# PROGRAM EXPENDITURE AND FINANCING ASSESSMENT

## A. Expenditure Framework

1. **Macroeconomic context.** Sri Lanka' s economic growth has fluctuated, registering gross domestic product (GDP) growth of 9.1% in 2012 and falling to below 5% since then. Both the World Bank and the Asian Development Bank (ADB) project that the economy will continue to grow at above 5% over the immediate term (2017–2019). Inflation has been steady at a little over 4% but is expected to increase to 6% in the coming years. Recognizing the importance of educated individuals with market-oriented skills to create rapid economic growth, the government aims to transform the education system into one that will provide the technological skills, educational content, and methods to promote the development of inquiring and adaptable minds in the medium term.[1] Recent government policy statements have indicated a renewed focus on increasing social sector spending, including a gradual increase in education spending from about 2% of GDP toward a 6% target by 2020.

2. **Focal ministry's budget.** The Ministry of Skills Development and Vocational Training (MSDVT) is the executing agency for the ADB-funded Skills Sector Enhancement Program. Eight semiautonomous institutions or agencies under MSDVT were identified as implementing agencies because of their responsibilities within the system such as quality assurance and training delivery. Despite the emphasis on skills development in the government's medium-term development plan, MSDVT expenditure was only about 4% of the education budget in 2015. The share of recurrent expenditures of MSDVT has declined from about two-thirds in 2013 to 50% in 2015, suggesting that the composition of MSDVT expenditures has moved toward greater focus on development expenditures, which is a positive sign.

3. Sri Lanka's Skills Sector Development Program (SSDP) for 2014–2020 is expected to help the government move toward medium-term planning and budgeting that is more tightly linked to outputs, targets, and outcomes for the skills development program. ADB supported SSDP implementation from 2014 to 2016, and helped strengthen the annual budget process and improve efficiency of spending and budget execution.

4. **Expenditure framework.** The SSDP serves as a medium-term development program. SSDP expenditures are estimated to be $874 million from January 2014 to December 2020, taking MSDVT's budget and the government budget of all relevant agencies under MSDVT as the expenditure framework (Table 1).[2] The program (2014–2016) accomplished $257 million (29%) of expenditure. This is less than program estimates because of the relatively weak implementation capacity of MSDVT in the beginning of implementation. The currently projected budget for 2017–2020 is $400 million, less than the program estimate of $617 million, but additional budget can be allocated as MSDVT capacity increases and additional ADB financing acts as incentive.

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[1] Government of Sri Lanka, Ministry of Finance and Mass Media. 2016. *Public Investment Programme 2017–2020 (Chapter 2: Knowledge and Skills for Excellence)*. Colombo.

[2] The budget executed by other ministries ($87 million) was included in the initial SSDP expenditure framework but then deducted as the coordination responsibility of other ministries is moved to the Prime Minister's Office.

**Table 1: Summary of Program Expenditure Framework**
(at current prices)

| Item | Current Program (2014–2016) Amount (SLRs million) | Amount ($ million) | Share of Total (%) | Overall Program (2014–2020) Amount (SLRs million) | Amount ($ million) | Share of Total (%) |
|---|---|---|---|---|---|---|
| 1. Recurrent budget | **18,709** | **144** | **56** | **47,505** | **365** | **42** |
| Personal cost | 4,679 | 36 | 14 | 11,880 | 91 | 10 |
| Operating expenditure | 1,214 | 9 | 4 | 3,083 | 24 | 3 |
| Transfer to institutions | 12,816 | 99 | 38 | 32,542 | 250 | 29 |
| 2. Capital budget | **14,720** | **113** | **44** | **66,143** | **509** | **58** |
| Equipment | 3,627 | 28 | 11 | 14,886 | 115 | 13 |
| Civil works | 8,118 | 62 | 24 | 26,822 | 206 | 24 |
| Knowledge enhancement [a] | 2,975 | 23 | 9 | 24,435 | 188 | 22 |
| 3. Total | **33,429** | **257** | **100** | **113,648** | **874** | **100** |

SLRs = Sri Lanka rupees.
[a] Delivery of skills training and professional development of instructors, managers, and staff.
Note: An exchange rate of $1 = SLRs130 was used for 2014–2020. Numbers may not sum precisely because of rounding.
Sources: Asian Development Bank and Government of Sri Lanka, Ministry of Finance and Mass Media estimates.

5. The recurrent budget of $365 million consists of salaries, allowances, operating expenditures, and transfers to semiautonomous institutions to meet recurrent requirements and subsidies for scholarships and stipends. The recurrent spending was $138 million for 2014–2016. From 2017 to 2020, the recurrent budget is assumed to increase by 2.5% annually. Among capital expenditures, equipment accounts for 13% and civil works for 24% of total expenditure, and about 22% is allocated to knowledge enhancement, which is for delivery of skills training and professional development of staff, managers, and teachers. From 2014 to 2016, spending on equipment and civil works was broadly on track, but knowledge enhancement contributed only 9% of expenditure. This reflects the low base in this kind of expenditures before the program. As the capacity strengthened, however, spending on knowledge enhancement increased by more than 15% from 2013, and will continue to grow in 2017–2020. It is important to note that the estimated recurrent budget is inadequate even to adjust for inflation, which is about 6% per annum. However, the shortage of recurrent budget can be met through recurrent parts of the capital budget, which are allocated to salaries, performance allowances for staff, fees for instructors, and stipends for students, but have been underutilized as of 2016.

6. An assessment of the SSDP expenditure framework in terms of effectiveness, efficiency and economy, and adequacy is presented below.

7. **Unit cost projection.** To judge whether the costs of the program are realistic, adequate, and efficient to meet the results of the program, per-student recurrent and capital costs were calculated by dividing the 2013 budget estimate for MSDVT's capital and recurrent expenditures by the total intake of publicly financed technical and vocational education and training (TVET) institutions. The unit cost was then projected for the SSDP period using a 6% annual inflation rate. This was then multiplied by the expected intake in future years, based on SSDP targets, to arrive at a rough total recurrent and capital allocation that MSDVT would need to receive if the same per-student cost adjusted for inflation were maintained. The findings in Table 2 reveal that the overall SSDP estimate of $874 million is lower than the one projected from a simple unit cost model ($985 million). This indicates that the SSDP would increase the efficiency of the TVET system.

**Table 2: Program Cost Projection Based on Unit Cost Estimates (2014–2020)**
(At current prices)

| Item | Amount (SLRs million) | Amount ($ million) |
|---|---|---|
| **Per-student unit-cost-based projection** | **128,050** | **985** |
| Recurrent | 55,380 | 426 |
| Capital | 72,670 | 559 |
| **Skills Sector Development Program estimate** | **113,647** | **874** |
| Recurrent | 47,505 | 365 |
| Capital | 66,143 | 509 |

SLRs = Sri Lanka rupees.
Note: The recurrent unit cost per student for 2013 is estimated at $260 (SLRs33,855) and the corresponding capital unit cost at $341 (SLRs44,379).
Source: Asian Development Bank estimates.

8. **Effectiveness.** The key issues in MSDVT budget allocation and expenditure before the program were: (i) inadequate budget for MSDVT programs (inadequate allocation for the recurrent budget and the budget for maintenance of facilities and equipment); (ii) focus on input- and activity-based budgeting with little consideration of results; (iii) emphasis on delivery of training through public agencies and insufficient public funds allocated to the private sector; and (iv) limited allocation to introduce or revise existing training programs to meet the changing labor market demand. The SSDP expenditure framework is based on a costing exercise focusing on results and outcomes. Progress was made in 2014–2016 under the SSDP framework: for one, budget allocation increased and provided adequate financing for recurrent expenditure. Capital spending increased by nearly 50% annually during 2014–2016, although it is still lower than estimated because it started from a low base. Second, result-based budgeting was implemented, including performance-related allowances and an increase in cadre positions. Third, the private sector is directly engaged in the training activities, through on-the-job training and employment-linked training programs, and MSDVT piloted public–private partnership programs. Fourth, MSDVT allocated more budget to develop new programs and revise existing programs as per private sector demand.

9. For 2017–2020, the SSDP expenditure framework will address remaining issues as described below:

(i) The SSDP activities are categorized and costed in detail by results, and the government continues to allocate funds for MSDVT based on the SSDP expenditure framework.
(ii) The government increases the budget allocation for 2017–2020 and ensure the budget is consistent with the SSDP expenditure framework.
(iii) More than one-fifth of capital expenditures are allocated to knowledge enhancement. This is important to ensure availability of resources given MSDVT's underestimated recurrent budget.
(iv) The SSDP makes budget provisions for supporting private training providers based on performance.
(v) The government has already taken some steps toward better planning, cost estimations, and budget allocation in the performance based financing pilot to introduce the bottom-up business planning process in the selected public institutions that MSDVT finances. MSDVT will improve the mechanism and expand it to more training institutions.

10. It should be noted that the SSDP reflects large increases in capital expenditure for constructing and/or rehabilitating buildings, which account for more than 24% of the total SSDP

estimate for the 7-year period. This can be justified for the initial years because most physical facilities and equipment have not been updated and maintained for quality training because of underfinancing in the past. Also, high infrastructure spending is expected to enable medium-level skills training expansion. However, the disproportionate emphasis on construction raises concerns about the effectiveness of the expenditure framework and the planned activities to achieve the program's development outcome of creating a market-responsive, inclusive, and quality TVET system. It is clear that more importance and a greater proportion of expenditure needs to be allocated in the future to the "soft" inputs of teacher training, workshops, and consulting services to ensure that the planned activities effectively deliver program outputs and meet program objectives.

11. **Efficiency and economy.** The budget process for MSDVT has been quite arbitrary, with allocations usually being incremental, i.e., based on the previous year's spending and not on targets or needs for the sector. As the World Bank skills development report comments, "budget allocations are (…) related neither to performance nor to national priorities (…). Budget estimates are based on the traditional 'negotiated' approach. Even allocation of recurrent expenditures is not strictly based on inputs, such as number of students."[3] In addition to the weaknesses in the budget preparation and execution process, the following shortcomings are likely to affect timely and cost-effective achievement of SSDP results:

(i) **Large-scale vacancies in public institutions.** A key problem in filling vacant positions is the lack of budget because the government recurrent budget does not include the salaries and allowances for vacant positions. The SSDP manages this issue by providing recurrent funds for incentives to instructors under the capital budget. This arrangement may not be efficient unless there is a good management information system, and is difficult to sustain in the long run.

(ii) **Effective program implementation by MSDVT institutions.** The achievement of results depends largely on the performance of MSDVT institutions. Most of them (except the Department of Technical Education and Training) are semiautonomous institutions and receive most of the recurrent funds and some capital funds through transfers. One of the key observations in the World Bank skills development report was that, "aligning budget allocations with the performance of training agencies and centers could promote innovation, efficiency, and accountability."

(iii) **Involvement of the private sector, especially in job placement.** Lack of full mobilization of the private sector has constrained the skills training program in several ways, not least through the limited employability of graduates because of weak job placement arrangements. The SSDP includes various measures such as cost sharing between the private and public sectors by improving system efficiency; and involvement of industry working groups and compulsory provision of on-the-job training to engage the private sector and increase public–private partnerships in skills development in Sri Lanka.

12. **Adequacy.** The SSDP expenditure framework is adequate to achieve intended results, provided it is reflected in MSDVT's annual budgeting and execution. Under the SSDP expenditure framework, MSDVT is required to request budget allocations from the Ministry of Finance and Mass Media (MOF&MM) based on an agreed annual implementation plan with fully costed interventions to achieve results. The plan projections will include both capital and recurrent expenditures and reflect detailed costing of activities for each component of the program. From 2014 to 2016, recurrent budget expenditure was in line with the expenditure

[3] World Bank. 2013. *Sri Lanka: Building the Skills for Economic Growth and Competitiveness*. Washington, DC.

framework, while the capital budget allocation was lower than the estimate. Subsequent budget allocations for 2017 onward will be determined based on a performance partnership agreement between MOF&MM and MSDVT confirming the performance targets.

## B. Financing Plan

13. **Sources of financing**. The government will provide $547 million (63%) and development partners will contribute $327 million (37%). ADB will provide $96 million in the beginning and $103 million through additional financing to meet the funding gap. The remaining $128 million will be mobilized from other partners such as the World Bank, which will contribute $102 million during the first 5 years of the program (Table 3). Government financing for 2014–2016 was $75 million. It is assumed that the government contribution will increase gradually. The main challenge is to get the development partners to meet the government share in case the government fails to mobilize committed funds. The government has initiated discussions with other development partners, such as Korea International Cooperation Agency (KOICA), Australia, and Canada to fill SSDP financing gaps.

**Table 3: Program Financing Plan**

| | **Current Program (2014–2016)**[a] | | **Additional Financing (2017–2020)** | | **Overall Program (2014–2020)** | |
|---|---|---|---|---|---|---|
| **Source** | **Amount** ($ million) | **Share of Total** (%) | **Amount** ($ million) | **Share of Total** (%) | **Amount** ($ million) | **Share of Total** (%) |
| Government | 74.9 | 29.2 | 472.5 | 76.6 | 547.4 | 62.6 |
| Development partners | | | | | | |
| Asian Development Bank | | | | | | |
| OCR (regular loan) | 50.0 | 19.4 | 40.0 | 6.5 | 90.0 | 10.3 |
| OCR (concessional loan) | 46.1[b] | 17.9 | 60.0 | 9.7 | 106.1 | 12.1 |
| JFPR (grant) | 0.0 | 0.0 | 3.0 | 0.5 | 3.0 | 0.3 |
| World Bank (loan)[c] | 60.0 | 23.3 | 41.5 | 6.7 | 101.5 | 11.6 |
| Export-Import Bank of Korea (loan) | 26.0 | 10.1 | TBD | TBD | 26.0 | 3.0 |
| **Total** | **257.0** | **100.0** | **617.0** | **100.0** | **874.0** | **100.0** |

JFPR = Japan Fund for Poverty Reduction, OCR = ordinary capital resources, TBD = to be determined.

Note: Percentages may not total 100% because of rounding.

[a] ADB and World Bank loan amounts are committed under the current program. But as of December 2017, ADB disbursed $87.0 million and the World Bank disbursed $41.2 million against actual expenditure of $257 million during 2014–2016.

[b] United States dollar equivalent of SDR32,600,000.

[c] The World Bank approved in 2014 parallel financing of $101.5 for 2014–2018.

Sources: Asian Development Bank and Government of Sri Lanka, Ministry of Finance and Mass Media estimates.

14. **Fiscal affordability and sustainability.** To analyze the SSDP's fiscal affordability, the government resource envelope for MSDVT, which provides the fiscal space of the government for the skills development program, is estimated on the basis of (i) GDP growth in current prices of 11% per annum (6% inflation and 5% real economic growth), (ii) allocations of 2% of GDP for government expenditure in education during 2014–2019 and 4% in 2020,[4] and (iii) allocation of 5% of government education expenditure for MSDVT. The estimated resource envelope indicates that it is able to fully cover the SSDP program expenditure during 2014–2020 if the economy grows at the annual rate of 11% at current prices. The SSDP expenditure framework is affordable because (i) a disbursement-linked indicator on sector finance motivates MOF&MM to increase sector budget allocations in line with the expenditure framework and (ii) the government is likely to allocate a higher budget share to MSDVT given its commitment to

[4] This is a conservative assumption in view of the government's plan to raise education spending from around 2% of GDP currently toward the 6% target by 2020.

reducing youth unemployment through investment in skills development. However, in the case of lower economic growth, the government may find it difficult to allocate the required resources for the SSDP. Long-term sustainability considerations are built into the SSDP design by (i) using country systems for budgeting, accounting, reporting, and auditing; (ii) strengthening institutions involved in skills development; (iii) leveraging development partner financing to increase government spending in skills development over time; and (iv) introducing new mechanisms to improve system efficiency (performance-based financing and performance-based allowance scheme) and private sector participation (public–private partnerships in university colleges and an employment offer agreement model, including a cost-sharing formula).

## C. Managing Risks and Improving Capacity

15. Table 4 summarizes key risks associated with the expenditure framework. The mitigating measures are reflected in the disbursement-linked indicators and the program action plan.

**Table 4: Expenditure and Financing Risks, and Mitigating Measures**

| Risks | Rating without the Mitigating Measures | Key Mitigating Measures |
|---|---|---|
| **Effectiveness of expenditure framework.** Achievement of the outcome goal may be constrained because of (i) inadequate recurrent and capital budget allocation as per the SSDP expenditure framework, and (ii) continuation of input- and activity-based costing. | High | – Communication between MSDVT and MOF&MM on project implementation and funding needs will be strengthened. Medium-term planning and budgeting frameworks are prepared annually for the skills sector, thereby establishing a results chain of inputs, process, outputs, and outcome.<br>– A performance partnership framework will be concluded and updated annually between (i) MOF&MM and MSDVT, and (ii) MSDVT and TVET agencies to increase results-oriented planning and budgeting. |
| **Efficiency and economy.** Suboptimal use of funds, unlike envisaged in the SSDP framework, by each of the semiautonomous agencies under MSDVT and suboptimal use of enhanced physical facilities and training equipment because of inadequate recurrent budget to fill vacant positions in the implementing agencies | Substantial | – SSDD within MSDVT will harmonize the activities of different agencies.<br>– Recurrent budget is included in the capital budget.<br>– Preparation of realistic annual budget based on an agreed AIP. |
| **Adequacy.** Given the underfunding of the sector in the past and inability to increase sector funding drastically, the estimated budget for achieving results may be inadequate, especially the capital budget given capacity constraints of MSDVT | Substantial | – SSDP estimates will be part of a rolling plan and actual budgeting will be done based on the AIP, and this arrangement ensures that adequate funds are released for achieving the results. |
| **Sustainability**. The government may not be able to maintain the level of sector financing after 7 years because the skills sector is not among the priority sectors of the government. | Medium | – The government is required to include the skills sector among the priority sectors during the SSDP period.<br>– The government should assess and expand the private cost sharing over time. |

AIP = annual implementation plan, MOF&MM = Ministry of Finance and Mass Media, MSDVT = Ministry of Skills Development and Vocational Training, SSDD = Skills Sector Development Division, SSDP = Skills Sector Development Program, TVET = technical and vocational education and training.
Source: Asian Development Bank.