme for farmers and fishermen could have, as its objective, the payment of a monthly benefit after a particular age specified in inflation-adjusted terms.

99. **Currently, the target benefit levels across schemes in Sri Lanka appear to vary arbitrarily as do the risks inherent in each of the pension schemes.** For example, civil servants are at risk from ad hoc indexation decisions, farmers from future inflation, and EPF members from low (or negative) returns on the fund investments and longevity. There is no obvious rationale for these differences.

100. **A clearly defined objective for adequacy would imply a certain financing stream needed to meet the second criterion, sustainability.** Defining the real benefit levels targeted for the farmers' pension scheme would imply a certain stream of minimum contributions and investment returns (assuming the liability is to be prefunded). The realism of these implied figures could be assessed periodically and appropriate changes made as needed. A similar exercise would yield the financing stream needed to provide a certain pension level for public sector workers covered under the CSPPS. Finally, the balance required at retirement in the EPF that would produce the target monthly, indexed benefit could be calculated and the stream of contributions and investment returns necessary to arrive at that balance could be ascertained.

101. **To arrive at realistic target benefit levels, reforms should ensure that target benefit levels are financed from realistic sources in the long term (over multiple decades).** One useful benchmark is that the financing should be robust at least through the lifetime of the system's youngest member. This implies adjustment of target benefit levels in accordance with financing sources.

102. **The models available to meet these objectives differ by the amount of redistribution they imply, by the required pre-funding, and by risk allocation.** In the first panel of Table 3.2, five methods of providing a minimum income in old age are listed (the aspect related to redistribution of scheme). Targeting the poor elderly would require one of the first three approaches. The means-tested schemes are specifically targeted to the elderly. A universal flat scheme is one in which all citizens above a certain age (e.g., 75 in Nepal and 60 in New Zealand) receive a flat amount. Clearly, the most affordable way to ensure that everyone is provided by a given target income is the narrow means-tested scheme, followed by the broad means-tested scheme and finally the universal flat scheme. On the other hand, universal scheme avoids the costs of means-testing and ensures complete coverage. The two minimum pension approaches listed at the bottom of the panel are relevant for contributory schemes with widespread coverage.<sup>52</sup>

**Table 3.2: Options for old age income support schemes by redistribution, required pre-funding, and risk allocation**

	<b>Country example</b>
<b>(a) Redistribution</b>	
Narrow means-testing	India
Broad means-testing	Australia
Universal flat	New Zealand
Minimum within DB	France
Minimum within DC	Chile
<b>(b) Required pre-funding and risk allocation</b>	
Fully funded DB	Holland
Partially funded DB	Korea
Pay-as-you-go DB	Germany
Fully funded DC	Hong Kong
Hybrid DB/DC	Argentina

*Notes: DB - defined benefit, DC - defined contribution*

103. **There are also several alternative approaches to pre-funding and risk allocation** (which together determine consumption smoothing properties of the system)—see Table 3.2. With regard to risk, a defined benefit plan links retirement income directly to a worker’s wage. Depending on the exact formula, there will be a high correlation between his wage history and his pension level. However, when the DB promise is not indexed (as in the case of the civil servants in Sri Lanka), there is an additional risk to the individual in the form of inflation. In the case of a DC scheme, individuals bear investment risk. While defined benefit schemes are most common around the world, most of the recent systemic reforms introduced hybrid or pure DC schemes. DC arrangements are also being applied increasingly for informal sector workers where there is no reference wage and contributions can be volatile due to the nature of employment (see next section).

104. **The approach taken to financing DB or DC schemes is crucial for sustainability.** Fully funded DB schemes run by governments are rare as countries have found it expedient to demand less in contributions than required to match assets and liabilities. Partially funded schemes are typically those that have been set up relatively recently and are ‘immature.’ Fully funded DC schemes and ‘hybrids’ where a DC scheme is combined with an unfunded DB element have become more common over the last two decades and can now be found in about two dozen countries. Despite the common DC feature (as well as a prominent role for private asset managers and insurers in most systems), the design of these schemes and the extent to which they relied on funding and the implementation details vary greatly.<sup>53</sup> In other words, each reform reflected local constraints and preferences.<sup>54</sup>

<sup>52</sup> For an illustration of the possible costs of these approaches in the Sri Lankan case, see Gaminiratne (2004).

<sup>53</sup> See Chlon (2004) for a review of eight systemic reforms in Eastern Europe and Palacios (2004) for a review of ten systemic reforms in Latin America.

<sup>54</sup> The pros and cons of these approaches have been the subject of heated debate at least since 1994 when the World Bank published a major research volume on the subject (World Bank 1994). The subsequent decade, as recently documented in another World Bank study, has refined these arguments and provided a wealth of experience on design and implementation issues (World Bank 2005g).

105. **Policymakers should review the reasons that the current models are being utilized for pension provision and explicitly determine the best approach for Sri Lanka.** Sri Lanka's pension system currently uses several approaches ranging from unfunded, defined benefits with high target replacement rates for civil servants to a defined contribution scheme with lump sum payouts for private formal sector workers. The alternatives should then be costed out and their administrative requirements assessed. As discussed in the next section, an approach that reduces duplication, makes subsidies transparent and allows for portability between all sectors of the economy should be considered.

### **Developing a coherent approach to the risks of death, disability, and ill health**

106. **Sri Lanka does not have health insurance, however the health care system covers all medical costs of the population.** As noted in chapter 1, health shocks are the most important income shocks suffered by Sri Lankan households and the coverage of medical fees helps to alleviate poverty. However, recent evidence suggests that the loss of income from sickness of the breadwinner is more onerous than direct medical costs (Gertler 2004), and lack of coverage of these costs may lead individuals deep into poverty. This may also be the case in Sri Lanka. More work is needed, however, to better gauge the impact of health and disability shocks on the economic welfare of households.

107. **Public policy objectives with regard to death and disability insurance should be clarified and arbitrary differences between workers eliminated.** In the kind of unified framework described below, workers could be covered for these risks through group self-insurance or purchase of external insurance. In both cases, the actuarially fair premium could be calculated and where necessary, subsidized). The focus from an income replacement standpoint should be on permanent disability that leads to large income losses. In order to assess the feasibility of such a program, information on disability incidence among these groups should be collected and published. Parallel reforms in insurance regulation would have to be implemented over the longer run, if necessary and particularly if these liabilities were to be pre-funded. Disability insurance would have to be closely coordinated with disability payments made under safety net programs, and form part of disability strategy of the country.

### **Building Blocks of Unemployment Insurance System Adapted to Sri Lanka**

108. **Sri Lanka should adapt standard UI system to take into account labor market circumstances and existing administrative capacity.** To minimize adverse employment effects, to reduce administrative costs, and to ensure affordability and a smooth start of the scheme, the following features—some deviating from the standard, OECD-type of the model—are recommended in the short to medium run:

- **Eligibility.** *Starting eligibility* for unemployment benefits should be on the basis of involuntary separations from employment, with a minimum period of insurance contributions. For practical purposes, starting eligibility conditions should be the same as for TEWA eligibility. In addition, UI eligibility could be extended to workers who would lose jobs if employers close down their businesses.<sup>55</sup> *Continuing eligibility* would require non-employment in the formal sector, which would be easily verified from administrative records. The system would thus avoid the need to subjectively assess the recipients' behavior and status (that is, verifying whether the beneficiaries are actively seeking a job, and whether they are available for and capable to work). This would not only save on administrative costs, but also eliminate the moral hazard associated with UI and

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<sup>55</sup> To qualify, such workers would have to produce a certificate stating that their employment was terminated because of the bankruptcy of the employer (such a certificate would be issued by the District Labor Office, based on workers' records kept by the office about the employment spell and the verification of the bankruptcy), and their contribution history would have to be verified to ensure that a minimum contributory period criterion is met.

thus encourage job seeking self-protection behavior (see Vodopivec 2004 for the discussion of the moral hazard effects of UI systems).

- **Coverage.** As a starting point and to simplify administration, coverage of UI would coincide with TEWA coverage. For example, Korea's UI system also started with the coverage in large enterprises (with at least 30 workers) and gradually gained universal coverage.
- **The level of benefits.** Affordability and employment incentives dictate a modest level of benefits. Based on international standards, duration of 6 to 12 months and a replacement rate of 50 percent can be recommended (see Vodopivec 2004 for the description of the level of benefits of UI systems around the world). A flat rate (equal amount paid to all) is also an attractive option, because it simplifies the administration of benefits, reduces the scope for misuses, contributes to affordability, and fosters redistribution from the rich to the poor.
- **Financing.** The system's expenditures (benefits and administrative costs) should be financed by employer and worker contributions. It must be remembered that the recipients of unemployment benefits will have the advantage of working in formal sector, while many other workers are underemployed and/or working in the informal sector. Scarce government resources should therefore be used for other purposes and no public funds should finance the operation of the UI scheme. Because the expected yearly inflow of beneficiaries (based on the history of TEWA beneficiaries) would not exceed 2 thousand workers, the total costs of the scheme once matured would be about Rs. 80 million (\$800,000) per year.<sup>56</sup> Indeed, as for sources of financing, unemployment benefit could be easily added as one of the benefits offered by Employees' Trust Fund (ETF)—which in practice already provides this type of benefits, as workers can access their individual ETF funds once they lose employment.
- **Administration.** To minimize administrative costs and to enable smooth start, unemployment benefit scheme should piggyback existing social security networks (for example, ETF) for its benefit administration. Such an arrangement would eliminate the need to create another expensive bureaucracy.<sup>57</sup> As in the case of pensions, a forecasting model for unemployment insurance to assess costs and financial sustainability (perhaps in concert with the development of actuarial costs of pensions/disability/death benefits) needs to be developed to better understand the benefits and costs of alternate options.

109. **Employment services for the benefit recipients.** Benefit recipients would be eligible for certain employment services, such as job brokerage via the JobsNet computerized bank of available jobs; labor market counseling; job-search assistance; and, possibly, training. A possible provider of such services could be a recently created, rapidly growing JobsNet network. The precise modalities of the provision of these services need to be determined to ensure that public provision of services is cost effective (e.g., job counseling/information) and training services are demand driven, and contracted to private providers (see also discussion in chapter 2).

110. **Other long-term features of the UI scheme should also be carefully considered.** First, the feasibility of monitoring of job search behavior and labor market status of benefit recipients should be

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<sup>56</sup> Assuming a 12-month average duration of covered unemployment spell, inflow of 2,000 beneficiaries per year, average salary of Rs.6,800 (equal to the average wages of TEWA beneficiaries in 2002), and the replacement rate of 50 percent.

<sup>57</sup> For example, if left on its own, the UI scheme would have to acquire the capacity to check whether employers' contributions for prospective beneficiaries have been paid—the capacity already residing by the ETF. Moreover, the UB scheme would also have to set up a new network to determine starting and continuing eligibility, to keep the balance of benefits to be paid, and effect the payments when they become due. Under the arrangements proposed here, existing capacity of ETF would suffice to implement the system.

explored. In that case, the options of declining level of benefits over individual unemployment spell could be considered, so as to minimize work disincentives. Second, active labor market policies would have to be carefully designed (including the possibility of the encouragement of private training providers by financing via vouchers) and evaluated. Third, the possibilities of expanding the UI coverage to include workers in smaller establishments would also be worth consideration.

### **Improving Coverage and Efficiency of Informal Sector Schemes**

**111. To improve the pension schemes for informal sector workers (in particular, for the self-employed, farmers and fishermen), the following measures could be considered:**

- Instead of specifying nominal benefits and contributions, a defined contribution approach could be considered instead.
- Annuities, based on actuarially fair premia and preserving their real value, could be introduced.
- Information systems could be upgraded and service improved.
- Fund management could be improved and investment portfolio diversified.

**112. To provide incentive for voluntary contributions, a defined contribution scheme for pensions and disability can be subsidized directly through matching contributions.** Such a scheme should lead to annuities (provision of a monthly benefit after reaching certain age limit) or to scheduled withdrawals. Direct subsidization is more transparent with regard to how the government contributes to the schemes' finances but it also requires a higher up front fiscal commitment.<sup>58</sup> The same schemes would provide also disability benefits. In this case, insurance is appropriate and could be provided on an actuarially fair basis. Although the rate of disability among the covered informal sector workers is not known, once they are ascertained, self-insurance or eventually, group insurance purchased from an insurance firm could be implemented. This may also help provide an incentive for minimizing any abuse of the system of determining eligibility (as it would impinge on costs to members in a transparent way).

**113. To address the problem of moral hazard affecting unemployment insurance schemes, introducing a self-insurance element via an unemployment savings account may be a useful option.** This could be incorporated into any workfare scheme should one be developed.

**114. Finally, a permanent workfare program could be instituted to provide income support to the poorest workers in case of unemployment (until the UI program becomes universal).** The development of unemployment insurance and extension of its coverage may take time. A workfare program could act as stop gap measure of providing a form of insurance to low income able bodied poor, in times of unemployment. However, as noted above, the program would need to be financially viable, and coordinated with the social assistance program in terms of benefit levels, eligibility and overall costs.

**115. The expansion of coverage should be preceded by an in-depth assessment of existing formal and informal initiatives and may need to be phased**—focusing first on an evaluation of current initiatives to determine best practice, and then a phased expansion to schemes where moral hazard is lower (life, pensions), and whose administration less complex as eligibility is easily determined and actuarial calculations are relatively straightforward. Finally, expansion of social insurance coverage is closely linked to the level of formality in the labor market. Thus, reforms in the labor market (noted in the

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<sup>58</sup> China has instituted a rural DC pension scheme and Vietnam is proposing to do the same. In India, attempts at extending coverage through DB-type pensions have so far failed. Meanwhile a draft bill will be considered in Parliament in December 2005 that creates the infrastructure for a DC scheme aimed at both informal sector workers and civil servants. In West Bengal, a state-run DC scheme with a matching contribution has been functioning since 2002 with a membership of 650 thousand unorganized sector workers.

previous chapter) and in other areas (such as tax policies) that help increase the coverage of the formal sector will be critical.

### **Towards a unified social insurance system with greater coverage**

116. **Reforming the existing programs for old age, disability, survivors and unemployment is clearly a daunting challenge.** Nevertheless, these reforms are a critical first step for extending the coverage to a greater share of the labor force. Furthermore, the recent laudable attempts at coverage expansion have tended to create new, parallel schemes that suffer from their own deficiencies.

117. **An alternative strategy would be to aim for a seamless, unified framework for covering each of these risks in a way that would lend itself to easier expansion of coverage.** *In pensions*, for example, a defined contribution scheme with parameters (contribution rates, retirement age etc.) set in such a way as to produce a certain target replacement rate level could be applied for all workers entering the labor force after a certain date. This would allow for complete portability and economies of scale in recordkeeping (which could be centralized) while avoiding the creation of new liabilities. Some of the measures recommended for the EPF, such as shifting to a diversified portfolio of investments and contracting out asset management could also be incorporated. *Death and disability insurance*, fairly priced based on actuarial results, could be purchased for members of this scheme as could some minimal level of annuitization after retirement. Similarly, a funded severance portion of the system could be added and integrated into the *unemployment insurance* program that would supplement individual savings by a social insurance component (the payment of unemployment benefits at the beginning of unemployment spell is drawn from individual's own unemployment benefit account, and only upon the depletion of this account from the solidarity fund (a version of such a program was introduced in 2003 in Chile).

118. **This approach has the advantage of improving efficiency of program administration.** Greater investment in, inter alia, improving recordkeeping, setting up individual accounts, and fund management will be required, but a unified approach would improve program efficiency:

- A unified architecture and information technology and identification scheme would reduce administrative duplication.
- A seamless system based on DC accounts would allow for movement between sectors and complete portability of benefits.
- An individual account based pension can be easily adapted for migrant workers.
- Scale economies in terms of management of funds can be achieved.
- Group purchase of insurance for disability, death and longevity helps control costs.
- Moral hazard can be reduced if own savings are drawn down for unemployment.<sup>59</sup>

119. **A unified framework with fairly priced insurance premium combined with self-insurance (in the form of individual DC accounts) also makes would also make it possible to facilitate coverage expansion.** Recognizing that mandates cannot be effectively extended to the informal sector, voluntary participation will have to be promoted through incentives. This is especially true for households with high discount rates and a preference for liquidity. Recognizing this, subsidies could be introduced in a transparent way to help finance part of the contributions/premia that the various types of coverage imply.<sup>60</sup> Successful coverage expansion would then depend on the fiscal constraints for providing the subsidy and the perceived benefits of joining. The Samurdhi Trust Fund could easily be incorporated into

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<sup>59</sup> See Vodopivec (2004) for a description of such a scheme introduced in Chile in 2003.

<sup>60</sup> Another alternative is to 'top up' DC balances at the time of retirement so as to meet a minimum pension level as is done in Chile and several other countries. This reintroduces a DB component and government liability on an ex-post basis as opposed to making the transfer ex-ante.

this framework and other existing self-help groups, workfare employees (were this to be implemented) and NGOs could 'plug into' the system with reduced transaction costs.

120. **Finally, it should be noted that the cost of prefunding such a program to the government would be offset partially by a reduced demand for social assistance.** In the pension area, this offset would come only in the very long term as the scheme matured. If implemented soon, however, it would help defray the cost of supporting what would likely be a growing number of elderly social assistance beneficiaries.<sup>61</sup>

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<sup>61</sup> A non-contributory pension scheme or social assistance is the only source of support for current elderly who would not have enough time to accumulate savings in a contributory plan even if coverage could be expanded rapidly.

## 4. COPING WITH RISK: SOCIAL SAFETY NETS

*'Samurdhi is making people walk on their posteriors, not on their legs.'*

*Samurdhi beneficiary, Bandarawela, as quoted in Gunatilaka et al. (1997)*

121. Social safety net programs traditionally provide families and individuals who fall through the 'cracks' of formal and informal protection systems with cash transfers (or social assistance) to help them cope with poverty (that is, they address poverty after the event as opposed to insuring against a potentially poverty inducing shocks). More recently, cash transfer programs have evolved from being a pure coping mechanism to one which helps the poor to escape from poverty (for example, by conditioning income transfers on health and education outcomes), and to addressing vulnerability (for example, by offering workfare programs that serve as unemployment insurance in countries without such formal systems). This chapter thus focuses on several important groups identified in chapter 1 as poor and vulnerable (children and adults): the chronically poor as well as several subgroups in need of special services, ranging from school dropouts, child soldiers, malnourished children to the disabled and displaced due to the civil conflict or natural disasters.

122. Sri Lanka has an extensive safety net system comprising income transfers (social assistance) to address chronic poverty and individual risks (illness, disability), and covariate shocks (e.g., conflict, tsunami). The chapter finds that the safety net system could be strengthened not only to produce more equitable outcomes but also to promote growth. The key ways to achieve that is by: (i) better targeting existing social assistance/cash transfer programs to the poor; (ii) ensuring that poor participate in human development and income earning programs; (iii) ensuring that programs are designed to help individuals cope with vulnerability (sickness, disability, and loss of employment) by providing them social welfare and care services and by integrating workfare into social assistance programs; and finally (iv) scaling up safety net programs to help address the community level shocks (natural disasters and the civil conflict).

123. The chapter is organized as follows. The first section reviews the main social safety net programs and presents their key characteristics. The next two sections describe the Samurdhi income transfer program and other safety net programs, including programs for displaced, disabled, and tsunami victims. The last section concludes by discussing policy options.

### 4.1 Overview of Social Safety Net Interventions

124. **In Sri Lanka, social safety net programs are implemented by two main ministries and by both the Central Government and Provincial Councils.** Government agencies provide overlapping safety net programs through a number of authorities and departments, which provide programs addressing both individual and covariate risks (see Table 4.1). In addition, welfare services are provided also by the voluntary sector, but they operate on a small scale (see the composition of the voluntary sector in Box 4.1). The main programs include:

- The Samurdhi income transfer to the poor (Ministry of Samurdhi and Poverty Alleviation). The income transfer is not indexed to inflation and the fixed amount is received as commodities and encashment stamps. In that sense the transfer is reliable and predictable. The program also includes a microcredit and micro-insurance component as well as a small-scale infrastructure development

component. The last two components aim to assist people to move out of poverty and to smooth consumption respectively, thus reducing reliance on the first component—income transfer.

- Income support for disabled soldiers and families of service personnel who died in the conflict (Ministry of Women’s Empowerment and Social Welfare).
- Assistance for persons displaced by the conflict (Ministry of Women’s Empowerment and Social Welfare).
- Emergency assistance to people affected by natural disasters such as drought and floods (Ministry of Women’s Empowerment and Social Welfare).
- Provision of free textbooks and school uniforms to children (Ministry of Education), and
- Assistance for indigent elders and families with disabled persons and people with incapacitating illness who are unable to work (Provincial Councils).

**Table 4.1: Social safety nets expenditures, 2000-04 (Rs. Million)**

	2000	2001	2002	2003	2004
<b>Total</b>	20,332	23,918	20,661	21,774	23,086
<b>Ministry of Samurdhi</b>					
Income transfers	9,927	12,574	9,910	8,715	8,498
Micro credit	1,822	2,670	1,990	3,055	3,481
Micro insurance	218	225	196	208	201
Small scale infrastructure	548	288	64	128	343
Infant milk subsidy	135	157	120	160	127
<b>Ministry of Women’s Empowerment and Social Welfare</b>					
Payment to disable soldiers	2,282	2,655	3,235	3,392	3,860
Rehabilitation & reconstruction — refugees	2,658	2,548	2,261	3,392	2,532
Flood and drought relief	75	156	185	273	1,466
Triposha supplement	320	488	590	491	305
Mother’s & child’s nutrition	30	36	30	43	100
Rehabilitation drug addicts	15	10	15	18	35
<b>Ministry of Education</b>					
School uniform	980	900	799	601	788
School text books	1,000	900	900	969	1,100
School season tickets	250	250	250	250	250
Other education welfare	64	48	100	79	...
<b>Provincial Councils</b>					
Assistance for indigent elders and disabled	8	13	16	...	...
<b>Memorandum items (percent of GDP)</b>					
Social safety net programs — total	1.6	1.7	1.3	1.3	1.1
Samurdhi income transfers	0.8	0.9	0.6	0.5	0.4
Education	2.5	2.0	2.4	2.2	2.1
Health	1.7	1.4	1.6	1.6	1.5
Total government expenditures	27.2	28.0	25.8	24.0	23.7

Sources: Ministry of Finance – internal material, and Central Bank (2003, 2005).

Note: Data reflect both current and capital expenditures (capital expenditures involved in social safety net were negligible).

125. **In 2002, approximately 1.9 million poor families received income transfers.** In addition, 20,000 disabled ex-soldiers and 100,000 internally displaced persons (IDPs) also received assistance. A total of about 400,000 families with disabled persons and people with incapacitating illness who are

unable to work were also targeted. However, there is some overlap between the beneficiaries of the programs administered by the Ministry of Samurdhi and Poverty Alleviation and the Ministry of Social Welfare (World Bank 2005).

#### Box 4.1: The voluntary sector

Many non-governmental organizations and charitable associations provide safety nets for the elderly, orphans and disabled children and adults in residential homes. Homes for the elderly, disabled and orphaned are run mainly by charitable organizations with religious affiliations. They receive some nominal assistance for recurrent expenditure from the Provincial Councils through the program targeted at indigent elders, families with disabled persons and people with incapacitating illness who are unable to work. The government does provide funds on occasion for capital expenditures. Even so, most of the funds are privately raised. The Department of Childcare and Probation monitors the administration of orphanages. The support provided by these institutions is of variable quality. Most are seriously under-funded and badly resourced. The table below lists non-governmental and community-based organizations engaged in social service in 2002:

	Number
Welfare organizations	1025
Mutual assistance societies	233
Social development/community development organizations	1298
Self-employed group organizations/bodies	74
Association of unorganized employees	49
Organizations of the poor	3
Social/economic development foundations	507
Micro-credit institutions	98
Cooperatives	279
Women's organizations	737
Pensioners associations	30
Elderly and aged people's welfare associations	157
Funeral assistance societies	2084
Sarvodaya	152
Child welfare organizations	164
Disabled welfare organizations	49
Organizations dealing with education and health	233
<b>Total</b>	<b>7172</b>

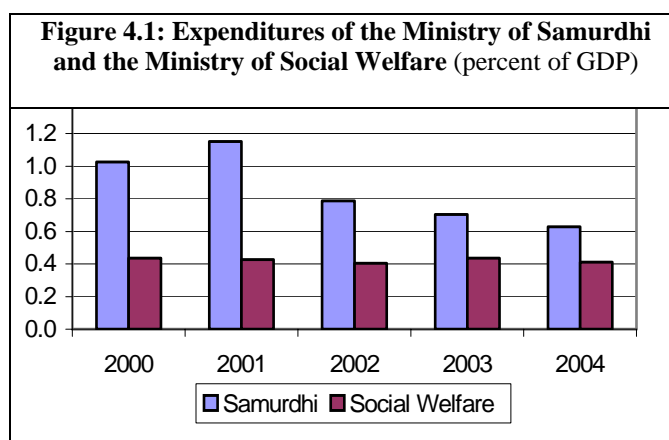
Source: Institute for Participatory Interaction in Development (2003), based on information from NGO Secretariat, Ministry of Policy Development and Implementation and Ministry of Social Welfare.

126. **Expenditures on income transfers programs have declined since 2001 and comprised 1.1 percent of GDP or 4.8 percent of total government expenditure in 2004.** This figure includes expenditures on the income transfers and the support to microcredit, microinsurance, and small scale infrastructure under the Samurdhi programs, as well as programs under the Ministry of Women's Empowerment and Social Welfare, Ministry of Education and Provincial Councils (Table 4.1).<sup>62</sup> In comparison to 2002, in 2003 and 2004 the expenditures of combined Samurdhi programs strongly declined both in absolute and relative terms (reflecting the strong reduction of the amount of the income transfer component), and the expenditures of the Ministry of Women's Empowerment and Social Welfare stayed constant as the share of GDP (see Figure 4.1). Reflecting a decrease of beneficiaries and an erosion of nominally fixed benefit levels, program expenditures on the Samurdhi transfers strongly declined from 0.9 percent of GDP in 2001 to 0.4 percent of GDP in 2004 (note that the microcredit component increased

<sup>62</sup> While most analyses in Sri Lanka include pensions to retired public servants under welfare payments, we have deliberately excluded them as they are part of social insurance, not safety nets.

in 2003-04, somewhat mitigating the reduction of program expenditures). It should be noted that 2004 the income transfers provided by the Samurdhi program were roughly equivalent to the three quarters of the combined amount paid to disabled soldiers and refugees. In broader terms, in 2000-2004 the expenditures on social safety net programs lagged substantially behind the expenditures on education (these ranged from 2 to 2.5 percent of GDP) and, after 2002, also behind health expenditures (see Table 4.1).

127. **Sri Lanka's expenditure on social assistance has been comparable with the amount spent by other countries except in 2003-04.** Sri Lanka's expenditure on social assistance during 1997 - 2002 was at the level of averages for Latin America and the Caribbean, the Middle East and North Africa (Figure 4.2). While the countries of East Asia and the Pacific spent slightly less, the countries of Eastern and Central European countries spent substantially more. As shown above, the spending of Sri Lanka in 2002-2003, however, substantially declined. In comparison to other South Asian countries for which data is available, Sri Lanka spends more on safety nets than Bangladesh with 0.6 - 0.8 percent of GDP or Pakistan with 0.5 percent of GDP, but less than India with 2-3% of GDP (spending refers to (sub)period of 2000-2004, Blank et al. 2005).



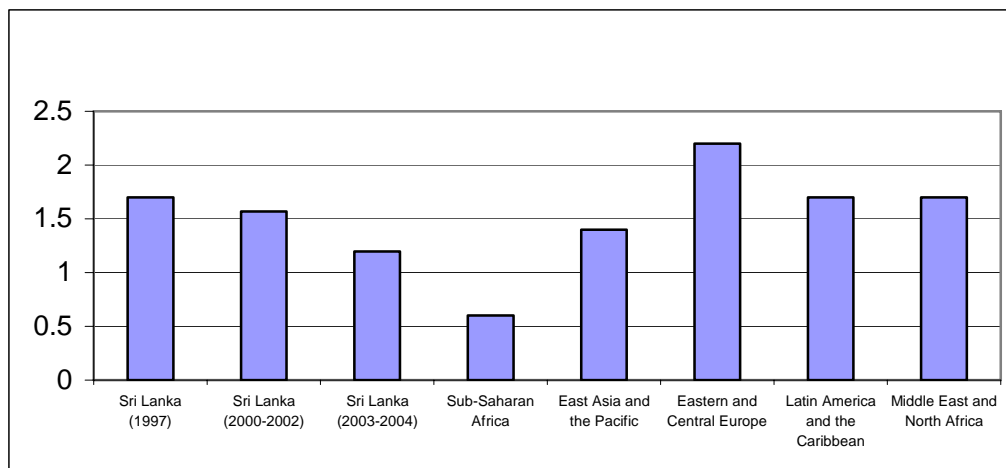
## 4.2 Income Transfer Programs

128. This section describes the key parameters and main issues confronting the implementation of the two main income transfer programs: the Samurdhi program and the disability benefits program.

### The Samurdhi Program

129. **Eligibility. Households are selected for eligibility for Samurdhi based on their level of income, but rigorous selection criteria are lacking.** While eligibility and determination of the level of benefits is based on a means test (Table 4.2), Samurdhi Development Officers (Niyamakas) select the poor in most areas on the basis of a household survey carried out in 1995. While the difficulty of means testing was understood, the officially established threshold was set artificially high in order to contain the outlay on the program. Niyamakas were also advised to use other household characteristics such as quality of housing and household assets as a means to identify the poor. However, as no specific method was established as to how this should be done, too much was left to Niyamakas' discretion. Meanwhile, the grievance handling procedures were not insulated from partisan interference by local politicians with the result that the number of recipients far exceeded initial estimates.

**Figure 4.2: International comparison of social assistance expenditure (percent of GDP), 1996-2003**



Source: For Sri Lanka: Table 4.1 for 2000—2004 and World Bank (2002) for 1997. For comparators, Blank, Grosch, Hakim, and Weigand (2005).

Note: The data represent average regional expenditure on social assistance based on the most recent country-specific data available (late 1990s or early 2000s).

130. **Those eligible for Samurdhi benefit are required to participate in microcredit and community infrastructure development programs, with uncertain impact on household consumption.** Linking the poor with consumption smoothing and income generation programs is an innovative approach that seeks to both reduce vulnerability and help the poor move on to higher income growth paths. However, questions remain about their effectiveness.

- *Commodities stamps and encashment stamps* can be used to purchase goods only at government cooperative stores, at unsubsidized prices. The public cost of providing food stamps appears to be larger than their value to recipients as prices and quality in the cooperative stores are reported as inferior to those of private and government stores (Glinskaya 2000, Gunatilaka et al. 1997).<sup>63</sup>
- *Savings/credit program.* A compulsory amount of benefit is deducted from the transfer and deposited in Samurdhi Banks, established through federated savings groups of the Samurdhi recipients, but the compulsory savings could not be used as collateral or withdrawn. The compulsory and voluntary savings accumulated through this program were used to provide consumption loans and other small loans to beneficiaries (Glinskaya 2000). However, the threat of withdrawing the transfer was used to ensure loan repayment and made the viability of the microcredit system too dependent on the income transfer.
- *Social insurance scheme,* which provides small lump sum payments in the event of contingencies such as death or the birth of a child (see discussion in chapter 3). This, too, was not a voluntary insurance scheme but functioned by way of mandatory deductions from the income transfer.
- *Work “test”.* Households receiving the income transfer have also been required to provide the labor of one member for small-scale infrastructure development projects. Note that although the wage rate offered is at levels far below prevailing market rates (Gunatilaka et al. 1997), it does not function as the vehicle of self-selection into the program. Households are required to provide labor after they were selected for the transfer, and thus the effective reward of participation in the

<sup>63</sup> This was also found to be the case with the mid-day meal/food-for-work-rice program in Trincomalee (Pietzch 2001).

program consists of both the wages for providing labor and Samurdhi cash benefits, thus rendering the work test ineffective.

**Table 4.2: Samurdhi eligibility criteria**

Monthly income in rupees and household size	Grant size (Rs. Per month)
Household income < 500 and number of members >=4	1,000
Household income < 1,000 and number of members >=3	500
Household income < 1,000 and number of members 2	200
Household income < 1,000 and number of members 1	100
Former Janasaviya recipients	250

Source: Ministry of Samurdhi, Youth Affairs and Sports. "Progress 1999, Programs 2000"

131. **Coverage and expenditures. Samurdhi coverage is extensive, with 41 percent of the population receiving benefit in 2002, with the coverage and expenditures declining since the late 1990s.** At the end of 2002, a total of 1.9 million families or 41 percent of the population received the income transfer (Central Bank of Sri Lanka 2003). The number of recipient families increased from about 1.5 million families at the start of the program to 2.3 million families by the late 1990s and remained at these levels until 2001, with budget cuts bringing a reduction of the number of beneficiaries in 2002 and thereafter (see Figure 4.3).<sup>64</sup> Program expenditures rose from Rs. 8 billion in 1995 to a high of Rs. 13.9 billion in 2001, and have declined since.<sup>65</sup>

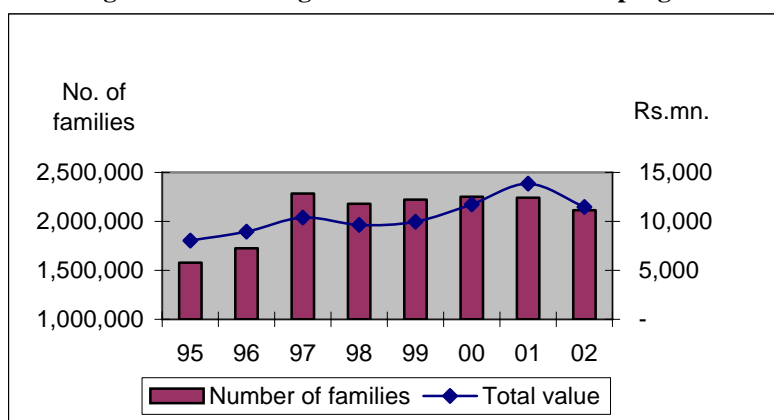
132. **Adequacy and work incentives. The level of benefit is low, covering a quarter of the food bill of the poorest households, and not adjusted for inflation.** The average size of the total Samurdhi transfer, according to SLIS 1999/2000 data, is Rs. 381, which translates into Rs. 95 per person in per capita terms (the breakdown of the number of families by the size of the grant in 2002 is presented in the Table 4.3). In 1999/2000, an average of 14 percent of total household food expenditure (and 21 percent for the recipients in the lowest income decile) could be met by the Samurdhi grant—roughly translated, five to seven days of food per month. As with previous programs, Samurdhi benefits are not adjusted for inflation and so their real value has eroded over time (Glinskaya 2000).

133. **Beneficiaries receive benefit payments that are much smaller than the stipulated grant.** As noted above, the Samurdhi recipients are eligible for food stamps, and participate in savings/micro credit, social security, and other schemes. For this reason, compulsory savings stamp, social security stamp (discussed in chapter 3), and a housing lottery stamp are deducted from the transfer at the time of receipt. Table 4.4 sets out the amounts deducted for each program component for each category of grant. SLIS data revealed that after deducting forced savings and social insurance, the average size of the *net* transfer is Rs. 310 per household and Rs. 78 per person.

<sup>64</sup> As a result of these measures, the total number of households receiving the supplement fell by 24 percent to 1,488,493 by end 2002. However, to encourage ineligible families to exit the program, departing families were paid Rs.140 supplement per month to cover compulsory deposits. This brought the total number of families covered to 1,886,737 as at end 2002.

<sup>65</sup> Note that "transfers" as defined by Samurdhi includes consumption grants to households as well as salaries of Samurdhi officers.

**Figure 4.3: Growing outreach of the Samurdhi program**



Source: Central Bank Annual Report (various years).

**Table 4.3: Samurdhi recipients by category of allowance, and of 2002**

Category of Allowance (Rs.)	No of families	%
1000	3,954	0.21
600	589,460	31.24
400	320,759	17.00
350	238,593	12.65
250	335,727	17.79
140	398,244	21.11
<b>Total</b>	<b>1,886,737</b>	<b>100</b>

Source: Samurdhi Ministry Progress report, 2002-2003, cited in CEPA 2004, Table 4.3.

134. **The income transfer at best increased, by 7 percent, food consumption of the average household in lowest 40 percent of the income distribution.** Glinskaya (2000) also reports that conditional on being a Samurdhi recipient, the size of the transfer is slightly larger among households in the lowest quintile, but in per capita terms, the grant is larger for better-off households. Nevertheless, there is also qualitative and quantitative evidence that the Samurdhi income transfer is an important safety net, particularly for households with unstable income (Centre for Poverty Analysis 2004).

**Table 4.4: Samurdhi program, deductions of compulsory payments (Rs.)**

Category	Commodities stamp	Encashment stamp	Compulsory savings stamp	Social Security stamp	Housing lottery fund stamp
1000	400	360	200	30	10
600	250	210	100	30	10
400	360	0	0	30	10
350	340	0	0	0	10
250	240	0	0	0	10
140	0	0	100	30	10

Source: Samurdhi Ministry Progress report, 2002-2003, cited in CEPA 2004, Table 4.4.

135. **Benefit is small when compared with the actual transfer needed to move households out of poverty.** In 2002, the average income shortfall needed to move a person over the poverty line, was four times the size of the actual grant. If targeted perfectly, Samurdhi could have moved 60 percent of the poor out of poverty with a budget one and a half times as much as was actually spent that year. Box 4.2 indicates that the average income shortfall needed to move a person over the poverty line in 2002 was Rs. 320, four times the size of the actual grant.

**Box 4.2: How much money will it take to move people out of poverty through income transfers?**

The average poverty gap or consumption shortfall of the average poor person in 2002 was Rs. 320 per person per month.<sup>1</sup> Twenty three percent of Sri Lanka's population *outside the North and East* were estimated to be poor in this year, and thus the total income shortfall was Rs. 1,227.6 million. Assuming a further 10 percent for the North and East (allowing for a higher poverty incidence in these provinces), the total budget that was required to reduce poverty in Sri Lanka through income transfers (without allowing for leakages and administration costs) is Rs. 1,350 million per month, or 16,204.5 million annually. This is 1.6 times the budget for Samurdhi benefits in 2002, and 4 percent of total government expenditure and 1 percent of GDP in this year. This implies that with perfect targeting, the budget for Samurdhi could have eradicated poverty among 60 percent of the poor. In fact, spending on Samurdhi was substantially reduced in 2002—in 2001, at its peak, spending was 0.9 percent of GDP, or 3.3 percent of total government expenditure.

Source: Gunewardena (2005).

136. **Despite the small size of the income transfer, labor-leisure decisions may be affected.** Although the size of the benefits as discussed above is relatively small, Glinskaya (2000) suggests that the possibility of a household to lose eligibility upon earning above Rs. 2000 can distort incentives for taking a job (for reference, the statutory minimum daily wage rate in 2005 for workers in the tea, rubber and coconut sectors was Rs. 121, Employers' Federation of Ceylon 2005). In practice, this criterion has been universally ignored, thus making work disincentives less plausible. While no rigorous analysis has been done about the incentive effects of the Samurdhi program to date, it should be noted that adverse incentive effects were found for other welfare programs in Sri Lanka. For example, participation in the food stamps program in Sri Lanka (in the early 1980s) was found to have reduced labor supply by two to three days per month (Sahn and Alderman 1996).

137. **Targeting. Samurdhi program suffers from weak targeting of benefits.** There is considerable evidence that the program suffers from both types of targeting errors, leakage to the nonpoor and undercoverage of the poor:

- **There is considerable leakage to the nonpoor.** Twenty seven percent of the non-poor received Samurdhi transfers in 1995/96 (Gunewardena 2000), and 44 percent of households in the top

three quintiles received them in 1999/2000 (Glinskaya 2000). Gaminiratne (2004) notes the leakage of Samurdhi to the non poor and undercoverage of the poor elderly.

- **The poor, and the elderly poor in particular, are undercovered.** Only 66 percent of households in the bottom decile received Samurdhi assistance in 1995/96 (Gunewardena 2000) and 60 percent of households in the bottom quintile received it in 1999/2000 (Glinskaya 2000). Undercoverage is even more pronounced for the elderly poor. Gaminiratne (2004) reports that only 23 percent of the poorest quintile of the elderly and 27 percent of the second poorest quintile received Samurdhi assistance. Targeting outcomes are similar to those of untargeted systems such as primary health care or primary education.

138. **Targeting errors are systematic, as some groups more likely to receive Samurdhi income transfer than others.** Poorer households in irrigation colonies, urban middle income neighborhoods and estates were less likely to receive Samurdhi than those in a traditional village (but no difference was observed for expansion colonies). The probability of being a Samurdhi recipient differed significantly according to ethnic status (controlling for income and area of residence, Sri Lankan Tamils, Indian Tamils and Moors are less likely than Sinhalese to receive Samurdhi benefits). Migration status was not related to the probability of Samurdhi receipt, but not having a national identity card reduced the probability of receipt (Glinskaya 2000). Party political affiliation also plays a significant role in determining one's chances of getting the transfer. For example, families identified as traditional UNP voters were less likely to have been granted Samurdhi benefits (ADB-PIMU 2000, Glinskaya 2000, Gunatilaka et al. 1997).

139. **Nevertheless, household characteristics associated with poverty also increase the chances of receiving support.** Households with disabled or chronically sick members were more likely to receive Samurdhi benefits, while houses owning livestock, and other assets, including land and possessing land title were less likely to receive Samurdhi benefits. Housing conditions were associated with the receipt of Samurdhi (households with no access to latrines, or communal latrines and households with no lighting or kerosene for lighting were more likely to receive benefits). The probability of receiving Samurdhi differed significantly by occupation of household head (farm laborers and members in the military were more likely to receive, government and private salaried employees and retirees less likely to receive benefits) (Glinskaya 2000).

140. **Mistargeting is the result of the lack of explicit targeting criteria at the local level.** As shown in Figure 4.4, the allocation of Samurdhi assistance at the central level corresponds to relative share of poor households in districts. The correlation of per capita district-specific Samurdhi funds and the poverty rate is 0.814, and the correlation with the poverty depth is 0.711 (Glinskaya 2000). It follows that most targeting errors occur at the local level.<sup>66</sup> Glinskaya also found that poorer provinces allocate a smaller share of their Samurdhi funds to the poor, so their targeting errors are more prevalent. Therefore targeting errors appear to be non-random and the consequence of the lack of rigorous selection criteria, leaving too much discretion to Samurdhi Development Officers, who are in turn influenced by local politicians. These flaws in the design of the program thus allow for the deliberate omission of certain individuals or groups depending on the configuration of local political forces.

### **Income Support for Disabled**

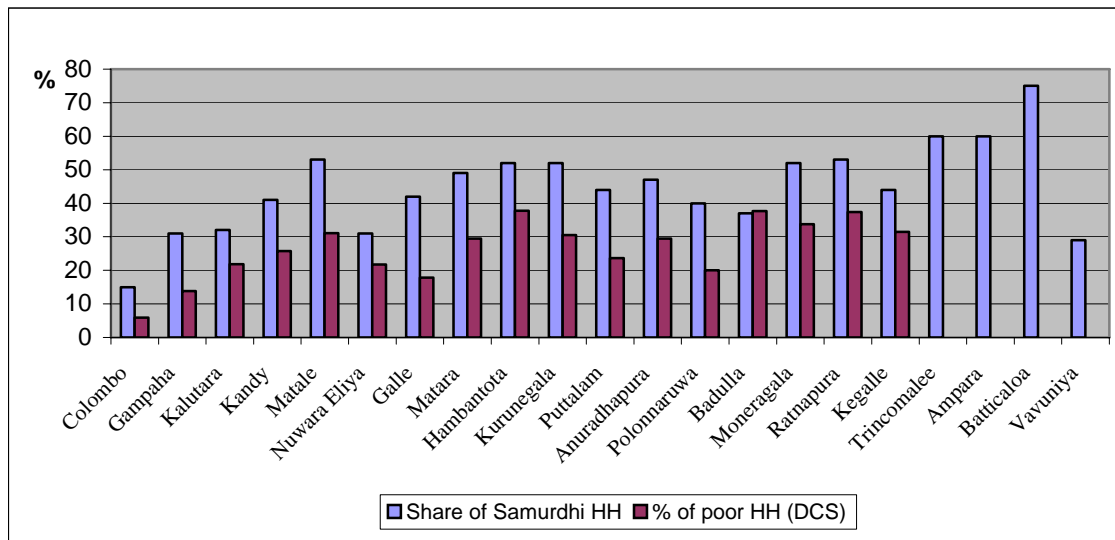
141. **Eligibility for disability benefits encompasses various types of disabilities.** The Protection of the Rights of Persons with Disabilities Act No. 28 of 1996 defines a person with disability as “any person who, as a result of any deficiency in his physical or mental capabilities, whether congenital or not, is

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<sup>66</sup> This contrasts to findings in other countries, e.g., Bangladesh, where pro-poor outcomes of income transfer programs were largely due to the success of communities in reaching the poor, rather than central government allocation (Glinskaya 2000).

unable by himself to ensure for himself, wholly or partly, the necessities of life”. This reasonably broad definition encompasses both the medical and socio-economic aspects of disability and forms the basis for government support of the disabled. Accordingly, the Ministry of Social Welfare encompasses people who have visual, speech, hearing, mobility, intellectual, and psychiatric disability and disability arising as a result of epilepsy and other causes in determining eligibility for income support. The Ministry’s definition also encompasses multiple disabilities, which are a combination of two or more of these disabilities in a single individual (Ministry of Social Welfare 2003).

**Figure 4.4: District allocations for Samurdhi income transfers**



Source: Ministry of Samurdhi, Progress Report 2003-2004, Central Bank (2003), DCS Poverty indicators/CEPA 2004.

142. **A survey of disabled persons showed that only 41 percent receive any sort of income transfer (including the disability allowance) from the government** (of persons suffering from intellectual, mobility, psychiatric, hearing, or speech disability, with no figures are available about the share of disabled in population—Ministry of Social Welfare 2003). Within the recipients, roughly 60 percent get Samurdhi income transfers and only the rest received income transfers for disabled persons from the Ministry of Social Welfare (the latter transfer can be received in addition to Samurdhi benefits). This split in transfer makes its administration more costly than if it were administered by a single agency. Eligibility for the disability benefit is determined through the Divisional Service Office of the Department of Social Services, and since 2003, it has been fixed at a low level of Rs. 100-300 per month.

143. **The main beneficiaries among the disabled are soldiers injured by the conflict, leaving other poor disabled groups undercovered.** Income transfers to the vulnerable by the Ministry of Social Welfare are highly skewed towards disability payments for soldiers injured in the conflict and families of soldiers killed in action. This component consumed 92 percent of transfers by the Ministry in 2003 and 85 percent of its total budget, leaving very little support for other vulnerable disabled groups.

144. **Expenditure on disability payments has increased over time.** This increase is explained by the growing burden on the exchequer through mounting loss of lives. The allocations have continued to increase in 2002 and 2003, both years where the ceasefire was in place and casualties among the armed forces were virtually nil. This is because payments have to continue until the year of retirement of a soldier who lost his/her life. In many developed countries, disability payments comprise the most rapidly increasing expenditures of any cash transfer programs. Disability payments suffer from moral hazard or

collusion problems. In many countries, individuals who certify disability can collude with individuals to help the latter obtain disability payments. There is often constant pressure on Government to extend the definition of disability which increases the number of individuals eligible for disability and therefore disability expenditures.

145. **Disability payments are a very limited way of supporting the disabled poor.** As noted in chapter 1, information about disability is in short supply, and the disabled suffer from stigma and lack of acceptance into society. The disabled face limited educational opportunities that increase the likelihood that they drop out or not attend school, and therefore have limited employment prospects. A more comprehensive approach to disability is needed that addresses prevention and enables the disabled to integrate better into society.

### 4.3 Coping with Large-Scale Disasters, Droughts, and Displacement

146. **In the short-term, disaster relief covers all affected persons on the basis of the impact and injuries suffered** (Welfare Benefits Board 2003). Divisional Secretaries in the affected regions select beneficiaries with the assistance of *Grama Niladharis* and Social Service Officers at the Divisional level. The value of the assistance varies according to the type of relief and is delivered in the form of cash grants, food relief, food stamps, etc. Selection of beneficiaries is carried out on the basis of the impact caused by the disaster and not on income poverty criteria. However, a broad income criterion of Rs. 3000 per family per month exists for long-term assistance for recipients of disaster relief.

147. **Drought relief is provided to families with income less than less than Rs. 2000 a month from agriculture or related activities.** Families become eligible for the relief if the cultivation of seasonal crops have been disrupted or damaged for at least two consecutive seasons due to drought, the crops have not been insured, and the family does not have an alternative source of income. The drought relief program seems to work effectively. In a case study of paddy farmers and chena cultivators in the dry zone area of Anuradhapura, Senaka-Arachchi (1998) found that drought relief by the government constituted the most important source of income for 85 percent of afflicted households. However, Samurdhi beneficiaries do not qualify for drought assistance as they receive relief through the Samurdhi program (Senaka-Arachchi 1998). Once again, the payment of cash through two separate ministries likely increases administration costs of delivery.

148. **Relief for displaced persons comprises food assistance but the amount is insufficient to meet basic nutrition needs.** The Ministry of Social Welfare provides food assistance to internally displaced persons (IDPs) if their monthly income less than Rs. 1,500 for 12 months from date of permanent resettlement.<sup>67</sup> From September 2004 there has been strict adherence to the eligibility criteria. As a result, the number of eligible families decreased by almost half, with 127,479 families receiving rations in January 2005. The non-eligible IDPs are expected to receive Samurdhi assistance, provided they are eligible for Samurdhi. The quantity of dry rations issued by the Ministry of Social Services is insufficient to meet nutritional needs (Jayasinghe 2005).

149. **Displaced persons are also eligible for rehabilitation assistance for permanent settlement.** Rehabilitation assistance is also provided but Permanent settlement is supported by the Unified Assistance Scheme (UAS) coordinated by the Ministry of Relief, Rehabilitation and Reconstruction. It is “made available only to families who have returned to land/property that they own, or which has been granted by the authorities, or is available to returnees for the purpose of durable settlement, and where the returnee and his family have demonstrated a clear intention to remain in the location in a permanent

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<sup>67</sup> There were roughly 600,000 internally displaced persons (IDPs) in June 2002, of whom 172,000 lived in refugee camps. Since the ceasefire, 345,000 IDPs have returned to their original homes (World Bank 2004).

capacity". The government offers Rs. 25,000 as a grant to returning IDPs to acquire basic tools, inputs and temporary shelter and to restart productive livelihoods. Each permanently resettled refugee/IDP family is also provided with an additional Rs. 250,000.

150. **However, fiscal restraints have limited the coverage of this provision and many families await assistance.** Currently, over 100,000 families have been paid this assistance, with a further 125,000 families awaiting assistance (of which funds are available only to pay 25,000 families) (Jayasinghe 2005). IDPs in government-controlled and LTTE-controlled areas receive food assistance through the Commissioner General of Essential Services (CGES). In 2000, 186,331 families comprising 674,150 persons received food assistance including 40,668 families comprising 170,857 persons in welfare centers, 141,353 families comprising 484,258 persons living with relatives and friends and 4,310 economically affected families (Gunewardena 2005).

151. **In late 2004 and early 2005, the government, aided by multilateral agencies, launched several Tsunami relief initiatives** to prevent chronic poverty and help restoring livelihood of the affected population. The main programs included cash transfers and the provision of loans and grants for microenterprises via microfinance institutions. In addition, numerous public works projects have been successfully carried out by several international agencies and NGOs. It must be stressed that the enormous proportions of the disaster provoked an unprecedented response from the indigenous voluntary sector immediately after the disaster and even today, it shoulders a large part of the relief and rehabilitation work. The groups involved included not just NGOs described in Box 4.1, but many others, including private sector firms, university students, schools associations, and other spontaneous groupings of individuals, revealing a bedrock spirit of voluntarism, self-organization, resource-mobilization and self-reliance across social strata.

152. **A cash transfer program of Rs. 5,000 per affected families was launched in the immediate aftermath of the disaster.** As of August 2005, three rounds of payments were completed. By the second quarter of 2005, over 245,000 families had received at least one round of the cash transfer. While no cases of deserving houses being excluded were reported, there was significant inclusion of unaffected households in the program confirmed for the first round of payments. The results will help understand if such error is preventable in case of a major disaster.

153. **Public works were widely implemented in tsunami-affected communities to help households cope with employment loss.** As noted in chapter 3, public works programs were mostly implemented through NGOs and CBOs. As of August, the total value of the programs was nearly \$6 million, and the programs have been implemented in all affected districts (see Table 4.5). Abeyratne and Weeratunge (2005) report that participation in the programs was most sought after by wage laborers and youth. According to Abeyratne and Weeratunge, these people considered public works as a temporary measure that would ease the immediate effects of the crisis, expecting to return to their customary livelihoods as the crisis eased. Daily wage rates for participating in the program ranged from Rs. 300 to 400. It therefore appears that the principle that participants are paid slightly below the prevailing local market rate for unskilled agricultural labor has been violated (note that according to the Central Bank data, in December 2004 daily wages in agriculture were Rs. 322-377 for males and Rs. 227-266 for females). Indeed, Abeyratne and Weeratunge report that in certain sectors in some districts, labor shortages resulted from these programs (for example, in the paddy sector in Trincomalee district), raising daily wage rates by 20 to 30 percent.

**Table 4.5: Public works organized in tsunami-affected areas, 2005**

Donor Agency	Total Value (US\$)	Period of activity	Location/ district	Activity
ADF (Govt. of France)	25,000	Feb-Aug 2005	Betticaloa, Trincomalee	Debris cleaning & roads
CARE - Germany & EU	530,400	Apr-Dec 2005	Hambantota	Debris, drainage, irrigation
USIAD	1,204,000	Jan-Sep 2005	Ampara, Hambantota, Matara	Debris, roads, irrigation, env. Construction
DFID/ILO + FA	998,130	Apr-Sep 2005	Kalutara, Trinco, Galle, Batti & Jaffna	Infrastructure construction
UNOCHA - Flash Appeal	750,000	Jan-Sep 2005	5 Districts	Infrastructure construction
DCA - Germany	115,450	Feb-Jun 2005	Ampara, Batticaloa	Debris cleaning & roads
JCCP - Japan	77,500	Jan-Apr 2005	Trincomalee	Debris cleaning roads
Spanish - Red Cross SP	130,000	Jan-Aug 2005	Galle, Kalutara	Debris, roads, drainage, env. construction
Govt. of Japan	800,000	Jan-Dec 2005	12 districts	Debris cleaning roads, env. Improvement
World Vision International & USAID	100,000	Mar-Dec 2005	Galle & Jaffna	Debris clearing & infrastructure improvement
OXFARM GB*	1,150,200	Feb-Dec 2005	Batticaloa, Hambantota, Matara	Rehabilitation of rural roads, irrigation
<b>TOTAL</b>	<b>5,880,680</b>			

*Source:* ILO's survey among donor agencies, September 2005.

*Note:* The data may be underestimated, because not all donor agencies responded to the survey.

#### 4.4 Reforming Safety Nets

154. **Reforming safety nets requires the development of an overall strategy that will re-orient safety nets to contribute to both equity and growth.** A four-prong strategy is proposed. First, cash transfers/social assistance should be better targeted to the chronic poor, with design features that reduce work disincentives (e.g., appropriate benefit levels, workfare). Second, safety nets should increasingly become “safety ropes”—means of helping people to move out of poverty and vulnerability—through improvements of the human capital and earning possibilities of the poor. Third, social assistance should also be linked to individual vulnerability—(orphans, at risk youth, abused women, and seasonal unemployment) by strengthening social welfare and care services. And finally, the response to aggregate vulnerability, such as natural disasters should be scaled up.

##### (a) Reforming the Samurdhi System: Addressing Chronic Poverty

155. **The Government of Sri Lanka has recognized the need to reform the welfare system, mainly by improving transparency in targeting the poor.** Welfare Benefits Act No. 24 of 2002 has paved the way for key reforms in the sector. The Act's mandate is to provide the necessary legal framework for the payment of all welfare relief, to set out a transparent process by which the recipients of such benefits can be identified, and to provide for the termination of such benefit. The main thrust of the Act is to (a) limit the program to the bottom 25-27 percent of the population (around 900,000 households), which will enable the increase of the transfer amount; (b) achieve better accuracy in identifying the poor; and (c) make the transfers progressive, i.e., give larger amounts to poorer households.

## Eligibility

156. **The Act requires that eligibility of households for the program will be made more objective and transparent and be assessed periodically.** In this regard, the government has implemented a formula-based system in the North and East and is looking to implement it in the rest of the country as well. Accordingly, households that have characteristics most closely associated with poverty—as determined by a transparent, proxy means test formula (PMTF)—will become eligible to benefits. The number of households will depend on the available budget constraint. The selection of eligible individuals will thus be made more transparent. Household eligibility is proposed to be checked every 1-3 years. However, higher administrative costs of re-checking beneficiaries will need to be balanced against addressing vulnerability, as new beneficiaries may become eligible for assistance, and reduce leakage—some may move out of poverty and should become ineligible for the benefit, making more frequent check-ups of eligibility (for example, every 6 months) necessary. The Samurdhi Ministry is currently engaged in devising alternative income generation schemes – as opposed to handouts – for those who will transit out of the cash transfers scheme as a result of better targeting.

157. **All homeless households are to be included in the program automatically, without applying the PMTF** (which would be difficult to calculate in any case). This would not lead to any significant change in the coverage and other estimates—homeless households are only about 1.3 percent of all applicant households in pilot areas, and the average household size is much lower for homeless households, which translates to relatively low amounts per household using the payment scheme described previously.<sup>68</sup>

158. **Ensuring exit clauses-helping people to move off eligibility rolls.** The program design should also include methods to help households (who can do so) to move out of the program. In some countries, exit is forced by limiting the duration of benefit (e.g., US) and with certain conditions for re-entering welfare rolls) or through improving the households prospects for earning income and helping their children escape poverty (through conditional cash transfer programs, e.g., Mexico and Brazil).

## Adequacy and work incentives

159. **The benefit will consist of two components:** a fixed component that is an equal amount for all eligible households, and a variable component that has a fixed amount per member or appropriately defined subsets of members. The variable amount has been defined as per vulnerable member of the household, where the vulnerable are children aged between 0 and 15, elderly aged 66 and above, and those who are disabled or permanently ill. The rationale for this scheme is that such individuals cannot, or should not earn income for the household, and are also the ones most affected by shocks to household income.

160. **The reform aims to increase the amount of support within existing budget through better targeting.** Simulations show that with the current transfer budget held constant (Rs. 9 bn.), a program targeted to around 27.5 percent of the population (which corresponds to the cut-off being considered by the Welfare Benefit Board), would cover a little over 900,000 households. Each household on average would receive around Rs. 830 per month, compared with the current average grant of Rs. 320 per household. It would also be important to avoid erosion of the benefits by inflation, so period adjustments of benefits in line with inflation rate should be considered.

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<sup>68</sup> Twenty four percent of homeless households comprise of a single member, compared to one percent of those living in homes. Five percent of homeless households comprise of a 6 or more members, compared to 37 percent of those living in homes (World Bank 2005).

161. **The increase in benefit level may create disincentives to work and should be carefully monitored.** If the average household transfer is significantly raised, this may create disincentives to take a job and may create a poverty trap. The option mentioned above, raising the benefit to Rs. 830 per month, may create such disincentives (such a transfer would amount to slightly more than a third of monthly wages of unskilled workers—daily wage earners in the tea, rubber or coconut sectors earn a minimum wages of Rs. 3,025, assuming they work 25 days per month). The impact of the increase in benefits will therefore have to be carefully monitored. Similarly, the eligibility for benefit needs to be monitored on an on-going basis (see above). Workfare programs (discussed in chapter 3) can help reduce disincentive by making benefit receipt for able bodied poor contingent on participation in small scale works programs.

162. **Benefits will be de-linked from savings and insurance.** The practice of deducting at source will be discontinued. Likewise, the Samurdhi social insurance scheme will cease to be a mandatory scheme and will operate more like a voluntary, contributory scheme. However, Samurdhi beneficiaries, as well as other poor who require loans will continue to be able to obtain consumption loans from the system so long as they have participated in the group savings scheme and established their credit worthiness. In this way, Samurdhi will become a strictly re-distributional transfer to the poor based on clear eligibility criteria. Such poor can participate in the ancillary programs of credit and insurance if they so wished, on a voluntary basis rather than a mandatory basis. However, some form of subsidy to the poorest for the very may well be required (see discussion in chapter 3).

### **Targeting**

163. **The reform introduces proxy means test to determine eligibility.** Two critical changes are to be effected. First, the introduction of a proxy means test formula (PMTF) as the selection criteria. This method should provide a more objective selection criteria than direct means testing under the circumstances where subjective reports of personal income cannot be easily verified (Box 4.3). Second, the selection of eligible individuals will be done by the Welfare Benefits Board, with decision-making delegated to the District Secretary, Divisional Secretary, or the *Grama Niladhari* (GN), i.e., through decentralized administration. The PMTF has already been tested in a pilot targeting survey covering 48,000 households in 114 GN divisions, backed up by a field survey of a sub sample of GN divisions (World Bank 2005).

164. **The targeting formula is to be adapted to conflict areas.** The pilot results did not uncover any evidence to suggest that the PMTF should not be applied in the conflict areas (World Bank 2005). However, a number of issues were raised by workshop participants on the need to change the way certain variables were defined and interpreted for the North and East, which would in turn imply a change in the instructions for the application form for the region. These included, for example, instructions about the definition of cultivable land, which is a variable in the PMTF. In the North and East, this definition will have to be reflect a possible impact of conflict—namely that land, cultivable in the past, cannot be cultivated next season because it may now have mines.

### Box 4.3: Developing a proxy means test formula

In principle, conducting a direct “means test” that correctly measures the earnings of a household is the best way to determine eligibility when the poor are the target group, as is the case with Samurdhi. In practice, however, such straightforward means tests suffer from several problems, the most important being that verifying incomes of households is very difficult in developing countries where reliable income records do not exist. Thus the idea of using a Proxy Means Test Formula (PMTF) that avoids the problems involved in relying on reported income is appealing. This involves using information on household or individual characteristics correlated with welfare levels in a formal algorithm to proxy household income or welfare. These instruments are selected based on their ability to predict welfare as measured by, for example, consumption expenditure of households. The obvious advantage of proxy means testing is that good predictors of welfare—like demographic data, characteristics of dwelling units and ownership of durable assets (as long as these cannot be changed or moved, respectively)—are likely to be easier to collect and verify than are direct measures like consumption or income. This has led to PMTFs being widely used around the world for targeting safety net programs, and the Steering Committee set up by the Government of Sri Lanka to guide the technical aspects of the reform process has also decided to adopt a PMTF to identify the target group for Samurdhi benefits.

*Source:* Sri Lanka Poverty and Social Impact Analysis, World Bank (2005).

165. **While not considered under this reform, community participation methods can be used to validate eligibility lists created by PMT formula targeting process.** Such a validation would be particularly important, as Coady et al. (2004) find that the method of targeting *per se* is virtually irrelevant for its effectiveness. For example, means tested programs scored among the best and among the worst among the 100 programs evaluated by the authors. They identify community participation as one of the rare approaches which does make a difference. Community participation is not new to Sri Lanka, and was practiced quite successfully in selecting beneficiaries for the Janasaviya Program, the Samurdhi’s predecessor (World Bank 1995; see Box 4.4). It is worth stressing that effective community participation is also one of the promising methods to include in the program the hard core, hard-to-reach poor. The government’s welfare reform as articulated in *Sri Lanka New Development Strategy* (Ministry of Finance and Planning 2005) also mentions the adoption of community screening methods as part of its proposed welfare reform. Thus, combining community participation with PMT may yield a stronger targeting approach.

166. **Strengthening administration of the Samurdhi program.** Cash transfers are to be distributed through individual accounts created in post offices (instead of Samurdhi banking societies as is the current practice), preferably in the name of the female member of the household (particularly in areas where alcoholism is a problem). Timely distribution of benefit will also be important, given that some of the benefits noted above are delayed, which cause undue hardship to eligible poor. Potential recipients are required to provide all information relating to the income and asset status of themselves and their families. To increase transparency, the names of eligible persons would be published in the media a time frame of 10 days given for receipt of objections, which would then be investigated. Any person or public officials found to be declaring false information would be subject to trial and if found guilty subject to a fine of 5-10,000 and imprisonment of up to one year. Divisional Secretaries are responsible for ensuring the update of names including omissions and deletions to the list of eligible persons (Centre for Poverty Analysis 2004). While fines and threats may reduce false claims, the verification of eligibility and monitoring of claims will still need to be undertaken, particularly if governance remains an issue. This could be strengthened via random audits, and fair complaints procedures. Community groups might also be used to help target and monitor programs and ensure benefits are delivered to those identified by PMT/community-based targeting methods.

**Box 4.4: Community participation in targeting welfare benefits-Sri Lanka's experience with Janasaviya**

Many non-poor received the income transfer in the first round of the Janasaviya Program. For example, the original income ceiling of Rs. 700 of Round 1 was found not to apply in practice, as a random survey of nearly 300 beneficiary households found that nearly 30 percent had incomes above Rs. 1,500 per month before entering the program. But having first used income-based indicators to select beneficiaries, the Janasaviya Program subsequently replaced these with a set of detailed, region-specific criteria identified with the assistance of the support team members and the Grama Niladhari under the supervision of the Divisional Secretary. These were framed on observable variables such as the ownership of land and consumer durables, and yielded valuable division-specific information on divisional economies, and the kind of income-generating opportunities that were available.

Officials then resorted to community-based screening methods to improve targeting and village-level committees used the new criteria to identify eligible families, and lists of those eligible in descending order of poverty were publicized. Anonymous complaints were then gathered and evaluated by the Divisional Secretary, and were thereafter inquired into by an investigative team comprising of government officials, NGOs and others among the general public. These inquiries were usually made at a public gathering or "Janahamuwa", where the selected family and others were questioned in order to verify that they were indeed eligible for Janasavi benefits. Fine-tuning of the screening process improved targeting efficiency considerably.

*Source:* Gunatilaka (1997).

**(b) Options for Helping the Poor Escape Poverty**

167. **Recent advances have moved social safety net programs from purely helping the poor to cope with poverty to helping them to escape from poverty**, while Samurdhi reforms discussed above help transform the program to one which is purely redistributive. Examples of such innovations include making income transfers conditional on the access of the poor to health and education services, particularly for children, and boosting the income earning opportunities of the poor via access to micro-finance. Many programs, for example in Latin America and in Turkey, that started out on a pure cash transfer basis have been now transformed into programs that simultaneously enhance human capital by adding measures to help the poor escape poverty to cash transfer assistance.

168. **Human Capital Development.** While the above describe Samurdhi reform does not address this issue, cash transfers could be used as incentives to reach the small share of children who are not enrolled in school and reduce dropouts, and also to help the poorest participate in nutrition based programs given malnutrition remains an important challenge for Sri Lanka.

169. **Improving school participation of poor children and reducing early drop-outs from schooling.** Our analysis identified financial constraints as an important factor behind lack of enrollment and early drop-outs from schooling (see chapter 2). A conditional cash program—the program that makes income transfers conditional on continued school enrollment—may help to prevent such dropouts. Such a program would be targeted to five and six year olds, to prevent late entry to school, and to eleven to fourteen year olds (those attending lower secondary grades), to prevent them from dropping out, and would be available in selected poor, rural and urban, areas. Evaluations show that these programs can raise school enrollment and attendance rates (and improve child health and nutrition, if that is the program's objective)—see Box 4.5. Such programs need to be well targeted, so that there is transparency about who receives the transfers. The level of benefits and the number of beneficiaries is also easily adjusted and extended in times of crisis. These programs may also need to be coupled with 'flexible' timing in the provision of schooling/non-formal education to meet the needs of working children, and

with programs that provide hearing and visual tests/aids to disabled children to increase their enrollment and prevent dropouts.

**Box 4.5: Conditional cash transfers as a way to improve school attendance, health and nutrition of the poor**

Conditional cash transfers provide money to poor households conditional on various desirable behaviors, such as sending children to school and visiting health centers for growth monitoring, immunizations, and nutrition interventions. These programs have been implemented in increasing number of countries, particularly in Latin America and Caribbean (Brazil, Honduras, Jamaica, Mexico, Nicaragua), but also elsewhere (Turkey, for example). Mexican “Progresa” in 1999 reached 2.3 million families, and in Brazil (Bolsa Escola and PETI) and Jamaica (PATH) conditional cash transfers are widely used to promote health and education of children (World Bank 2004b).

Evaluations show that conditional cash transfers are an effective means for promoting human capital accumulation among the poor households, as well as for poverty reduction. There is clear evidence of success in increasing enrollment rates, improving preventive health care and raising household consumption (Rawlings and Rubio 2004), as well as enabling households to make previously unattainable investments in income generating activities (Gertler, Martinez and Rubio 2005). For example, the Mexican program (Progresa) increased primary school attendance by more than 2 percent and secondary enrolment by more than 8 percent, while it led to an increase in health visits by some 20 percent. The Brazilian Bolsa Escola reduced school drop out from 5.6 percent to 0.4 percent (Rawlings and Rubio 2004).

170. **Combating child malnutrition.** Currently, the government applies a four-prong approach to fight child malnutrition: (a) measures to address specific nutrition problems, (b) health interventions, (c) direct food consumption based measures to ensure adequate nutrition intake among households and individuals, and (d) poverty reduction programs (World Bank 2005a). However, there is little evidence about the effectiveness of these public nutritional interventions. Given the lack of solid and robust research, these measures may also fail to address some important aspects of malnutrition. Therefore, more work is needed to understand and tackle the causes of malnutrition and design interventions that will help address this problem. Assuming income will be a major constraint in program participation of the poorest children, to ensure their participation (and potentially that of their mothers), the Samurdhi program could be made conditional on participation of poor children in the appropriately designed nutrition programs.

171. **Increasing Income of the Poor.** There is growing evidence that linking the poor with programs that help them generate income, e.g., training and micro-finance, help these groups escape poverty. We have already discussed training of poorer informal sector workers in chapter 2, and focus here on the provision of micro-finance programs to the poor. Samurdhi, too, has developed such programmes. But forced participation has been damaging to overall objectives. Hence, delinking the microfinance programs from the income transfer program, giving the poor a choice about whether to participate, and ensuring the autonomy of the other programs may yield more positive outcomes. In addition, linking the poor to community based self-help groups may also be useful in helping them escape poverty.

172. **Microfinance for the poor: strengthen the micro finance industry and pilot innovative financial services to the very poor.** Given the wide outreach of microfinance institutions, enhancing their services to the very poor may provide new ways to the poor to escape poverty. To achieve this goal, efforts must be made in two directions (see Annex 4.1 for the description and analysis of key problems of the microfinance industry in Sri Lanka). *First*, improve conditions of the industry by strengthening the regulatory framework to ensure the security of deposits and probity of microfinance organizations. An independent regulatory body with representatives of major stakeholders on its governing board needs to be established with sufficient safeguards to prevent its capture either by the government or by the

microfinance providers themselves. There is also a need for greater transparency about the extent of subsidy received by the microfinance providers. And the Samurdhi Bank system needs strengthening of its governance to gain the autonomy from the political establishment. *Second*, efforts should be redoubled to rigorously assess the impact of microfinance on poverty, especially of the very poor clientele. Moreover, while promising examples exist about how to weave in financial service to standard safety net programs, not enough knowledge exists about the methods and conditions that bring success in microfinance (see an example of an “opportunity ladder” provided by financial services in Box 4.6). Piloting various methods of providing financial services *cum* training and provision of selected business services to the very poor segments of population, and rigorously evaluate them (including analyzing the effects of poverty reduction by longitudinal surveys), is therefore needed.

#### **Box 4.6: Combining public works with financial services**

Under the Rural Maintenance Program of CARE, Bangladesh, poor women have been recruited for a four-year period to maintain earthen village roads as part of a public works program. They have to enroll in a compulsory savings plan, setting aside 22 percent of their earnings, and they have to participate in a comprehensive cycle of life-skills training (including basic numeracy, health, nutrition, and income generating activities). The program is active in approximately 90 percent of districts in rural Bangladesh, employing over 40,000 women with 10,000 of them graduating every year. Seventy nine percent of these women continue with self-employment activities, and 66 women graduates have been elected to local government office to date.

The program has successfully met the twin challenges of targeting the poorest and ensuring program graduation. Equipping them with necessary skills and helping them to generate substantial savings prepared women to start a microenterprise.

*Source:* Hashemi (2005).

### **(c) Helping the Poor Cope with Vulnerability**

173. Aside from addressing chronic poverty, safety net programs can help address other individual vulnerabilities and help individuals cope against large covariate shocks. Strengthening these programs may not be fiscally neutral and fiscal cost will require careful consideration prior to implementation.

#### **Addressing individual vulnerabilities**

174. **Disability/illness of main breadwinner, or other household member, is likely one of the largest health shocks affecting families.** As noted above, addressing disability requires a comprehensive approach and also much more facilities and resources. Such an approach is embodied in Sri Lanka’s national strategy for disability, and it will have to be assessed against the overall budget envelope. The efforts in this area should include: (i) improved information and awareness about the problems of the disabled.<sup>69</sup> This requires providing more and better information about the incidence and type of disability, public awareness campaigns which would inform the public of the benefits of preventing disability, and help reducing the stigma about the disabled and including them in the society; (ii) improved prevention—developing measures to improve road safety, safety at the workplace, improving nutrition; (iii) facilitating participation of disabled fully in the socio-economic life of their community, including in education and health programs (through, for example, provision of hearing aides or glasses, or improved emergency treatment and care of mental illnesses, trauma and depression); and (iv) better coverage of disabled in safety net programs (and *ex ante* in disability insurance programs, see chapter 3). Perhaps most

<sup>69</sup> It was found, for example, that the lack of disability awareness negatively impacted the inclusion of people with disabilities at all phases of the recent tsunami relief efforts.

importantly, ensuring the participation of the disabled in employment/training programs to help them access jobs will be critical for improving their well being and helping them escape poverty.

175. **Social welfare and care services.** Attending the needs of other vulnerable groups, such as alcohol and drug abuse, orphans, and street children, requires strengthening social welfare and care services, which is a very useful complement to cash transfer programs. These services provide or facilitate the provision of counseling for victims of trauma, alcoholism, divorce, loss of parents, and other social problems. While services can be outsourced to private providers/NGOs, the government agencies need to set standards of care, license providers, and regulate the provision of services. The scaling up of these services will also require adequate financing, with the benefits of provision reflects against the long term consequences of inadequate care. Sri Lanka already implements programs in this area (including NGOs), but these programs would need to be adequately funded and strengthened to address these important vulnerabilities.

### **Addressing Aggregate Vulnerabilities**

176. **To address *disaster/drought relief*, the government could consider a package of interventions: cash/livelihood grants, workfare, and social welfare and care services, to be scaled up in case of disasters.** One of the painful lessons of tsunami has been the lack of programs prepared in advance and readily available for relief and recovery response. A social protection component of such an intervention would systematically prepare and design programs to protect the affected population (appropriately defined), ready to be rolled out in terms of emergencies, and form an integral part of the country's disaster prevention and coping strategy. Specifically, the safety net component would (i) meet immediate basic needs by ensuring food, shelter, and medical aid for immediate relief of disaster victims; (ii) distribute cash grants to provide for the minimum subsistence needs of affected households (and perhaps to restart livelihoods and rebuild housing); (iii) facilitate income earning opportunities for poor during the post-crisis through access to micro-credit and grants to start up businesses; (iv) offer workfare programs for those able bodied poor who are not able to find a job or increase their income (see Box 4.7 for key design elements of a successful workfare program); and (v) link affected individuals to social welfare and care services that could help provide, for example, needed counseling and family placement for individuals suffering the trauma of the loss of family members (e.g., orphans and widows), and help the disabled (with rehabilitation, orthotics, and psycho-social support).

177. **Providing relief for conflict-affected groups and areas.** This effort could have several major thrusts. First, helping demobilized soldiers (and perhaps to other previous active participants in combat) to reintegrate into the civil society through programs that support their employment or creation of self-employment, including labor market counseling and job training. Such programs are common in countries which have undergone civil conflicts in other regions countries which have undergone civil conflicts, e.g., in Bosnia Herzegovina (see Box 4.8). Second, addressing the special needs of children—ex-combatants and others, for example, to ensure that these children attend school and obtain needed health care. Third, measures also need to be taken to integrate disabled children and youths into society to ensure access to treatment including trauma counseling and other psycho-social assistance (see above section on disability). Finally, community rehabilitation—of schools, roads and essential infrastructure through public works or workfare—could also be provided (at the same time, offering temporary income support to the unemployed or demobilized soldiers).

#### **Box 4.7: Key design elements of a successful workfare program**

In designing public works programs, several general principles should therefore be followed. First, forgone earnings should be minimized by attracting workers who have low alternative earnings opportunities. Second, displacement effects should be avoided, among others, by the careful selection of areas of activities. Third, while the program should in principle be open to anyone, wages should be set low enough so as to trigger a self-selection mechanism through which only those in need participate. Low wages also encourage participants to search for a regular job. And fourth, to maximize their intended effect on income generation by the poor, projects that require heavy non-labor costs should be avoided, particularly during crises. In general, public works should be more labor intensive than required by pure profit maximization.

Argentina's Trabajar program is a very well known example of a successful workfare program, illustrates the above design elements. Trabajar allocates funds across provinces based on the distribution of the unemployed poor. Proposals to use the funds are made by municipalities and non-government organizations. These proposals are approved at the regional level, based on a system of points related to poverty in the area and the merits of the proposed project. The government pays for the costs of unskilled labor and the sponsoring units pay for the equipment, materials, and the skilled labor. The wages for unskilled labor are set at two-thirds of the average wage for the poorest decile in the capital city. In principle there are no restrictions on the eligibility of beneficiaries to participate in the program, but in practice there is rationing. The financing of the Trabajar program as a matching grant scheme not only induces local governments to commit to the project, but it also induces local governments to make use of more labor. The use of labor intensive approaches is thus enhanced through incentives to local governments rather than through instructions to contractors and engineers.

*Source:* Vodopivec (2004) and de Ferranti et al (2000).

**Box 4.8: Emergency labor redeployment project**

Following the Dayton Peace Agreement of November 1995, an estimated 425,000 soldiers were demobilized from the armies in Bosnia-Herzegovina. Their reintegration into civilian life—supporting them to find employment or to create sustainable jobs and businesses—was facilitated by the two successive Emergency Demobilization and Reintegration Projects implemented by the World Bank. The projects provided labor market counseling services and promoted on the job training and self employment in small business activities and in agriculture. In one of the projects, 5,426 ex-soldiers participated, of which 1,520 took jobs under the on-the-job training component; 3,450 started farming (the project supported, for example, the purchase of cattle and farming machinery), and the rest undertook vocational training. The table below summarizes some demobilization programs targeting ex combatants or aiming at reducing military in other countries:

<b>Project/ country</b>	<b>Skills</b>	<b>Assistance</b>	<b>Average US\$ per beneficiary</b>	<b>Duration of Assistance</b>
Angola 2002	Low	Cash and in-kind	300-900	6 months
Bosnia 2000	Low	In kind grants, job placement, training	2,900	One year
Bosnia 2003	All-levels	Cash	5,000	NA
Bosnia 1996	All levels	Training modules	500	3 months
Cambodia 2001	Low	Cash and in kind	1,126	NA
Chad 1996 1997	Low	Cash	860-1,480	One year
Djibouti 1995	Low	Cash	1,000-2,000	6 months-1 year
Eritrea 1993	All levels	Cash	800-1,600	6months
Namibia 1990	Low	Cash and in kind	1,263	9months to 1 year
Rwanda 1997	Low	Cash	750-1,600	10 months
Rwanda 2002	Low	Cash and in kind	110-1,100	6 months
Uganda 1992	Low	Cash and in kind	1, 114	6 months

*Source:* Naqvi (2005).

## 5. CONCLUSIONS AND RECOMMENDATIONS

*Equity is complementary with the pursuit of long-term prosperity, and institutions and policies that promote equal opportunities—where all members of societies have similar chances to become socially active, politically influential, and economically productive—contribute to sustainable growth and development.*

*World Development Report 2006*

178. Previous chapters described the main risks and identified the poor and vulnerable in Sri Lanka, and studied the functioning of the main programs and formulated policy options in key social protection areas — labor market, social insurance, and social safety nets. Building on the above analysis, this chapter summarizes key analytical findings and presents a unified policy framework to address social protection issues across its diverse areas and programs.

### 5.1 Summary of analytical findings

179. **The report identified the following key poor and vulnerable groups.** Among *children*, those living in large families, who are disabled, out-of-school children, child workers, and malnourished children. Among *working age adults*, informal sector workers living in remote and infrastructure poor areas (particularly uneducated, casual and own-account workers), unemployed youth from low income families, displaced due to the civil conflict or natural disasters, and the disabled. Among *the elderly*, only the oldest face above-average poverty rates, but rapid aging of the population may lead to strains in the traditional and formal income support systems and contribute to future vulnerability among the elderly.

180. **The report found that Sri Lanka should be commended for putting in place an extensive social protection system.** Sri Lanka's social protection system is much more extensive than in other South Asian countries, with up to a third of the workforce covered in case of employment protection and social security, and about 40 percent of households covered in the case of the largest safety net (cash benefit) program (see Table 5.1, which is summarizing social protection programs, key issues, and proposed policies directions). In 2004, social protection expenditures amounted to approximately 3 percent of GDP (2 percent for pensions and 1 percent for safety nets). The main safety net programs are the Samurdhi income transfer to the poor, income support for disabled soldiers and families of service personnel who died in the conflict, assistance for persons displaced by the conflict, and emergency assistance to people affected by natural disasters. Sri Lanka is also to be commended for ratifying eight ILO conventions on core labor standards and for establishing tripartite mechanisms for social dialogue.

181. **But the country's social protection system could be strengthened in all three core areas — labor markets, social insurance, and social safety nets.** By forcing many individuals to cope with rather than avoid poverty and vulnerability, Sri Lanka's segmented labor market benefits the non-poor and excludes the poor, thus importantly contributing to both inequality and inefficient utilization of resources. Moreover, despite the fact that a substantial share of labor force is covered by formal old age income support, there is still a large coverage gap, benefits are inadequate and fiscal sustainability of several schemes questionable. And the main safety net program, Samurdhi, is poorly targeted, provides a low level of benefits, and is not appropriately linked to human capital development or income generation of the poor.

182. **(a) Key issues in the labor market:** While devoting significant attention to worker protection and promotion, Sri Lanka has yet to achieve the right balance of policies and programs. In line with its focus on social policies, Sri Lanka's legislation covers various aspects of working conditions and protects core labor standards. On the other hand, Sri Lanka's *employment protection* institutions (such as the employment protection legislation and wage setting mechanisms) ensure overly generous benefits and wages to formal sector workers, and by doing so, reduce access to 'good' formal sector jobs (and associated insurance schemes) for two thirds of the labor force working in the informal sector, as well as to some particular groups such as unemployed youth and women. Sri Lanka's depressed job flows a likely consequence of the restrictive TEWA system—have potentially adverse implications for productivity growth and access to formal jobs by marginal groups. The limited education of informal sector workers and their location in poorer rural areas also reduce their access to better paying formal sector jobs. And restricted formal sector job opportunities appear to lower expected returns from schooling for the poor. In turn, this reduces schooling participation of the poor and creates a cadre of less educated workers with lower formal job prospects, thus perpetuating a vicious cycle of poverty.

183. **(b) Key issues in the social insurance.** Sri Lanka's social insurance schemes provide some measure of protection, but they offer limited coverage, provide inadequate benefits, have weak administration and regulation, and their financial sustainability is in question. The diverse schemes are also not coordinated in terms of benefit levels while the limited portability of benefits also constrains labor mobility. Individuals are protected against health shocks through coverage of medical fees, but loss of income from sickness—which often constitutes the larger income loss from sickness—is not compensated, and can lead to poverty. In its effort to promote labor market reforms, Sri Lanka is considering the introduction of a formal unemployment insurance system, but its design has to be adjusted to fit the country weak administrative capacity and large informal sector providing abundant opportunities for undeclared paid work. To provide income support for the workers in the informal sector, workfare schemes exist on an ad-hoc basis, but Sri Lanka does not have a permanent workfare scheme.

184. **(c) Key issues in the social safety nets.** The key income transfer program, Samurdhi, provides limited benefits and has large inclusion and exclusion errors. Similarly, income support to disabled is focused on soldiers injured by the conflict, leaving other poor disabled groups under-covered, and a more comprehensive approach to disability is needed, focusing on prevention and enabling the disabled to integrate better into society. And while disaster relief seems to work relatively effectively and acts as an important source of income for the affected persons, the relief for the displaced (in the form of food assistance) is insufficient to meet basic nutrition needs, and rehabilitation assistance for permanent settlement faces strong fiscal constraints that limit the coverage. To support families and individuals affected by the devastating tsunami of December 2004, the government, aided by multilateral agencies, introduced cash transfers and helped to provide loans and grants for small, medium and micro enterprises.

**Table 5.1: Summary of social protection programs, key issues, and proposed policies**

Area—program/ Objective	Targeted beneficiary groups	Risk addressed	Expenditures (Rs, 2004)	Key issues/gaps	Proposed policies directions
<b>I. EMPLOYMENT PROTECTION AND PROMOTION (risk reduction mechanisms)</b>					
<ul style="list-style-type: none"> <li>• Employment protection (core labor standards, employment protection legislation, wage setting)</li> <li>• Employment promotion (facilitation of job search, training)</li> </ul>	Informal sector workers Unemployed	<ul style="list-style-type: none"> <li>• Loss of formal sector jobs</li> <li>• Occupational health and safety hazard</li> <li>• Child labor</li> <li>• Discrimination</li> <li>• Unemployment</li> </ul>	...	<ul style="list-style-type: none"> <li>• Excessive Employment protection, e.g. TEWA, limits job creation and access to “good” jobs</li> <li>• Wage setting increases formal sector wages</li> <li>• Civil service recruitment distorts labor incentives and contributes to unemployment</li> <li>• Possible gaps in employment promotion</li> </ul>	<ul style="list-style-type: none"> <li>• Create a more equitable and efficient employment protection program by reducing excessive job protection and strengthening protection of basic rights and social protection of workers</li> <li>• Consider cost effective active labor programs, e.g. job counseling and information, and demand driven training programs</li> </ul>
<b>II. SOCIAL INSURANCE (risk mitigation mechanisms)</b>					
Old age income support programs (civil servants scheme, EPF, private funds, voluntary schemes)	Elderly	Old age	31,123 mln. (2.0 % of GDP) (2002, civil servants only)	<ul style="list-style-type: none"> <li>• Limited coverage (a third of the labor force is covered)</li> <li>• Inadequate benefits</li> <li>• Questionable financial sustainability, depending heavily on future government finances</li> </ul>	<ul style="list-style-type: none"> <li>• Improve the adequacy and sustainability of formal schemes (increase retirement age, outsource fund management, and diversify investment options)</li> <li>• Explore possibilities to expand the coverage of formal schemes</li> </ul>
Disability and survivor benefits (civil servants scheme, ETF, Samurdhi’s microinsurance, NGOs)	Disabled/ Survivors	Disability/ Death	...	There is a patchwork of programs, with benefit levels set ad hoc and not indexed to inflation, and their financial sustainability is not known	<ul style="list-style-type: none"> <li>• Cover disability and death risk through group self-insurance or purchase of external insurance, based on actuarially fair premiums and selected subsidization</li> </ul>
Unemployment insurance program (under preparation)	Unemployed	Unemployment	80 mln. (0.01 GDP) — forecast	The country lacks important prerequisites for functioning of a standard, OECD-type of UI system	<ul style="list-style-type: none"> <li>• Adapt an OECD-type of UI system to SL by eliminating personalized monitoring of beneficiaries and simplifying administrative procedures</li> <li>• Strengthen workfare programs</li> </ul>

**Table 5.1: Social protection programs, beneficiary groups, and risks addressed (cont.)**

Area—program/ Objective	Beneficiary groups	Risk addressed	Expenditures (Rs, 2004)	Key issues/gaps	Proposed policies directions
<b>III. SOCIAL SAFETY NETS (risk coping mechanisms)</b>					
Samurdhi program (income transfers, micro credit, small scale infrastructure, infant milk subsidy)	The poor	Poverty	12,449 mln. (0.62% of GDP)	<ul style="list-style-type: none"> <li>• Benefits are low and their impact on the welfare minimal.</li> <li>• Large inclusion and exclusion errors</li> <li>• Program expenditures declined from 0.9% in 2001 to 0.4% of GDP in 2004</li> </ul>	<p>A strong safety net system with four key areas:</p> <p>(1) Address chronic poverty:</p> <ul style="list-style-type: none"> <li>• Improve targeting of the program by introducing proxy means testing, and avoid poverty traps</li> <li>• Increase benefit level, without compromising work incentives and fiscal sustainability</li> <li>• Consider including disability payments under the Samurdhi program</li> </ul> <p>(2) Help the poor escape poverty:</p> <ul style="list-style-type: none"> <li>• Consider conditional cash transfers to reduce school non-attendance and child malnutrition</li> <li>• Promote access of to poor through skill development and access to micro-finance</li> </ul> <p>(3) Address individual vulnerabilities:</p> <ul style="list-style-type: none"> <li>• Strengthen delivery social welfare and care services through public private partnerships</li> <li>• Implement national disability policy</li> </ul> <p>(4) Address aggregate vulnerability:</p> <ul style="list-style-type: none"> <li>• Develop a package of interventions to be scaled up in disasters</li> <li>• Strengthen relief for conflict affected groups and areas</li> </ul>
Civil conflict related programs (payments to disabled soldiers, rehabilitation and reconstruction)	Conflict affected population	Civil conflict	6,392mln. (0.32% of GDP)	The relief for the displaced is insufficient to meet basic nutrition needs, and rehabilitation assistance for permanent settlement faces strong fiscal constraints	
Flood and drought relief	Population affected by natural disasters	Natural disasters, climatic shocks	1,466 mln. (0.07% of GDP)	Disaster relief covers all affected persons and works effectively	
Other safety net programs (Triposha supplement, mother's and child's nutrition, disability allowance, assistance for indigent population and disabled)	Specific groups (poor mothers and children, disabled, indigent population)	Specific risks, including child malnutrition	456 mln. (0.02% of GDP)	<ul style="list-style-type: none"> <li>• There is little evidence about the effectiveness of current interventions to combat child malnutrition</li> <li>• Less than a half of the disabled receive any sort of income transfer from the government</li> <li>• Disabled suffer from stigma and lack of acceptance into society, limited access to education, jobs</li> <li>• No evidence on the impact of provincial council programs</li> </ul>	

*Note:* The above programs are a subset of public mechanisms available to manage social risks (see World Bank 2001). Mechanisms in other areas (such as macroeconomic policies, banking and financial policies, infrastructure and land policies etc.) complement social protection mechanisms in managing social risks.

## 5.2 Gaps in knowledge

185. The report identified a host of important knowledge gaps in all key areas of social protection to be covered by future analysis. Being conceived as a desk-top analysis, the report covered only areas which have already been examined by existing studies.<sup>70</sup> In doing such analysis, the report identified several areas exhibiting important gaps in knowledge. In terms of diagnostics, one such area is vulnerability, which, in the absence of panel data on household expenditures, has not yet been studied adequately (that is, the main risks causing vulnerability, the characteristics of groups such as suffering a decline in wellbeing, and the magnitude of the decline, are yet to be analyzed). Important knowledge gaps exist also in all three functional areas of social protection:

- In labor markets, further work is needed to learn about successful strategies and institutions promoting labor market outcomes for the youth, and about the effects of labor market and other institutions on productivity, labor demand, and job creation.<sup>71</sup> Cost effective active labor market programs also need to be determined, as many findings from industrialized countries about the impacts of active labor market programs may not apply in the developing country setting, given much larger informal labor markets and weaker implementation capacity.
- In social insurance, further analysis is needed to determine the modalities of extending coverage of social protection, in particular, to arrive at proposals on how to reduce transaction costs and administrative barriers for those that should be covered by the existing programs (like EPF), and to propose a voluntary and subsidized approach to expanding coverage in sequential fashion. Introduction of the unemployment insurance in Sri Lanka will also call for a further analysis of the design of the institutional features of the program.
- And in social safety nets, important knowledge gaps relate to the analysis of exit conditions from income transfer programs. For example, under what conditions can microfinancial services (coupled by entrepreneurship training, as well as marketing and accounting services) be successfully linked with standard safety net programs, and how to successfully weave in the workfare requirements into income transfer programs? Moreover, there is little evidence about the effectiveness of current interventions to combat child malnutrition, and analysis leading to the preparation of a holistic plan to address macro/aggregate vulnerabilities is also lacking.

## 5.3 Policy directions

186. **Social protection programs are vital to promote growth while ensuring that the dividends of growth are shared more equally among population, and promoting such programs is one of key challenges for Sri Lankan policy makers.** A key message of the World Development Report 2006 is that the dichotomy between policies for growth and policies specifically aimed at equity is false, and that important “double dividend” policies exist in all key areas of social protection (World Bank 2005e). The present report applies that general message and identifies key such policies in the Sri Lankan context (see summary in Table 5.1):

- In labor markets, employment prospects of the poor and vulnerable should be increased. That goal encompasses both expanding job opportunities (among others, by changing the paradigm from protecting jobs to protecting workers) and enhancing equal access to formal sector jobs, as well as improving skills of the current and future workers, thus boosting their employability. This will not only promote the access of informal sector workers and other marginalized groups to “good” jobs, fostering equity, but also enhance productivity.

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<sup>70</sup> Note, however, that the report undertook original analysis in two areas: the impact of employment protection legislation on job flows and size of firms, and the determinants of informal sector employment.

<sup>71</sup> As mentioned above, the joint WB-ILO initiative under the UN-sponsored “Youth Employment Network” will go long way toward addressing these issues (the work started in 2004 and will be completed in 2006).

- In social insurance, adequacy and financial sustainability of insurance schemes for old age, disability and survivors, both formal and informal, will need to be improved, and the possibilities to expand coverage to the informal sector explored—the tasks that will contribute to greater equity, but also to more sustainable growth.
- And social safety nets should be strengthened, not only by ensuring that programs target the poor, but also by linking assistance to human capital investments and the expansion of income earning opportunities of the poorest groups, thus helping the poor and making the economy more productive.

187. **The proposed directions effectively link various areas of social protection under a unified social risk management framework.** Boosting employment prospects is an obvious priority, as it not only increases earnings but also brings more people under the coverage of social insurance and ultimately reduces the need for safety net interventions. Improved and innovative insurance programs can help the poor to better utilize their productive resources, for example, by investing in high risk and return activities. And the provision of safety net programs can be productively linked to activities related to labor market. For many of the poor, breaking the dependence on Samurdhi assistance may require enhancing their access to training and upgrading their skills, and/or relaxing restrictive labor and wage regulations. Similarly, the provision of cash transfers that are contingent on participation in schooling and health care improves employment prospects of the next generation and thus helps the poor to escape the vicious circle of poverty. By weaving social protection instruments into informal and market-based mechanisms in the most productive fashion, the proposed approach thus combines policies aimed at coping with shocks with policies reducing the frequency and magnitude of shocks.

#### **(a) Enhancing Employment Prospects for the Poor and Vulnerable**

188. **An important short-term task to increase employment chances of the poor and vulnerable is to improve their skills.** This includes introducing cost effective active labor programs, such as job counseling and labor market information, and demand driven training programs for vulnerable, disadvantaged workers, particularly in rural or remote areas. Piloting of new programs is warranted to design appropriate national strategy (paying special attention to youth, women and disabled). Similarly, helping the poor children and youth to improve their education outcomes will also improve their labor market chances. To increase participation of children in school and reduce dropouts, one option is to defray the costs of education of the poorest children by providing safety nets contingent on school participation. Innovative approaches to tailor schooling and training around the needs of the working children, or children who have dropped out of school, may also be needed.

189. **To expand and enhance equal access to formal sector jobs, an important, long-term task is to shift the paradigm from job protection to worker protection.** Under such a reform (which would undoubtedly be a protracted and gradual one), costly protection of formal sector *jobs* via stringent employment legislation would be reduced (and essential protection of basic rights enforced), and the protection of *workers* assured via unemployment insurance and other social protection programs. This shift would not only promote the access of informal sector workers and other marginalized groups to “good” jobs, fostering equity, but also enhance productivity growth. Moreover, such a reform would also improve competition for jobs and reduce wage premium of protected workers. In turn, this will help reduce labor costs and increase both demand for labor as well as international competitiveness of Sri Lankan firms. And such a reform would help spur productivity growth, because firms would be more inclined to introduce new technology and because Sri Lanka would become more attractive for foreign investors.<sup>72</sup>

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<sup>72</sup> Note also that reducing informality will require reforms in other, complementary areas. For example, a recent investment climate assessment in Sri Lanka shows that while regulatory requirements to entry are low, both rural

## **(b) Reducing Vulnerability through Social Insurance**

190. **The adequacy, administration, and regulation and financial sustainability of formal sector insurance schemes need to be improved, and the possibilities to expand coverage explored.** In the long run, to improve the fiscal sustainability and coverage of informal sector insurance programs, more radical measures may be needed, such as the creation of a unified insurance program covering formal and selected informal sector workers (with the system being implemented gradually, and after the labor market is further formalized and improvements in regulation and administration of current programs are achieved). Thus reforms should both increase coverage (thus contributing to equity), as well as lower fiscal expenditures spent on social safety nets (thus reducing constraints to growth).

191. **In the short run, important gradual reforms of social insurance institutions involve improvement of their services, expanding their coverage and scope, and ensuring financial solvency.** For the civil service scheme, these measures include gradually reducing target replacement rates and introducing employees' contributions, and for Employees' Provident Fund and approved retirement schemes, increasing retirement ages and improving the linkage of benefits to contributions (or introducing fully contributory schemes) rather than specifying nominal benefits and contributions in schemes covering informal sector workers. Moreover, with regard to death and disability insurance, public policy objectives should be clarified with a view to reducing arbitrary differences and inequities between workers—paying due attention on political economy considerations. For all schemes, information systems need to be upgraded and supervision improved. Moreover, to pave the way to greater labor market flexibility and ease the political costs of reducing job protection, Sri Lanka should consider the introduction of unemployment insurance program, but a standard OECD model needs to be adapted to the Sri Lankan context (for example, the elimination of personalized monitoring of continuing eligibility conditions and a much simplified benefit and administration structure would render the OECD model more appropriate for a low income country). For informal sector workers, particularly the poor, a workfare program may be considered.

192. **A longer-term strategy is to create a seamless, unified framework for formal and informal sector workers, covering old age, disability, survivor and unemployment risks.** Social security (old age, death, disability) should be based on a defined contribution scheme (or with contributions strongly linked to benefits) with parameters set so as to produce a target replacement rate. This would allow for complete portability of benefits (individuals would not lose accumulated benefit when they move jobs, easing labor mobility) and increase economies of scale in administration (e.g., record keeping) and avoid the creation of new liabilities. Death and disability insurance, fairly priced based on actuarial results, could be purchased for members of this scheme. Annuitization of benefit (the conversion of a lump-sum benefit into a stream of benefits paid in regular intervals) after retirement could also be made possible. Similarly, a funded severance portion of the system could be added and integrated into the unemployment insurance (UI) program, with UI benefits being funded by withdrawals from both individual saving accounts as well as from the solidarity fund, the latter being financed by pooled contributions of workers and their employers. This approach offers advantages not only in terms extension of coverage, but also greater labor mobility and financial solvency. A unified system would need to be designed carefully, and would only be implemented gradually once improvements in regulation and administration of current programs are achieved. Increased formalization of the economy would complement expansion in coverage.

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and urban firms suffer from poor quality of infrastructure (especially energy and transport) and costly and limited access to finance, the factors which pose formidable barriers both to new startups and to investment and increased productivity by existing firms (Asian Development Bank and World Bank 2005).

### **(c) Reforming Social Safety Nets**

193. **Samurdhi income transfer program needs to be better targeted and the incentives of recipients to escape poverty improved.** The ongoing reform—aiming to increase the amount of support within existing budget through targeting based on a proxy means testing formula—is an important initiative and will improve objectivity and transparency. Eligibility could also be validated via community participation. Because inflation has strongly eroded the real value of benefits, current benefits should at least be maintained in real terms and continually adjusted for inflation. But higher benefits may create work disincentives (poverty traps), so suitable exit/incentive clauses from the program need to be designed (e.g. workfare to improve community infrastructure, which can act as a work test for able bodied poor), and continual eligibility frequently monitored. Once disability is included as a criterion for receiving Samurdhi benefits, it would be possible to consider the option of folding disability transfers into Samurdhi, or at least ensure consistency across the two main cash transfer programs as a first step.

194. **The safety net programs could be strengthened by helping the poor to participate in human development and income earning programs, and to improve their access to skill development.** The Samurdhi reform could be strengthened by using cash transfers providing incentives to improve school enrollment and reduce dropouts, and also to help the poorest participate in nutrition based programs, thus confronting child malnutrition. Helping the poor access micro-finance and training will also assist poor people to exit the safety net.

195. **Programs addressing individual and community wide vulnerabilities need to be upgraded.** Existing social welfare and care services for vulnerable groups need to be improved. While these services can be outsourced to private providers/NGOs, the government agencies need to shape policy, set standards of care, license providers, and regulate the provision of services. Strengthening programs for disabled is also important, and as part of the implementation of the national disability action plan, efforts across a number of agencies, both public and private, will need to be coordinated to raise awareness/reduce stigma of disability, strengthen prevention of disability, and promote the inclusion of disabled in socio-economic activities. Among community wide programs, a package of disaster/drought relief interventions could be developed, to be scaled up in case of disasters (cash/livelihood grants, workfare, and social welfare and care services), and the relief for conflict affected groups and areas could be strengthened by helping demobilized soldiers to reintegrate into civil society, by attending the special needs of children and youths affected by the conflict, and by rehabilitating schools, roads and essential infrastructure through public works.

196. **Towards a more integrated social protection system.** The above policy options also help to steer various social protection instruments in the direction of an integrated system. As a first step, a coordination mechanism could be introduced (an inter-agency committee, for example) to reduce coverage gaps and overlaps between programs, align benefits and eligibility conditions, strengthen capacity to forecast and evaluate program costs and impact, and pilot and evaluate new approaches. Over time, it would be important to move beyond coordination of programs towards developing a more integrated, financially viable social protection system, the system that would provide adequate work incentives, that would address both chronic poverty and risks, and that would extend coverage to the very poor. Such a system would be based on reduced employment protection (while protecting basic workers rights and core labor standards) and the provision of explicit income protection (e.g., workfare or unemployment insurance) and safety nets, including social assistance/cash transfer programs as well as social welfare and care services, financially viable and well administered formal and informal social security schemes. Such a system could potentially evolve, under particular pre-conditions noted above, into a unified social security system.

#### **(d) Cross Cutting Issues**

197. **Ensuring adequate and fiscally sustainable funding for the social protection programs.** Social protection spending in Sri Lanka is skewed towards higher income groups both in the case of safety net programs (e.g., Samurdhi) and in social insurance (e.g., pensions). The proposed Samurdhi reforms, as well as social insurance proposals of this report, would not only help to correct these imbalances, but they would also help keeping public expenditures on these programs in check. In particular, improved targeting under the proposed Samurdhi reform will create ample room for increasing benefit per recipient — the level of which has been strongly eroded because the amount per beneficiary has been nominally fixed — without necessarily increasing the overall spending level. Over the long term, to ensure fiscal sustainability the country will need to reduce spending on pension schemes for civil servants (and the scheme’s large implicit debt burden) and link pension benefits strongly to contributions. Moreover, public expenditures may also be re-directed towards (potentially subsidized) insurance coverage of the poor and towards adequately funded and efficiently targeted safety net programs. Overall spending for safety nets in developed countries peaks at about 2 percent of GDP (World Bank 2005e) and could serve as upper bound target expenditure for safety net programs for Sri Lanka, including cash transfers and social welfare services. Some flexibility and set aside in safety net spending may be needed to respond to social protection needs stemming from emergencies, such as natural disasters.

198. **Strengthening capacity to administer programs is critical for program implementation.** Although social protection reforms may bring strong efficiency gains and may promise to improve welfare of the poor, such reforms are technically demanding and, therefore, the capacity of the country to design and implement such reforms need to be developed. Social protection reforms are difficult to design because they require meticulous attention to adequacy, incentives, fiscal costs, and monitoring and evaluation, and because they often have to be coordinated across different areas (ranging from social protection to financial markets, fiscal management, education, and health), and because local circumstances need to be carefully accounted for.

199. **Appropriately accounting for political economy considerations is vital for ensuring successful adoption of proposed changes.** Social protection reforms are politically difficult because many groups prefer the status quo. For example, current beneficiaries of strong employment protection—incumbent workers and their unions—may oppose any reduction of job protection as they consider alternatives, such as unemployment insurance, inappropriate; existing beneficiaries of Samurdhi may oppose reforms because they do not wish to lose eligibility if a more transparent method of selection is adopted. And because potential beneficiaries are often without adequate political representation (informal sector workers, or the poor who are excluded from safety net programs, for example), and because the benefits of reforms often accrue only in the long run (such as in reforms of old age income support), social protection reforms need to be coupled with adequate attention to political economy of reform.

200. **Introducing strong monitoring and evaluation of social protection programs to evaluate policy impact and inform program design.** Sri Lanka already has an effective mix of surveys and administrative data collection that can be strengthened and used on a regular basis to inform policy design and impact. Monitoring and evaluation activities involve using sound administrative data, timely household surveys to evaluate program coverage, incidence and adequacy; impact evaluations based on timely survey baselines which address a broader range of impacts than the input/output focus of most concurrent evaluations; periodic use of process evaluation tools such as public expenditure tracking surveys for programs where leakage is more pronounced; effective implementation of social audits which are allowed for in some schemes but rarely used in practice. The capacity to assess actuarial soundness of social security schemes and make actuarial projections of the financing impact of project design are also important tools for policy evaluation and design, and needs to be strengthened.

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## **ANNEXES**

## ANNEX 1.1: POVERTY PROFILE

**Table A1.1: Poverty profile for Sri Lanka, 2002 (in percent)**

	Total					Urban poverty rate	Rural poverty rate	Estate poverty rate
	Poverty rate	Poverty gap	Poverty severity	Share of the poor	Share of total pop.			
Total	22.7	5.1	1.7	100	100	7.9	24.7	30.0
<b>By province</b>								
Western	10.8	2.3	0.7	15.5	32.3	6.0	12.7	25.9
Central	25.1	5.3	1.7	16.4	15.1	11.3	27.0	24.5
Southern	27.8	6.5	2.2	17.4	14.3	17.1	28.6	35.7
North-Western	27.4	6.1	2.0	16.0	13.3	13.8	27.9	34.8
North-Central	21.5	4.4	1.3	6.4	6.7	4.1	22.2	14.4
Uva	37.3	9.0	3.2	11.9	7.3	14.6	37.2	42.7
Sabaragamuwa	33.6	7.6	2.5	16.4	11.1	8.8	34.6	33.3
<b>HOUSEHOLD CHARACTERISTICS</b>								
Size of the family								
1 - 3 members	11.0	2.2	0.7	8.9	18.4	1.1	12.2	13.9
4 - 6 members	19.9	4.1	1.3	42.8	48.8	7.3	21.8	20.3
More than 6 members	33.4	8.1	2.8	48.3	32.8	11.2	36.9	47.5
Children present	27.0	6.1	2.0	82.2	69.2	9.9	29.2	34.9
Presence of children in househ.								
Presence of 1 child	18.1	3.6	1.1	26.9	40.3	6.1	20.0	17.8
Presence of 2 children	27.0	5.8	1.8	35.7	35.7	8.0	29.4	35.4
Presence of 3 children	38.3	9.5	3.2	24.6	17.3	12.9	40.9	49.5
Presence of 4 or more children	51.7	14.7	5.6	12.8	6.7	27.9	57.1	56.8
Presence of elderly in househ.								
Elderly 60-69	19.9	4.4	1.5	18.5	21.1	7.4	21.2	37.3
Elderly 70-79	22.2	5.0	1.6	12.7	12.9	5.1	24.0	47.9
Elderly 80 and over	25.0	6.3	2.2	5.5	5.0	7.0	27.5	40.2
Widows	21.8	4.8	1.6	5.2	5.4	4.9	24.2	30.0
Widowers	19.0	3.9	1.3	1.1	1.2	2.8	21.8	17.6
Labor market attachment								
Household with at least one formal sector worker*	8.7	1.9	0.5	10.2	26.8	2.9	9.6	25.9
Household with at least one informal sector worker*	31.1	7.1	2.3	70.2	51.3	12.6	33.9	31.1
Number of employed in the household								
None	15.8	3.9	1.4	3.7	5.4	7.3	17.9	10.5
One	23.8	5.4	1.8	46.3	44.3	9.9	25.8	30.8
Two or more	22.6	4.9	1.6	50.0	50.4	6.2	24.3	30.3
Number of unemployed in the household								
None	21.1	4.7	1.5	67.5	72.7	6.9	22.8	28.8
One	23.5	5.0	1.6	18.4	17.8	7.8	25.7	31.3
Two or more	33.7	7.7	2.6	14.1	9.5	14.6	37.5	35.4
Households receiving disability payments	34.4	10.8	4.0	3.8	2.2	29.7	41.4	32.6

**Table A1.1: Poverty profile for Sri Lanka, 2002 (in percent) (cont.)**

	Poverty rate	Poverty gap	Total Poverty severity	Share of the poor	Share of total pop.	Urban poverty rate	Rural poverty rate	Estate poverty rate
<b>INDIVIDUAL CHARACTERISTICS</b>								
Age								
Below 5	24.9	5.6	1.8	8.4	7.6	10.8	26.0	39.0
5-14	30.8	7.3	2.5	24.5	18.1	11.8	33.2	36.0
15 - 24	23.5	5.1	1.7	19.7	19.1	8.5	25.8	27.0
25 - 44	20.8	4.5	1.5	26.9	29.3	7.0	22.6	30.7
45 - 54	18.2	3.9	1.2	9.8	12.2	6.4	20.1	19.4
55 - 64	16.5	3.3	1.0	5.1	7.0	5.3	17.8	25.7
65-74	17.9	4.0	1.4	3.5	4.4	3.2	19.6	39.4
75-84	21.7	5.1	1.7	1.8	1.9	4.5	23.9	26.9
85 and above	21.1	5.6	2.3	0.5	0.5	8.6	22.1	43.2
Education								
5 grade or less	31.1	7.3	2.5	52.0	37.6	14.4	33.3	31.5
6-9 grader	22.7	4.8	1.5	39.2	38.9	8.1	24.7	26.2
O/L above but not A/L	10.9	2.1	0.6	6.9	14.2	2.2	12.5	20.9
A/L & above	4.8	0.9	0.3	2.0	9.2	1.0	6.0	10.7
Labor market status								
Employed	19.6	4.2	1.3	38.9	43.4	5.7	21.1	25.5
Unemployed	26.5	5.8	1.9	11.6	9.6	11.5	28.9	29.6
Inactive	23.0	5.2	1.7	49.5	47.0	7.8	25.3	31.9
Formal/informal								
Formal sector workers*	5.8	1.1	0.3	32.0	8.9	10.8	30.0	26.5
Informal sector workers*	27.6	6.1	2.0	68.0	91.1	1.6	6.6	15.0
Occupational category of employment								
Senior Managers and officials	3.3	0.6	0.2	0.6	3.5	0.0	4.6	0.0
Professionals	2.2	0.4	0.1	0.8	7.7	0.7	2.6	3.0
Technicians and ass. professionals	3.2	0.5	0.2	1.0	6.4	0.9	3.1	24.0
Clerks	4.4	0.6	0.2	1.4	6.4	0.6	5.0	21.1
Service and market workers	12.6	2.8	1.0	3.3	5.5	3.7	14.2	21.4
Skilled agr. and fishery workers	27.2	5.6	1.7	1.3	1.0	16.7	28.5	22.6
Craft and related trades	21.1	4.2	1.2	17.0	16.7	9.5	22.4	26.7
Plant and machine operators	13.4	2.8	0.9	5.2	8.1	5.9	14.9	13.6
Elementary (unskilled) occupations	31.9	7.2	2.4	69.4	44.9	13.3	35.5	26.7

*Source:* Own computations, based on HIES 2002.

*Note:* Formal sector workers are defined as persons engaged in paid employment and having one of the following principal occupations: legislators, senior managers, and officials; professionals; technicians and associate professionals; clerks; and plant and machine operators and assemblers.

## ANNEX 2.1: EMPLOYMENT PROTECTION LEGISLATION IN SRI LANKA

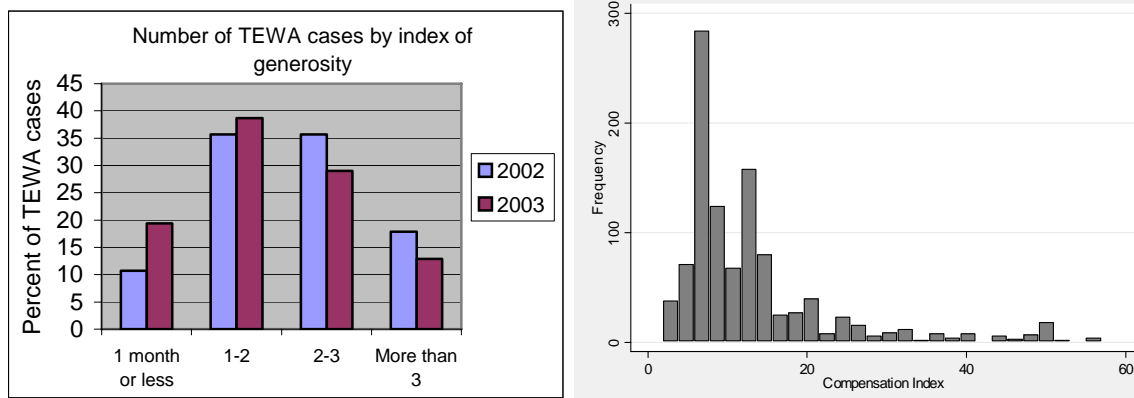
31. **The Termination of Employment of Workman Act (TEWA) of 1971 imposes severe layoff restrictions.** It requires employers with more than 14 workers to inform the Commissioner of Labor about their intended layoffs – and obtain his/her authorization for doing so (for each individual case, not only for mass layoffs). The act requires that the request is examined and response provided in three months, but until 2003, it did not prescribe the compensation to be provided for the laid off workers.

32. **In recent years, the government has tried to expedite the process and to introduce more transparency in determination of the benefits.** To speed up the legal process, a special act was introduced in March 2003 (Special provisions act, No. 13 of 2003). The act requires that the Labor Commissioner responds to applications seeking the layoffs permission, and to complaints about the termination of employment in breach of the act, within 2 months of the receipt of the application or complaint; that the arbitrator makes a decision about disputes between employer and employees within 3 months; and that the labor tribunal makes a decision about applications against the termination of employment within 4 months. To improve transparency, compensation formula was introduced in 2003 and amended in 2005. Below we describe past experience with the act and present simulations to illustrate the generosity of the current formula.

### Past experience

33. **Even before 2005 formula, TEWA compensation of laid off has been very generous.** During 2000-03, the generosity index approved by the Commissioner (the multiple of the monthly salary per year of service) was up to a maximum of 6 monthly wages per year of service, and on average it was between 1.6 and 3.1 monthly wages per year of service. In 2002-03, the generosity index in over 60 percent of cases was between 1 and 3, and it exceeded 3 in about 15-20 percent of cases (Figure A2.1). In 2002, the compensation index (the multiple of the monthly salary awarded to workers) averaged at 16.2, and amounted to 20 or more in just over one fifth of the cases (Figure A2.1).

**Figure A2.1: Generosity of TEWA orders and compensation index, 2002-03**

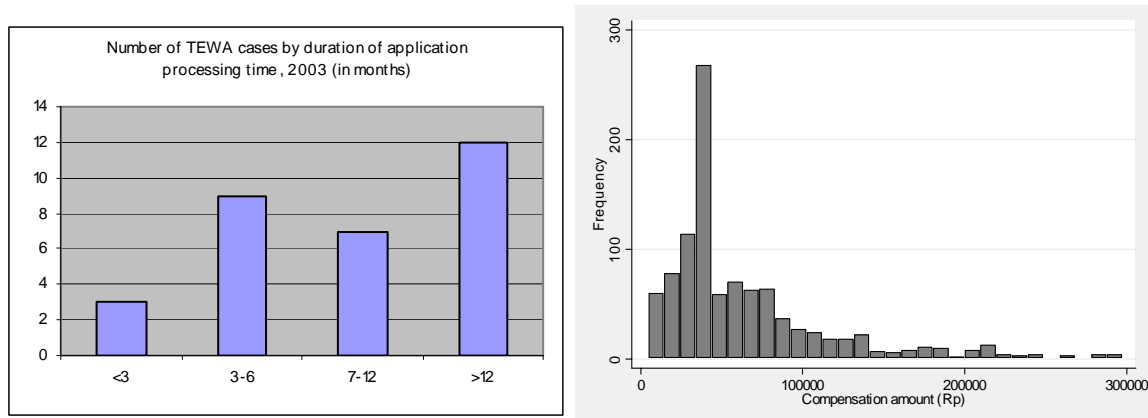


*Source:* Own computations based on the information provided by the Commissioner.

*Notes:* The index of generosity is the multiple of the monthly salary per year of work service, above computed from the TEWA orders for firms; compensation index is the multiple of the monthly salary awarded to workers, above computed from compensation awarded to workers in 2002.

34. **The corresponding layoff costs to employers were commensurately large.** The total sums paid out to laid off workers have been large, with the average payment in 2002 being Rs. 161,000 and the with payments of over Rs.1 million in five percent cases (see Figure A2.2). Additional costs were produced by the unpredictability and lengthiness of the TEWA procedure. In 2003, the average processing time of cases concluded by the Commissioner’s order was 9.8 months, and in many cases it can take much more (see Figure A2.2 for the distribution of cases by processing time). What is more, the procedure typically involves hearings, where employers explain their financial performance and business plans to government bureaucrats to justify layoffs.

**Figure A2.2: Application processing time (2003) and compensation amounts awarded to workers under TEWA orders (2002)**



35. **Older workers were awarded less generous rate of compensation.** While the generosity index was awarded on the case-by-case basis for each individual application (taking into account, above all, the financial standing of the employer and its capacity to pay compensation to the laid-off workers), our regression results show that apart from financial and other conditions of the firm, workers’ length of service significantly influenced the generosity index, with additional 10 years of service *reducing* the generosity index by 0.3.<sup>73</sup> It therefore seems that implicitly, the labor commissioner based the order also on the “denied future service.” That is, the commissioner’s decisions took into account the fact that more experienced workers – other things equal – were to lose less from the layoff, because they faced smaller forgone earnings due to shorter duration of service forgone with the employer.

36. **The number of applications by employers under the TEWA has been quite modest,** ranging from 71 to 105 per year in 2000-03 (Table A2.1). In that period, less than half of cases were concluded by the order of the commissioner – others were withdrawn, dismissed or settled outside TEWA via voluntary retirement schemes. In 2002-03, about 30 orders were issued, involving 900 to 1100 workers. (Note that because of extremely high costs and cumbersome procedure, the majority of layoff cases are quite likely handled via voluntary retirement schemes and are thus not recorded as layoffs.)

<sup>73</sup> In the regression, the dependent variable was index of generosity and explanatory variables were, apart from dummy variable for each firm, wage of the worker (proved to be insignificant) and his/her years of service.

**Table A2.1: TEWA cases –applications by employers and orders made, 2000-03**

	2000	2001	2002	2003*
<b>Application on termination made by employers</b>				
Applications received	71	105	96	71
Applications disposed	23	60	110	94
Cases pending	55	100	86	63
<b>Orders made by the commissioner</b>				
Number of orders			28	31
Number of workers involved			11000	897
Average generosity index (number of monthly wages per year of service)	1.6	3.1	2.1	1.9
Average duration of years of service of workers involved (years)			7.4	
Average amount of compensation (Rs.)			160,006	

*Sources:* For applications, Gazette of Ministry of Labor, 2004; for orders made, own calculations based on documentation on TEWA cases of the Ministry of Labor and Foreign employment; and ILO (2003) for Average generosity index in 2000-01.

*Notes:* 2003 refers to January – September.

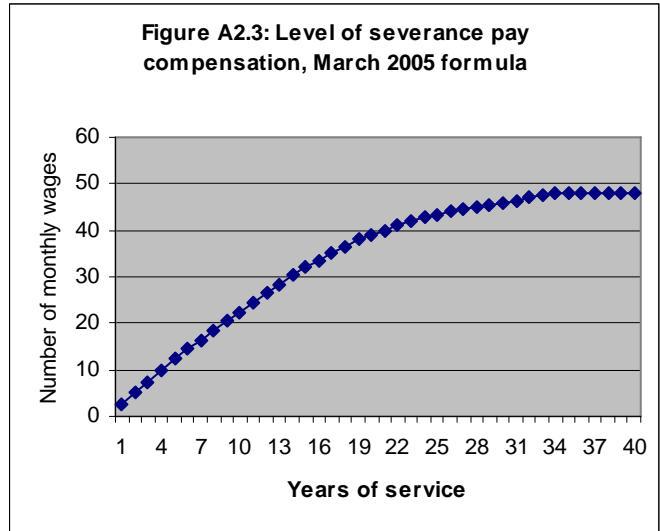
### **Introduction of formula-based amendments of TEWA**

37. **By ex-ante determining the amount of severance pay, the recently introduced formulas reduced arbitrariness, but the separation process still requires prior approval.** The government has made several attempts to impose a compensation formula. In 2001, a *recommended* formula was introduced, calling for “two to three months salary for each year of actual service or full salary for the remaining period (denied service) up to retirement, whichever is less, subject to a maximum of 50 months salary” (Sri Lanka Labor Gazette, Vol. 52, No.1). In December 2003, a *mandatory* formula was adopted by a special act amending the TEWA, calling for generous benefits and adopting a rather complex structure (The Gazette of Democratic Socialist Republic of Sri Lanka, No. 1321717, December 31, 2003). But the new government, which assumed office in April 2004, suspended that formula and introduced a new formula in March 2005. While the recently introduced compensation formulas link the amount of severance pay to worker’s length of service (as common in other countries) and thus reduce non-transparency and arbitrariness in the firing process, the process still involves ‘prior approval’ by the Labor Commissioner and is thus not free of non-transparency and arbitrariness.

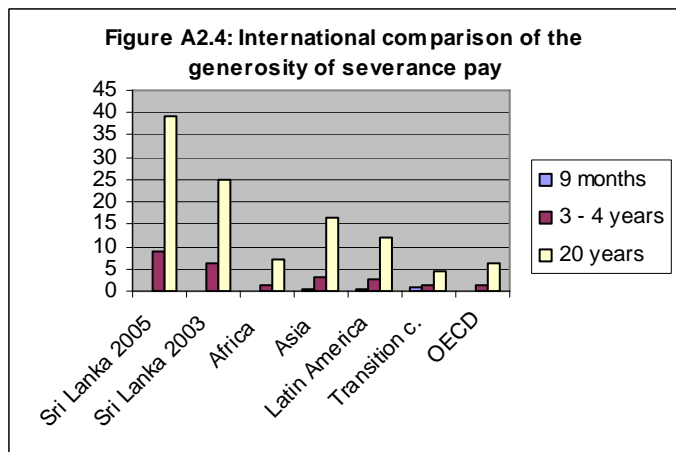
38. **The separation benefits under the March 2005 compensation formula are well above international standards.** The March 2005 formula starts with a factor of 2.5 of monthly wages per year of service for workers with 1-4 years of service. It calls for the increase of total benefits with the years of service, but at a decreasing rate, and stipulates the maximum of 48 monthly wages for service of 34 years and above (see Figure A2.3). For workers with short service, 3 to 4 years, as well as for those with 20 years of service, the generosity of the severance pay according to the new formula exceeds the average generosity in all regions in the world by a multifold factor (Figure A2.4). Even for workers with lengthy service, the severance payment is very generous. For example, under the new formula a Sri Lankan worker with 20 years of experience is awarded by a severance pay of 39 monthly wages, in contrast to average severance pay of 16.3 monthly wages in other Asian countries, 11.9 in Latin American, 7.1 in African, 6.4 in OECD, and 4.4 in transition countries—a staggering difference!

39. **The generosity of the March 2005 TEWA formula strongly increases the overall generosity of payments.** This can be shown in two ways, by comparing the present and previous formulas, and by simulations:

- Under the new formula, the highest benefit per year of service is 2.5 monthly wages for a year of service, dropping to 2 monthly wages for 19 years of service, and to 1.4 for 40 years of service. This exceeds the generosity under the December 2003 formula for all categories of workers, particularly for those with more work experience.

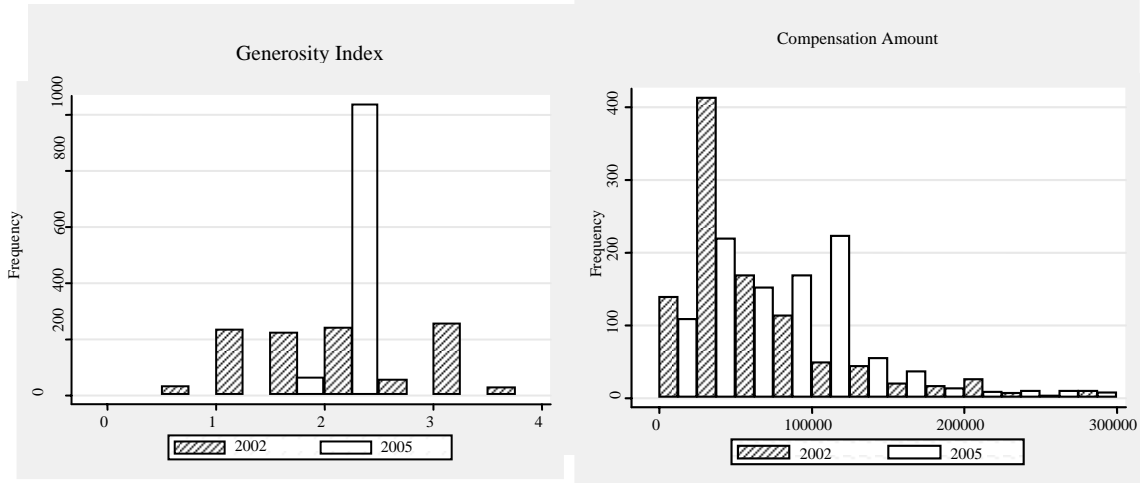


- To take into account the likely composition of layoff workers, we also evaluated the generosity of the 2005 formula based on the following simulations. For all 1100 individuals who were awarded TEWA compensation by orders of the Commissioner of Labor in 2002, we computed the values for their severance payments assuming that the 2005 formula applied (knowing the years of service of each worker and using the formula rules). As shown in Figure A2.5, the 2005 formula awards a higher generosity index to workers whose assigned generosity index in 2002 was below 2, and reduces somewhat the generosity indices for workers who were previously assigned exceptionally high values. As the result, the simulated compensation amount of most workers increased, particularly of workers with few years of experience.



Source: Own computation, for Sri Lanka; Holzmann, Iyer and Vodopivec (2005), for other countries.

**Figure A2.5: Simulation of the generosity of the 2005 TEWA compensation formula**



## **ANNEX 4.1: REVIEW OF MICROFINANCE INSTITUTIONS IN SRI LANKA**

Microfinance denotes financial services for people who cannot access credit from the formal banking system and includes credit for investment and consumption. Traditionally targeted at self-employed to boost their ability to take advantage of market opportunities, microfinance also caters to the very poor and vulnerable, ensuring that they do not suffer from drastic erosion of incomes and well-being due to sudden shocks (Hashemi, 2005). Below we describe coverage and the main providers, review their financial performance, and discuss the regulatory framework of the industry. We argue that while the **microfinance coverage in Sri Lanka is broad, the providers are highly subsidized and the regulatory framework is weak.**

**Having a long history, microfinance in Sri Lanka has a widespread coverage and provides a mix of services.** Together with Bangladesh and Indonesia, the coverage exceeds 8 percent of population, in contrast to most countries, where microfinance institutions reach less than 2 percent of population (Honohan 2004). Gant et al (2002) found adequate coverage throughout the country except in the North and East. There are high levels of savings mobilization, even among the poorest. Most providers offer a mix of consumption and small micro enterprise loans, within a graduated system of loans. The providers often involve savings groups and societies and use revolving fund ‘seed’ funding. Credit-plus services include non-financial inputs such as business development services, management training, financial and accounting training, and access to information, markets, product design and packaging. These are costly and require substantial subsidy from donors or collaboration with government.

**Both government and non-governmental organizations participate** (Table A4.1). In 2000, the largest providers were the Samurdhi Bank Societies (1.2 million shareholders), SANASA TCCSs (1 million – but the extent of the participation of the poor is unclear), SEEDS (200,000), and Hambantota Janashakti Banku Sangam (25,000). Individuals may be members of more than one organization, so membership is hard to estimate, but the total outreach is unlikely to exceed 3 million. The Samurdhi Bank Societies appear to be reaching large numbers of the poor excluded by other programs (Gant et al. 2002)

**Microfinance providers have relied on high levels of subsidy, thus jeopardizing their sustainability.** The survey of providers by Gant et al. (2002) found that the entire microfinance sector except the cooperative rural banks and the regional development banks is subsidized by donors or the government, ‘making microfinance unsustainable, let alone commercially viable.’ For example, even assuming that total staff costs of a Samurdhi Banking Society is borne by the government, in 2001 more than 50 per cent of these banks were not breaking even (Gant et al. note that the Samurdhi Banks are not donor dependent and are entirely based on members’ savings for capital). While the literature recognizes that microfinance programs are highly cost-sensitive and most rely on subsidies (Morduch 1999), there needs to be greater transparency about the extent of subsidy required.

**Weak regulatory framework poses a threat to sustainability.** The current regulatory environment is not conducive to the security of people’s funds or the probity of microfinance institutions. Contrary to the Banking Act (Section 76 A (1), amended by Act No. 33 of 1995), almost all microfinance organizations mobilize savings and on lend to their members without the written approval of the Monetary Board. Moreover, since the requirements for financial disclosure under the Ordinances under which they need to register are relatively simple, microfinance providers do not have to demonstrate either their financial accountability or probity.

There is also no legal structure governing the operation of international NGOs in microfinance. These organizations are thus permitted to receive funds from foreign donors without any restrictions, control or supervision by the government.

**Table A4.1: Microfinance Providers in Sri Lanka**

Sector	Government	Non-Government/Private	Multilaterals/ Bi-laterals and INGOs
Formal Sector Financial Institutions associated with microfinance programs	Central Bank (RRDBs) State-owned banks (People's Bank Bank of Ceylon National Savings Bank)	Hatton National Bank (HNB) National Development Bank (NDB) Development Finance Corporation of Ceylon (DFCC) Ceylinco Development Bank	UNDP UNHCR (Conflict Areas)
Microfinance Institutions ( MFIs)	MFIs set up by Central Bank Samurdhi Banks	Sarvodaya/SEEDS SANASA Bank and PTCCS Janashakti Banku Sangam – Hambantota (WDF) Agromart Foundation Ltd. NFPO Sewalanka Co-operative Rural Banks and others	CARE SAP FORUT SCF Oxfam and others
Traditional village-based financial services		Merchants/Moneylenders Community Based Organizations (CBOs) such as Death Benevolent Societies	

*Source:* Nayar and Gunatilaka (2000).

**Microfinance for the poorest segments is dominated by the government.** Gant et al. (2002) note that Samurdhi Banks have reached large numbers of the ultra poor who have been left out by NGO, commercial banks, and other microfinance programs. Gunatilaka and Salih (1999) reported that even the poor who were excluded from the Samurdhi transfer program were encouraged to form savings groups and purchase shares. Where Samurdhi Banks were established and the poor managed to purchase their shares, the system became an important source of emergency credit for small loans of about Rs. 300. According to Gunatilaka and Salih, roughly a third of bank shareholders regarded the Samurdhi Bank as the principal source of emergency credit for small loans, relative to 40 percent of shareholders that relied on friends and relatives, and to 7 percent that continued to rely on shopkeepers and moneylenders. Similarly, World Bank (2002) revealed that roughly 10 per cent of all loans of households in the lowest two quintiles were from Samurdhi, compared with 7 per cent from money lenders and 9 per cent from friends. There also appears to be a high degree of beneficiary participation and ownership of the Samurdhi Banks. In the North and the East, microfinance for social protection is provided by the expanded relief activities of international and national non-governmental organizations (see Box A4.1), although the Samurdhi Bank societies are also being set up in these areas.

#### **Box A4.1: Microfinance for Social Protection in the North and East**

Microfinance services to the poorest of the region have been provided international agencies and organizations such as CARE and FORUT, along with national organizations such as the Cooperatives, Sarvodaya, Sewalanka and other NGOs. Demand for credit has been high and credit operations of organized savings and credit groups have been oversubscribed.

The survey of the microfinance sector in the North and East identified two groups of extremely vulnerable poor in the region who needed consumption, distress and livelihood loans (typically of up to Rs. 7500). One was the extremely vulnerable individuals, consisting of IDPs in welfare centers, and individuals belonging to short-term resettled and relocated communities. The other group were those belonging to the medium-term resettled and relocated communities. Other than for the IDPs in welfare centers, access to consumption and distress loans for the extremely vulnerable was found to be fairly easy, interest rates were subsidized, procedures were simple, and transaction costs low (because of high social collateral). For the medium-term resettled and relocated, too, access to microfinance for social protection was found to be easy, with a mix of below market and market related interest rates, simple procedures and interest payments on savings.

*Source:* Gant et al (2002).

**There is little rigorous analysis of access to microfinance by poor or its impact on employment creation.** Information about impact of microfinance is limited to evaluations of specific programs, both independent and in-house, usually initiated by donors. Such evaluations are rarely representative, are usually qualitative and few have baseline data against which to measure progress. Establishing causality is also a problem. Many factors besides access to finance impinge on the success of micro enterprise initiatives. In the absence of panel-type data, it is virtually impossible to quantify the contribution of microfinance to self-employment success. Anecdotal evidence suggests that microfinance services aimed at assisting the poor at best succeed in protecting them, but they do not help them move to higher income growth paths (Gunatilaka and Salih 1999). But there is broad consensus that microfinance organizations have helped to empower the poor, particularly women, and have raised their confidence levels, and have thus also enhanced employability (see Box A4.2).

#### **Box A4.2: Women's Development Federation, Hambantota**

The Women's Development Federation (WDF) of Hambantota, or the *Janashakti Banku Sangam*, began in the late 1980s and currently has over 33,000 members in five divisions in Hambantota District. It is owned and managed solely by females and its modus operandi is founded on social mobilization efforts and participation of women in social and economic activities. Its community driven activities benefit a large number of women-headed households and their micro businesses. Examples of such community improvement activities are harvesting rainwater for cultivation and consumption, and access to safe water from both micro and minor irrigation system. Recently, the WDF has used World Bank assistance to expand its outreach, undertake more intensive training and capacity-building among poor women, and assist Tsunami affected beneficiaries to set up income generating activities, infrastructure.

*Source:* internal material of Women's Development Federation project (World Bank).