

**Relevance of Development Assistance to the Economy and Its  
Impact after Sri Lanka's Elevation to  
Upper Middle Income Status**

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**Introduction**

Development assistance can be defined *inter alia* as foreign aid, foreign loans, and grants. The flow of development assistance is essential to most developing countries. Development assistance began shortly after World War II, with the primary goal of spurring the economic growth of countries. For example, five of the World Bank's first six loans were given to the Western European countries. At first, development assistance was largely confined to raising aggregate national income. But over the years, the concept of development assistance has changed. With rapid population growth, attention was directed to per capita income. Unequal income distribution paved the way for international financial institutions and Governments to respond to the prevailing challenges. In recent years, the goals of development assistance have come to embrace the elimination of poverty, inequality, illiteracy, poor health, poor infrastructure, education, and insecurity of income. Development assistance has helped most developing countries to improve their investment climate by building the factors that contribute to investment growth and empowering people through education, health, and social protection. These allowed them to progress towards closing the economic gap with rich countries.

As a middle income country, Sri Lanka received large portions of development assistance from the beginning. According to the World Bank, middle income countries are those with a Gross National Income (GNI) per capita between USD 1,036 and USD 12,615. The middle income category in turn divided into two sub categories; Lower Middle Income (\$1,036-\$4,085), Upper Middle Income (\$4,086-\$12,615). But different lending agencies have different mechanisms to indicate the income levels to define economic status of the countries. Development assistance is has played and continues to play a major role in the Sri Lankan economy in responding to obstacles prevailing in sectors such as infrastructure, education, health, and elimination of poverty. The Asian Development Bank, World Bank, Japan, China, UN agencies, Western and Middle Eastern countries are major donors in the form of loans and grants to Sri Lanka. As a result, Sri Lankan economy rebounded strongly in 2013 with an annual GDP growth of 7.3% and per capita

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income increased into US\$ 3280. Sri Lankan Government and policymakers believe that Sri Lanka will transit from the lower middle income country to an upper middle income country in 2016. They expected the economy to grow 7.8% in 2015 and gradually expand it into 8.5% in 2016.

Sri Lanka is already in lower middle income country category: having graduated from a poor country to a lower middle income country a few years ago. First Sri Lanka has to go a long way to consolidate its position as a lower middle income country and move to climb the ladder of upper middle income country and finally into a sustainable high income country. But it is not a very clear straightforward process without hassle. The main midway hassle is the 'middle income trap' and which makes it difficult for middle income countries move forward. Middle income trap is the inability of move up the value chain and generate a sizeable mass of companies with high productivity, producing high-value goods. Nobel Prize winning economist Michael Spence (2010) used to call it 'the middle income transition' rather than middle income trap. The policy makers are concerned about the possibility that Sri Lanka may be trapped in a lower middle income trap before elevation to upper middle income status.

### **Problem statement**

As a developing country, the relevance of development assistance to the economy of Sri Lanka is relatively critical. On the other hand, the impact of the transition of Sri Lanka from a lower income country to an upper middle income country on such assistance is the main obstacle faced by the Sri Lankan economy. Therefore, this paper will also take into consideration the challenges that Sri Lanka would face within the transition period as an upper middle income country with a lack of development assistance. The main objective of the paper is to examine whether Sri Lanka's transition to upper middle income status will be affected by development assistance.

### **Methodology**

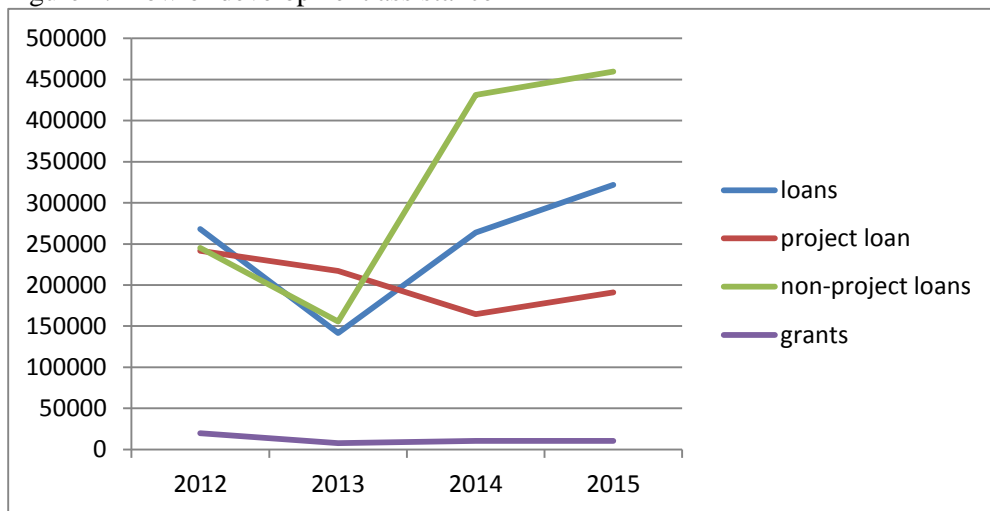
This paper is based mainly on secondary data in which the impact of development assistance on the Sri Lankan economy and future trends can be observed. Basically it uses data published in the annual reports of Central Bank of Sri Lanka, the reports of Foreign Ministry and Department of External Resources, Institute of Policy Studies (IPS) publications and the annual reports of the IBRD, IMF and ADB. As the paper is based on time series data, few variables like major donors, total amounts, trends, future possibilities, challenges are discussed. Simple and advanced statistical techniques are applied to identify the main objectives. Impact of and trends in the receipt of development assistance by the economy of Sri Lanka is

assessed by comparing the amounts of development assistance received in previous years, and comparing domestic economic standards with other lower middle income countries. The possibilities of receiving further development assistance after being elevated to an upper middle income country is assessed by the economic performance of upper middle income countries and their mechanisms to beat the middle income trap. For that purpose a case study has been conducted to examine the mechanisms that have been used by other countries to beat the middle income trap. The major variables are analysed using descriptive statistics and graphical presentations.

### **Results and Analysis**

According to the data collected by the study, the per capita income of Sri Lanka is increasing gradually. In 2013 the per capita income was only US\$ 3,610 and in 2014 it was US\$ 3,853. But in 2015 the per capita income further increased to US\$ 3,924 and most economists believe that in 2016 the per capita income will be over US\$ 4,000. When considering the growth of per capita income and the flow of development assistance, there has been a significant reduction in development assistance received. According to the Central Bank Report the growth of per capita income has clearly affected the flow of development assistance of Sri Lanka. Loans and non-project loan categories are regularly increasing while the project loans and grants are decreasing. Borrowing of loans and non-project loans under high interest rates may further increase interest payments due.

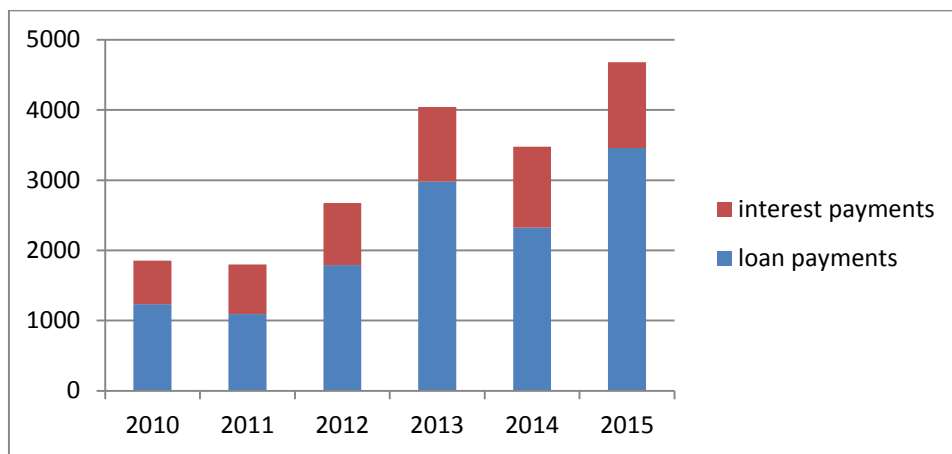
Figure 1: Flow of development assistance



*Source: central Bank reports*

Moreover, prevailing debts are high in number and the interest payments are also increasing gradually.

Figure 2: Loan and interest payments



Source: Central Bank reports

The increase in loan and interest payments due has clearly become a burden for the Sri Lankan economy. Therefore, there is a possibility that Sri Lanka will be trapped-in when transiting from a lower middle income country to upper middle income status. Apart from this main obstacle, the study identified several other challenges which Sri Lanka may face.

#### 1. Limited development assistance

Sri Lanka already faces limitations in receiving development assistance as a MIC. Some argue that foreign aid and grants should be provided to the poorest countries and question why development assistance should be given to MICs. But there are others who argue that aid to MICs is a legitimate need in order to meet the Millennium Development Goals and eradicate poverty.

#### 2. Reduction of concessional financing

As Sri Lanka elevates from a lower middle income country with increased demand for public investment the concessional financing the country has enjoyed over the past years is on the decline. This concessional financing was extended by development partners like ADB, IFAD, UNDP, OPEC fund, European Investment bank, Japan, Korea, France, Austria, Germany, Denmark, USA, and Middle East. India and China provided assistance in the form of outright grants, credits with longer maturities with a longer grace period and low interest, and mixed credit combining loans and grants. However, at present Sri Lanka has access to a limited range of concessional funding from IDA, ADB, UN agencies, selected bilateral

development partners and dedicated development funds. According to IPS discussions with several aid missions, the Deputy Head of Mission of a leading European aid donor has revealed that ‘since 2010, Sri Lanka no longer qualifies for bilateral development assistance due to lower middle income status of the country’.

### 3. Lacklustre flow of loans

The loan flow to Sri Lanka reflects a decline since 2012. Most development projects of the country are mainly financed through these loans. If this trend continues for the next two years, Sri Lanka would have to seek alternatives in order to fulfill the requirements to become an upper middle income country. On the other hand, the interest payment for loans is increasing annually.

Table 1:

year	Interest payments US\$ million
2009	357
2010	619
2011	707
2012	881
2013	1126

*Source: Central Bank report 2013*

### 4. Imperative taxation

Lately, Sri Lanka realised the benefit of increasing its volumes of borrowing from international debt capital markets. According to Lewis (1984), ‘an increasing share of tax revenue in national income or in GDP is an instrumental objective of economic development policy’. High income countries maintain rising shares of tax revenue and Government expenditure to income. As a developing country, Sri Lanka should spend more on public infrastructure, education, health and welfare. In order to improve the living standards of the people developing countries including Sri Lanka can increase their tax ratio. According to the benchmark tax GDP ratio, a middle income country can increase their tax ratio up to 25% and Sri Lanka has just 12.4%. Sri Lanka performs poorly in its collection of taxes generation just ¼ of revenue from direct taxes and rest from indirect taxes like VAT.

### 5. Reduction of investments in education and health

For several decades, Sri Lanka has continued to be the key provider of social services such as education and health. But these two sectors received the least investment sectors during the last few years. Investment in education is low and has declined over time up to 2.3% of public expenditure during 2000-2010. In 2012, the total expenditure in education was 1.9% of GDP, relatively low compared to other low income countries. Upper middle income countries spend an average of 5% of

GDP and lower middle income country spend 4% of GDP for the improvement of education. On the other hand, only 10% of schools in urban areas were capable of offering students facilities to study Advanced Level science subjects. Total expenditure on health remained below 5% of GDP during 1995-2008 and was comparatively lower than the global average. The requirements of the health sector were fulfilled by the private sector. Education and health sector produce the country's educated, skillful and healthy workforce.

### 6. Political and foreign policy structure

After the thirty-year war, the internal ethnic crisis, human right violations, murdering journalists, corruption, unequal distribution, and election structure have badly affected the image of the country in the international arena. The withdrawal of GSP+ concession and other economic concessions were a result of above mentioned factors. These directly affected the flow of development assistance to Sri Lanka. Dramatic changes in the politics and foreign policy of Sri Lanka directly influenced economic growth, investment, and financial receipts. If Sri Lanka can build a better image in the international arena, Sri Lanka will be able to secure the assistance required to fuel transition into an upper middle income country.

### Case study

Furthermore, according to the South Korean shift into upper middle income status, the development of five-year plans intended as guidelines to coordinate public and private efforts to improve the performance of the country may prove useful to Sri Lanka.

South Korea is a successful model and an exceptional case of swift transition to an advanced economy. In 1960, the per capita income of South Korea was only US\$ 2,000 and by 2008 it was around US\$ 28,000, elevating it to a developed country. South Korea's quick transition to an advanced country can be divided into 3 stages: The first stage began in 1962, with the establishment of five year plans. This stage was further strengthened by high levels of savings, and investments, and a determined industrial policy framework which inspired technological upgrades to align exports with South Korea's evolving comparative advantages. During that period, South Korean Government outlawed unions and created conditions for a labor market with cheap and abundant labor.

The second stage covered the financial crisis of 1997-1998, which slowed down economic progress and increased the unemployment rate. The economic indicators like balanced fiscal and current accounts, a low public debt (8% of GDP IN 1996), high domestic savings, investments (38% of GDP) and imbalances had accumulated in the domestic private financial markets. Short term private external debt to international reserves was high and there was continued overinvestment in

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manufacturing sectors that had excess capacity even before the crisis. On the other hand, unregulated financial liberalisation had induced overindebtedness on the part of the private sector. The South Korean financial crisis put banks and businesses in a crunch, and paved the way to a broader economic crisis.

The third stage of the South Korean economy was characterised by the recovery of the financial crisis. In 1999, South Korean GDP grew by 10.7%: the highest GDP growth in East Asia since 1988. Exports went up by close to 9 percent in 1999 and 18.2 percent in 2000. Unemployment dropped from 6.8 percent in 1998 to 4.5 percent by the end of 1999. The share of poor households fell from 23.2 percent in 1998 to 18.0 percent in 1999. Subsequently, the South Korean economy was able to sustain an annual growth rate of 5 percent from 1998 to 2008. Countercyclical monetary and fiscal policies, growth in export sector, high inflows of foreign direct investments recovered the South Korea's financial crisis. In addition, the country implemented economic reforms that included measures to restructure the business sector, banking, public sector, and labor market.

However, after a decade of rapid growth, South Korean economy was not immune to the current global recession. In 2008, exports were down 19.5% and they continued to drop until mid-2009. The economy grew by just 2.3 % in 2008. But it recovered in 2010 to a growth rate of 6.2%, similar to the one achieved before the crisis. This swift recovery of the South Korean economy was led by rapid growth in exports due to the depreciation of currency, strong demand in China, and an effective and aggressive monetary and fiscal policy response.

Period	Economic indicators		Macroeconomic indicators					
	GDP per capita income US\$	per US\$	GDP growth (%)	Fiscal balance (%)	Public debt (% GDP)	Current account (% GDP)	Inflation (%)	Exports (% GDP)
1962-1997	1962-1,704		8.0%	-1.0%	13.4%	-1.4%	14.10%	24.40%
	1997-18,239						%	
1998	16,867		-6.9%	0.9%	14.30%	11.30%	5.80%	44.30%
1999-2008	18,366		5.3%	2.3%	22.90%	1.80%	2.40%	39.50%
	26,875							
2009	26,850		0.2%	0.0%	32.60%	5.20%	3.40%	49.90%
2010	28,389		6.1%	1.4%	32.10%	2.60%	2.20%	54.80%
2010-2015	38,734		2013-3%	-1.5%	-33.8%	0.706%	5%	53.92%

*Source: IMF-World Bank Economic Outlook data*

## **Conclusion**

Sri Lanka's performance in many areas including education, health, skills development, infrastructure development, irrigation and poverty reduction has been exceptional in comparison with other countries in the region due to the flow of development assistance. But this flow of development assistance to Sri Lanka will be limited in the eve of elevation to upper middle income status. The decreasing trend in the flow of development assistance can be seen in the distribution of development partners. Most lending agencies and countries argue against giving development assistance to MICs rather than LDCs. On the other hand, Sri Lanka has gained a remarkable position in indicators for education and health compared to other South Asian countries, and the Government has implemented new initiatives to overcome this obstacle to achieving its goal of becoming an upper middle income country and avoiding the middle income trap by overcoming the lack of funds by way of development assistance.

## **Recommendations**

To overcome the challenges of elevating Sri Lanka to upper middle income status, and to seek alternative income flows due to reduction of development assistance, the following policy options can be implemented:

1. Maintenance of human and physical capital and reforming the education system
2. Expansion of public sector and government thrust for international trade
3. Economic reforms and attracting FDIs
4. Strengthening investments and concentrating on fiscal affairs under public finance management
5. Technological advancement, good governance and rule of law

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