

Chapter 6.

State-Owned Enterprise Reforms in Sri Lanka: The Way Forward

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6.1. Introduction

State-owned enterprises (SOEs) in Sri Lanka, as in many other countries, have experienced episodes of nationalization and privatization and have been exposed to varied degrees of competition. The conceptualization of reforms has largely, but not always, corresponded to the political ideology of the ruling party.¹ Although the decades of experience with public enterprise reforms have provided stakeholders in the policy space with a rich knowledge base, the current state of these entities' affairs indicates that much more needs to be done. Importantly, sustainable SOE reforms need to go beyond technical solutions and unpack and resolve the more controversial political elements to secure broad-based stakeholder buy-in.

The primary research objectives underpinning this Chapter's analysis are to contextualize and to locate strategic reform pathways for SOEs to support more inclusive growth. The impetus for and trajectory of the current policies on public enterprise reforms are being shaped by a combination of internal and external factors including the bipolarity of the present political leadership² and

¹ The policies promulgated by President Chandrika Bandaranaike Kumaratunga (1994–2005) deviated from the traditional ideology of her party, the Sri Lanka Freedom Party (SLFP). While the SLFP has tended toward state-led economic policies, several complex privatization exercises were carried out during these years.

the Extended Fund Facility arrangement granted to Sri Lanka by the International Monetary Fund (IMF)³ in 2016 (IMF 2016b, c).

The rest of this chapter will address the following issues pertaining to SOE reforms in Sri Lanka: the next section sets out the methodology and limitations of this study. Section 6.3 considers public enterprise reforms in the context of inclusive growth, while section 6.4 provides a snapshot of the historical evolution of SOE reforms and important lessons learned. Section 6.5 takes stock of the current state of affairs and the need for reform, including the performance of SOEs in terms of efficiency, fiscal, and distributional dimensions; political economy realities; and the reform agenda. Section 6.6 looks at international experience with public enterprise reform and section 6.7 defines the types of SOE reform. Section 6.8 discusses potential reform pathways and sets out key building blocks for sustainable outcomes. The discussion in this chapter draws on the case studies on the areas or sectors identified as pivotal to an effective public enterprise reform strategy, such as state plantations (termed “estates” in Sri Lanka), electricity, and transport.

6.2. Methodology and Limitations

The analysis in this chapter is based on mixed methodology—a combination of quantitative and statistical methods using secondary data and qualitative methods such as content analyses of important literature and key person interviews (KPIs).

The KPIs, which were held with prominent decision makers and thought leaders in Sri Lanka’s policy space, together with content analyses, provided for useful “triangulation,” fine-tuning of research findings, and rich contextual details. However, gaps in trend data together with data discrepancies and the

² The President and the Prime Minister come from two different political parties, each with differing ideologies. The President’s SLFP has historically been more statist and welfare-oriented, while the Prime Minister’s United National Party (UNP) has tended toward more open markets and trade. 2015 has also seen increased engagement by the Committee on Public Enterprises in terms of scrutinizing approximately 450 SOEs and coming up with recommendations for reform. The Committee on Public Enterprises is currently headed by a member of Parliament from the Janatha Vimukthi Peramuna, a political party with a socialist mindset. The party is allied with a number of trade unions across the public, private, and estate sectors and has traditionally been an instigator of contestation between the citizenry and the state. While this party has historically been vehemently ideologically opposed to privatization, it has modernized its outlook to some extent in the recent past.

³ In Sri Lanka, as in other countries, public opinion of the IMF has not always been positive.

absence of publicly available data were major limitations encountered in the research process. As such, key unpublished data, including how much SOEs owe specific state banks and how much SOEs owe each other, could not be accessed for this study. Moreover, 2014 data had to be used in some instances, such as in the analysis of the efficiency dimensions of the state plantations sector and the Ceylon Electricity Board, in the absence of the 2015 numbers.

There is also no precise count of SOEs, with the figure cited varying among the multiple organizations that govern these enterprises.⁴ As mentioned during one of the KPIs, the number of SOEs may be more than even tentatively estimated given that some entities have 100% owned subsidiaries that are not formally classified or counted as SOEs.⁵ Per another KPI, the number of SOEs is estimated to be over 400, with approximately 250 of them being categorized as commercial enterprises⁶ and just over a 100 entities coming under the purview of the new Ministry of Public Enterprise Development, which was set up to spearhead the SOE reform process.

Such discrepancies in classifying and counting SOEs undermine the formulation of an accurate understanding of the status quo and impede a comprehensive analysis of SOEs and possible pathways to reform.⁷ In view of the data limitations and practical realities pertaining to accessing data that are not in the public domain, this chapter will largely focus on a subset of SOEs referred to as state-owned business enterprises (SOBEs) with four case studies (Appendix A6). The working definition for SOEs used in this study is as follows (MOF 2015b: 1,2):

I. Entities deemed to be Regulatory Agencies, Promotional Institutions, Research and Development Agencies or Educational Institutions, which were established under an Act of Parliament.

⁴ SOEs come under the purview of the Ministry of Finance, the new Ministry of Public Enterprise Development, and the various line ministries.

⁵ For example, Sri Lanka Insurance Corporation (SLIC) is classified as an SOE. However, its fully owned subsidiary Litro Gas Lanka Ltd. is not counted as an SOE.

⁶ DPE (2015) gives the number as 257 while MOF (2015a) gives the number as 245.

⁷ This point of view was also reiterated at the Asian Development Bank's Consultation Workshop in August 2016, with participants pointing to the need for accurate data on public enterprises, from basic figures such as the number of SOEs and state-owned business enterprises (SOBEs), to precise numbers on outstanding debt liabilities. Moreover, participants highlighted that the numbers, when they are available, vary from organization to organization—for example, the Central Bank of Sri Lanka, the Treasury, the Ministry of Public Enterprise Development, and line ministries.

II. Companies incorporated under the Companies Act No. 7 of 2007 in which the Government or a Public Corporation or local authority directly or indirectly hold fifty percent or more of the shares of that company.

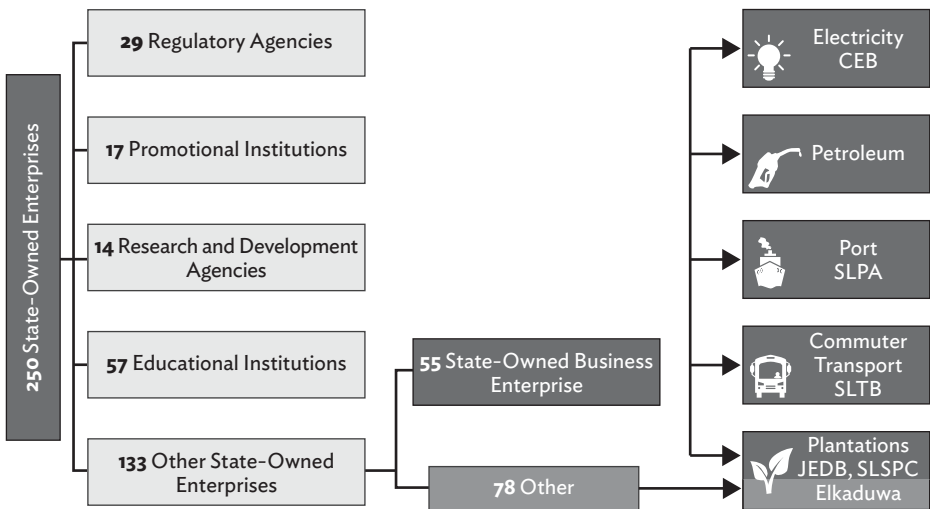
III. Public Corporations (i.e., corporations, boards or bodies which were or are established by or under any written law, other than the Companies Act).

The working definition for SOBEs used in this chapter is (DPE 2015: 1):

SOEs that have been identified as **Strategic** State Owned Business Enterprises ... engaged in **commercial activities** (emphasis added).

Figure 6.1 illustrates the SOE and SOBE categories and relates them to the four case studies in the chapter's Appendix A6.

Figure 6.1: Classification of State-Owned Enterprises



CEB = Ceylon Electricity Board, JEDB = Janatha Estates Development Board, SLSPC = Sri Lanka State Plantations Corporation, SLPA = Sri Lanka Ports Authority, SLTB = Sri Lanka Transport Board.
 Source: MOF (2015a, b).

6.3. State-Owned Enterprise Reforms and Inclusive Growth

Despite the ebb and flow in the depth and breadth of SOE reforms in Sri Lanka and in the global arena, SOEs are likely to remain a crucial part of a country's socioeconomic and political landscape.⁸ For example, the proportion of public enterprises among the Fortune Global 500 grew from 9% in 2005 to 23% in 2014 (PWC 2015). The pivotal role SOEs play in a country's development trajectory emphasizes the need to ensure that they deliver effectively on a range of outcomes—efficiency, fiscal, and distributional.

Given the research questions underpinning this study, the role of the state and of SOEs in the context of inclusive growth is central to this analysis.⁹ In Sri Lanka, the state has historically been viewed as a benefactor, with the economic policies of a welfare state. Private enterprise and privatization have traditionally been viewed with skepticism and as potentially exploitative—a perception that has also been nurtured by surreptitious SOE reform episodes that have fostered distrust between the government and the citizenry. The challenge therefore is to get to a middle ground in the SOE reform process where the objectives of inclusive growth are clearly set out, the need for reform is clearly communicated, the details of the reform process are made transparent, and stakeholder expectations are realistically appraised.

A very senior member of the present government noted in a KPI that the current reform process is being conceptualized as one of “improving operational efficiency, restructuring, increasing private participation to provide high quality goods and services at competitive prices.”

Moreover, the Economic Policy Statement by Prime Minister Ranil Wickremesinghe in Parliament on 5 November 2015, set out the following:

We all agree that state enterprises must be more efficiently run. This can be achieved by ensuring that good economic management is practiced and efficient managers are put in place. Most of these ventures are loss-making due to various reasons. Those managing these ventures and politicians are

⁸ Examples of the need for public enterprises in an economy include natural monopolies, strategic industries such as defense and nuclear power, public service obligations (PSOs) and public goods, market failures, and provision of competition to the private sector.

⁹ Details of the political economy rationale for setting up and reforming SOEs over time are in section 6.4.

benefiting while pretending that they are under public ownership. We will take steps to change this (News.lk 2015: 9).

The articulation of the concept of a competitive social market economy in the policy space is potentially relevant to the inclusive growth narrative. This concept, which promises to advance both economic competitiveness and social justice, was articulated by the United National Party (UNP) in its election manifesto and in the memorandum of understanding between the UNP and the Sri Lanka Freedom Party that forms the basis of the current coalition government (News First 2015a, b). However, there has been little visible policy discourse on a social market economy for Sri Lanka, except in a few writings by members of the academic community and isolated comments by members of the UNP.

Given the political economy milieu, four elements of the inclusive growth narrative are critical to a sustainable SOE reform process:

- efficient state provision of public goods and public service obligations (PSOs), with the cost being explicitly estimated and taken into consideration when evaluating the performance of public enterprises;
- a competitive business environment with competitive pricing;
- independent regulation; and
- full transparency of SOE finances, including the implicit subsidies and payments, combined with the functioning of public enterprises under a hard budget constraint.

Efficient state provision of PSOs is particularly critical in an ideological space that is tilted toward a welfare state. In Sri Lanka, a clear example of PSOs is given in Appendix A6 Case Study 4, on the Sri Lanka Transport Board (SLTB). Rural bus routes, less profitable routes, and transport to school and university students at subsidized fares are left to the SLTB to serve, while the private sector focuses on the more lucrative routes. The SLTB maintains 95 million kilometers of uneconomical routes, which is approximately 22% of its network routes. In 2015, the SLTB's cost of providing bus services on uneconomical routes was equivalent to 95% of its operating losses (MOF 2015a). For the provision of PSOs to be sustainable, the costs must be explicitly taken into account in the operations of SOEs that provide the services.

A reform process that aims to realize inclusive growth must also ensure that competition is the driving force, whether it is within SOEs,¹⁰ across the public enterprise sector, or between SOEs and the private sector. Competition promotes efficiency, drives productivity and growth, and enhances the quality of service. State banks in Sri Lanka compete with private banks, and evidence shows that competition has benefited the banking sector, resulting in significant market efficiencies, rapid utilization of modern technology, and an expanded bank network coverage (Edirisuriya 2007). Another clear example of the benefits of competition and contestability is Sri Lanka's telecommunications sector (section 6.4). Competitive pricing is also a part of the competitive process.

While emphasizing the fundamental importance of competition in the reform process, it is also critical to acknowledge that competitive markets may take time to develop and that there is therefore no *prima facie* case against state intervention. The state has a critical role to play as regulator: balancing efficiency, fiscal, and distributional objectives and ensuring that the nature and extent of regulation is appropriate to the nature of the enterprise or industry. For example, the SOE reform process should be complemented by effective, independent ex-ante and ex-post regulators¹¹ to achieve the inclusive growth objectives set out for the enterprises, to promote and sustain effective competition where possible, and to ensure that the interests of stakeholders such as consumers are safeguarded. Moreover, effective regulatory institutions are critical, particularly when ownership change is being considered as a modality for SOE reform. In a climate where rent seeking and crony capitalism may be rampant, privatization without effective regulation can further entrench rent-seeking interest groups and provide more or different opportunities for rent extraction.¹²

Finally, fiscal transparency and discipline must be maintained. Meaningful budget constraints coupled with public exposure of SOE finances (including otherwise hidden implicit subsidies) are critical in ensuring that reforms have a chance of succeeding. This is particularly important to avoid crony capitalism.

¹⁰ Anecdotal evidence suggests that there is some degree of competition between counters at Sri Lanka's Passport Office, which has speeded up processing times. This was also confirmed in some of the KPIs.

¹¹ Sri Lanka does not have a comprehensive competition law (see for example, Knight-John [2004a] for an account of the issues impeding the enactment of this legislation, which persist to date).

¹² Two examples (Lanka Marine Services Ltd. and Sri Lanka Insurance Corporation Ltd.) of privatization being reversed on such grounds by rulings of the Supreme Court of Sri Lanka will be discussed in section 6.4.

6.4. Historical Evolution: Learning from the Past

Public policy on SOEs in Sri Lanka, as in other countries, has been interspersed with episodes of nationalization, privatization, and competition across the decades. In Sri Lanka, the policies have been influenced and shaped by various internal and external sociopolitical and economic factors: macroeconomic imperatives, welfare disbursement, political patronage, rent-seeking dynamics, and the international financing community. The years of experience with SOE reforms have endowed policy makers with a rich repository of knowledge on both the technical and the political economy aspects of the process. Prudent decision makers could build on the learning and extensive research on SOE reforms in Sri Lanka, rather than reinventing the wheel. This section describes SOE reform episodes from the liberalization of the economy in 1977, to acquire useful insights for the current reform process. The narrative on the evolution of public enterprise reforms will also highlight key successes and failures together with underlying sociopolitical and economic considerations.

Sri Lanka's development space prior to 1977 was marked by a heavy reliance on SOEs, with successive political regimes embarking on large-scale nationalization programs, creating new public enterprises, and fostering state monopolies. Support for the policies was secured by strategically catering to populist objectives such as employment creation and price controls, and cultivating perceptions of a welfare state. A large number of the SOEs were burdened with issues of overstaffing, mismanagement, corruption, and politicization (Kelegama 1997).

The UNP government that swept into power in 1977, securing a four-fifths parliamentary majority, had a strong political mandate for economic reform. However, while the regime carried out an extensive liberalization program, SOE reforms were placed on the back burner for over a decade. The absence of public enterprise reforms during this "first wave of liberalization" was, to a large extent, a rational policy response to the sociopolitical conditions prevalent during those years (Dunham and Kelegama 1997). The massive influx of concessionary aid that came in with the opening up of the economy eased resource constraints and made it possible for the government to carry on with its practices of political patronage. In addition, the first decade of liberalization was one of mounting political violence, where transforming what the public perceived as "sacred cows" was not a rational policy decision.

By 1989, at the start of the "second wave of liberalization" (Dunham and Kelegama 1995), the internal economic and external financing environment began to change. Budgetary transfers to SOEs averaged about 10% of gross

domestic product, indicating that the macroeconomic fallout of wavering on public enterprise reform could not be ignored for much longer (Knight-John and Athukorala 2005). In addition, the multi- and bi-lateral financing community began to flag the need for macroeconomic stabilization, which included the need to address the massive fiscal costs imposed by SOEs (World Bank 1988).¹³ Privatization was announced as a state policy in 1988 (Ministry of Finance and Planning 1988), aiming to ease the fiscal burden and improve the efficiency of public enterprises, and the divestiture program commenced in 1989.

This “first wave of privatization” coincided with the election of a new UNP government led by President Premadasa, whose social background differed from the English-speaking urban elite that had traditionally dominated the political party in the past. The President cultivated strong ties with the urban underclass, the rural poor, and a new political business class to secure political support. An interesting and successful strategy the populist president used was dubbing the process “peoplization,” to highlight the people-friendly aspects of the program and secure public buy-in for SOE reforms. Moreover, presidential directives were issued to the effect that retrenchment was not an option, in order to placate trade unions.

Extensive public sector reforms were carried out between 1989 and 1993 with the partial and full divestiture of about 43 commercial enterprises that yielded gross receipts of approximately \$102 million. However, the privatization proceeds were not transmitted to an ear-marked account and went instead into a fungible slush fund (Kelegama 1997). The entities that were sold during 1989–1993 could be typified as “easy picks” in contrast to the more complex utility and service sector divestitures that were carried out in the 1994–2000 reform episode that followed. The default modality for privatization was a “51:30:10” formula, where a majority shareholding of 51%–60% was sold to corporate investors, 30% was offered at par to the public, and 10% was given free of charge to workers under an employee share ownership plan. In some cases, the formula was not applied—examples are permitting employee buy-outs, such as the Buhari Hotel; giving 50% of shares to workers in the SLTB; selling assets of public corporations with the state assuming the liabilities (Ceylon Petroleum Corporation); and making management contracts (for the plantations).

Following the announcement of privatization as a state policy in 1987, several measures were undertaken to set up the legal and institutional structures

¹³ Privatization per se was not a conditionality imposed by the multi- and bi-lateral financing community. However, the political leadership strategically used the notion of external pressure to implement these reforms (Kelegama 1993).

necessary for reform. Two pieces of legislation were enacted in 1987 to facilitate the commercialization of SOEs: *Conversion of Government Owned Business Undertakings into Public Corporations Act No. 22* and *Conversion of Public Corporations or Government Owned Business Undertakings into Public Companies Act No. 23*. In addition, several institutions, including the Presidential Commission on Privatization (renamed the Presidential Commission on Peoplization in 1989), Public Investment Management Board, and Commercialization of Public Enterprises Division of the Ministry of Finance were created to facilitate the privatization process. Specialized entities were also set up to oversee sectoral divestitures—for example, the Plantation Restructuring Unit to handle the privatization of the estate sector and a separate unit within the Ministry of Industries to handle the privatization of industrial enterprises. The involvement of these numerous organizations in the divestiture process and the inability to bring the program under one umbrella entity was largely because of the prevailing political climate at the time, when the President was facing impeachment proceedings and coalition building was critical for political survival.

Despite the positive elements in the 1989–1993 reform episode—in particular, the ability of the president to strategically steer the process amid potential political economy obstacles—this period is also viewed as one in which rent-seeking and asset-stripping were prevalent (Dunham 2004). Although several enterprises were divested, the process was mostly ad hoc and conducted behind closed doors. Moreover, the absence of sound regulatory governance structures—with the political leadership claiming that the speed of reform specified by multilateral financiers did not allow for setting up regulatory institutions prior to privatization—provided space for a policy process inimical to good governance (Salih 2000).

In late 1994, some elements of the public voiced dissatisfaction about spreading corruption, authoritarian rule, and political violence. This led to the end of 17 years of UNP rule and the election of a People's Alliance government, comprising a coalition of the Sri Lanka Freedom Party (SLFP), the traditional left parties, and splinter groups from the UNP. However, contrary to public expectations that the liberalization process would be reversed given the political economy ideology of this regime, it carried out complex privatization exercises in sectors such as telecommunications, airlines, and gas using the slogan “Free Market Economy with a Human Face” (Bandaranaike Kumaratunga 1995). This period also saw the divestiture of 51% of the shares of plantation companies, following the recognition that the 5-year management contract modality previously used in this sector was a disincentive to long-term capital investment. The gross privatization proceeds during the “second wave of privatization” (1994–2000) amounted to approximately \$403 million.

Issues of alleged corruption in the previous UNP regime's privatization program had been highlighted as a major issue by the People's Alliance government in its election campaign. As such, the Public Enterprise Reform Commission was set up under an Act of Parliament in 1996 to be solely responsible for the privatization program and to ensure that the process was carried out in a structured and transparent manner. Although transparency and access to information about SOE reforms and divestitures did improve for a while with the establishment of this entity, allegations of questionable deals began to emerge in the policy space over time (Box 6.1). To protect the interests of workers in failed privatized entities and to limit industrial disputes, the government also enacted the Rehabilitation of Public Enterprises legislation in 1996.

**Box 6.1: Lanka Marine Services and Sri Lanka Insurance Corporation:
The Perils of Institutional Lapses**

In 2002, a majority stake of Lanka Marine Services was sold through the Treasury and the Public Enterprise Reform Commission, with these same institutions selling a controlling interest in Sri Lanka Insurance Corporation in the following year. However, following a complaint by the Committee on Public Enterprises that the privatization process was carried out in a corrupt manner, these two transactions were investigated by the Supreme Court of Sri Lanka. Subsequently, between 2008 and 2009, the Supreme Court reversed both divestitures and ordered that the enterprises be reverted to state ownership.

On the privatization of Lanka Marine Services, the judgment stated that it was “done without lawful authority” for the benefit of a private holding company. On the divestiture of Sri Lanka Insurance Company, the Supreme Court determined that “the execution of the Share Sale and Purchase Agreement with parties not known and not approved by Cabinet was a wrongful executive act done without jurisdiction and as such was illegal and null and void *ab initio*” (GAP [n.d.]: 3).

Clearly, both these transactions point to the workings of rent-seeking, private interest groups, aiming to secure unlawful benefits from the privatization process. However, it is also important to understand that the incidents relate more to a failure in institutional and regulatory capacity than to the disposition of a particular political party.

Sources: Nanayakkara et al. (2008, 2009); GAP (n.d.).

However, this legislation was operational for only 6 months because the chambers of commerce began to voice concerns about renationalization and the government did not want to send erroneous signals to the investor community. The compensation packages drafted for retrenched workers also had inherent problems, including an inbuilt adverse selection bias where the relatively more skilled employees took the monies and quit the entity.

A significant feature of the divestiture structure during the “second wave of privatization” was the granting of exclusivity provisions without adequate regulatory arrangements in the sale of key entities such as telecommunications,

gas, and airlines, and the underpricing of assets. The rationale for the policy decisions, according to KPIs conducted for this study, ranged from an absence of committed bidders for the transactions in the midst of a civil war and an unstable political climate, pressing budgetary constraints, and a dire need for investment. Two somewhat contrasting narratives on privatization episodes during this period are set out in Box 6.2.

Box 6.2: The Privatization of Sri Lanka Telecom and the Colombo Gas Company

In 1995, the shares of the state-owned Colombo Gas Company, which supplied the entire local market and dominated the market for liquefied petroleum gas were sold to Shell Gas, a large multinational. The privatization contract included exclusivity provisions for 5 years to the effect that Shell would be the only company to undertake liquefied petroleum gas business during this period. Moreover, in spite of the fact that the setting up of an independent regulator for this market had been a stated policy goal, this was not done, resulting in suboptimal distributional impacts, particularly post-privatization gas price hikes.

In contrast, the privatization of Sri Lanka Telecom (SLT) stands out as a success story in the reform narrative. In 1997, 35% of the government's shareholdings in SLT was sold to Nippon Telegraph and Telephone Corporation through a competitive bidding process for the large sum of \$225 million. The government retained 61.5% share ownership and employees of SLT were given the balance 3.5%. An Employee Share Ownership Plan was used to counter anticipated trade union resistance, members of these unions were sent to Latin American countries to study similar privatization processes, and letters were written to the wives and families of the members by the minister in charge of the subject area explaining the entire divestiture process.

Similar to the case of Shell, Nippon Telegraph and Telephone Corporation was granted exclusivity provisions such as the nonissuance of any other basic wireline and international licenses for 5 years and the nonimposition of universal service obligations on this entity. However, unlike in the case of the gas industry, competition was a major driver in the telecommunications sector. Competition in the fixed telephony segment existed prior to the privatization of SLT, due to the presence of two wireless loop operators. This structure also generated a dynamic of contestability in the fixed sector. Competition in the mobile segment was relatively higher than in its fixed counterpart—with Mobitel a fully owned subsidiary of SLT also in the mix. The privatization process was also accompanied by setting up an independent regulator—the Telecommunications Regulatory Commission—which at least in the early years was focused on pro-competitive reforms (in spite of the fact that the trifurcation of policy, operations, and regulation was not precisely separated).

Sri Lanka's telecommunications industry is viewed as one of the most progressive in the region, with the sector also being hailed as a key driver of socioeconomic growth. The reforms put an end to the high unmet demand for telecommunications services, long waiting periods, and poor transmission quality. Competition in the mobile telephony sector has also had beneficial impacts on users as reflected in low mobile prices and in the high rates of market penetration. This narrative on the telecommunications sector also shows that competition, contestability, and regulation oriented toward competition are as important as (and sometimes more important than) modalities that lean toward divestiture and that sequencing of reforms is crucial.

Sources: Knight-John and de Zoysa (2001); Jayasuriya and Knight-John (2002); Asia Foundation and Verite (2015).

The election of a new political regime in 2001 saw the formation of a coalition government led by Prime Minister Ranil Wickremesinghe (UNP) and President Chandrika Bandaranaike Kumaratunga (SLFP). The national policy statement of this government, contained in a voluminous document—*Regaining Sri Lanka*—set out an acceleration of the privatization process as one of its three main themes (Wickremesinghe 2002a, b). Although this episode coincided with the signing of a stand-by arrangement with the IMF, privatization was not included as an aid conditionality. The locus of the reform process was centered in the Public Interest Program Unit, a sunset organization headed by technocrats. A major thrust of the work carried out by this entity was the framing of sound legislation and the setting up of strong, independent regulatory institutions for the SOE reform process. The Public Utilities Commission of Sri Lanka (PUCSL), an umbrella body set up to facilitate multisector regulation, was institutionalized under the purview of the Public Interest Program Unit. The PUCSL is generally considered to be an example of good regulatory governance, with its members appointed in concurrence with the Constitutional Council, to minimize the influence of partisan politics.¹⁴ Yet, despite these positive elements, the scope of the PUCSL is still limited to regulating the electricity industry.

In spite of all the progressive reform efforts undertaken by this UNP regime on the economic front, a robust strategy to secure the political capital required to sustain the reforms was lacking, resulting in the dissolution of Parliament in 2004. As a result, the United People's Freedom Alliance led by President Mahinda Rajapakse came into power in 2005. In view of public opposition and in response to the experience of its predecessor UNP regime, the election manifesto of the United People's Freedom Alliance declared that the privatization of national resources and public institutions would be stopped. In 2011, an expropriation law was also enacted under dubious principles to allow the government to acquire and manage 37 “underperforming” or “underutilized” private enterprises (GSL 2011). Moreover, the government reneged on competition-oriented electricity sector reforms, despite the enactment of supporting legislation, in the face of trade union opposition.

In line with the ideology that the sale of public assets will not be an option, President Rajapakse resurrected the Strategic Enterprise Management Agency created by ex-President Bandaranaike Kumaratunga to manage several strategic SOEs in various sectors, including banking, energy, transport, and plantations. The agency was given a clear mandate in terms of the strategic enterprises under its purview to improve the efficiency, fiscal, and distributional performance

¹⁴ However, as set out in the case study on Ceylon Electricity Board (Appendix A6), Cabinet approval is required for the revision of tariff methodology.

of the entities without privatization. KPIs conducted for this study indicated that the Strategic Enterprise Management Agency had a systematic approach to the reform process: first looking at the SOEs in silos and then moving on to considering interrelations between the various entities (for example, the Ceylon Electricity Board and Ceylon Petroleum Corporation). At the time of writing, however, the Strategic Enterprise Management Agency is largely a passive entity in the current SOE reform space.

Another entity created during this period was the State Resources Management Corporation, set up under the Ministry of State Resources and Enterprise Development as a holding company with an aspiration to graduate into a Temasek-like model. KPIs indicated that the State Resources Management Corporation was intending to reform 100% government-owned companies. Private placements with other state companies were also being considered. However, the State Resources Management Corporation was shut down in what some of the stakeholders interviewed perceive as an attempt to create the space for the Public Enterprise Board (PEB)—the current regime’s version of the Temasek model—which will be described later in this chapter.

At least three key political economy lessons emerge from the historical narrative on SOE reforms in Sri Lanka. First, strong political leadership with a focus on pragmatism and a strategy to win the public mind is critical for the success of the process. Second, as evidenced in Boxes 6.1 and 6.2, sound regulatory structures and institutional capacity are essential for an effective and sustainable reform process. While Sri Lanka has had some success stories—for example, the PUCSL and financial regulation—competition policy and law as well as sectoral regulation in areas such as transport are very much below par. As mentioned above, reforms in the absence of such institutional safeguards may well foster crony capitalism and entrench rent-seeking behavior. Third, as discussed in Box 6.2, competition and contestability combined with effective regulation are as important as or more important than ownership change in terms of reform outcomes.

6.5. State-Owned Enterprises: The Current Context

The public enterprise reforms that are important for Sri Lanka in the medium and long term are as highlighted in the historical evolution of this process. In addition, a key takeaway from the KPIs is the assertion that SOE reform is essential beyond the IMF’s Extended Fund Facility (see Box 6.3 for the IMF’s Pillar 4 objectives on public enterprise reform), given the efficiency, fiscal, and distributional issues

that pervade this sector.¹⁵ Moreover, the SOEs' underperformance is attributed to a range of factors, including the prevalence of a murky governance structure, the absence of systems of management and accountability amenable to enhanced efficiency, and additional burdens imposed by social and PSO objectives.¹⁶ This section aims to provide some context to these insights by presenting a flavor of the size and scope of the sector as well as its performance at the time of writing. The section will also briefly outline the current reform agenda together with the political economy backdrop to this reform process.

Box 6.3: International Monetary Fund Extended Fund Facility, Pillar 4—State-Owned Enterprise Reform

Objectives of the pillar are as follows:

- a resolution strategy for Sri Lankan Airlines to be completed by September 2016, effectively removing the enterprise from the government's accounts;
- recording of the fiscal cost of noncommercial obligations (such as utility subsidies) for state-owned enterprises in the central government budget, starting in 2017;
- Ministry of Finance, line ministries, and state-owned enterprises to sign and publish statements of corporate intent for the six largest state-owned enterprises (Ceylon Petroleum Corporation, Ceylon Electricity Board, Sri Lanka Airlines, National Water Supply and Drainage Board, Airport and Aviation Services, and Sri Lanka Port Authority) by December 2016, in order to enhance oversight and financial discipline;
- the Ministry of Finance to introduce an automatic fuel pricing mechanism that ensures retail prices above cost-recovery levels and a financial position of Ceylon Petroleum Corporation amenable to covering debt service, by December 2016; and
- the Cabinet to introduce an automatic electricity pricing mechanism that ensures retail prices above cost-recovery levels and a financial position of Ceylon Electricity Board amenable to covering debt service, by December 2016

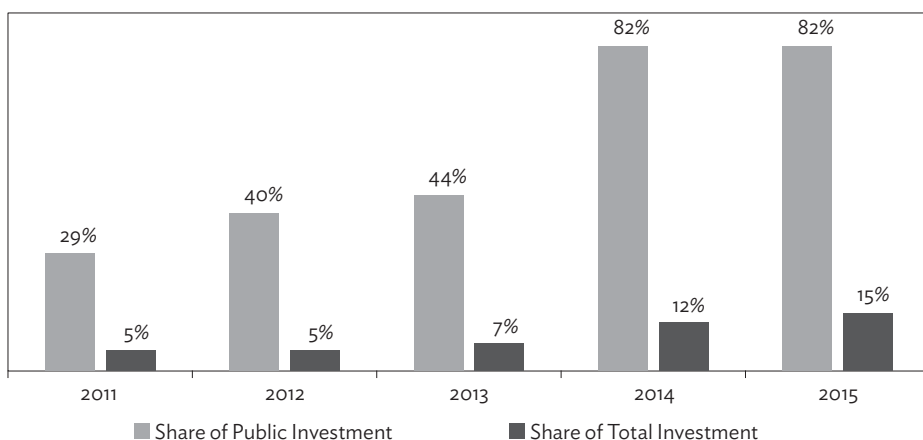
Source: IMF (2016b).

¹⁵ Interestingly, a stakeholder interviewed for this study who had vehemently opposed SOE reforms on ideological grounds in the past, had this to say: "SOE reform is necessary not because of neo-liberal prescriptions, but because we need to do so anyway in order to ensure productivity and sustenance. We must resolve to restructure existing SOEs, not for the IMF, but because we need to."

¹⁶ Examples cited in the KPIs were the subsidization of water and of public transport and the failure to adjust the prices of these services to reflect marginal costs.

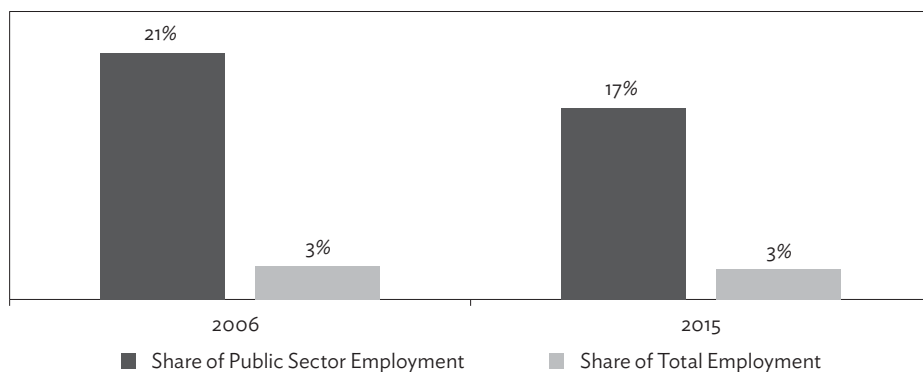
Although, as detailed in section 6.2, it was not possible to obtain comprehensive data on the SOE sector, the following numbers provide a useful snapshot of the enterprises. According to MOF (2015a), SOBE revenue was 12% of gross domestic product in 2015.¹⁷ In addition, the size of the SOE sector in terms of investment and employment is depicted in Figures 6.2 and 6.3. As evidenced by these statistics, public enterprises have a substantial presence in Sri Lanka's economy, underscoring the need to ensure that this sector performs at its full potential.

Figure 6.2: Investment in State-Owned Enterprises



Sources: Calculated using MOF (various years), CBSL (various years).

Figure 6.3: Employment in State-Owned Enterprises

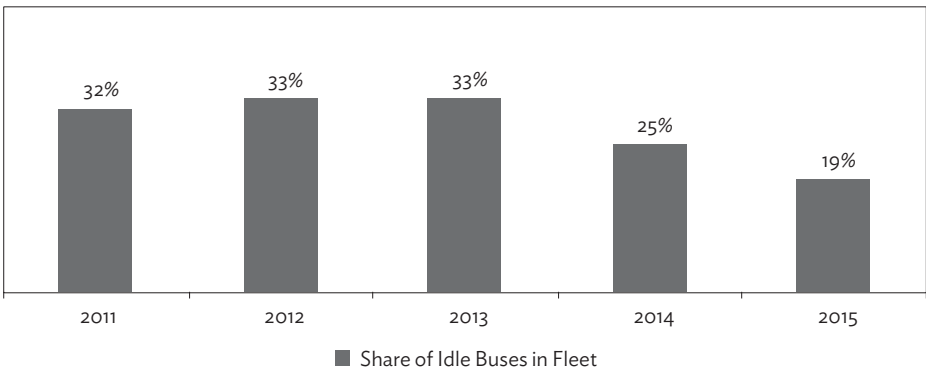


Sources: Calculated using MOF (various years); DCS (2014, 2015).

¹⁷ In the absence of complete data, this revenue calculation is used as a proxy for the size of the SOE sector in terms of gross domestic product. The calculation is based on the revenue data for the 55 SOBEs.

The assessment of Sri Lanka’s public enterprises for this analysis highlights the fact that the sector is underperforming at several levels, undermining its ability to effectively contribute to the country’s socioeconomic development trajectory. As mentioned earlier and as will be set out below, there are significant efficiency, fiscal, and distributional dimensions¹⁸ to the problems afflicting the SOEs. Figure 6.4 illustrates the problems of operational efficiency in the SLTB, using the share of idle buses in the total fleet as an indicator. Although the utilization of buses has improved from 2013 to 2015, a significant proportion of the fleet is still idle. Inefficiencies are also prevalent in the energy sector due to excess capacity in Ceylon Petroleum Corporation’s refinery, resulting from a fall in demand for fuel oil for the Ceylon Electricity Board’s electricity generation, with the installation of the Norochcholai coal power plant (MPRD 2015). Additionally, the local retail prices of petroleum products are not revised based on fluctuations in world market prices or the taxes and levies imposed by the Treasury. As such, Ceylon Petroleum Corporation is, in most instances, compelled to sell petrol and diesel at prices that vary from the import cost (MPRD 2015).

Figure 6.4: The Operational Efficiency of Sri Lanka Transport Board



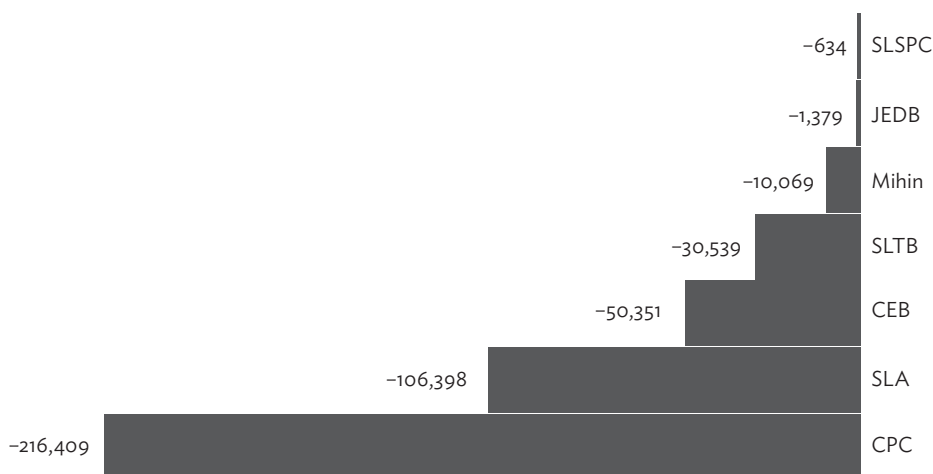
Source: Ministry of Transport and Civil Aviation (n.d.).

Fiscal considerations also provide a strong impetus for public enterprise reform, as illustrated in Figure 6.5. The figure shows the net accumulated losses for selected SOBEs during 2011–2015, and Figure 6.6 points to the five entities

¹⁸ Given the contextual variations pertaining to different SOEs, these dimensions are mostly illustrated in terms of the individual case studies analyzed later in this chapter. More detailed sectoral time-series data on operational efficiency, profits and losses, and quality of service are set out in the case studies.

that performed the best and the five that performed the worst in 2015 alone.¹⁹ Financial sector public enterprises were not included in the calculations for the following reasons. First, it is more appropriate to evaluate public sector banking enterprises in relation to the private sector, given the level of competition in this market. Second, public sector banks that form a large part of the SOE sector have recorded profits for the last 10 years. By contrast, nonfinance sector public enterprises are a burden to their finance sector counterparts, and by extension to the entire financial system and to the economy.

Figure 6.5: Net Losses of Selected State-Owned Business Enterprises, 2011–2015 (SLRs million)

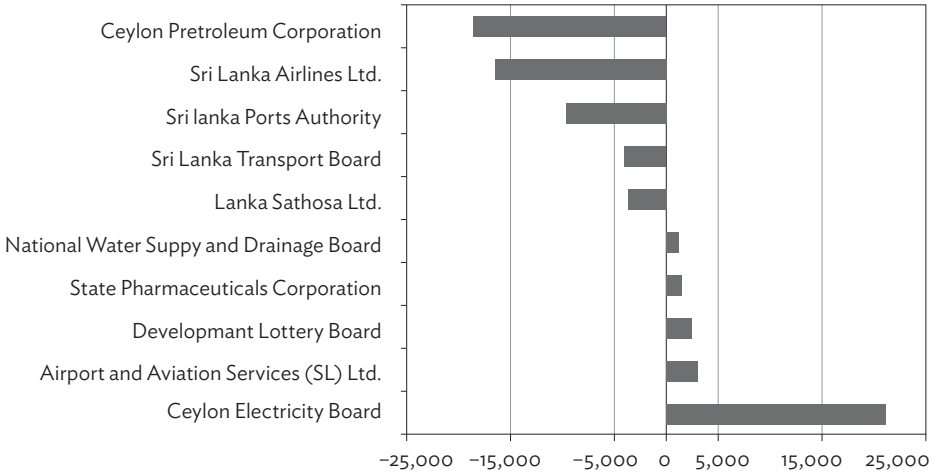


CEB = Ceylon Electricity Board, CPC = Ceylon Petroleum Corporation, JEDB = Janatha Estates Development Board, Mihin = Mihin Lanka, SLA = Sri Lanka Airlines, SLSPC = Sri Lanka State Plantations Corporation, SLTB = Sri Lanka Transport Board.

Source: MOF (various years).

¹⁹ Data in IMF (2016b) indicate that the financial obligations of selected SOEs amounted to approximately 11.5% of gross domestic product (Ceylon Petroleum Corporation [3.8%], Sri Lanka Airport [2.8%], Sri Lanka Ports Authority [2.2%], Ceylon Electricity Board, [2.1%]; Other [0.6%]) and 15.1% of public debt in 2015.

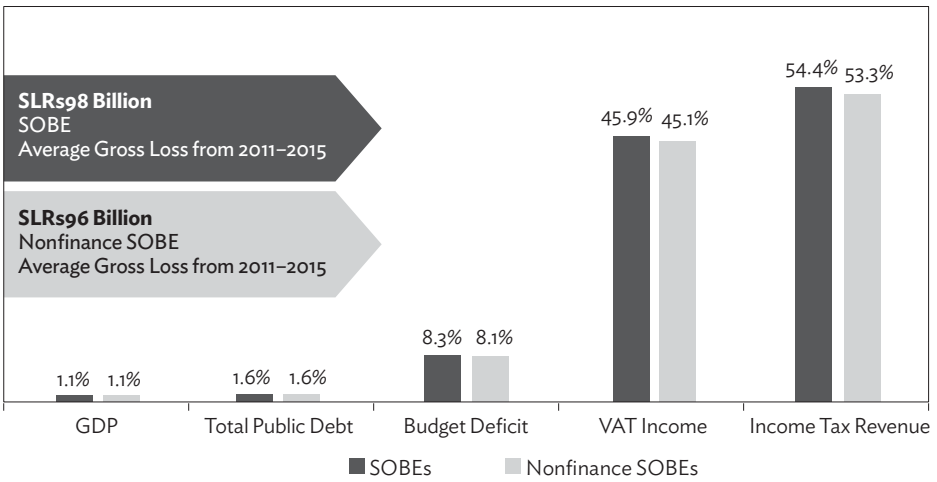
Figure 6.6: Five Biggest Winners and Five Biggest Losers, 2015 (SLRs million)



Notes: The losses of the five biggest losers were 185% of the profits of the five biggest winners in 2015. Moreover, the operating losses of the five largest losers were approximately 30% more than the 2015 budget of the Samurdhi program—a welfare payment system for low-income households. Source: MOF (various years).

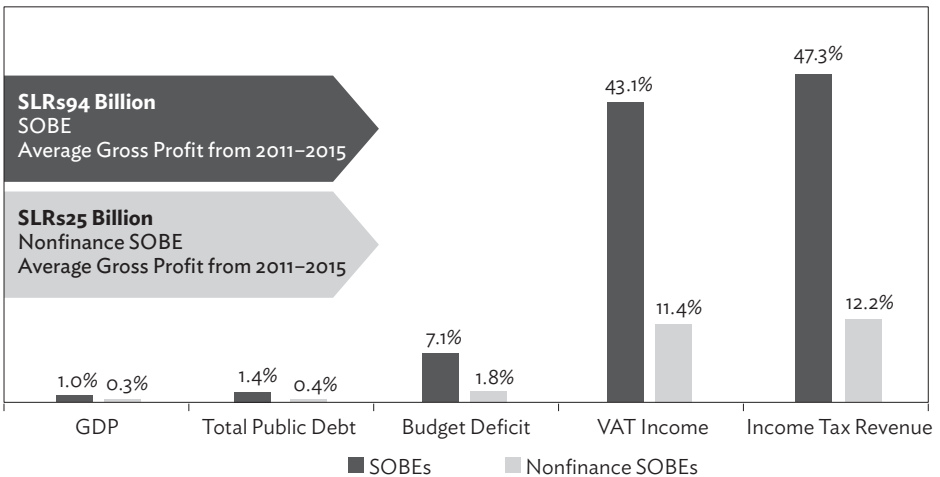
Figure 6.7 compares the annual average accumulated losses of all SOBEs and of nonfinance SOBEs from 2011 to 2015, and Figure 6.8 compares their annual average gross profits for the same period. As indicated in Figure 6.7, removing the effect of financial sector SOBEs only leads to an SLRs2 billion fall in the annual average losses of SOBEs. In contrast, as shown in Figure 6.8, removing the effect of financial sector SOBEs leads to a significant fall in profits, from SLRs94 billion to SLRs25 billion. It is therefore evident that SOBE profits for the last 5 years were largely generated by the financial sector, underscoring the necessity of treating the financial sector enterprises differently from the others in the reform process.

Figure 6.7: Comparing the Annual Average Losses of Nonfinance and of All State-Owned Business Enterprises, 2011–2015



GDP = gross domestic product, SOBE = state-owned business enterprise, VAT = value-added tax.
 Source: MOF (various years); CBSL (various years).

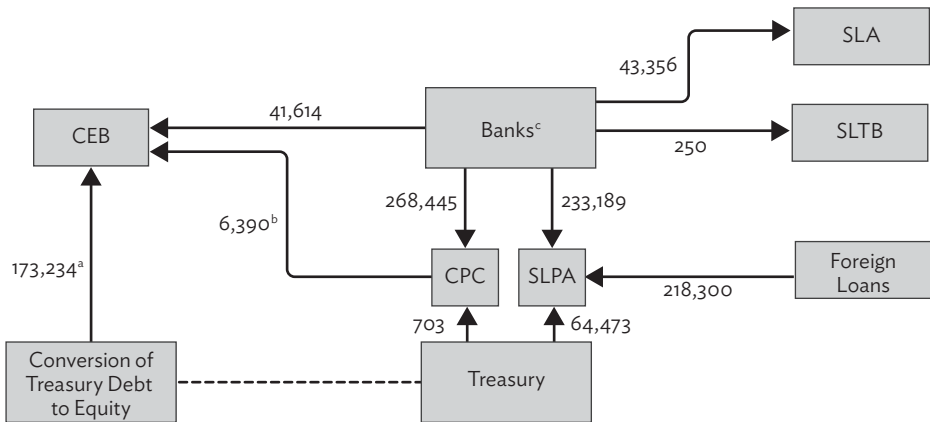
Figure 6.8: Annual Average Profits of Nonfinance and of All State-Owned Business Enterprises, 2011–2015



GDP = gross domestic product, SOBE = state-owned business enterprise, VAT = value-added tax.
 Source: MOF (various years); CBSL (various years).

As illustrated in Figure 6.9, interlinking debts, obligations, and payments between many SOE entities further complicate their current state of affairs.²⁰ As detailed in Appendix A6, the circular debt situation can impose unnecessary costs on the Treasury and is not conducive to the efficient functioning of the SOEs. An additional dimension to the fiscal burden, highlighted in KPIs with representatives from rating agencies, is the link between country ratings and the performance of SOEs. For example, in June 2016, Moody’s changed the outlook on Sri Lanka’s rating from stable to negative with weak financial performance of SOEs being a sizable contingent liability risk for the government and a potential source of fiscal and balance-of-payments pressure (Moody’s 2016).

Figure 6.9: Circular Debt in 2015 (outstanding SLRs million)



CEB = Ceylon Electricity Board, CPC = Ceylon Petroleum Corporation, SLA = Sri Lanka Airlines, SLPA = Sri Lanka Port Authority, SLTB = Sri Lanka Transport Board.

^a For 2014 and 2015 according to Ministry of Finance Annual Report 2015.

^b Outstanding debts to both CPC and independent power producers.

^c Includes state banks.

Sources: MOF (2015a, 2016b).

The underperformance of SOEs in terms of efficiency and fiscal dimensions also has adverse impacts on distributional outcomes. For example, as of 2014, the state plantations (estate) sector directly employed approximately 11,755 workers (COPE 2016), with significant indirect employment and a dependent plantations community. The plantations sector consists of a large, economically vulnerable, and socially marginalized population that depends on the performance of the state plantations. For example, the statutory dues of SLRs1.5 billion owed to employees of the Janatha Estates Development Board’s Employment Provident Fund and

²⁰ State banks have a large portfolio of lending to SOEs, which are effectively a captive market for state banks, given that most SOEs are only allowed to use state banks for their financial and banking needs.

Employment Trust Fund benefits in 2015 have a particularly unfavorable impact on this community (MPI 2016). Similar distributional consequences are seen in the electricity sector where operational inefficiencies—including inadequate planning—have resulted in a tradeoff between cost and uninterrupted power supply to consumers (Case Study 2 in Appendix A6).

The inefficiencies and financial malaise in Sri Lanka’s SOE sector are also associated with networks of political patronage that pervade the country’s sociopolitical institutions. Historically, the government has used state organizations to disburse welfare in the form of employment opportunities or subsidized goods and services. Welfare disbursement in and of itself is not necessarily inappropriate; however, the hijacking of such objectives for narrow political gain is inimical to the public interest. Several such examples are documented in COPE (2016) and discussed in section 6.4. Box 6.4 provides one example: the Lankaputhra Development Bank.

The stance on SOE reform articulated by the Prime Minister and by high-ranking UNP politicians is set out in section 6.3. In addition, the following statement by the finance minister in the 2016 Budget Speech suggests that the government is cognizant of the political costs of hasty privatization and is exploring other means of public enterprise reform:

The government reiterates that no SOEs will be privatized simply as a means to increase revenue. Instead, the government is keen to follow a more strategic approach, where the SOEs will be strengthened and made independent (MOF 2016a: 86).

Box 6.4: Lankaputhra Development Bank

The performance of the Lankaputhra Development Bank contrasts starkly with that of other finance sector state-owned enterprises—in particular the Bank of Ceylon and the People’s Bank, which have shown profits in the last decade.

The Lankaputhra Development Bank was established in 2006, following the 2005 elections, to assist local businesses. However, it was not run on a commercial basis or even managed effectively to provide development assistance. Instead, it was used to lend money as patronage and senior appointments to the bank were being made on a similar basis.

Unsurprisingly, early in 2007, the enterprise was declared unviable and merged with the SME Bank (which was also in financial distress due to questionable loans) as a means of rescue.

The Committee on Public Enterprises is scrutinizing the Lankaputhra Development Bank with a view to reform. Key elements the Committee is addressing include the need to follow stipulated procedures in terms of loans and interest rates on loans disbursed, and inconsistencies in recruitment procedures.

Source: COPE (2016).

The mandate of the Ministry of Public Enterprise Development in the context of the current SOE reform process was also described by its minister in an interview with the Oxford Business Group (2016). The minister set out five key elements. First, a key mandate of the new ministry is to restructure SOEs and not merely to run them. Second, a major objective of the reform process is to reduce the fiscal burden imposed by the enterprises. Third, the restructuring process needs to balance PSOs with profitability. Fourth, a crucial element of reforms is to address the politicization of the SOEs and to provide increased scope for technocrats in managing these entities. Fifth, two modalities being carefully considered by the government are public–private partnerships (PPPs) and joint ventures.

The ongoing initiatives for SOBEs are set out in Figures 6.10 and 6.11. A more detailed discussion of some of these initiatives, such as for example the PEB, is contained in the final section of this chapter.

Figure 6.10: State-Owned Business Enterprise Reforms—Initiatives



Sri Lankan Airlines and Mihin Lanka

- Seeking strategic investor and management partner
- Internal unbundling
- Wet lease of three airbus A330 aircrafts to PIA



State Banks

- Consolidating banks (SMIB and HDFC)
- Strategizing future for Bank of Ceylon, People's Bank, and National Saving Bank
 - Drawing up a plan for future capital requirements



Nonstrategic Investment Divestiture

- CSE listing or request for proposals in 2016
- Entities to be included
 - Lanka Hospitals
 - Hotel Developers PLC
 - Hyatt Residencies
 - Waters Edge
 - Grand Oriental Hotel
 - Ceylinco Hospital
 - Mobitel

CSE = Colombo Stock Exchange, HDFC = Housing Development Finance Corporation Bank, PIA = Pakistan International Airlines, SMIB = State Mortgage and Investment Bank.

Note: A “wet lease” is an arrangement covering the hire of an aircraft including the provision of a flight crew and sometimes fuel. PIA returned the airplanes in 2017.

Sources: Collated using MOF (2016a); News.lk (2015); interviews with key persons; various pieces in the English and vernacular press.

**Figure 6.11: State-Owned Business Enterprise Reforms—
Institutional Arrangements**



Strengthen Regulation

- Broaden PUCSL scope to include NWSDB and CPC
- Enhance PUCSL authority in setting tariffs
- Enable more cost reflective pricing mechanisms



Public Enterprise Board

- Government holding company
- Temasek (and Khazanah) elements
- Public Enterprise Development Act (being drafted)

CPC = Ceylon Petroleum Corporation, NWSDB = National Water Supply and Drainage Board, PUCSL = Public Utilities Commission of Sri Lanka.

Sources: Collated using MOF (2016a); News.lk (2015); interviews with key persons; various pieces in the English and vernacular press.

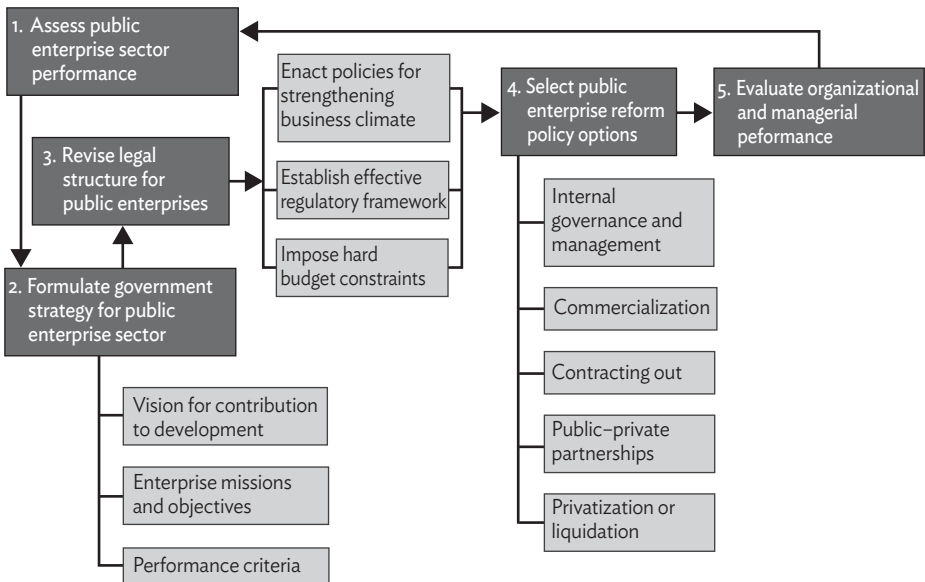
Despite statements by the government, the SOE reform initiatives, and the creation of a separate ministry to spearhead the reform process, the perception of a large number of stakeholders interviewed for this study is that policy for public enterprise reforms lacks coherence. Some stakeholders further expressed the view that reform initiatives were not aligned with practical realities and that public discourse is being driven by ideology rather than pragmatism.

The current political context highlights the potential opportunities and challenges that frame the public enterprise reform process. While the bipolar structure of the present government provides opportunities for cooperation, it also creates the opportunities for contradictions when consensus building is poorly managed. Given the differences in the political economy of the two main political parties that comprise the current government, political will for privatization is unlikely to be strong. Modalities of SOE reforms other than privatization are likely to be emphasized in the policy arena. Further, the need to secure mass consensus (including from key trade union actors) and legitimacy for public enterprise reforms also highlights the importance of the Janatha Vimukthi Peramuna, a socialist party, which has been traditionally averse to privatization.

6.6. Successful State-Owned Enterprise Reforms: International Experience

SOE reforms implemented across countries vary significantly—there is no one-size-fits-all approach. Rondinelli (2005) posited that an SOE reform program should commence with a comprehensive performance review by a government commission or agency to list the SOE’s resources and assets, determine the financial standing of the SOE, and evaluate its past performance in terms of meeting its financial and development objectives. The results should be used as inputs in designing an effective strategy for reform, which in turn should spell out a clear vision of the SOE’s role in national development, mission, objectives, and performance targets (Figure 6.12).

Figure 6.12: Framework for Assessing Public Enterprise Reform



Source: Rondinelli (2005).

More often than not, the government must revise the legal structure of SOEs (Rondinelli 2005). The rights of parties within an SOE, their dynamics, and the ways by which an SOE transacts and behaves with external parties will basically be governed and guided by its legal structure. Therefore, diffusion and institutionalization of change in formal organization structure is importantly determined by the extent to which a measure is institutionalized—whether by law or any form of legitimation. For example, after embracing a socialist market economy as a national objective in 1992, the 1993 *Company Law* of the People’s

Republic of China (PRC) provided the legal basis for SOEs to be corporatized into shareholding companies with a modern corporate board structure, creating a variety of corporate SOE forms.

Because SOE laws and regulations define the legal structure, administration, oversight arrangement, and functions of each governing body of SOEs, the reform program needs to ensure a clear and robust legal framework. Often, SOEs are subjected to overlapping and contradictory provisions that may weaken accountability arrangements, limit profitability, and contribute to ineffective decision-making. The legal and regulatory framework should foster a level playing field for SOEs and private enterprises alike and protect the rights of businesses, consumers, workers, and citizens. It is important to establish a balanced regulatory framework that deters public and private enterprises from abusing market power but at the same time fosters an environment that encourages SOE managers to achieve the enterprise's objectives efficiently.

Moreover, policies should be enacted to provide an attractive business environment, which means improving the macroeconomic environment, financial system, and physical infrastructure. Lastly, the regulatory framework should include hard budget constraints to impose financial discipline among SOEs.

The literature on SOEs presents different types of SOE reforms that could lead to the financial and operational independence of SOEs. Figure 6.12 illustrates Rondinelli's proposed framework for assessing public enterprise reform.

In the Asia and Pacific region, different types and variants of SOE reforms have emerged over time. These include corporatization of public provision in sector networks and natural monopolies; corporate, including organizational and management, restructuring; financial restructuring and commercialization; PPP such as management of SOEs to transition toward contract-based private provision of important types of infrastructure services; and privatization to transition toward regulated private provision in selected sectors. The reforms implemented by SOEs reflect the nature of the infrastructure service taking into account the technological advances, their country's recent economic performance, and their level of institutional development (ADB n.d.).

6.7. Types of State-Owned Enterprise Reforms

Corporatization attempts to explicitly separate political considerations from economic considerations. Although the separation will not be total, the long-term economic and social objectives of the SOE are more likely to be achieved

by instituting procedures that can help improve governance within the operating entity and strengthen accountability and transparency. Corporatization serves as the basis for commercialization.

Corporate restructuring is the act of reorganizing the legal, ownership, operational, or other structures of an entity to make it more profitable or better organized for its present needs. Corporate restructuring includes restructuring the organization and management with the aim of improving the entity's corporate governance through competitive recruitment, rationalization of staff compensation, and appointment of an independent board of directors to reduce political influence in the management.

Commercialization attempts to reorganize the SOE into a profit making commercial venture without financial support from the government (Zayyad n.d.). It is accompanied by financial restructuring to help improve the SOE's financial viability. Commercialization includes gradually withdrawing implicit guarantees or support from government, restructuring debts and/or assets, converting government loans into equity and writing off government loans (including accumulated interest), liquidating unviable SOEs, and reforming tariff to improve the SOE's financial viability.

Public-private partnership can be defined as a long-term contract between a private party and a government entity for providing a public asset or service, in which the private party bears significant risk and management responsibility and remuneration is linked to performance. PPPs can take many forms. The basics of an effective and strong PPP usually include (1) an agreement that allocates the tasks, obligations, and risks among the public and private partners in an optimal way; (2) a partnership structure that is designed to allocate risks to the partners that are best able to manage the risks and thus minimize costs while improving performance; and (3) an agreement that recognizes that the public and the private sectors each have advantages in performing specific tasks.

One form of PPP is outsourcing and contracting, where government retains ownership of the enterprise but contracts out some of the services, such as construction of infrastructure, management of operations, or provision of services. In Indonesia, this form of PPP was employed to provide transport services to economically lagging and geographically remote regions and enable Indonesians to have access to essential services (Box 6.5).

Box 6.5: Pioneer Service in the Transport Sector—Indonesia

The Indonesian Constitution obligates the government to ensure that all Indonesians, regardless of their income level or location, have access to essential services. To help achieve the objective of regional economic development, a “pioneer services” scheme was implemented for providing infrastructure services. Pioneer services are provided in various transport modes (land, sea, and air) to promote the development of economically lagging and geographically remote regions and to develop national unity and stability. Private service providers are engaged on annual contracts through a bidding process. Tariffs for the services are set by the government, which compensates the service providers for the difference between the tariff and the cost of operations and maintenance plus pre-agreed profit margins.

One major pioneer service is the provision of shipping by private services that operate 56 routes and 30 ports throughout the country. Many of the routes serve intraprovincial shipping, with the time per round-trip voyage ranging from 10 to 27 days and the frequency ranging from 14 to 36 voyages per year. The average passenger load factor is low but the continuity of such services is essential.

Following implementation of the pioneer service scheme, a number of issues the providers faced have been identified. At the policy level, these include lack of clarity and consistency in applying the subsidy policy, decision making processes that are not transparent and prone to political influence, limited information available on market potential and target groups, the promotion of monopolistic behavior by current processes, and limited budget available to meet the increasing subsidy required to improve the quality of services. At the implementation level, pioneer services suffer from a lack of clear targets for the level and quality of service they should deliver, short-term service contracts that promote targeting of short-term goals and returns, payment delays, and difficulty in estimating the annual outlay for subsidies.

The Government of Indonesia has drawn up a comprehensive plan to overcome the issues to ensure more efficient and effective achievement of intended outcomes of providing the pioneer services. At the policy level, the scheme will promote fair competition among the service providers, with the gradual phasing out of direct contracting. Selection will be through an open bidding process with value for money as a key guiding principle. The contractual agreements will be based on an agreed level and quality of service, and will span multiple years to attract more private sector participation in the service provision. At the implementation level, the strategy will be agreed by relevant ministries (Bappenas, the Ministry of Transport, the Coordinating Ministry of Economic Affairs, and the Ministry of Finance) taking into account accountability and transparency in accordance with existing laws and regulations.

The initial step is for regional governments to prepare an “outline business case,” which indicates (1) compliance of the proposal with the government definition of a pioneer service, (2) target beneficiaries, (3) economic benefits from the pioneer service, and (4) a budget strategy that clearly outlines the size of the subsidy. In step two, the regional government submits its outline business case to the Ministry of Transport for inclusion in the national planning process. Third, the Ministry of Transport prepares the final business case, including the proposed bidding and contracting arrangements as appropriate and the service delivery contract with performance measures indicated. This is submitted to Bappenas for conformity with the national planning process decision; to the Ministry of Finance to confirm if there is enough fiscal space for the required subsidy; and to the Ministry of State Owned Enterprises to confirm if the assigned state-owned enterprise can deliver the service without compromising its financial viability. Step four is the actual implementation during which Bappenas monitors the physical and financial performance of the pioneer services system based on established benchmarks, the Ministry of Finance allocates budget in accordance with Indonesia’s law on financial management, and the Ministry of Transport manages and monitors the implementation of the pioneer services through annual performance reviews.

Source: Australian Agency for International Development (2010).

Privatization refers to the act of transferring ownership of specified property or business operations from a government organization to a privately owned entity, and the transition of ownership from a publicly traded or owned company to a privately owned one. Chang (2007) and Welch and Fremond (1998) noted the key conditions of a successful SOE privatization as follows: (1) the SOEs operate in a competitive environment where competition cannot be enhanced without privatization; (2) the domestic capital market is well developed; (3) government has adequate regulatory capacity; (4) domestic firms are available that can value and arrange the sale of the SOE at an adequate price; (5) privatization is tailored to the circumstances of the country and the enterprise—there is no “right” approach; (6) strong political support and leadership, which is vital, are present; (7) transactions are well-prepared and attractive to private investors; (8) transparency, fairness, and a level playing field, which are essential, are in place; (9) outside expertise is sought; and (10) related structural reforms keep pace with privatization.

Governments of fast-growing economies have recognized the importance of pursuing SOE reforms because their successful implementation can help improve resource allocation, instill confidence in the economy, enable other important reforms to be implemented, and (more importantly) unlock new drivers of growth. This is why the PRC has included SOE reform as one of its main strategies for rebalancing its economy. The PRC’s 5-year plan encourages various forms of ownership and private sector participation in SOEs and highlights the need to restructure enterprises that have been considered as “zombies” and at the same time strengthen the SOEs to be able to deliver the services while serving the national interest. Box 6.6 presents the key principles of the PRC’s reform strategy.

6.8. Potential Reform Pathways

The preceding sections discussed the importance of SOEs in terms of inclusive growth, set out key lessons from the historical narrative on public enterprise reforms, and described the economic and sociopolitical context that frames the current reform episode. The objective of this section is to set out the broad contours of potential SOE reform pathways in Sri Lanka. Specific discussions on workable modalities are provided in the four case studies in Appendix A6.

When conceptualizing and operationalizing SOE reforms in the present context, one must consider at least three significant pitfalls: ideology, political realities, and a one-size-fits-all approach. First, there is a danger of the current discourse assuming an ideological slant, potentially missing out on the crucial lessons from the past.

Box 6.6: Key Principles of the People's Republic of China's State-Owned Enterprise Reform Strategy

The People's Republic of China's reform strategy for state-owned enterprises (SOEs) has four key elements.

Transform the role of the state from an operator to investor. The role is being transformed to allow for greater private sector participation in SOEs. This entails allowing for a spectrum of ownership structures, including cross-share holdings, public listing, etc.).

Classify SOEs into broad categories with specific ownership structures, reform plans, and assessment criteria. The categories identified include (1) commercial strategic SOEs, such as telecommunication and energy, where the state will remain the major shareholder and the SOE will be tasked to support the country's national strategies such as "going global" and "creating champions"; (2) commercial nonstrategic SOEs that will compete directly with the market; and (3) SOEs with social obligations to improve the provision of public services.

Institutionalize the leadership role of the communist party by selecting a party member to serve as chairman of the board of the SOE.

Restructure or expedite the closure of nonviable SOEs, including their subsidiaries and local SOEs, to cut aggregate losses.

Source: IMF (2016a).

Second, the present political dynamics (section 6.5) are not amenable to privatization.²¹ Moreover, as evidenced in the international literature²² and as clearly demonstrated in the cases of the Lanka Marine Services and Sri Lanka Insurance Corporation privatizations, divestiture is not a panacea for the ills of underperforming SOEs. If the objective of privatization is to protect SOEs from political capture, there is no guarantee against the misuse of public benefits for private gain by crony capitalists when strong institutional and regulatory structures are not in place. Given this political context, policy makers must explore other means short of divestiture, at least for the strategic enterprises, to improve efficiency, reduce the fiscal burden, and ensure that distributional objectives are met. Additionally, the choice of reform modalities will hinge on the nature of institutional and regulatory arrangements.

Third, the unique circumstances that characterize individual SOEs require a case-by-case approach to the reform process. For example, Gunaruwan (2016) notes there are three types of public enterprises in Sri Lanka: departments (with inflexible rules and regulations, no space for risk taking, inadequate authority to

²¹ The follies of privatization in the Russian Federation and Latin America, for example, without sufficiently taking the sociopolitical context into consideration, are well documented (e.g., Birdsall and Nellis [2002]).

²² For example, Hodgson and Jiang (2007) and Rose-Ackermann (1999).

meet responsibilities, and political interference); companies (with heavy political interference and lack of accountability); and body corporates such as authorities, boards, and corporations (with the negative features of both of the other types). The case studies in the appendix provide examples.

Two potential points of convergence with respect to reform modalities are management and accountability-oriented reforms and PPPs. There is no conclusive evidence from around the world that ownership change is a necessary or sufficient remedy for underperforming SOEs.²³ Instead, examples of public enterprise reforms globally show that what matters for enhanced performance is the structuring of incentives in line with principal-agent dynamics. In the case of SOEs, the principal is by definition the public and the agent is the management of the enterprise, with politicians adding another layer to agency dynamics. Therefore, the challenge lies in institutionalizing incentives that firm up the line of accountability between the public and the management and in locating workable solutions that can do this on a sustainable basis.

According to the KPIs—and as further illustrated in the appendix—public enterprises have significant management and accountability problems: lack of flexibility to hire and set wages, absence of corporate plans, absence of accountability mechanisms, and complex governance structures with no clear lines of accountability. PPPs, which are being actively explored by the present government, are likely to be viewed by the public with less suspicion than an outright sale of assets in the public mind.²⁴ However, as documented in an audience survey (CCC 2016), while 85% of the participants endorsed PPPs as a viable modality for infrastructure projects, only 44% believed that Sri Lanka has the expertise to structure these complex deals, reiterating the point that institutional capacity is key to sustainable reforms and positive outcomes.

Experience with successive episodes of SOE reform demonstrates that certain key principles need to be in place if the process is to be sustainable with positive outcomes for inclusive growth. These principles, which are associated with the principal-agent and management dynamic, include governance aspects such as information, visibility, answerability,²⁵ and

²³ Consider for example, the failed privatization experiment of the British railways.

²⁴ As set out in Knight-John (2009), while a survey in 2002 found that more than 80% of respondents viewed privatization as having a negative impact on poverty and living standards, even this group perceived PPPs as a feasible option for SOE reforms. For example, the KPIs with representatives of the Janatha Vimukthi Peramuna indicated that competition and PPP models could be introduced in nonstrategic entities such as dairy farming, with small-scale cooperative businesses being encouraged at the village level for sectors such as handicrafts and jewelry.

²⁵ These aspects are also likely to improve with Sri Lanka's new *Right to Information Act*.

internal operational (efficiency) aspects such as performance incentives and competition.²⁶ Two reform options that work on these principles and that are likely to have considerable potential in Sri Lanka are performance contracts and the government holding company models. As mentioned earlier, Sri Lanka is currently in the process of establishing a government holding company that is a hybrid of Singapore's Temasek and Malaysia's Khazanah structures.

The essence of performance contracts is to institutionalize effective incentive structures and processes that reward managers and employees for improvements in efficiency, productivity, and consumer service. This approach is particularly useful when ownership change is not a workable option. Performance contracts may also be implemented as an incremental step in the process of eventual privatization. Performance contracts can be operationalized at all levels of public sector management, including for board members, directors, senior executives, and rank-and-file workers.

A typical performance contract sets out clear, transparent, and measurable targets and indicators, with a focus on three key areas: performance evaluation, performance information, and performance incentives. Performance evaluation deals with issues such as the selection of entities responsible for designing, implementing, monitoring, and evaluating a contract and the technical procedure pertaining to evaluation. Performance information focuses on providing timely and relevant information to the management and to rank-and-file workers on the chosen performance criteria. Performance incentives link the performance of the stakeholders to rewards and penalties, based on the outcome of the evaluation exercise. These incentives are designed to create and foster a competitive dynamic within the SOE—by providing, for example, additional compensation to managers who achieve a specific financial target or bonuses to workers who achieve a production output or service level or by institutionalizing profit sharing mechanisms (Knight-John 1997).

Although the performance contract modality has immense potential in the Sri Lankan context, it has not been sufficiently explored by policy makers, except for a few isolated experiments such as the Ceylon Leather Products Corporation and the Sri Lanka Tyre Corporation during the “first wave of privatization.” Decision makers could conduct a more detailed review of this modality and its associated advantages and limitations in the current sociopolitical and economic context.

²⁶ The beneficial impacts of competition are discussed in sections 6.3 and 6.4.

An SOE management reform option that has gained significant traction internationally as well as in Sri Lanka's current public discourse is the Temasek model. Temasek is a state-owned holding company that owns and manages state assets in a wide range of sectors on behalf of the Singapore government. Temasek also takes investment decisions on behalf of the government, including on listing, divestment, and acquisition of shares. SOEs that function under Temasek make commercial decisions like private business entities and do not provide services below cost.

To implement the Temasek model requires certain political economy conditions such as a strong regulatory governance framework, accountability processes that are not muddied by political patronage, and access to an adequate pool of technocrats and professional civil servants. Without these essential prerequisites, adopting the Temasek model may not lead to improvements in management accountability and may, in fact, only add another layer of bureaucracy.

Nevertheless, some elements of the Temasek approach—specifically, listing shares of commercial SOEs on the stock exchange and institutionalizing performance contracts—could be considered in the Sri Lankan context. Listing even a modest percentage of SOE shares on the Colombo Stock Exchange could instill management discipline and make board members and senior executives accountable to shareholders. For the listing of shares to bring about effective improvements in management, however, regulatory institutions such as the Securities and Exchange Commission need to be robust. The 2017 Budget Speech (Paragraph 203) sets out the listing of non-strategic enterprises such as Grand Oriental Hotel, Hambanthota Salt, Hilton, Hyatt, Manthai Salt, Waters Edge, and West Coast during 2017.²⁷

The precise structure and scope of Sri Lanka's version of this Temasek—the PEB—has not been made public. However, the KPIs provided some details. The legislation governing the PEB is currently at the Attorney General's department and is expected to be enacted in 2017. The PEB membership will likely be appointed by the Constitutional Council (Dissanayake 2017).

First, a key PEB objective is to address issues pertaining to the complex governance structure within which SOEs are currently embedded. As set out in sections 6.2 and 6.5, SOEs are governed by numerous organizations. The envisaged institutional strategy is to introduce the PEB as a central point of

²⁷ In addition, this commitment is included as a policy action in the second tranche of ADB's Capital Market Development Program loan to Sri Lanka.

contact to enhance operational efficiency and reduce political interference. Given this arrangement, the PEB will also have the following responsibilities for commercial SOEs: appointing board members and senior management; monitoring performance, including using key performance indicators to measure social and commercial returns; and restructuring the processes.

Second, the PEB's mission is to create wealth for the country rather than to draw resources from the public. As such, the following areas are high priority: securing public buy-in for restructuring, professionalizing boards and management to drive performance, rationalizing portfolio to maximize returns, transforming the organizational culture to be productive and competitive, and leveraging assets to enhance the entity's growth.

Third, the proposed strategy for SOE reforms under this approach is to be carried out in three stages: (1) make SOE operations profitable with positive cash flows (e.g., set performance incentives, professionalize boards and managements, and incorporate good governance practices); (2) make the SOEs comparable to the Sri Lankan private sector (e.g., restructure balance sheets, tie remuneration to performance, issue dividends, make an initial 15% public offering on the Colombo Stock Exchange); and (3) set examples for commercial enterprises in Sri Lanka (e.g., a strong balance sheet for sustained growth, have a return on investments, benchmark global players, and make a second float on the Colombo Stock Exchange). Based on performance indicators, private sector-level wages could be offered.

Fourth, the PEB is to be funded by a management fee of approximately 1% of the profits of SOEs. The feasibility of using the dividends of the restructured enterprises to reform other entities is to be discussed. As evidenced in the international literature and in Sri Lanka's regulatory governance context, such mechanisms are crucial to "ring fence" institutions from political interference (e.g., Knight-John 2004a).

The foregoing narrative indicates the PEB model's potential for SOE reforms. However, it is too early to estimate the extent of operational flexibility that the PEB will actually have. Predictability in implementation and the right people for the right jobs are key for the effective functioning of this organization. Given Sri Lanka's experience with public enterprise reforms (section 6.4), whether issues of institutional capacity and political indiscretion are handled better this time remains to be seen.

The management contract modality is also useful for addressing issues pertaining to SOE management inadequacies and is a form of PPP. Empirical

evidence from around the world indicates that this modality is effective at infusing competition and improving productivity and the quality of service in situations where divestiture is not feasible. Similar to performance contracts, this modality can also be used as a step toward eventual privatization. In the plantation sector (Case Study 1, Appendix A6), 5-year management contracts were used as an interim step toward privatizing the estates. However, the short terms of the contracts proved to be a disincentive to long-term investment, and the government divested 51% of the shares of these enterprises in 1995.

Sri Lanka's experience with management contracts points to some crucial ingredients that need to be in place to produce efficient and socially beneficial outcomes (Knight-John 2004b).

- First, management contracts must be drafted transparently, with all stakeholders able to access the content of the contracts.
- Second, management companies must be selected on a competitive basis using open bidding procedures.
- Third, the basis and calculation of management fees must be clearly set out in the contract.
- Fourth, conditions such as investment requirements and environmental and social obligations must be specifically delineated in the contract.
- Fifth, exit and termination clauses should be clearly laid out.
- Sixth, service standards and default triggers should be clearly defined.
- Finally, private management partners must have sufficient autonomy to respond to market forces and take decisions in line with principles of competition.

Sri Lanka has an opportunity to undertake meaningful reform of public enterprises. There are, as always, significant sociopolitical, institutional, and technocratic challenges. However, giving due consideration to international good practice and to Sri Lanka's own experience with reforms can contribute to sensible policy conversations.

As highlighted throughout this study, the SOE reform process must unpack and work around underpinning sociopolitical and economic realities. Policy makers must strategically work with the winners and losers of reforms to get to outcomes that are sustainable in terms of inclusive growth. Given that details of debt and losses in public enterprises have been in the limelight during the last 2 years more than ever before, there is political space for reform. However, because of the deep sociopolitical suspicion of privatization, reforms such as the sale of assets and retrenchment are unlikely to be feasible for strategic enterprises, even in the medium term.

A crucial element in all of this is to mobilize public opinion through effective communication strategies, an area that the present government could ramp up. Facilitating an informed public dialogue is critical for greater stakeholder buy-in—communicating, for example, that the key objective of the reform process is to enhance the public benefit rather than narrow private or political interests. Therefore, a political economy strategy is needed that has the capacity to address opposition to SOE reforms in a rational, transparent, and systematic manner. Dramatic reform is unlikely and expectations need to be managed, but incremental progress is certainly achievable.

Appendix A6: Four Case Studies of State-Owned Business Enterprises

Case Study 1: State Plantation Sector

Elkaduwa Plantations Limited (EPL), Janatha Estates Development Board (JEDB), and Sri Lanka State Plantations Corporation (SLSPC)

Background and Context	Current Challenges	Reforms Undertaken	Further Reform Options
<ol style="list-style-type: none"> The plantations are primarily engaged in tea, rubber, and coconut production. The 3 state-owned plantations (EPL, JEDB, and SLSPC) only engage in tea and rubber production. Although the sector has a large community, its labor accounts only for 2.3% of Sri Lanka's total employment and its resident population is 4.4% of the total. State plantations only account for a small share of the production of tea and rubber crops. Labor unions are established and influential due to support from political parties such as the People's Liberation Front. 	<p>A. Operational Inefficiencies</p> <ol style="list-style-type: none"> Low productivity <ul style="list-style-type: none"> JEDB and SLSPC have the lowest yield per hectare of tea estates. Yields per hectare in rubber are below the average of the 23 regional plantation companies. Land utilization is below 60% and is compounded by issues such as squatting. EPL, JEDB, and SLSPC incurred huge losses, ranging from SLRs21/kilogram (kg) to SLRs142/kg of tea and SLRs50/kg to SLRs166/kg of rubber in 2014. High cost of production and low profitability were exacerbated by the low productivity. Labor issues contributed to the poor productivity resulting in poor financial performance in the last 5 years. Operational losses for the three entities combined during that period averaged SLRs435 million in 2015 prices. 	<p>1972—First wave of plantation nationalization: private landownership capped at 50 acres (about 20 hectares); state acquired land in excess of that ceiling.</p> <p>1975—government acquired plantation companies.</p> <p>1976–1977—Majority of plantation lands vested under JEDB and SLSPC.</p> <p>1992—Regional plantation companies formed from JEDB and SLSPC lands, and put under private management contracts.</p> <p>1993—EPL formed as the 23rd regional plantation company under a private management contract.</p> <p>1995–1997—Privatization of regional plantation companies started. Estate workers offered a 10% stake in the plantations; state retained the remaining “Golden Share,” with power over the regional plantation companies’ critical decisions.</p>	<ol style="list-style-type: none"> Institutionalize worker retention policies, to include: providing labor and unions voice in the management decision making process, addressing health and dignity concerns of workers, and encouraging dialogue and transparency during management-labor discussions. Introduce flexible labor cost structures to facilitate labor mobility from labor excess to labor shortage plantations. Consider employing performance contracts, i.e., productivity-based, revenue sharing, out-grower model, or a mixed model, to incentivize workers and help increase productivity.

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Case Study 1 continued

Background and Context	Current Challenges	Reforms Undertaken	Further Reform Options
	<p>B. Persistent Fiscal Burden</p> <ol style="list-style-type: none"> 1. Government has been providing annual subsidies of about SLRs1.5 billion for their continued operation. 2. State plantations have incurred arrears of about SLRs3 billion on their statutory dues. <p>C. Distributional Impacts</p> <ol style="list-style-type: none"> 1. People living in the plantation communities have the countries' lowest human development indicators (least access to safe drinking water, highest poverty incidence, high child under-nutrition rates, and low access to medical services). 2. Access to opportunities is affected by social stigma associated with being a plantation worker and of Indian Tamil ethnicity. 3. Wage rates provided to plantation workers are below market values and close to the poverty line. 		<ol style="list-style-type: none"> 4. Implement management reforms, such as allowing unions to assume management roles and women to take leadership roles to address labor issues. Allow longer-term management contracts and tie them to performance to help improve plantation productivity. 5. Explore alternative land utilization options, such as dairy farms, water bottling, ecotourism, and mini hydro power projects. 6. Promote public-private partnership

Source: Authors.

Case Study 2: Electricity Sector Ceylon Electricity Board (CEB)

Background and Context	Current Challenges	Reforms Undertaken	Further Reform Options
<p>1. CEB operates as a virtual monopoly in the electricity sector and is a vertically integrated entity.</p> <p>2. CEB is engaged in power generation, transmission, and distribution and currently holds six licenses issued by the regulator, Public Utilities Commission of Sri Lanka (PUCSL).</p> <p>3. CEB owns the majority share in Lanka Electricity Company Ltd., a distribution company.</p> <p>4. Demand for electricity is expected to grow at 6.9% annually during 2017–2020, while supply is predicted to be in deficit.</p>	<p>A. Operational Inefficiencies</p> <ol style="list-style-type: none"> Poor planning and demand forecasts result in expensive power purchases from independent power producers to meet the energy requirements. Poor operation and maintenance of power plants result in island-wide blackouts. Inefficient management practices result in high operating costs and excess employment at the same time as high-skilled workers are in short supply. Chronic losses in the last decade threaten CEB's long-term sustainability. <p>B. Fiscal Burden</p> <ol style="list-style-type: none"> CEB has financial obligations of SLRs237 billion, or about 2.1% of gross domestic product in 2015. Government has been intervening to reduce CEB liabilities and allowed CEB to forgo making Treasury repayments for several years. <p>C. Distributional Impacts</p> <ol style="list-style-type: none"> CEB employs a large unionized labor force. Unions have undermined decision making and even legislative changes to address efficiency and other concerns. Poor management, system, and technical planning have threatened CEB's ability to provide a sufficient and reliable supply of electricity and resulted in total system failure in the past. Electricity tariff is set to be affordable without due consideration for the cost of generation. 	<p>1983—Lanka Electricity Company established to take over the distribution function from CEB in selected areas.</p> <p>1997—Private sector participation initiated in electricity generation and first independent power producer commissioned.</p> <p>2002—Sri Lanka Electricity Act and Public Utilities Commission Act enacted. CEB internally unbundled into generation, transmission, and four distribution units, though no legal or financial separation occurred.</p> <p>2009—Sri Lanka Electricity Act enacted and CEB partially unbundled through PUCSL licensing requirement.</p> <p>2010—CEB and other operators required to obtain licenses from PUCSL. New tariff methodology approved, tariff filing conducted, and first public hearing regarding tariff adjustment held.</p> <p>2013—Sri Lanka Electricity Act No. 31 amended and second public hearing on tariff held.</p>	<ol style="list-style-type: none"> Pursue partial or complete unbundling, i.e., financial separation and independent reporting of all licensees under CEB. Implement performance contracting through a results-based performance monitoring system to help increase efficiency and transparency within CEB. Consider private sector participation through management contracting, marketization, and public-private partnerships to achieve sufficient and affordable supply of electricity without substantial subsidies from government.

Source: Authors.

Case Study 3: Ports Sector

Sri Lanka Ports Authority (SLPA)

Background and Context	Current Challenges	Reforms Undertaken	Further Reform Options
<ol style="list-style-type: none"> 99% of Sri Lanka's trade is carried out via its ports. Sea freight is the country's third-largest service export. SLPA established in 1979 under the Sri Lanka Ports Authority Act No. 51 to function as owner, operator, and regulator of marine and cargo handling services at all ports. SLPA has commercial ports operating in 7 locations including the Port of Colombo, one of the largest and busiest ports in South Asia. SLPA owns 15% of South Asia Gateway Terminals, a private operator in the Port of Colombo. 	<p>A. Operational Inefficiencies</p> <ol style="list-style-type: none"> SLPA is the least competitive port terminal operator and is losing market share to its competitors and the private sector due to antiquated container terminals and equipment, slow turn-around time, and berths that cannot accommodate mega ships. SLPA's low capacity utilization and high nonoperational costs threaten the entity's financial sustainability. In 2015, SLPA incurred losses of SLRs9,575 million due to high administrative expenses, finance costs, and interest on foreign loans. Competing interests (SLPA acting as regulator and operator), governance issues, and weak institutional capacity have undermined management and operational efficiency. <p>B. Fiscal Burden</p> <ol style="list-style-type: none"> SLPA's financial obligations are estimated at SLRs240 billion or approximately 2.2% of gross domestic product. SLPA's total liabilities increased due to the implementation of development projects. In 2015, SLPA's liabilities amounted to about 69% of its total assets. 	<p>1958—Port Cargo Corporation Act enacted, leading to establishment of the Port Cargo Corporation and nationalization of cargo handling services at the Port of Colombo.</p> <p>1967—Port Tally and Protective Services Corporation formed to perform on-board tallying and watchman services for agents.</p> <p>1979—SLPA set up under an Act of Parliament, incorporating three entities aimed at creating a unified and autonomous entity under a single line of management control.</p> <p>1980s—Modernization of the Port of Colombo.</p> <p>1999—First private terminal operator entered the sector under a build-operate-transfer agreement.</p> <p>2004—SLPA brought under the purview of the Strategic Enterprise Management Agency to improve the performance of ports.</p> <p>2000–2013—Large scale port development projects and port modernization initiatives planned, i.e., Colombo Port expansion and Hambantota Port development.</p> <p>2013—Entry of the second private sector operator in the Port of Colombo.</p>	<ol style="list-style-type: none"> Implement management reforms such as institutionalizing merit-based management, recruitment systems, and performance contracting, and building of effective communication and consultation between management and labor. Pursue public-private partnerships (PPPs). First step is to establish a PPP unit to handle PPP initiatives. Unbundle SLPA into smaller business units that are legally and financially independent (e.g., separate units for terminal management, bunkering, stevedoring, etc.) and run as self-driven cost-profit centers.

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Case Study 3 continued

Background and Context	Current Challenges	Reforms Undertaken	Further Reform Options
	<p>3. SLPA's outstanding debt is projected to increase by 141% during 2015–2018. SLPA has not remitted to the government any dividends or levies, even during SLPA's profitable years (2011–2014).</p> <p>C. Distributional Impact</p> <p>1. SLPA's workforce uses a significant share of its administrative costs, which are mostly based in Colombo.</p> <p>2. SLPA's ports are overstaffed given low utilization of port services.</p>		<p>4. Consider diversifying business operations beyond the Port of Colombo to realize full benefits of SLPA's strategic maritime location. Logical extensions are Galle (major leisure and marine tourism destination), Oluvil (center for commercial fisheries), and Trincomalee (the major shipping and export hub).</p>

Source: Authors.

Case Study 4: Transport Sector Sri Lanka Transport Board (SLTB)

Background and Context	Current Challenges	Reforms Undertaken	Further Reform Options
<p>1. Demand for bus services accounted for 47% of total motorized transport services in 2014, but there has been a shift from public to private modes of travel.</p> <p>2. Only 7% of public investments in the transport sector have gone to bus transport.</p> <p>3. SLTB and private operators provide bus transport services.</p>	<p>A. Operational Inefficiencies</p> <p>1. SLTB's average vehicle utilization is below the optimal level and SLTB has a large idle, unusable vehicle stock of vehicles.</p> <p>2. The bus fleet suffers from lack of modernization, which has affected quality of service and led passengers to shift to private transport.</p> <p>3. Poor management practices in recruitment and allocation of human resources resulted in overstaffing.</p>	<p>1979—Liberalization of bus transport; entry of 5,000 private bus operators.</p> <p>1991—National Transport Commission established to regulate interprovincial private sector bus services while provincial authorities regulated intraprovincial private bus operations. The Commission is criticized as being ineffective.</p> <p>2002—Coherent bus fares introduced.</p>	<p>1. Create an independent regulator to shield the sector from political interference and improve the sector's efficiency.</p> <p>2. Implement organizational and management reforms to include unbundling SLTB operations; reducing its workforce; implementing an effective incentives scheme to address low productivity;</p>

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Case Study 4 continued

Background and Context	Current Challenges	Reforms Undertaken	Further Reform Options
<p>4. SLTB is the single largest transport provider. It operates on approximately 1,500 routes island-wide, with 5,285 buses operating daily, covering 1.2 million kilometers.</p> <p>5. SLTB has a social obligation to operate unprofitable routes.</p> <p>6. SLTB is largely self-regulated.</p>	<p>4. Operating costs consistently exceeded operating revenues, resulting in losses.</p> <p>B. Fiscal Burden</p> <ol style="list-style-type: none"> 1. Costs for fulfilling SLTB's universal service obligation drastically increased in 2014–2015. 2. Government is obligated to subsidize SLTB operations to provide transport services on uneconomical or unprofitable routes. 3. Government at times had to provide interim support (salary and welfare adjustments) due to the time lag associated with recovery of universal service obligation costs from the Treasury. <p>C. Distributional Impacts</p> <ol style="list-style-type: none"> 1. SLTB's large workforce is a result of political patronage. 2. Wage disputes, disproportionate wages among various job streams, and delayed wage payments have been sources of discontent. 3. An active labor union presence affiliated with major political parties at times increases tension in management–worker relations. 	<p>2004—Strategic Enterprise Management Agency established to oversee the (then) Sri Lanka Central Transport Board. The Agency played an advisory role and brought in sector expertise.</p> <p>2005—Sri Lanka Central Transport Board reconstituted as SLTB.</p>	<p>and setting a clear, long-term corporate vision to streamline management within the organization.</p> <ol style="list-style-type: none"> 3. Pursue private sector participation through liberalization and public–private partnerships. 4. Implement operational reforms such as (a) converting urban and intermodal corridors that are heavily used by buses into a bus rapid transit system; (b) modernizing the bus fleet, customer service systems, and terminal stops; and (c) franchising routes to enable route-based management services and demand-based dispatching.

Source: Authors.

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