South Asia Economic and Policy Studies

Dushni Weerakoon
Sisira Jayasuriya *Editors*

Managing Domestic and International Challenges and Opportunities in Post-conflict Development

Lessons from Sri Lanka

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Editors

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Dr. Saman Kelegama
(6 April 1959–23 June 2017)

This volume is dedicated to the memory of Dr. Saman Kelegama, a distinguished Sri Lankan economist and one of the most eminent scholars of South Asia who passed away suddenly in June 2017.

Preface

This volume is dedicated to Dr. Saman Kelegama. Dr. Kelegama was a prolific and versatile scholar, publishing and editing many books and over 100 articles in refereed journals on a wide range of development issues, covering national and regional trade policy, regional economic integration and free-trade agreements, macroeconomics, governance, industry policy and public enterprise reforms. But above all, he was an engaged and committed public intellectual whose research was motivated by the search for solutions to major economic policy issues, including the economic costs of conflicts and war, and the challenges of post-conflict recovery and reconstruction. He joined the newly established Institute of Policy Studies of Sri Lanka (IPS) in 1990 after completing his doctorate at Oxford University and became its Executive Director in 1995, a position he held right up to his passing away. With visionary leadership and total commitment, he built up the IPS to be globally recognized as the leading independent policy research institute of Sri Lanka. He served as the President of the Sri Lanka Economic Association, was a Director of academic and corporate entities such as Postgraduate Institute of Management in Colombo, and Chairman of Singer Sri Lanka, and provided non-partisan, independent policy advice to successive Sri Lankan governments. At the time of his untimely demise, he was serving as the lead negotiator on Sri Lanka's free-trade agreements with India, China and Singapore. He was a patriot who understood that in an era of globalization, Sri Lanka's path to development and prosperity was linked to developments in the regional and global economy. In particular, he was passionately committed to the cause of South Asian economic integration and built lasting collaborative partnerships and networks with scholars and institutions in South Asia. We hope that his legacy of intellectual integrity, commitment to rigorous and high-quality policy-relevant research, and dedication to the cause of social and economic development will serve as an inspiration to a new generation of Sri Lankan and South Asian economists.

Colombo, Sri Lanka — Dushni Weerakoon
VIC, Australia — Sisira Jayasuriya

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Editors and Contributors

About the Editors

Dushni Weerakoon is the Executive Director of the Institute of Policy Studies of Sri Lanka (IPS). Her research and publications chiefly focus on regional trade integration, macroeconomic policy, and international economics. She has extensive experience in economic policy formulation, serving as a member of the Macro and Trade Policy Steering Committee of the Ministry of Policy Development and Implementation (2002–2004), an official delegate to the Committee of Experts to negotiate the South Asian Free Trade Agreement under the Ministry of Trade and Commerce (2004–2005) and member of the Trade and Tariff Committee of the National Council for Economic Development (NCED) of the Ministry of Finance (2004–2010), amongst others. She holds a B.Sc. in Economics from the Queen's University of Belfast, UK, and an MA and Ph.D. in Economics from the University of Manchester, UK.

Sisira Jayasuriya is a Professor of Economics at the Monash University, Australia. He is a development economist with a focus on economic policy issues in Asia. He has held previous appointments at the International Rice Research Institute (Philippines), the Australian National University, Melbourne University and La Trobe University, and has been a consultant to the Asian Development Bank, International Food Policy Research Institute, World Bank and several United Nations agencies such as ESCAP, FAO and ILO. He is also an Honorary Professor at the Arndt-Corden Department of Economics at the Australian National University, Canberra, and the Institute of Social and Economic Studies, Osaka University, Japan, as well as a Non-Resident Senior Fellow, National Council of Applied Economic Research, New Delhi. Prof. Jayasuriya holds a BA (Hons in Economics) from the University of Ceylon (Peradeniya), and a Masters and Ph.D. from the Australian National University.

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Acronyms

ADB	Asian Development Bank
BOC	Bank of Ceylon
BOP	Balance of Payment
BRI	Belt and Road Initiative
C&C	Command-and-Control Policies
CBSL	Central Bank of Sri Lanka
CEA	Central Environmental Authority
CGE	Computable General Equilibrium
CRI	Climate Risk Index
CSE	Colombo Stock Exchange
DCS	Department of Census and Statistics
DDR	Disarm, Demobilize and Reintegrate
ECRI	Economic Cycle Research Institute
EFF	Extended Fund Facility
EIA	Environmental Impact Assessment
ERD	Department of External Resources of Sri Lanka
ES	Ecosystem Services
ESOP	Employee Share Ownership Plan
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FTA	Free-Trade Agreement
FTC	Fair Trading Commission
GDP	Gross Domestic Product
GPN	Global Production Network
GSP+	Generalized System of Preferences Plus
HDI	Human Development Index
IAP	Indoor Air Pollution
IDPs	Internally Displaced Persons
IFRPI	International Food Policy Research Institute
IMF	International Monetary Fund

IPR	Intellectual Property Right
ISB	International Sovereign Bond
ITC	International Trade Centre
IUCN	International Union for Conservation of Nature
IWMI	International Water Management Institute
JAAF	Joint Apparel Association Forum
JICA	Japan International Cooperation Agency
LFPR	Labour Force Participation Rate
LMS	Lanka Marine Services
LNG	Liquefied Natural Gas
MBI	Market-Based Instruments
MFA	Multi-Fibre Agreement
MFI	Multilateral Financial Institution
MFN	Most-Favoured Nation
MMWD	Ministry of Megapolis and Western Development
MNC	Multinational Corporation
MODSIT	Ministry of Development Strategies and International Trade
MOF	Ministry of Finance
MTDCRA	Ministry of Tourism Development and Christian Religious Affairs
NAP-CC	National Adaptation Plan for Impacts of Climate Change in Sri Lanka
NARESA	Natural Resources, Energy and Science Authority of Sri Lanka
NBER	National Bureau of Economic Research
NBRO	National Building Research Organization
NEA	National Environment Act
NPSSD	National Policy and Strategy for Sustainable Development
NTM	Non-Tariff Measure
OAP	Outdoor Air Pollution
PB	People's Bank
PCA	Paris Climate Accord
PCEB	Public Commercial Enterprise Board
PERC	Public Enterprise Reform Commission
PIPU	Public Interest Programme Unit
PPP	Public–Private Partnership
PSO	Public Service Obligation
PUCSL	Public Utilities Commission of Sri Lanka
RBI	Reserve Bank of India
RCEP	Regional Comprehensive Economic Partnership
ROAs	Return on Assets
SBA	Standby Arrangement
SDGs	Sustainable Development Goals
SITC	Standard International Trade Classification
SLA	Sri Lankan Airlines
SLEDB	Sri Lanka Export Development Board
SLIC	Sri Lanka Insurance Corporation
SLP	Sri Lanka Ports Authority

SLSFTA	Sri Lanka–Singapore Free-Trade Agreement
SLT	Sri Lanka Telecom
SLTDA	Sri Lanka Tourism Development Authority
SOBE	State-Owned Business Enterprise
SOE	State-Owned Enterprise
TDS	Tourism Development Strategy
TPP	Trans-Pacific Partnership
TRC	Telecommunications Regulatory Commission
TSP	Tourism Strategic Plan
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNHRC	United Nations Human Rights Council
UNWTO	World Tourism Organization
USAID	United States Agency for International Development
WHO	World Health Organization
WRMDP	Western Region Megapolis Development Plan
WTTC	World Travel and Tourism Council

Introduction: Challenges and Opportunities of Sri Lanka's Post-conflict Economic Development Overview

Sisira Jayasuriya and Dushni Weerakoon

In May 2009, Sri Lanka's nearly three-decade-long separatist war ended when government forces crushed the separatist insurgency and annihilated its leadership. A war weary population hoped and expected that this would usher in a period of peace and national reconciliation, political stability and sustained economic growth. But a decade after the end of the war, those hopes and expectations have faded as the country once again faces the reality of political instability, a struggling economy, and sharpening ethnic, religious and social tensions.

Why did Sri Lanka fail to achieve the goals of reconciliation, stability and economic prosperity? What are the wider lessons of Sri Lanka's post-conflict experience for communities and countries grappling with similar challenges of achieving successful and sustainable post-conflict recovery and reconciliation? The contributors to this volume address these questions by reviewing the dynamics of Sri Lanka's post-conflict experience, analysing the reasons for the failure to establish a foundation for stability and sustainable growth and drawing the wider lessons of this experience. They also highlight the need to urgently address a set of daunting policy challenges if the country is to cope with emerging issues of severe economic vulnerability and political instability.

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1 Post-war Economic Recovery: A Temporary Boom

The challenges that face any country emerging from a protracted conflict are difficult and complex. As Sri Lanka entered the post-conflict era, it faced major economic as well as political challenges both in the national and international arena.

Successful and sustainable post-conflict recovery and growth required a combination of economic and political measures (a) to lay the basis for national reconciliation by sensitively addressing the root causes of minority grievances, in particular ethnic and regional inequalities and perceptions of discrimination; (b) to provide a quick peace dividend to the population as a whole through employment and income growth and reductions in poverty and income inequality, and (c) to set in place a sound medium-term macroeconomic framework for growth with stability to underpin a strategy for long-term economic development.

These were daunting challenges that were made all the more difficult by international economic and political developments. In 2009, the global economy was struggling to recover from the deepest recession since the 1930s following the Global Financial Crisis of 2007–2008. A severe and possibly quite prolonged downturn in Sri Lanka's main export markets was looming. The major Western governments and donor agencies, the traditional sources of capital and assistance, were facing unprecedented economic problems of their own. At the height of the separatist war during 2006–2009, the Sri Lankan Government increasingly looked to countries such as China and Russia for assistance to obtain military hardware whilst attempting to appease calls for a 'negotiated settlement' to the conflict from elsewhere such as India, USA and Europe. Politically, given its strategic geographic location, Sri Lanka could not avoid being caught up in the so-called Great Game going on in the Indian Ocean region involving China, India and the USA.[1]

Successfully dealing with these challenges required a leadership with a vision and strategy for long-term development, able and willing to implement fundamental transformations in policy, institutions and governance.

In the immediate aftermath of the end of the war, the government led by President Mahinda Rajapakse that had successfully defeated the separatist forces enjoyed huge popular support, at least among the Sinhalese majority.[2] President Rajapakse was acclaimed as a national hero, as the leader who liberated the country from the scourge of separatist terrorism. He promised the electorate that he would deliver peace and economic prosperity, and took immediate steps to capitalize on the military victory by calling for fresh presidential and parliamentary elections in 2010, decisively winning both electoral tests. Soon after the parliamentary election victory, he used a two-thirds majority in the parliament to amend the constitution

[1]The strategic moves by the various powers in Asia are now widely described as the 'New Great Game' in Asia involving China, USA and India drawing parallels with the 'Great Game' of the nineteenth century between the British and Russian Empires targeted on countries such as Afghanistan seen as the doorway to India.

[2]The rest of this section draws on Athukorala and Jayasuriya (2015).

and vastly extended the executive powers of the presidency. By 2012, the President and a small group around him had almost total control over the financial, security and judicial powers of the state.

The massive popular mandate given to the government reflected the expectations of an electorate that looked forward to enjoying the benefits of peace. The President and the new government were seemingly in a position to address the high-priority post-conflict challenges: achieve national reconciliation by addressing the deep-rooted grievances of the Tamil community that had led to the separatist war and establish the foundations for sustainable and equitable economic growth.

In the economic sphere, the immediate post-conflict economic performance appeared to support optimistic expectations of recovery and growth. Despite the unfavourable global economic environment, gross domestic product (GDP) growth accelerated impressively from 3.5% in 2009 (6% on average during 2006–2009) to an average annual rate of over 8.0% in 2010–2012 (Table 1).

Per capita income increased from USD 1,062 in 2004 to USD 3,191 in 2013. Inflation came down from a historical high of 22.6% in 2008 to an average annual rate of 6% during the following five years. Unemployment fell from 8.3% in 2004 to 4.4% in 2013. Between 2006 and 2012, the poverty head count ratio declined from 15.2 to 6.7%, accompanied by a reduction in the poverty gap from 3.1 to 1.7%. Rapid growth was accompanied by an improvement in income distribution according to figures from the Central Bank as the Gini coefficient declined from 0.40 to 0.36 between these two years (CBSL 2013).[3] The government attributed these successes to its new development strategy ('Mahinda Chinthanaya'—Mahinda Vision); this strategy seemed to have delivered an economic miracle by revitalizing the economy without any unpopular policy reforms or expenditure cuts.

But the government appeared not much interested in achieving national reconciliation through political interventions. Not surprisingly, the overriding message appeared to be one of triumphalism for a war victory that successive governments before had abandoned pursuing to the end. Indeed, some leading government figures were emboldened to openly proclaim that Sri Lanka was the land of the Sinhala Buddhists, where minorities had to accept the supremacy of the majority. Calls for greater regional autonomy were rejected as undermining the unitary state of the country, whilst the Jaffna Peninsula with a majority of Tamils continued to feel the heavy presence of the armed forces where the population remained under tight military vigilance. Extremist violence did not end with the military victory in 2009. Extreme forms of Sinhala Buddhist organizations emerged and appeared to have been given free rein to engage in campaigns that targeted not only the Tamils but also the other major ethnic and religious minorities, the Christians and Muslims. The unprecedented concentration of political power had a more serious downside as well; a slide towards undemocratic steps, embodied by the lifting of presidential term limits through a constitutional amendment.

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[3]These official statistics need to be treated with some caution (see Athukorala and Jayasuriya 2015).

Table 1 Selected economic indicators, 2006–2017

Annual average	2006–2009	2010–2012	2013–2014	2015–2017
GDP growth, % change	6.0	8.5	4.2	4.2
Per capital GDP, USD million	1	3.073	3.713	3.921
Unemployment, %		4.4	4.4	4.4
Inflation, % change	13.0	6.8	5.1	4.3
Fiscal balance, % of GDP	−7.7	−6.2	−5.6	−6.2
Total public debt, % of GDP	85.1	70.5	71.1	78.0
Total external debt, % of GDP	41.8	47.4	53.9	57.3
Debt service ratio, %	16.6	16.5	24.3	26.0
Current account balance, % of GDP	−4.9	−4.9	−3.0	−2.3
Exports, % of GDP	21.2	15.2	14.0	12.9
FDI, % of GDP	1.5	1.1	1.2	1.2

Source Based on CBSL (various years)

But the government retained its support base in the Sinhala Buddhist majority largely because of its initial successes on the economic front. Its new development strategy had strong nationalist overtones and signalled a significant break from the outward and market-oriented policy stance that successive governments had supported for over three decades. There was a renewed emphasis on import substitution in both manufacturing and agriculture. New export taxes were introduced on raw and semi-processed tea and rubber exports to promote more domestic processing. A range of duties that impacted on international trade raised both the level and interindustry variations in protection rates. Foreign investment approval procedures became more interventionist and opaque. Privatization of state enterprises was ended, and a number of new state-owned enterprises were set up. In 2011, the government enacted an act giving it the power to acquire and manage 37 'underperforming' or 'underutilized' private enterprises.

The government implemented a large-scale infrastructure development programme and some current consumption-oriented spending initiatives. An infrastructure programme certainly had a strong economic rationale: after three decades of a destructive war, rebuilding of infrastructure had to be a core component of any recovery and rebuilding effort. The other spending initiatives also had appeal to a population that had gone through years of economic restraints and difficulties. These involved a large fiscal stimulus that became the main driver of economic growth.

These were policies that appealed to the resurgent nationalism of the immediate post-war years and reflected the ideological leanings of many in the government leadership who had never fully trusted or had faith in the viability of the strategy of policy liberalization and opening up to globalization. The global economic crisis had strengthened the hand of proponents of a nationalist and state-interventionist development strategy. Not coincidentally, as has been observed so often in developing countries, this kind of economic ideology was ideally suited to the needs of the regime that sought a developmental rationale for expanding centralized state power (Whitehead 1990).

But these initial economic successes were deceptive. On closer examination, the indicators of economic performance were not nearly as robust as seemed at first glance. The economic boom itself was built on shaky foundations.

The improvement in real national income was significant but the headline grabbing claim of a 'threefold increase in per capita income in current USD terms between 2004 and 2013' was an exaggeration. If the data were expressed in real 2005 prices, the real per capita income growth of 2013 was only 62% higher than in 2004. The nature of growth was heavily biased towards non-tradeables, with 70% of GDP growth in non-tradeable sectors (construction, transport, utilities, trade and other services), reflecting the dominant role of infrastructure development and construction projects. Manufacturing growth was in primarily home-market-oriented (rather than export-oriented) sectors and quite sluggish; its share in GDP declined from 18.5% during 2000–2004 to 16.5% during 2005–2013. Unemployment did decline, but this was largely due to increased public sector employment (10.4% in 2004 to 14% in 2012) and emigration of workers (mostly) to the Middle Eastern countries; overseas employment reached 23% of the total labour force in 2011 (Arunatilake et al. 2011). In the major conflict zones of Eastern and Northern provinces, poverty remained high despite several large infrastructure projects (Sarvanathan 2015). With regard to inequality, there was a wide discrepancy between figures reported by the CBSL and by the Department of Census and Statistics (DCS) for 2012.[4]

FDI inflows did increase somewhat, but went primarily into construction and services sectors. Manufacturing attracted only just over 30% of FDI during 2010–2013. Whilst some FDI went to the recovering tourism sector, the closing down of a large number of export-oriented foreign firms was a signal that the country's international competitiveness was eroding. This was reflected in an appreciation of the real exchange rate and a consequent contraction of export growth. Exports of goods and services as a share of GDP fell sharply from an average level of 25.6% during 2004–2009 to 16.8% during 2010–2013. In principle, such an appreciation of the real exchange rate with its immediate negative impact on international competitiveness is not unexpected during a large-scale investment programme, and not necessarily a serious problem. But the real exchange appreciation was higher than it would otherwise have been because the Central Bank was committed to a stable nominal exchange rate. This helped moderate inflation, but aggravated the negative effects on net exports and widened the current account deficit, thereby requiring additional foreign funds to finance the deficit.[5]

In the immediate post-conflict period, Sri Lanka found that it was easily able to access foreign funding thanks to two global developments that had transformed the global financing landscape. Firstly, the adoption of unconventional monetary policy in advanced economies as a response to the global financial crisis resulted in an

[4]The Department of Census and Statistics reported a Gini as high as 0.48 in contrast to the Central Bank figure of 0.36 (DCS 2015).

[5]This also helped distort a range of conventional measures of economic performance and stability. For example, it boosted national income measured in US dollars and lowered the ratio of external debt to GDP.

unprecedented lowering of interest rates, attracting investors to the relatively higher yields available in emerging economies. Secondly, China emerged as a major source of development finance, and Sri Lanka's strategic position at the tip of South Asia made it a particularly attractive destination for Chinese funding that included both direct investments as well as commercial debt. Both sources provided 'easy' money with few questions asked and no conditions attached.

Despite significant Chinese development loans, the primary source of financing turned out to be commercial debt, whilst an attractive proposition in the short term, a foreign debt-driven spending programme, must meet several conditions to be viable in the longer term.

First, the debt must be used for efficient and productive investments. Second, long-term investments must be financed by long-term debt; otherwise, debt repayments will fall due before returns from the investment are available.

The economic viability of several large Chinese-financed projects, such as an international airport in the south of the country, was certainly questionable. But the majority of borrowings from China were long term, on terms that were somewhat higher than from traditional concessional sources, though not excessively so. But above and beyond these purely economic concerns, Chinese funding became a source of political controversy. Sri Lanka came under increasing pressure from India and the Western powers who were concerned that Chinese financing was tilting Sri Lanka towards closer integration with China's wider military-strategic initiatives.

The core issue of concern about external financing was that a large and increasing proportion came in the form of relatively short-term, non-concessional commercial borrowings. This was a major new development for Sri Lanka, as it had historically relied on concessional finance from traditional sources (multilateral finance institutions (MFIs), Japan and Western countries). From just 7% of total outstanding external debt in 2006, such non-concessional loans rose to 50% by 2012.

The chapters in this volume show Sri Lanka's immediate post-war growth recovery did not reflect a strong underlying dynamism. Constraints to sustainable economic growth remained deeply entrenched. The dismal level of economy-wide productivity growth, poor state enterprise performance, weak environmental management and the deterioration of its external sector performance all attested to fundamental policy and institutional failures. The (unofficial) policy of a pegged exchange rate masked the underlying problems of debt accumulation by lowering the ratio of measured external debt to GDP. But the overvalued exchange rate eroded international competitiveness: exports fell from over 21% of GDP in 2006–2009 to only 14% in 2013–2014. Easy access to foreign funds masked these structural problems and policy failures, but only temporarily. High levels of domestic consumption and growth could be maintained only with ongoing injections of foreign borrowings. Increasingly concerns began to emerge about the longer-term viability of this debt-driven strategy.

In the political sphere, serious concerns developed about erosion of democratic rights and rule of law, freedom for press and media rights, corruption and aggravation of religious and ethnic tensions. The Muslim community became a particular target; in June 2014, anti-Muslim mob violence erupted, leading to several deaths, damages to homes, businesses, mosques and the displacement of thousands of people. Though the government officially dissociated itself from the anti-Muslim campaign, allegations of links between senior government leaders and the perpetrators abounded. The government's response to the violence was to deepen unease not only among Muslims but also among other religious and ethnic minorities.

These concerns could be ignored when the economy was experiencing strong growth with many highly visible large infrastructure projects reinforcing the picture of a vibrant dynamic economy. But the growth spurt had started to lose momentum by 2013 and growth started to slow down. Serious internal and external sector imbalances started to surface. Facing a splintered opposition, the government decided to call early elections before the economy slowed down further. It was confident that a two-pronged appeal to the electorate based on 'peace and political stability' together with 'economic growth and prosperity' would give the President another term.

This proved to be a major political miscalculation. The divided opposition united behind a 'common opposition candidate', Maithripala Sirisena, a senior minister and the General Secretary of Mr. Rajapakse's political party, the Sri Lanka Freedom Party (SLFP). Some sudden and unexpected political moves and alignments took place, allegedly supported by India and the Western powers concerned by Sri Lanka's 'pro-China' stance.[6] Maithripala Sirisena left the government and challenged the President at the election. The regime paid the price not only for alienating the ethnic and religious minorities—minority votes played a decisive role in the defeat of the President—but also for underestimating the hostility generated in the wider community by its economic policy failures, increasingly authoritarian methods of governance and seeming disregard for the legal restraints and conventions of a constitutional democracy. To the surprise and shock of many, Mr. Rajapakse lost the election held in January 2015. A coalition government headed by Mr. Sirisena as President, who now became the head of the SLFP to which the defeated President also belonged, and Mr. Ranil Wickramasinghe, the leader at the right-of-centre United National Party (UNP) as Prime Minister, came into power, with the support of Tamil and Muslim political parties.

The new coalition government had to confront the complex and difficult tasks of placing the economy on a sustainable trajectory of sustainable growth and poverty alleviation, satisfying the demands of an assertive electorate for an end to corruption and abuse of state power, addressing minority rights issues to ensure ethnic and religious harmony, and dealing with the foreign policy changes expected by India and the Western powers. The electorate expected that economic growth would quickly recover and be more equitable, minorities hoped for constitutional reforms

[6]This united opposition comprised a wide array of disparate political and social groups including the conservative right wing UNP, the 'Socialist' Nava Sama Samaja Party (NSSP), some Sinhala Buddhist political groups that had previously been part of the Rajapakse government such as the Jathika Hela Urumaya (JHU), the Tamil National Alliance (TNA) and the Muslim Congress, and various 'civil society' organisations and groups. It also gained, though more tacitly, the support of the populist-nationalist Janata Vimukthi Peramuna (JVP).

to enshrine minority rights, human rights groups looked forward to legal and judicial redress for rights abuses during the war and its aftermath, and India and the Western powers welcomed a government that was quick to demonstrate its desire to end the pro-China stance of the previous government. These were high expectations.

2 The Coalition Government: 2015–2018

The new government was warmly welcomed by many as the beginning of a new era of democratic freedoms and political stability, ending the period of abuse of power and authoritarian excesses. But less than three years after coming to power, the new government unravelled dramatically in October 2018 with the President sacking the Prime Minister and replacing him with the defeated Ex-President Rajapakse as the Prime Minister, precipitating the most serious constitutional and political crisis in post-independence Sri Lanka. This was the culmination of a process of intensifying conflicts between the coalition partners from almost the first day of the new government encompassing almost every major political, economic and social policy issue.

Disputes and differences between partners are of course normal and expected in coalition governments. But the new government was a particularly unusual coalition. In theory, it brought together the two major parties, traditional foes, to form the new government. But the defeated President and his supporters, though they remained nominally members of the SLFP, never really accepted that they were now partners with the UNP in the new government and constituted a de facto opposition in parliament. The President and his supporters from the SLFP and the Prime Minister and members of the UNP had little in common except the opposition to the previous President and the group around him. Despite the rhetoric about a grand unity forged in a struggle for democracy, the coalition was very much a marriage of convenience and an uneasy alliance from the very beginning. It was an alliance that was bound to be tested when under pressure.

It did not take long for the pressures to build up from all directions.

The government's commitment to eliminate corruption and implement good governance—a central theme during the election—came into question almost immediately when the new Governor of the CBSL, a handpicked appointee of the Prime Minister, became embroiled in a very public scandal about CBSL bond sales that helped a related party company to make massive profits. The inept manner in which the issue was handled and the resulting demand for an impartial public enquiry into the controversial bond deals made matters worse. It also exacerbated simmering tensions between the President and the Prime Minister that were already evident in relation to economic policy, and resulted in the President taking steps to replace the Governor with an appointee of his choice. Tensions also developed over the issue of an independent international investigation demanded by Western powers into alleged war crimes committed during the concluding phases of the war.

The Prime Minister and his party appeared prepared to consider such an investigation, but the President, who had been a leader of the government at the time, rejected any outside investigation that could lead to the persecution of the military leadership. The differences over the war crimes investigations were also reflected in attitudes towards demands from the Tamil community for constitutional reforms to guarantee greater regional autonomy.

In foreign policy, the new government treated the restoration of closer ties with the West and India as a matter of highest priority and took a range of diplomatic initiatives to 'restore balance' to foreign policy by reversing the pro-China tilt of the previous regime. The President and the Foreign Minister both made a series of foreign visits in the immediate aftermath of the election, with India and the West being prioritized over China.[7] But most importantly perhaps, the government announced in March 2015 that it would stop work on the huge USD 1.5 billion Colombo Port City project funded by a Chinese company. Members of the new government had been critical of Chinese-funded projects prior to the elections; however, this was a step that was probably unanticipated and certainly interpreted very negatively by the Chinese government.

The government had badly miscalculated the impact of this move. There was a sudden drying up of Chinese investment flows into the country. This highlighted the reality that debt finance, of which Chinese investments were an important component, had been the basis of rising real incomes and the sense of growing prosperity. Even if some of the Chinese-funded projects were economically wasteful 'white elephants', they had helped to sustain high levels of spending and economic activity. In the absence of other sources of economic vitality and growth (there were no compensating investments from India or the West), the immediate effect of the cessation of Chinese investments was a sharp decline in economic momentum.

In addition, the government's 100-day programme that saw pre-election populist spending promises being met—such as public sector salary increases and administered price reductions—also took its inevitable toll on already weak public finances. It did not take long before unhappiness with a slowing economy began to affect the popularity of the government, though progress with some limited constitutional reforms and measures to address minority grievances temporarily helped to contain disenchantment with the government.[8]

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[7]The Foreign Minister Mr. Mangala Samaraweera visited India just five days after the election, pledging to re-establish good relations, and then visited the USA in early February; at a meeting with the Secretary of State, he made the new policy stance very clear, stating that he hoped to revive and strengthen the very strong bonds Sri Lanka has had with the USA for several decades. It was only after making those visits to India and the USA that he visited China. In mid-February, the President himself visited India—which led to a reciprocal visit by Prime Minister Modhi in early March, the first visit by an Indian Prime Minister since 1987. His second visit, in early March, was to the UK.

[8]For instance, an amendment to the Constitution passed by parliament took away some powers of the Executive Presidency; most notably, it reintroduced a two-term presidential limit and reinstated a Constitutional Council to oversee appointments to independent Commissions.

The government did take some steps to improve export performance by measures such as eliminating para tariffs and enhancing market access to export markets. The CBSL's shift to more flexible exchange rate policies also helped to decelerate the erosion of export competitiveness. But these did not lead to a large stimulus for exports and were inadequate to attract large private FDI inflows. The country continued to rely on the same unsustainable foreign debt-based strategy to sustain consumption and employment levels.

When, economic growth is achieved through unsustainable spending booms rather than through a process of technological transformation that enhances total factor productivity growth based on investments in enhanced skills and capital and other productive factors, growth supported by appropriate institutions, at some point such growth becomes unsustainable; the spending boom ends in a crash and a financing crisis. This is why by the end of 2015 the government had little scope to manoeuvre or to engage in populist spending measures; economic policies were increasingly tightly constrained by the imperatives of avoiding a foreign debt crisis. Investors were getting impatient with the inability of the government to implement measures to improve the investment climate. The general population was losing patience with the government's inability to revitalize economic growth and employment. The government itself had to eat the humble pie and go back to China requesting not only that the projects be restarted but also asking for more funds. It was becoming clear that the coalition government of disparate and ideologically divergent politicians could not act decisively to satisfy the demands and aspirations of any major social groups.

The spectre of the looming economic crisis forced the government to sign a Stand-By Agreement with the International Monetary Fund (IMF) in mid-2016. The focus of economic policies shifted to stabilization, rather than growth and development. But stabilization measures to help contain the fallout from a debt-financed spending binge are not conducive to accelerating economic activity and growth. They are also deeply unpopular, particularly when the distributional outcomes are seen as inequitable and 'reforms' are overwhelmingly associated with spending cuts: cuts to investment, welfare payments, consumer subsidies, etc. As the Institute of Policy Studies of Sri Lanka (IPS) report on 'Sri Lanka: State of the Economy 2017' (pp. 3–4) pointed out:

> Some of the harder reforms that came with the IMF programme imposed a heavy burden on household incomes as a result of higher taxes. This included an unpopular increase in the value-added tax (VAT) to start shrinking a large fiscal deficit that was partly the result of populist adventurism in the run up to the 2015 elections. The impact on cost of living was made worse unfortunately by adverse weather that disrupted agriculture production in 2016–2017. Added to this, slow growth meant modest wage gains and job creation; in fact, Sri Lanka's employed to population ratio has remained stagnant at 37% in this period. Against this backdrop, higher prices on food and other essentials were sufficient for the public's mood to swing dramatically and provoke a voter backlash at the much delayed local government polls in February 2018.

> This first test of electoral popularity for the government deepened the cracks in the ruling coalition.[9] The manifestations of this, such as the decision by the President in March 2018 to take economic management under his chairmanship of the National Economic Council (NEC) and abolish the Cabinet Committee on Economic Management (CCEM) headed by the Prime Minister, sends mixed signals as to who in government is responsible to push changes through on economic policy matters. Outward dissent has also been a recurring problem with a spate of strikes and demonstrations gathering momentum. The number of man days lost as a consequence of strikes in the private sector has risen to an annual average of 80,000 days during 2015–2018 compared to a figure of 50,000 during 2012–2014 disrupting day-to-day business operations. A 12-day state of emergency was declared in March 2018 following inter-community clashes. Some of it is no doubt politically motivated, but it adds to the overall impression of disarray and the seeming absence of a sense of urgency to address the problems firmly.

The internally divided coalition government was unable to effectively impose the spending cuts necessary to achieve macroeconomic stability in the short-term or to articulate and implement a viable long-term strategy for sustainable growth. Facing a deteriorating economic situation, Sri Lanka's commercial foreign borrowing spree continued; In 2018 alone, Sri Lanka raised USD 2.5 billion from International Sovereign Bond (ISB) issues, and a syndicated loans of USD1 billion, and for the first time ever USD 1 billion as a foreign currency term financing facility from the China Development Bank. The latter was in addition to entering into a controversial debt-to-equity swap agreement with the Chinese government, whereby a 70% stake in the Hambantota Port (built by China in the south of the country) was leased to China on a 99 year lease for an estimated USD 1.1 billion. For Sri Lanka, this not only provided immediate relief from debt servicing, but it also generated an injection of much needed non-debt foreign capital inflows. But, the port is seen as having significant military-strategic value and the government came under intense pressure from India and the West as well as from the opposition forces in the country over the leasing of this port.[10] Subsequently internal government conflicts intensified when India offered to acquire an adjacent airport that had also been built by China over whether to accept India's offer or not.

Meanwhile, Sri Lanka has been moving ever closer to an unprecedented debt crisis as a large bunched up volume of repayments, borrowed both pre- and post-2015, falls due from 2019. The implosion of the coalition government was grounded in its inability to confront the economic and political challenges of the legacy of the foreign debt-based growth strategy of the immediate post-conflict

[9]Mr. Rajapakse's supporters enjoyed a major electoral success over the coalition government supporters.

[10]Senior figures in the US Administration and international media have claimed, and the claim is now widely repeated as fact, that China had lured Sri Lanka into a debt trap that forced it to hand over the port to China. In fact, the more accurate interpretation of what happened is Sri Lanka fell into a debt trap mainly because of its past short-term borrowings from international (non-Chinese) investors and other financial institutions. China proved to be the best source for the Sri Lankan government to acquire funds to meet repayments to those international investors. Chinese debts to Sri Lanka have been typically long term and on terms not much different to those of multilateral donor agencies.

years. From a longer-term perspective, the failure of Sri Lanka to maximize opportunities in post-conflict reconstruction and recovery reflects the failure of successive governments to move beyond the politics of populism and establish the conditions for sustainable and equitable growth. A decade after the end of the war, Sri Lanka finds itself in unchartered waters having to cope with deeply entrenched economic problems, unprecedented levels of political uncertainty and institutional stresses.

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Part I
Policies, Regulations, and Governance for Smart Growth

Trade and Competition Policies: Implications for Productivity Growth in Sri Lanka

Sarath Rajapatirana

Abstract Trade liberalization is necessary but not sufficient to get the full return to trade reforms in the absence of liberalization of non-tradable goods through competition policy. Even if resources to augment factor growth are readily available, that too could fizzle out because of diminishing returns. Sri Lanka has made only limited progress on trade liberalization in the post-conflict era and at present has no competition policy to speak of. Sustained growth has to be based on total factor productivity (TFP) growth. Otherwise, Sri Lanka will have to keep raising savings to increase capital, assuming that labor growth sees a steady increase. However, as living standard increases, population growth declines, and labor supply does not grow fast. In fact, Sri Lanka is now past the demographic dividend phase and already in a situation where there is a steady decline in population. In this context, low average TFP growth means that the country has to keep on increasing saving and borrowing from abroad to raise GDP growth, based on factor augmentation. This leads to a difficult macroeconomic situation as excessive foreign borrowing is needed to augment domestic savings that Sri Lanka cannot afford to service in view of the fact that access to capital is more costlier than before. The study finds TFP growth in Sri Lanka to be low. It finds that trade and competition policies that would have raised TFP growth were not sustained after their initial introductions.

1 Introduction

Trade policies in their fundamental form are aimed at altering the relative prices of traded goods, through tariffs, subsidies, quotas, and antidumping, safeguards and countervailing duties. These policies drive wedges between foreign and domestic relative prices and affect resource allocation in any economy. Developing countries came to recognize the importance of competition policies later than their acceptance

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of trade policy as a means of increasing competitiveness. Thus, while a spate of trade liberalizations took place in the 1990s by many developing countries, competition policies were to come later. This sequence makes sense. With trade liberalization, two powerful effects take place to bring about competition. First, the most powerful effect comes from import competition where import tariffs and quotas have protected the domestic market and may have led to monopolies. Second, *ceteris paribus* effect comes from the reduction of the bias against exports arising from the reduction of tariffs on imports.[1] Also, most trade liberalizations are accompanied by exchange rate devaluations which contribute to reducing the bias against exports and increasing the returns to investments in the exportable sector and among more efficient and contestable import substitution activities (Krueger 1978).

Similarly, competition policies are also known to bring a host of benefits. They bring about competition. When customers have choices of firms that provide goods and services, competition leads to lower prices for the customers as in the case of trade reforms that reduce domestic prices which lead to increases in welfare with higher consumer surpluses.

Together, trade and competition policies have a most important role to play specially in developing economies like Sri Lanka to improve resource use and allocation to lead to sustained growth.[2] Since two significant trade liberalizations in Sri Lanka in 1977 and 1989, there have been limited reform attempts. In post-conflict Sri Lanka, the reliance on large public investments in infrastructure to drive growth, coupled with creeping protectionism in trade policy, led to heavy dependence on non-tradable growth.

This chapter attempts to understand whether reforms to trade and competition policies in Sri Lanka manifested on the ground by raising TFP in the economy. Section 2 discusses the generic case of trade and competitiveness reforms. Section 3 gives the Sri Lankan context of trade policies and competition policies, including the special case of state-owned enterprises (SOEs). Section 4 examines the likely contribution of trade and competition policies to total factor productivity growth. Section 5 concludes.

2 Trade and Competition: The Generic Case

At the firm level, competition policy induces firms to compete with each other which leads to innovation, better use of resources (allocation effects) and higher productivity growth. Productivity growth is more important for sustaining total output growth than factor augmentation with capital and labor increasing. Competition

[1]This is owed to the Lerner theorem which holds that under a set of plausible assumptions, a tax on imports is a tax on exports, and in parallel terms, a reduction of tariffs on imports leads to a reduction of taxes on exports. In more general terms, one can interpret it as a symmetry in incentives.

[2]The interaction of trade and competition policies is depicted in Appendix I.

policies by encouraging entry raise competitiveness of a particular activity. Experience in many countries shows that pro-competitive interventions raise productivity growth (by which we mean in this paper, total factor productivity growth). Productivity growth is the increase in output per unit of input. This is best measured by TFP growth that comes from those management know-how, technological change, innovation and what has been generally referred to as X-efficiency that are beyond what comes from using increasing amounts of capital and labor.

There are two effects from well-implemented competition policies on firms. Some studies which look at productivity growth by industries show that there is a positive effect of competition within the firm and between firms. The most cited and classic study by Nickell (1996) who took various industry-level measures of competition in the industries in the UK and found higher competition is statistically significantly associated with higher productivity growth (Nickel 1996). Dutz and Hayri (1999) claim that while there is no clear theoretical answer between competition policy and economic growth, there is empirical evidence that in some sectors more competition leads to more innovation and accelerates productivity growth. They examine the impact of intensity of domestic competition beyond trade liberalization on growth and find that the effectiveness of antitrust and competition policy enforcement is positively associated with long-run growth. The operative word is 'effectiveness,' suggesting that a mere passing of laws does not ensure that the benefits of competition can be achieved. Thus, the relationship between competition policy and output growth is more difficult to measure than that between import competition and output growth which clearly belongs to trade policy. Thus, a country could have competition without competition policy. It would, however, be restricted to tradable goods and services.

It is clear that the presence of non-tradable goods prevents a full transfer of the incentive from the trade liberalization even for all tradable goods to the extent that they use non-tradable good in their production. Thus, higher the coefficient of non-tradable goods in production, lower is the competitive effect of trade liberalization, and whether the good happens to be an exportable or an importable does not matter.

A number of caveats must be recognized when discussing the impact of trade and competition policy on TFP growth. Other policies and institutional aspects impact on TFP growth; these include technological change, economies of scale, measurement of capital and labor and similar economy-wide issues. Quantification of competition policies is hard. Many institutional factors come into play such as the law dealing with entry and exit of firms, markups due to imperfect competition, and gains or losses from sectoral relocations. An econometric approach poses other challenges such as the impact of TFP growth itself on the deployment of factor inputs and access to proper instrumental variables to overcome endogeneity problems in econometric estimates.[3]

[3]Such problems led to the eschewing of an econometric approach in this chapter. Given that situation, the paper uses a more heuristic approach to explore the link between trade and competition policies and TFP growth.

3 The Sri Lankan Context

3.1 Trade Policies

Significant trade policy reforms were undertaken in 1977 and 1989. The 1977 trade liberalization was the first undertaken by a South Asian country and was among the early trade policy reforms among developing countries. It was a far-reaching reform with implications for the competitiveness of the economy. The political context of policy making is also presented to highlight the motivations for changes in policies.

Sri Lanka had a liberal trade regime from independence to around 1960 when it began to use strong trade restrictions based on both the balance of payment (BOP) reasons and the ideological change arising from the government that came into power in 1956. After nearly a decade, an attempt was made to undertake a partial liberalization of the economy, mainly through an export bonus scheme. Another left of center coalition during 1970–1977 saw Sri Lanka's strongest interventions in the goods and factor markets and a spurning of liberal trade spurred by BOP problems (specially following the first international oil shock and many years of trade tightening) and a strong dose of control, based on ideology than even before, which made the country one of the most controlled economies outside of the Soviet Union (Athukorala and Jayasuriya 1994).

A change of regime in 1977 saw the liberalization of the economy and the trade regime significantly, in the wake of the success of East Asian economies relative to Sri Lanka's poor economic performance. The first round of reforms saw the replacement of quantitative restrictions with tariffs. It was followed by the reduction of tariffs and their variance (Athukorala and Jayasuriya 1994). It also included a devaluation of the currency by more than 168% in nominal terms. These measures reduced the bias against exports, making them more competitive and creating incentives for greater production and exportables. This led to a rise in the volume of exports through greater rewards to exportable activities. Similarly, the reforms reduced the premiums on imports and the prices of importables. This gave incentives for efficient import substitution. Both these measures helped to increase the competitiveness of tradable goods. Meanwhile, the devaluation of the rupee raised the real exchange rate, providing greater incentives for producing tradable goods (Athukorala and Jayasuriya 1994).

Sri Lanka embarked on a second wave of trade liberalization in 1989. It included an ambitious privatization program, further tariff reductions and simplification, removal of exchange controls on current account transactions and commitment to a flexible exchange rate (Athukorala and Rajapatirana 2003). The latter aimed to ensure that a bias against exports was not allowed to manifest with the rise in domestic prices, particularly in non-tradable goods. However, the ambitious program of privatization was to bring some negative effects due to the lack of a competition policy which would have included a good regulatory framework where privatization does not replace state monopolies with private sector monopolies.

A government with a new left of center platform adopted the liberal agenda, whereby over time, the average tariff rate (excluding para-tariffs) fell significantly.

By the time of Sri Lanka's heightened war effort in 2006, the nominal tariff rate had fallen to 11.2%, reflecting the weighted average of 9.2% for manufactured goods and 23.8% for agricultural goods (Athukorala 2012). However, due to the war more revenue had to be raised by across the board increases in domestic taxes on imports and exports with the use of para-tariffs and charges on exports, respectively (Pursell and Ahsan 2011). While the end of the war provided an opportunity to reduce tariffs and the variance of tariffs, and increase competitiveness of the economy through trade liberalization, that opportunity was not taken. Thus, during 2008–2014, Sri Lanka had high protection once again and a complex trade regime. It was unpredictable, protected agriculture significantly and deviated from the earlier near uniformity in protection.

While efforts have been made since 2015 to reduce protection through the phased elimination of para-tariffs, the rate of tariff reduction may not be high enough to bring about a greater degree of competition. Equally, resource misallocation from wide variance in protection (in addition to its level) could not be reduced appreciably. This meant that the power of import liberalization was not harnessed to increase the competitiveness of the economy given the high level of protection with high para-tariff rates (Corden 1984, 1977).

3.2 Competition Policies

Unlike trade policies, competition policies are complex. For them to work, a triad of policies, laws and institutions must work together to lead to an effective competitive environment to emerge.

Following other developing countries, Sri Lanka introduced its first competition policy law in the form of the Fair Trading Commission Act, No. 1, of 1987. There were two precursors to this act which were the National Prices Commission Law No. 42 of 1975 and the Control of Prices Act of 1950. The National Pricing Law of 1975 reflected the philosophy of price controls; the 1950 Price Control Act was motivated by the fear of inflation at the time with the Korean War breaking out in June 1950. Both these acts were not aimed at fostering competition in the standard definition of the word, but in protecting the consumer. But it would have led to relative price distortions in the medium term as a result, even though it may have protected the consumers in the short run. In the medium and long term, these distortions would have led to the reductions in TFP growth.

However, the act that was intended to institute competition policy was the Fair Trading Commission (FTC) Act of 1987. It had *prima facie* features at least, the prevention of monopolies, competitiveness preserving laws which were adequate for the purpose, but lacked an implementation guide for the FTC. The most glaring shortcomings of the act were the lack of a specific distinction between public and private sectors and the lack of an independent authority for the FTC; the commission members were to be appointed, maintained and removed by the Minister responsible for commerce and industry. The way the act was implemented gave rise to concerns that it led to departures from competition rather than promoting competition. Indeed, it is claimed that it deviated from protecting competitive processes and favored producers demonstrating anticompetitive behavior (Knight-John 2002). Thus, despite wide powers over the control of monopolies, mergers and anticompetitive practices, these were considered illegal only if they were contrary to 'public interest.' But what was public interest was not defined; consequently, in practice, there was no attempt to limit anticompetitive practices.

In 2003, the Fair Trading Act was repealed and a Consumer Affairs Authority (CAA) Act No. 09 of 2003 was enacted, with a separate adjudicative investigation body. The CAA had power to eliminate anticompetitive practices and promote effective competition between traders and manufacturers, and legislative provisions to deal with monopolies and mergers. The act laid down the legal provisions empowering the CAA to take necessary actions to safeguard the interests of consumers while maintaining effective competition among suppliers of goods and services. But it worked principally as a consumer protection authority rather than one that promoted pro-competitive policies and practices. The CAA was seen as a backward step compared to the FTC Act with respect to the prevention of anticompetitive practices and promotion of competition in the goods and services market. Thus, Sri Lanka at present has no effective competition policy. Trade liberalization will bring import competition that could lead to greater productivity, but there is no such authority dedicated to promote competition in the non-tradable sector.

The challenges faced with respect to raising factor productivity point to a few conclusions. First, trade liberalization is necessary but not sufficient to get the full benefits from trade reforms. Second, even if resources to augment factor growth were available—for example through increased labor—that could fizzle out because of diminishing returns as shown by Solow (1956).[4] The returns to the labor factor decline as more labor is used. Third, nearly all tradable goods use non-tradable goods and services such as electricity, water, transport, retail and sale of tradable goods. Studies done in many developing countries show that competition policies help to raise total factor productivity; the extent of the rise in productivity depends on different country settings, but they mostly show a positive relationship between competition policies and TFP growth (Dutz and Hayri 1999).[5]

3.3 Outcome of Reforms

The 1977 trade liberalization which was impressive both in scope and its speed had to taper out in terms of returns because non-tradable goods were not liberalized through competition policy.

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[4]Based on models built on the Solow growth model with extensions and different basic assumptions. See Appendix 1.

[5]Dutz and Hayri (1999) show that strong competitiveness-promoting policies raise TFP.

There was a significant increase in TFP in the manufacturing sector following the 1977 trade reforms (Athukorala and Jayasuriya 2000). But, economy-wide TFP declined following these reforms. Trade policy by itself was insufficient to promote competition. A number of hypotheses can be offered for this phenomenon. First, the time lag needed to convince potential investors that a change had occurred from the seven-year control regime that preceded the 1977 reforms. Second, the private sector funding could have been a problem as it was public funds that were available for investment from foreign assistance. The macroeconomic disequilibrium brought about through the public expenditure expansion of the economy and related aid inflows that lead to a Dutch disease phenomenon meant that the liberalization could not produce the expected high returns (Corden 1984; Lal and Rajapatirana 1988).

Thus, Sri Lanka failed to achieve a higher and a longer lasting jump in GDP growth through an increase in TFP (Darvas 2012). It failed to materialize because the non-tradable sector—which was not liberalized through competition policy—could not produce the needed lift. Crucial inputs are needed for high and sustained growth such as inputs from electricity, gas and water which are non-tradable, that are all state monopolies. The other two non-tradable sectors—retail trade and unskilled labor—are more competitive than the other inputs. The competitive effect on a tradable sector can be offset by monopoly power in retail trade. In addition, there could be implicit price and distribution arrangements to limit competition.

3.4 State-Owned Enterprises: The Special Context

No discussion of competition policy in Sri Lanka is complete without including SOEs in the discussion.[6] The SOE sector underwent some reforms in the early 1990s by way of privatization, followed by a more intense effort in the latter half of the decade. Since the divestitures were done without a proper regulatory framework, it resulted in many irregularities leading to accusations against privatizations. Since then, reforms have stalled with privatization precluded as a way of improving economic performance during the conflict years and in the immediate aftermath. In fact, during 2006–2014, their hold on the economy increased with some re-nationalizations and setting up of new SOEs.

There are many features of SOEs that impinge on competition policy. First, SOEs have created a protected institution that has many privileges not accorded to their rivals. Second, SOEs are not subject to the same codes of conduct as private firms; they have privileged access to state-owned banks, quicker time for clearing goods at

[6]SOEs include public corporations, statutory boards, companies registered under the Companies Act which carry out both commercial and non-commercial activities and regulatory agencies, promotional institutions, research and development agencies and educational institutions set up by an Act of Parliament. Contingent liabilities of SOEs amount to 11% of GDP without counting non-financial SOEs.

customs and easier access to certifications with respect to exports and imports. Third, SOEs have a stranglehold on domestic businesses since they dominate crucial services like electricity, water, gas and petroleum products, among others.

Finally, there is no effective parliamentary control of SOEs. They can often behave with impunity with no consequences to their management since the system of political patronage protects them. Apart from a massive financial cost to the country —e.g., losses incurred from hedging by the Ceylon Petroleum Corporation (CPC) or the losses recorded by SriLankan Airlines—the more damaging loss is that of competitiveness and future prospects to grow faster. Sri Lanka's Parliamentary Committee on Public Enterprises (COPE) has powers to investigate, but no executive authority to insist on any reform, being a creature of the legislature. Lack of up-to-date data, financial accounts and updates on the management of individual SOEs has also hindered any reform attempts (Kelegama 1997, 2004, 2006).

The political hold on SOEs is strong. The chief executives of most of these entities are appointed as political patronage. There is no 'natural' exit for SOEs as in the case of private firms. These firms continue to make huge losses that have to be made good through the treasury accommodation and letters of comfort offered to state-owned banks that underwrite their losses.[7] The case of state-owned banks (Bank of Ceylon and Peoples Bank) is a special case of SOEs that have great power and influence in the economy as they facilitate the survival of SOEs that would have been bankrupt without their financial assistance. As a result, large losses of SOEs are carried in the books of the two state banks. The pursuit of competition policy in the presence of SOEs, including the state-owned banks, is difficult.

In addition, the cost of not using the means to raise competition leads to low productivity which is measured by TFP growth. Among the reasons for the poor performance of SOEs is that the lack of a policy and an inadequate legal framework to govern SOEs. There are important concerns arising from this situation. First, their poor performance leads to the poor performance of the GDP growth rate as their value addition component is close to 11% of GDP. It leads to limiting opportunities to raise employment, income generation opportunities and ability to produce surpluses to pay off the national debt. Second, it leads to a huge waste of capital that has been created by domestic savings and FDI. Third, social and public service obligations cannot be adequately met in a low growth situation. Finally, a statistical measure of performance such as TFP growth is kept low due to the large presence of SOEs.

4 Likely Contributions of Trade and Competition Policies to Productivity

Figures 1 and 2 show a series of TFP growth estimates for the period 1970–2016 developed using the standard Solow residual growth accounting framework.

[7]Contingent liabilities of SOEs amount to 11% of GDP without counting non-financial SOEs.

However, developing a regression model that relates a number of right-hand variables to explain the left-hand variable, TFP, is of limited value for several reasons. First, the right-hand variable depicting policies is fraught with problems because the number of variables that would go to make such an index is formidable. For example, the Global Competitiveness Index (GCI) uses some 125 indicators and is available only from 2007 (12 pillars with an average of ten variables).

Fig. 1 Labor, capital and labor and capital productivity and growth of TFP

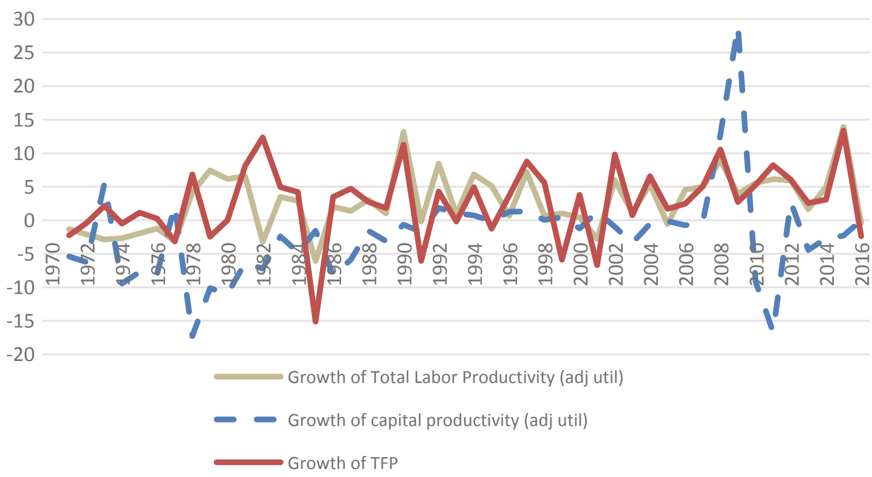

Fig. 2 Growth of TFP, labor productivity and capital productivity

Table 1 Total factor productivity growth averages 1971–2016

Pre-1971–1986	−2.6%
1987–2002	1.8%
2003–2016	2.5%

Source Based on IMF data

Table 2 Trade and competition policy switches and TFP growth outcomes (%)

Trade policy	Solow_0.3 k-TFP	Solow-0.4k_TFP	Adj util_0.3k_TFP	Adj util_0.4k_TFP
Trade lib 1977- +3 years 1978–1980	1.9	0.5	−0.5	−2.7
Trade lib 1989- +3 years 1990–1992	4.5	4.0	4.8	4.1
Trade lib 1977 +5 years 1978–1982	1.0	-0.1	-0.8	-2.5
Trade lib 1989- +5 years 1990–1994	4.0	3.6	4.1	3.6
3 years before				
Trade lib 1977 minus 3 years	−0.8	−1.7	−4.2	−5.0
Trade lib 1989 minus 3 years 1990–1992	1.1	0.4	−0.1	−0.9
Competition policy	Solow_0.3 k-TFP	Solow-0.4k_TFP	Adj util_0.3k_TFP	Adj util_0.4k_TFP
Competition policy 1987 +3 years	3.3	2.7	3.3	2.5
Competition policy 2003 +3 years	2.7	2.4	2.1	1.7
Competition policy 1987 +5 years	3.5	2.9	3.2	2.6
Competition policy 2003 +5 years	3.3	3.0	3.9	3.6
3 years before				
Competition policy 1987 minus 3 years	−1.7	−2.0	−1.8	−2.3
Competition policy 2003 minus 3 years	0.9	0.6	0.9	0.7

Given the lags involved in competition policy shifts and trade policy shifts on TFP growth, a heuristic approach is taken to observe the behavior of TFP, three years before and three years after and five years after the policy switch. Similarly, the same approach can be taken to evaluate the impact of competitiveness policy changes on TFP growth three years before and three years and five years after the policy change. The results of the approach are summarized in Tables 1 and 2, when applied to the Solow residuals assuming 7% depreciation of capital and use of 4 units of capital per one unit of output and 0.7 units of labor.

4.1 Contribution of Trade and Competition Policies for TFP Growth

Trade policy saw two main switches that would have led to increases in TFP growth. The first switch is discussed above as the trade liberalization of 1977 and the second switch is the trade liberalization in 1989. The first panel in Table 2 summarizes the outcomes of trade liberalizations in these two phases following the policy switches by tracking the TFP growth rate three years following the trade liberalization of 1977 (namely 1978–1980) and three years following the trade liberalization of 1989 (namely 1990–1992).

This panel also depicts TFP with 0.3 and 0.4 capital use and TFP with the same capital use but un-adjusted for capital utilization. Without the adjustment for capacity utilization, TFP growth is positive for the first liberalization, but negative when TFP is adjusted for capacity utilization. The adjustment makes the TFP number more reliable since output levels cannot be ignored when productivity is being measured.

The situation with respect to three years before the first trade liberalization shows a very poor TFP position of −5.0%. This is not surprising given that the 1970–1977 period was one of the complete *dirigiste* economic policies where protection was high, variance wide and great uncertainty prevailed. For instance, laws passed with respect to the takeover of private enterprises, with near 100% quantitative restrictions of imports, had taken its toll.

The negative TFP growth despite the strong trade liberalization was due to uncertainty that moved over from the earlier period of a highly controlled economy; potential trade entrepreneurs had to be convinced that the liberalization was to be sustained. Access to imported inputs was induced with the 1977 reforms, but the immediate impact was on imports of consumer goods rather than raw materials and capital goods. There was no chance for TFP to grow in response to the trade liberalization. Even five years after the trade liberalization was initiated that is 1978–1982, TFP remained negative, although marginally better than during 1978–1980. This confirms the observation that it takes time for policy reforms to impact on TFP. Five years may still not be enough to invest in the tradable sector after a long period of import controls and high protection overall.

The story of the second liberalization, even in three years, was different. TFP growth rose to 4.3%, reversing the situation that was seen in the first liberalization. Import inflows, especially raw material and capital (technology, management associated with new capital), can boost TFP growth. While output growth rose, the availability of cheaper imports provided the incentives to increase the scale of production of tradable goods and also to undertake investments in the economy. It is noteworthy that even three years before the second liberalization, TFP growth was −0.9%. This confirms the suggestion that trade policies during that period could not substitute for the absence of competition policies. It is significant that the second liberalization saw positive TFP responses given a five-year lag, but equally important, a longer lag (1977–1989) for the trade side to have an impact on TFP. Thus, the second liberalization saw positive TFP responses in 1990–1992 and 1990–1994 of 4.1% and 3.6%, respectively. By 1994, the full effect of the Dutch disease may have manifested with exchange rate appreciation and growing macroeconomic imbalances.[8]

The data indicate that TFP growth is sensitive to the amount of capital used and the level of capacity utilization. Thus, the more capital used leads to more negative TFP growth, other things remaining the same, as seen in the first trade policy switch. Also, as capacity utilization falls, so does TFP. This is seen in the Solow equation. It provides sensitivity analysis with different amounts and mixes of capital and labor and different levels of capacity utilization.

Competition policy also saw two switches in 1987–1990 and 2003–2006. Unlike in the case of trade when the first liberalization found TFP growth to be still negative, competition policy appears to have given a boost to TFP growth at 2.5% and 1.7%, respectively.

In the five-year horizon, both liberalization episodes had a positive impact on TFP growth of 1.7% and 3.6%, respectively, for the first and second competition policy changes. It is also noteworthy that three years before the first competition policy change and the second competition policy change (namely, FTC Act of 1987 and CAA Act of 2003), competition policy was negative for the first episode (−2.3%) and positive (0.7%) for the second, respectively.

However, it must be noted that since these policies do not work in isolation, there is statistical noise around the single numbers for TFP growth rates. Competition policy numbers are subject to larger errors because a mere passing of the laws is not adequate to bring about changes in the competitive environment. It is clearly known that both the FTC and the CAA were less effective in bringing about competition than replacing quantitative restriction on imports with tariffs. Adding to this uncertainty of competition policy is the presence of SOEs that are sources of anticompetitive behavior, supported as they are by political patronage. Finally, it is

[8]Rupee appreciation is directly linked to the rise in public expenditure that has a larger proportion of non-tradable goods to tradables. See Rajapatirana (2013) and Lal and Rajapatirana (1988). This becomes clear when the real exchange rate is defined as the ratio of non-tradable to tradables.

also important to note that despite the trade liberalizations and competition policy changes, SOEs remain untouched. Their presence keeps average TFP growth low.

What about the interaction of trade and competition policies in Sri Lanka? The generic case is that competition policies complement trade policies and vice versa. The initiation of liberal trade policies in 1977–1992 and 1990–1995 would have helped to raise TFP growth with competition policy initiations during the 1987–1992 and 2003–2009 periods. But by how much TFP growth was affected is difficult to determine without a fully-fledged model. It is noteworthy that the effects of a trade policy initiation continue from 1977 onward, albeit waning as time passes. Thus, when competition policy was first initiated, trade policy was in a waning phase.

In the second phase of trade reforms initiated in 1989 (which is taken as 1990–1994 due to rounding off the months), competition policy was initiated in 1987 when this phase of trade reform was strong. Here, TFP growth was 4.1% and competition policy-associated TFP growth was 2.5%. In the second phase of competition policy (2003–2006), TFP growth was 1.7%. As noted above, the CAA did not have much strength as a competition-promoting arrangement. It was meant and implemented as a consumer protection policy.

5 Conclusion

The growth of TFP over the 1970–2016 period averaged at 1.7% per year over a 46-year period. This is low compared to other Asian countries, especially the East Asian group, and after 1990, among the South Asian countries. Trade and competition policies of Sri Lanka that would have raised TFP growth were not sustained after their initial introductions. Also, related to the policy variations were variations in TFP growth rates over this period.

Subject to the caveats recognized above, the chapter's analysis provides a few broad conclusions.

In the case of trade, there were two episodes of trade liberalization and reform—i.e., a five-year period after 1977 (1977–1982) and after 1989 (1989–1994). In the first episode, the trade liberalization was not sustained beyond the first period. It was due to the undertaking of a large public expenditure program and backsliding on the trade reform program. By 1982, the enthusiasm for trade liberalization was waning. Meanwhile, the second oil shock had taken place and it transmitted a general price increase to the economy. Reform fatigue is a well-known phenomenon. The second trade liberalization was less far-reaching than the first one.

With respect to competition policy, both attempts in 1987 and 2003 were rather weak. The first attempt was the creation of an FTC. The act was quite adequate in terms of the legal requirements, but it was not well implemented. The norms for intervention to maintain and promote competition were not well formulated. The 2003 Act did not emphasize competition policy; rather, it placed greater emphasis on consumer protection with the establishment of the CAA.

Both trade and competition policies (or policy switches) were not sustained. Consequently, the incentives to change the competitive environment were not sustained beyond the first five years following the policy switches. With regard to competition policies also, there was no sustained progress. Thus, Sri Lanka witnessed long intervals of inactivity of both trade and competition policies with episodic changes.

Three factors contributed to the low TFP growth in Sri Lanka. First, the resolve to sustain both policies began to wane due to political economy reasons. The changes in political regimes brought with them different political ideologies (based on Rajapatirana (2007) ideology and economic policy making: a framework and exploration of comparative experience (unpublished) mimeo). Those that supported trade and competitive policies were followed by those who belonged to a more control-oriented ideology. Second, political regime changes leading to policy switches in 1970–1974 and 2005–2010 led to sustenance of trade protection, on the one hand, and abandoning of competition policies and changing competition policies toward consumer protection. In that case, price controls acted in the same direction as raising protection. Third, when trade liberalization was implemented, its full benefit to promote competition was missed because of macroeconomic management issues—i.e., allowing the economy to expand rapidly particularly through higher foreign inflows, causing an appreciation of the exchange rate, raising inflation rates.

Other factors also played their part to keep TFP growth low. One dominant factor was the country's long separatist conflict. Successive governments were focused on the conflict situation, and attention paid to the economy was limited. Additionally, the power of SOEs over the policy agenda is considerable. The preservation of the SOEs leads to a real damper on TFP growth. First, these enterprises are notoriously inefficient, with low TFP growth. Second, pro-SOE or contra-SOE stances reflect different ideologies and act as a constraint to reaching higher GDP growth rates. Finally, SOEs have a stranglehold on the economy because of their prominence in the crucial input sector of the economy and many in non-tradables, such as electricity, petroleum, gas, water supply, retail trade and transport.

Progress on trade and competition reforms stalled for much of the immediate pre-war and postwar years. During this period, there was also greater state involvement in economic activities with new SOEs and policy aversion to privatization. Post-2015, despite a shift in the policy stance, the nature of the coalition governing arrangement casts doubts on much progress with regard to trade liberalization and pro-competition policies. The result is that Sri Lanka will be entering a more uncertain future for policy reform that could well mean that the country is unlikely to have higher TFP growth.

This will mean that Sri Lanka would need to find more capital investment to compensate for limited TFP growth. However, that option is somewhat limited given the country's high debt burden; new capital too has to be found above what is needed for the debt service to make up for the low TFP growth. Some consequences would follow. First, it could lead to greater demand expansion, a lowering of credit ratings by the rating agencies, making it more difficult to manage debt by borrowing more as the cost of borrowing goes up. Second, Sri Lanka's ambition to become a high middle-income country may not be realized, and the country could experience greater challenges of keeping a lid on demand growth, distorting relative prices and making returns to investment low. Third, and more worryingly, Sri Lanka will be squandering the opportunity to join important Asian production networks owing to loss of competitiveness.

Thus, an independent and strong competition policy institution is needed to fill a large vacuum since no institute is in charge of it at present. An initiative to create such an institution fashioned after the Australian Productivity Commission is under preparation which will make an important difference to the maintenance of competition in Sri Lanka's domestic markets and ensure that non-tradable goods are subject to competitive forces.

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Appendix I

Trade and Competition Policies, Four Cases

In the standard neoclassical model of trade with two goods (X_1 X_2), a small country assumption and community utility functions (Salter 1959), four cases are possible for the interaction of trade and competition policy. These are: Case 1, free trade with competition policy; Case 2, free trade with no competition policy; Case 3, restricted trade with competition policy; and Case 4, restricted trade with no

Fig. 3 Free trade

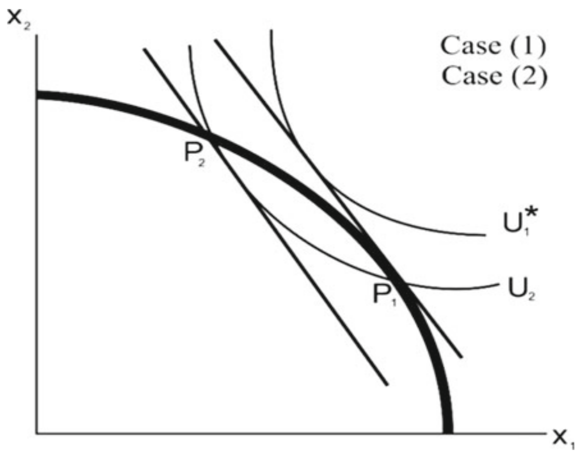
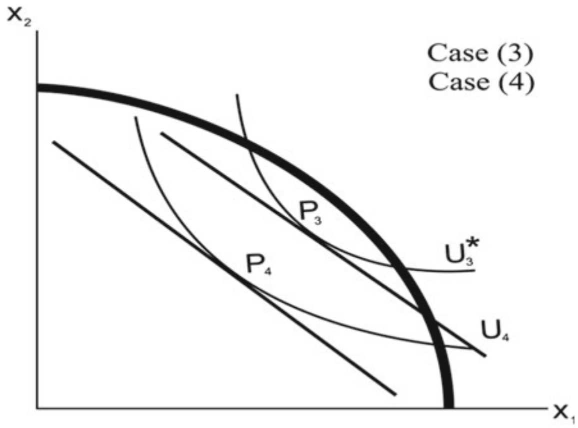


Fig. 4 Restricted trade



competition policy. Case 1, which gives the highest utility, is free trade combined with competition policy. This is seen in Fig. 3 which shows free trade with and without competition policy. The values for utility shown by U_1 are superior to the other possibilities. The case of free trade with no competition policy is shown with U_2 which is Case 2 (Guasch and Rajapatirana 1994).

Figure 4 shows the two cases with restricted trade with and without competition policies. Case 3 is one that has restricted trade with competition policies. Case 4 is restricted trade with no competition policies.

Given the standard assumptions of this model, it is possible to rank the order of combinations of trade and competition policies as $1 > 2 > 3 > 4 >$. When the assumptions do not hold, due to increasing returns to scale and the presence of externalities, this ranking could change in less predictable ways. In the first instance, the ranking between 2 and 3 could lead to a reverse order—i.e., when protection is pursued for strategic trade theory purposes. However, this situation is not viable in the presence of less than altruistic public officials who may be tempted to extract their own rents so that societal welfare is reduced.

The present case of Sri Lanka is closer to Case 3, restricted trade with no competition policy to speak of.

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Regulatory Reforms in Post-conflict Sri Lanka: Breaking the Cycle?

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Abstract Sri Lanka's state-owned enterprises (SOEs) play a significant role in the country's socioeconomic development trajectory. Despite decades of analysis and reform efforts, SOEs continue to have outsized fiscal and political impacts on the country. The analysis suggests that privatization is not a panacea for the problems afflicting SOEs. In the absence of sound regulation, the sale of assets may well maximize rents to politicians and investors at the expense of the public interest. The post-conflict period provided a fresh opportunity to embark on meaningful public enterprise reforms. However, these years have witnessed only halfhearted attempts at reforms aimed at inclusive development, pointing to the embeddedness of and interaction between extractive economic and political institutions. As this chapter discusses, such reforms have not produced meaningful results, primarily due to Sri Lanka's bipolar political regime and the failure to undertake essential governance changes. This chapter reviews recent developments in SOE reform, analyzes political economy considerations, and proposes limited, and more achievable, institutional reforms to reset the public enterprise reform process.

1 Introduction

Sri Lanka's SOEs have been subject to varied degrees of reform over several decades, spanning political regimes with differing ideologies. Yet, the state of these entities remains much the same in terms of their impact on inclusive growth, public service obligations (PSOs), and commercial viability. The narrative over the years points to strong path dependence with the impetus for reform being closely linked to electoral cycles and the nature of political institutions. As such, while the

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technical aspects of SOE restructuring remain a key element in this process, getting the politics of reform right stands out as the foremost ingredient for success.

At present, close to a decade since the end of Sri Lanka's conflict, there has been little substantive progress in terms of public enterprise reform. While the war years may have presented unique challenges with respect to robust institutions, including effective regulatory governance, the post-conflict period ought to have opened up the space for deeper reforms. However, these years have witnessed only halfhearted attempts at reforms aimed at inclusive development, pointing to the embeddedness of and interaction between what Acemoglu and Robinson (2012) refer to as extractive economic and political institutions. The strong synergies that prevail between these two types of extractive institutions often set in place vicious cycles that further entrench and perpetuate their existence.[1] Although breaking this cycle is not impossible, as is evidenced from international experience, it is also not an easy task and will require a fundamental transformation of Sri Lanka's political and economic institutional milieu.

Sri Lanka's SOE reform process is presently contextualized within three key parameters: bipolarity of the current political regime (2015-to date),[2] the Extended Fund Facility (EFF) arrangement granted to Sri Lanka by the International Monetary Fund (IMF) in 2016, and preparations for three major elections (provincial, presidential, and parliamentary) expected to be held in 2019–2020. Sri Lanka is once again at crossroads, with the window of opportunity for change narrowing as political parties look toward elections and policy choices are framed within the associated objective of vote maximization. Further, each missed opportunity imposes accumulated costs in terms of both inclusive economic growth and political structures. As such, reforms, even if incremental, must be expedited.

This chapter takes a close look at the political economy of SOEs in post-conflict Sri Lanka in an attempt to unpack a strategic path to successful reform. Section 2 provides an account of the historical evolution of public enterprise reform in Sri Lanka to understand important lessons learnt. Section 3 examines the public enterprise reform process in pre- and post-conflict Sri Lanka. Section 4 analyzes the current state of affairs in terms of these entities' efficiency, fiscal, and distributional performance; regulatory governance; and political context. Section 5 sets out reflections on potential SOE reform options and on breaking the cycle to get to inclusive economic and political institutions for equitable and stable development. Section 6 concludes.

[1]The close connection between economic and political institutions is also analyzed in the context of violence in North et al. (2009).

[2]The President and Prime Minister are from two separate political parties, each with differing ideologies.

2 Path Dependence: Sri Lanka's Public Enterprise Reforms in Context

The evolution of SOE reforms in Sri Lanka points to cycles of episodic change and pullback. An institutional framework conducive to durable reforms was missing during the conflict years. With narrow political interests gaining precedence over broader socioeconomic aspirations, these years witnessed several instances of missed opportunities.

Sri Lanka's state sector played a central role in a wide range of economic activities when the country embarked upon liberalization in 1977. The SOE sector had expanded from about 5.7% of the gross domestic product (GDP) in 1961 to 12.2% in 1974 and to more than 15% by 1977 (Kelegama 1997). Further, the public sector accounted for around one-third of investment and 40% of formal sector employment by then. Many SOEs made losses and were burdened with overstaffing, mismanagement, deficient procurement processes, corruption, and politicization. Yet there was no change in these circumstances for nearly a decade after liberalization. SOEs offered an easy avenue for rent-seeking and political patronage through employment opportunities, and the massive influx of concessionary aid that accompanied the 1977 reforms eased the government's resource constraints, making it possible to sustain these practices. The 1977–1989 period was also not favorable to deepen reforms in the face of mounting macroeconomic instability and political violence. As argued in Dunham and Kelegama (1997), the slow pace of SOE reforms was a rational policy response to the political infeasibility of change in the face of domestic social pressures.

By the mid-1980s, budgetary transfers to SOEs averaged around 10% of GDP annually (Knight-John 2004b). Donors who had previously deprioritized such unsustainable losses now made aid contingent upon a series of stabilization and liberalization measures, including privatization. As such, privatization was formally specified as a government policy in 1987 to tackle the fiscal burden and to enhance the efficiency of SOEs. In 1989, two pieces of legislation were enacted designed to facilitate the commercialization of SOEs. Several entities to handle the privatization program were also established.[3]

In an astute populist strategy, the privatization process was dubbed 'peoplization', connoting a process of handing public assets from bureaucrats to the people. A presidential decree declaring that no worker would lose their jobs due to privatization further cemented this characterization. Although these strategies were a part of the government's political tactics to deflect protests from trade unions and opposition parties on allegations of corruption, the government ultimately did divest a substantial number of enterprises. For example, the privatization program from 1989 to 1994 (first wave of privatization) witnessed a partial and full sale of around

[3]These included a Presidential Commission on Privatization, Public Investment Management Board and the Commercialization of Public Enterprises Division, Ministry of Finance.

43 commercial enterprises with gross receipts approximating to around 0.3% of GDP in divestiture proceeds a year (Knight-John 2004b).

The government adopted a standard 51:30:10 formula: Corporate investors acquired a majority shareholding of 51–60%, the public had the opportunity to acquire 30% of the enterprise, and employees were provided a 10% stake under an employee stock ownership plan (ESOP). This approach was designed to incentivize corporate investors to transfer technology and productive capital, to boost the Colombo Stock Exchange (CSE) and diversify share ownership, and to win over trade unions ideologically opposed to these reforms.

Several SOE privatizations deviated from this standard structure, including employee buyouts (e.g. Hotel Buhari), gifting 50% of shares (bus transport sector workers), and management contracts (plantations). These five-year management contracts later turned out to be a disincentive to long-term investment in the plantation sector. As such, in 1995, 51% of the shares of profitable plantations were divested with the initial purchase offer made to the management company, followed by the sale of 51% of loss-making companies on an all-or-nothing basis on the CSE.

As Knight-John (2004b) contends, the involvement of multiple agencies combined with an absence of transparency and accountability undermined efficacy as well as good governance in the privatization process. Privatization provided unprecedented opportunities for large-scale rent-seeking and contracts being signed based on political connections. A new government that came into power in 1994, contrary to the expectations that it would reverse the liberalization process, carried out complex privatization exercises in sectors such as telecommunications, airlines, and gas under the slogan ‘Free Market Economy with a Human Face’ (Bandaranaike 1995).

According to Knight-John (2004a), these exercises were more complex and broad ranging than those undertaken in the first wave of privatization. In this 1995–2000’s wave, the government realized gross receipts of around 0.9% of GDP annually. Institutions underpinning privatization also demonstrated better governance than previously. At least in the initial stages of operation, transparency and access to information improved with the establishment of an apex organization, the Public Enterprise Reform Commission (PERC), intended to assume sole responsibility over the privatization process.

However, the realities of coalition politics gradually stymied the reform momentum with the government’s ability to make resolute decisions undermined by the conflicting interests. The government also enacted legislation, the Public Enterprise Rehabilitation Act, to gain favor with workers. This Act was designed to address the interest of workers in privatized entities that had to be shut and to limit industrial disputes. Seven entities were re-vested with the government under this legislation. Given the size of the enterprises being privatized, rent-seeking grew to an even larger scale, further compromising good governance.

The government made several policy choices that damaged good governance, including using exclusivity provisions without strong regulation in the telecommunications, gas, and airline sectors. As Knight-John (2004a) describes, exclusivity provisions are not uncommon when developing countries are faced with hard budget constraints and are in dire need of foreign direct investment (FDI), creating space for multinationals to drive a hard bargain. Yet, the more troubling feature, and one that has been a hallmark of all governments since liberalization, is the lack of solid regulatory institutions.

Box 1 Sri Lanka Telecommunication Sector Reforms Sri Lanka's telecommunication sector is widely hailed as a success story with privatization putting an end to high unmet demand for services, long waiting periods, and poor transmission quality. However, as contended in Jayasuriya and Knight-John (2002), it is structural competition and contestability in the sector that has driven performance in terms of high rates of market penetration and low mobile prices. Indeed, although a pro-competitive regulator headed the sector regulator, the Telecommunications Regulatory Commission (TRC), at the time of privatization, the TRC reported to a line ministry and the Secretary to the ministry was the ex officio chairperson of the commission, a structure that created a conflict of interest and was likely to undermine regulatory independence over time.

The election of a new government in 2001 saw the announcement of a wide liberalization program that specified an acceleration of privatization as one of its three main goals (Government of Sri Lanka 2002). During 2001–2004, significant regulatory initiatives under a special sunset entity—the Public Interest Programme Unit (PIPU)—go underway. One important initiative was the creation of a multi-sector regulator, the Public Utilities Commission of Sri Lanka (PUCSL), to facilitate regulation of the electricity, water, and petroleum sectors.[4] The government enhanced regulatory governance in this process with judicious measures taken for the PUCSL to be accountable to a Constitutional Council (CC), effectively making it answerable to Parliament. This arrangement set the PUCSL apart from other utility regulators that reported to single line ministries. Yet, while the structure of the PUCSL adhered to principles of good regulatory governance, the PUCSL has been unable to counteract the negative political economic tides that it faces in implementing good policy choices.

Further examples of failures in institutional and regulatory capacity in Sri Lanka's privatization process during these years include the sales of Lanka Marine Services (LMS) and Sri Lanka Insurance Corporation (SLIC). In 2002, the Treasury and PERC sold off a majority stake in LMS and a controlling interest in SLIC in the following year. Following allegations by the Committee on Public Enterprises (COPE) that these privatization exercises were conducted in a corrupt manner, the Supreme Court investigated these transactions. Subsequently, between 2008 and

[4]As at the time of writing, the PUCSL only regulates the electricity sector, while serving as a shadow regulator for the petroleum sector (advising and providing technical assistance on the formulation of a regulatory framework).

2009, the Supreme Court reversed both divestitures and ordered that the entities be reverted to state ownership. The judgment on both these transactions points to rent-seeking and crony capitalism, with private interests aiming to secure unlawful benefits from the privatization process (Knight et al. 2017).

3 The SOE Reforms in Post-conflict Sri Lanka

3.1 Eschewing Privatization, 2005–2014

A new government that took office in 2005—straddling both the war and immediate postwar years in Sri Lanka—eschewed mentioning the privatization of public entities and national resources. Further, the government reneged on competition-centered electricity sector reforms, even with enabling legislation in place, to placate trade unions. Expropriation legislation was also enacted in 2011, under questionable principles, to acquire and manage 37 ‘underperforming’ or ‘underutilized’ private enterprises (Government of Sri Lanka 2011).

The government resurrected the Strategic Enterprise Management Agency (SEMA) created in the first wave of privatization to manage strategic SOEs in several sectors, including banking, energy, transport, and plantations. SEMA’s mandate was to improve, without privatizing, the efficiency, fiscal, and distributional performance of the SOEs under its purview. This period also saw the establishment of the State Resources Management Corporation (SRMC)—a holding company intended to evolve into a Temasek-like organization. Overall, however, the institutional environment that prevailed in the immediate post-conflict years was not conducive to SOE reforms. These years witnessed massive infrastructure projects that added to the numbers of state entities, such as the Hambantota Port and the Mattala International Airport.

The Ministry of Finance (2017) estimates suggest that there are 400 SOEs at present, with the Department of Public Enterprises overseeing 264 entities and the Department of National Budget supervising the remaining 136 entities. By contrast, the Department of Management Services (2017) numbers SOEs at 272.

The 264 SOEs coming under the Department of Public Enterprises include 55 state-owned business enterprises (SOBEs) that are engaged in commercial activities, have at least 50% state ownership, and have been classified as strategically important by the government. These 55 SOBEs have a significant presence in the country’s economy with a turnover of approximately 13% of GDP as at 2017 (Ministry of Finance 2017). Data from the Ministry of Finance (2017) also indicate that the energy, aviation, and banking sectors make up more than 80% of SOBE turnover. The state banks dominate the banking sector with 40 and 44% of total industry assets and lending portfolio, respectively. In the energy sector, the Ceylon Electricity Board (CEB) holds a virtual monopoly and the Ceylon Petroleum Corporation (CPC) has a duopoly market share with Lanka Indian Oil Company

(LIOC)—with CPC as the market leader—supplying over 80% of the country's energy demand (Ministry of Finance 2017).

Further, the IMF (2018b) estimates that contingent liabilities of non-financial SOBEs stand at nearly 11% of GDP.[5] The employment numbers published in the Ministry of Finance (2017) and by the Department of Census and Statistics (2016) indicate that public enterprises (including state banks) account for 17% of total public sector employment (in 2017) and for around 3% of Sri Lanka's total employment (in 2016).

In 2017, 39 SOBEs recorded a cumulative profit of Rs. 136 billion, while 16 SOBEs made a cumulative loss of Rs. 87 billion (Department of Public Enterprises 2017). However, excluding the financial sector (eight state banks, Employees' Trust Fund, and four insurers), the SOE sector actually made a net loss of Rs. 43.8 billion in 2017. Further, the return on assets (ROA) for SOBEs was just 0.6% in 2017, with the ROA for the non-financial sector reflecting a far worse situation at −18.5%.[6] Data set out in IMF (2018b) show that the losses of CEB and SriLankan Airlines (SLA) amounted to −0.4% and −0.1% of GDP, respectively, in 2017 and that the outstanding financial obligations of these enterprises were 2.3% and 2.8% of GDP, respectively, at the end of 2017. In addition, trend data indicate that the losses made by SLA averaged 0.1–0.4% of GDP in 2011–2017. In contrast, as reported in the Ministry of Finance (2017), the Sri Lanka Ports Authority (SLPA) together with the financial sector SOBEs—Bank of Ceylon (BOC) and People's Bank (PB)—showed significant profits.

The size and scale of these public enterprises emphasize the importance of thoroughly understanding the challenges posed by them, and getting to workable solutions before yet another window of opportunity closes.

3.2 Public Enterprise Reforms Post-2015

Sri Lanka's new government of 2015 has articulated a commendable vision to adopt a model similar to Singapore's Temasek to manage the country's strategic SOEs. It aims to create a Public Wealth Trust to hold the shares of these SOEs on behalf of the people (Wickremesinghe 2015). The Treasury Secretary and Governor of the Central Bank of Sri Lanka (CBSL) are expected to act as the custodians of this Trust, with the other members of the board being nominated by the CC and the board being directly answerable to the Parliament. Further, legislation—Public Enterprise Act—was to be instituted to ensure transparency in the reform process. These policy proposals were restated with additional information on the setting up of a Public Commercial Enterprise Board (PCEB) to manage SOEs on a

[5]However, this calculation may well underestimate the fiscal burden imposed by these enterprises, given the circular debt that prevails in the sector. Currently, there is considerable borrowing and lending between non-financial SOBEs as well as between these entities and state banks.

[6]Calculated using Ministry of Finance (2017) data.

commercial basis (Wickremesinghe 2016). Policy statements on the SOE reform process are further elaborated in terms of public–private partnerships (PPPs) (Government of Sri Lanka 2017); the role of SOEs is also specified in terms of fiscal consolidation in relation to the IMF's EFF framework (Box 2).

Box 2 Extended Fund Facility and State-Owned Enterprises Reforms
The key elements of the EFF-related SOE reforms are (IMF 2016a):

- Recording the fiscal costs of SOEs' non-commercial obligations (including subsidies) in the central government budget from 2017;
- Statements of Corporate Intent (SCIs) for the six largest SOEs—CPC, CEB, SLA, National Water Supply and Drainage Board (NWSDB), Airport and Aviation Services (AAS), and SLPA—to be signed and published by the Ministry of Finance, line ministries, and SOEs by December 2016 to enhance oversight and financial discipline;
- Cabinet to approve a resolution strategy for SLA by September 2016, removing the entity from government accounts;
- Ministry of Finance to introduce an automatic fuel pricing formula for CPC, ensuring retail prices above cost-recovery levels and securing a financial position that facilitates debt service, by December 2016;
- Cabinet to introduce an automatic electricity pricing formula for CEB, ensuring retail prices above cost-recovery levels and securing a financial position that facilitates debt service, by December 2016.

The Fund's Fourth Review under the EFF, conducted in June 2018 (IMF 2018b), records progress on milestones as follows:

- SCIs for five (CEB, CPC, NWSDB, AAS, and SLPA) of the six major SOEs were signed in 2017. These SCIs outline the entity's mission, multiyear corporate plan, and performance indicators and include biannual compliance reports, providing for increased transparency and better governance practices.
- The resolution strategy for SLA is not on target, and attempts to secure a strategic partner for the enterprise have not been successful. A newly established Restructuring Committee is currently in the process of updating the original resolution strategy to place the airline on a sound operational and financial footing.
- In May 2018, Cabinet finally approved an automatic fuel pricing formula. As at now, Cabinet approval for an automatic electricity pricing formula is envisaged by September 2018. The IMF notes that although the approval of a fuel pricing formula is a significant achievement, an electricity pricing formula also needs to be established without delay, given the elevated fiscal risks faced by Sri Lanka.

While the policy vision and objectives of the reform plans are commendable on paper, the problem lies in that very few of these proposals have been implemented. For instance, the Public Enterprise Act and PCEB are yet to see the light of day, while progress on the divestiture of non-strategic SOEs such as Lanka Hospitals, Colombo Hilton, Hyatt Residencies, Water's Edge, Grand Oriental Hotel, Ceylinco, and Mobitel has been very slow. Crucial regulatory governance institutions, such as a competition policy framework and independent sector regulators, are still pending despite much discussion on the need for these in the post-conflict years.

One of the main reasons for this foot-dragging is the dynamics of Sri Lanka's coalition politics, with the policies of the two major parties being shaped by differing ideologies. While the need to coexist for political survival may have prevented any major perceivable shakeups, it has certainly introduced a series of hiccups as is evident from the sluggish pace of reform. The fact that the SOE reform process has been slow despite IMF conditionality also points to the substantial difficulties resulting from deeply entrenched extractive institutions.

4 Sri Lanka's SOE Reform Process: A Reality Check

Caught up in extractive institutions, economic policy choices have failed to effectively address three key challenges faced by the SOEs: efficiency, fiscal, and distributional.[7] As discussed in Knight et al. (2017), the efficiency, fiscal, and distributional dimensions of SOE performance are interlinked and have common threads. For instance, the absence of institutional structures conducive to efficiency will also weaken fiscal performance and undermine the delivery of PSOs. Similarly, fiscal deterioration together with PSO expenditure that is not appropriately targeted will have an adverse impact on efficiency. Further, the politicization of decision-making will have harmful effects on all three of these dimensions.

Reflecting upon Sri Lanka's postwar SOE reform narrative suggests that any windfall opportunities may have been squandered due to institutional dynamics such as flawed regulatory governance and the absence of forces conducive to the coalescing of political economy reform.

Political patronage in the form of employment opportunities and subsidized goods and services continues in this sector, as in other state organizations. Although welfare disbursement is not necessarily inapt, the hijacking of these policies for narrow political gain will have a perverse impact on inclusive development. Further, while PSOs are intrinsically linked to public enterprises, these objectives cannot be effectively fulfilled in the absence of commercial viability.

A suboptimal institutional milieu also encompasses Sri Lanka's regulatory governance structures. As described in Knight-John (2004b), solid ex-ante and

[7] See Knight-John and Athukorala (2005) and Knight et al. (2017) for historical analyses of these dimensions in the context of Sri Lanka's political and economic institutions.

ex-post regulatory institutions are crucial for successful SOE reforms. And yet any change in this regard has been episodic and has not proved to be stable. For instance, at present, the PUCSL is effectively hostage to the operator, the CEB. Disagreements centering on Sri Lanka's energy mix—whereby the regulator amended the operator's 'Least Cost Long Term Generation Expansion Plan' to increase the share of liquified natural gas (LNG) and renewables and to omit coal—ended with the PUCSL backing down. The CEB did not accept the amended plan and sought approval from the Cabinet to stick to its original proposal, including coal power. Although this Cabinet paper was rejected by the regulator, the plan was subsequently approved to avert crises ensuing from CEB union threats to shut down power plants. Presently, the CEB effectively controls the policy, operational, and regulatory space, contravening principles of trifurcation that buttress effective checks and balances.

Sri Lanka's ex-post regulation is also ineffective despite years of policy discussion and attempts to create a robust competition law framework. At present, the country does not have a comprehensive competition law. The existing legal framework, embodied in the Consumer Affairs Authority Act of 2003, provides for the institutionalization of the Consumer Affairs Authority (CAA) and focuses primarily on consumer protection. Sri Lanka did have broader antitrust provisions until 2003 through the Fair Trading Commission Act of 1987 as well consumer protection provisions through the Consumer Protection Act of 1979. However, the 2003 law repealed this legislative framework.

In practice, what this means is that policymakers do not have adequate tools in their arsenal to investigate, deter, or penalize anticompetitive behavior stemming from monopolies and mergers. As argued in Jayasuriya and Knight-John (2002), pro-competitive regulation is an essential component of the SOE reforms, including privatization, to improve consumer welfare and stimulate dynamic growth. In the absence of such regulation, there is greater opportunity for rent extraction on the part of new private investors, politicians, and favored bureaucrats.

While there are several factors that feed into the efficiency of Sri Lanka's SOEs, the most important element is management weaknesses. Deficiencies in the governance framework, flawed systems of accountability and transparency and political interference in the running of these enterprises are some of the main reasons for weak management. An instructive example, highlighted by the Committee on Public Enterprises (2016) in this regard, is the mismanagement of the Norochcholai coal power plant. Specifically, the Committee report identified the following major factors as contributing to three blackouts that occurred in 2016: selection of a supplier for the plant constructed with Chinese aid by China itself; poor maintenance of transformers and shortcomings in the planning of machinery maintenance; lax supervision during the first phase of construction; and appointment of new teams for the second and third phases of construction under deficient management. On a related note, coal purchasing undertaken by the CEB's subsidiary, Lanka Coal Company, for Norochcholai was held to have failed to comply with procurement guidelines established by the Auditor General's Department (2016). According to this report, the failure to comply with these guidelines together with irregularities in the bidding process resulted in continuous losses from 2009 to 2016. Once again, this state of affairs points to the entrenched nature of extractive institutions.

Weak management capacity or political pressures undermine proper due diligence processes. As such, financial obligations of individual SOEs are sustained and passed on to other entities in this space, perpetuating the circular debt predicament. The dismal fiscal performance of SOEs is mainly due to the management deficiencies discussed above, constraints in adopting some degree of cost-reflective pricing and the prevalence of 'pseudo' PSOs. Any wasteful expenditure on public enterprises encompasses monies that might have been spent elsewhere for potentially more productive and socially constructive purposes. As such, the opportunity cost of SOE spending must be carefully considered even in the context of PSOs. It is important that these obligations are targeted to meet genuine distributional concerns and inclusive growth rather than to placate political interests.

Further, the existing institutional structures are not amenable to the principal agent dynamics that should ideally govern public enterprises—with the public as owners and SOE managers as agents. As at 2017, only 18 of the 55 SOBEs had submitted their annual reports to the Treasury (Department of Public Enterprises 2017). The Ministry of Finance (2017) rightly identifies factors such as an inadequate policy and legal framework, absence of good governance practices, lack of clear accountability mechanisms, and weak organizational supervision as underpinning the dismal performance of SOEs. While the SCIs signed by five major SOBEs and a recent circular issued by the Ministry of Finance (2018b) holding Ministry Secretaries and Heads of Departments accountable for employment beyond the approved cadre and for salary payments are unquestionably steps in the right direction, much more needs to be done to instill the right mind-set—the management culture essential for the long-term viability of these enterprises.

Policymakers also must contend with another challenge in the reform process: the ramifications of cost-reflective pricing. While cost-reflective pricing is important to establish financial viability, the flipside of adopting this measure in terms of its impact on vulnerable segments of the population needs to be considered. Further, it is essential that the cost of subsidized pricing be assessed in the context of the sustainability of PSOs in the long term. As rightly emphasized in the IMF (2016a), there needs to be rationalization of pricing structures with any subsidies being directed only to vulnerable groups.

Politically, however, these reforms are difficult as evidenced in the delays encountered in the establishment of both the CPC and CEB price formulae. In May 2018, prior to introducing the fuel price formula, the government raised the prices of petrol, diesel, and kerosene. A key rationale for hiking kerosene prices was to disincentivize the adulteration of fuels such as diesel using kerosene oil. However, the increased prices had a disproportionate impact on poorer segments of the population, including fishermen. As such, kerosene was not included in subsequent fuel price hikes and policymakers promised targeted subsidies for fisherman and Samurdhi beneficiaries to mitigate the distributional impacts of change. The IMF (2018b) also specifies the need for social safety nets combined with a social registry and means-testing criteria to compensate low-income groups for higher energy prices.

5 Breaking the Mold: SOEs for Inclusive Growth

The analysis in this chapter highlights the adverse impact of extractive institutions on policymaking, in this case Sri Lanka's SOE reform process. Path dependence on crony capitalism, rent-seeking, and deficient regulatory governance that characterized these reforms since liberalization and through the war years has extended into the post-conflict period. At present, the murkiness of the reform process is linked to the realities of bipolar politics and electioneering with IMF conditionality having only a limited impact on policymaking and outcomes. In this context, it is likely that only low-hanging fruit such as the divestiture of non-strategic enterprises may be completed before the next round of elections in Sri Lanka. Still, if reforms are to be realized in a sustainable fashion even after elections, it is crucial to frame the efficiency, fiscal, and distributional issues confronting these SOEs in a manner that can easily be comprehended by a wide segment of stakeholders.

Sustainable reforms require inclusive institutions—a challenging condition as indicated in the narrative set out in preceding sections. However, even if these first-best conditions are not immediately possible, there is room for meaningful, if incremental, SOE reforms. While being cognizant of institutional, political, and human capital constraints for instance, it is critical to increase transparency and to open dialogues with politicians, unions, business groups, and other key stakeholders even in a limited number of sectors. Stakeholder contestation tends to be the strongest in the case of trade unions.

The common failures are lapses in transparency and stakeholder dialogue. By contrast, the 1997 Sri Lanka Telecom (SLT) privatization incorporated strategic measures to counter anticipated trade union resistance: Policymakers used employee stock ownership plans (ESOPs), sent trade union members to Latin American countries to study similar privatization processes, and transmitted letters from the telecommunications sector minister to affected families explaining the rationale for and nature of the divestiture exercise.

Sequencing is also integral to durable reforms; competition and effective regulation must be instituted prior to privatization if the process is to foster inclusive growth and not be hijacked by crony capitalists. Again, the presence of contestability (two fixed-line wireless local loop operators in addition to SLT) and competition (four mobile operators including SLT's subsidiary, Mobitel), together with establishing the TRC (despite the structural impediments described above) contributed immensely to the success of the telecommunications sector. According to Knight-John (2011), this sequencing of reforms resulted in the incumbent, SLT, posting an average connectivity increase from 12.88 to 31.97% in the pre- and post-competition periods, respectively. Further, the compound annual growth rate in 1995–1998 was 48.6% in the relatively more competitive mobile market as against 36.5% in the fixed-access market, which retained barriers to competition in international telephony. In fact, as asserted in Knight et al. (2017), competition and contestability combined with solid regulation are as, or more, critical than privatization for sustainable reform outcomes. It is important therefore that policymakers accelerate the process of establishing sectoral regulators as well as the competition authority that has been discussed by successive governments and is long pending.

As set out in Knight-John (2011), there is also no conclusive evidence that ownership change is essential for positive reform outcomes. Instead, what the international experience shows is that it is management reform based on the structuring of incentives around principal agent dynamics that can enhance the performance of the SOEs. In the context of public enterprises where the principal is the general public and the agent is management, the challenge lies in institutionalizing incentives that firm up the line of accountability between the public and SOE managers. In addition, implementing blanket privatization initiatives without sufficiently unpacking the broader socioeconomic and political milieu may well result in perverse distributional outcomes and resistance to any form of SOE reform.[8] Sri Lanka's present political context does not allow for large-scale privatization. Moreover, in the absence of solid regulatory entities, privatization could result in public monopolies transmuting into private monopolies, with adverse socioeconomic effects. The nature of the SOE sector—with different types of enterprises—demands a case-by-case approach to reform. Further, as discussed before, management inefficiency is one of the biggest issues eroding SOE performance. As such, going forward, a strategic path to SOE reform must be centered around enhancing management efficiencies and accountability.

Three modalities that have gained traction internationally, and can potentially be modified to fit the Sri Lankan environment, are performance contracts, management contracts, and government holding company models. As described in Knight-John (1997), the objective of performance contracts is to institutionalize effective incentive structures and processes that reward managers and employees for improved efficiency, productivity, and service quality. These incentives are designed to foster a competitive dynamic within the SOEs by providing, for instance, additional compensation to managers who achieve specific financial targets or bonuses to workers who achieve a particular production output or service level. While this modality has considerable potential in the Sri Lankan context, it has not been sufficiently explored by policymakers 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. Given that performance contracts are effectively an extension of the SCIs already in place for five major SOEs, it would be relatively easy to institutionalize these measures at least for these enterprises.

Management contracts provide for the outsourcing of specific management functions to the private sector. International experience suggests that this reform option is effective at infusing competition and improving productivity and service quality when privatization is not feasible. Sri Lanka experimented with this modality in the plantations sector. This experience with management contracts points to the following ingredients that must be in place for efficient and socially beneficial

[8]Recall the follies of privatization in Russia and Latin America following 'Washington Consensus' prescriptions and the failed British railways privatization experiment.

outcomes (Knight-John 2004b): These contracts must be drafted transparently with all stakeholders able to access these documents; management companies must be selected on a competitive basis using open bidding procedures; the basis and calculation of management fees must be set out in the contract; any conditions such as investment requirements and environmental and social obligations must be specifically delineated in the contract; exit and termination clauses must be clearly specified; service standards and default triggers must be clearly defined; and the private management must have autonomy to take decisions in line with competition and market forces.

Two other reform options that have figured in the country's policy discourse as well as practice are the government holding company and PPPs. Although its precise structure and scope has not been made public, the PCEB is essentially a government holding company designed as a hybrid of Singapore's Temasek and Malaysia's Khazanah models. However, this entity has still not been established. Further, as evidenced from the Singaporean experience, this modality requires political economy conditions such as a strong regulatory governance framework, accountability processes not muddied by political patronage, and access to an adequate pool of technocrats and professional civil servants. In the absence of these factors, the adoption of this modality may not result in improved management accountability and may only add another layer of bureaucracy. Still, some elements of this model such as listing SOE shares on the CSE could be considered; listing even a modest percentage of shares could instill management discipline and make board members and senior managers accountable to shareholders. Once again however, regulatory entities such as the Securities and Exchange Commission need to be robust for the listing of shares to enhance management efficiency.

At present, the government is actively pursuing PPPs as exemplified by the establishment of a public–private partnership unit in the Ministry of Finance. While policymakers may have expected this option to face less resistance than privatization, PPPs have been caught up in circumstances involving opportunistic political elements, undermining their ability to deliver positive reform outcomes. Further, this modality requires significant technical expertise to structure and negotiate complex deals—an element that is scarce in today's SOE sector space. For instance, it is unlikely that the South Asia Gateway Terminal (SAGT) PPP, which is widely hailed as a success, can be replicated in today's institutional context.

More recently, there has been considerable controversy over the structuring of power purchase agreements (PPAs) between CEB and independent power producers (IPPs), with the PUCSL (2016) highlighting unfair risk allocation where the state assumes disproportionately high risks with zero returns, while IPPs get disproportionately high returns for virtually risk-free investment. In the final instance therefore, PPPs do not sit well with Sri Lanka's political and economic institutional milieu and are not likely to facilitate inclusive growth.

Clearly, Sri Lanka's SOEs are underperforming at several different levels with extractive political and economic institutions limiting their ability to enter into sustainable reform processes. Path dependence in terms of rent-seeking, crony capitalism, weak regulatory governance, and policy gaps over the years eroded the potential for positive reform outcomes. Yet, the current political economy context, even with the dynamics of bipolarity and electioneering, offers a narrow window of opportunity for even incremental reform. Although the embedded nature of extractive institutions precludes the possibility of moving from a vicious to a virtuous cycle within this election period, meaningful reforms can be instituted if policymakers adopt a realistic and pragmatic approach to change. As such, it is important that concrete steps be taken to convert challenges into opportunities in terms of inclusive development before yet another window for reform closes.

6 Conclusion

The chapter points to deep set issues of rent-seeking, crony capitalism, and abysmal regulatory governance in Sri Lanka's public enterprise reform process. While the narrative from 1977 does show episodic reform, the strong path dependence of extractive institutions outweighs any small successes. A conspicuous element in the country's SOE reform process is the absence of political ownership, with the political leadership focused on other priorities such as coalition management. Successive regimes have failed to address issues of inclusive development in the reform process, with the well-connected benefiting from increased rent opportunities under non-transparent divestiture, while the relatively poor have little or no access to gains from privatization. Even at present, the SOEs face a dire situation and need urgent attention if the country is to seize a narrowing window of opportunity, avoid repeating history, and secure inclusive growth.

The discussion in the chapter demonstrates that the SOE reforms present fundamental challenges that need to be urgently addressed if the country is to seize a narrowing window of opportunity. The bipolarity of Sri Lanka's coalition governing arrangements combined with three impending elections has deflected focus from crucial reforms despite the IMF conditionality. Moreover, path dependence with respect to extractive institutions and regulatory governance has characterized the post-conflict years. Systemic weaknesses have undermined episodes of sound policy. Once again, the fundamental message emerging from this narrative is that the contingent path of history plays a key role in shaping the reform process.

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Managing Macroeconomic Stability While Investing in Reconstruction in Post-conflict Sri Lanka

H. N. Thenuwara

Abstract In the aftermath of an exogenous shock such as resolving the prolonged conflict in Sri Lanka, it is expected that markets begin to revive, domestic and foreign investment increases, and the government and donor communities begin to extend substantial rebuilding efforts. The major impact of such events and efforts is the expansion of the economy which may also exert inflationary pressures, create exchange rate upheavals, and expand external and internal imbalances. Addressing and managing the forces of such instability on the economy to ensure a sustainable growth path require well-designed policy measures. However, policy design becomes complicated if the external economic environment becomes unhealthy, while it is facilitated by some external help such as assistance from international organizations such as the International Monetary Fund (IMF). To evaluate the stability of the Sri Lankan economy after the end of the conflict in 2009, this chapter compares it with Sri Lanka's liberalization shock of 1977. The paper concludes that after the end of the conflict, Sri Lanka's economic stability was better maintained with a tighter monetary policy, and it was facilitated by the lesser impact of a shock, a gradual global recovery from the great global recession of 2007, and the effects of assistance from the IMF.

1 Introduction

Macroeconomic stability is commonly identified as the predictability of a country's macroeconomic environment (Zagha and Nankani 2005). According to Ames et al. (2001), macroeconomic stability exists when key economic relationships such as aggregate demand and supply, savings and investments, foreign capital inflows and outflows, and fiscal revenues and expenditures are in balance. The prevalence of

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imbalances or macroeconomic instability is portrayed by low economic growth, high rates of unemployment and inflation, high fiscal deficits and rising government debt, volatile exchange rates, as well as current account deficits and falling international reserves.

Maintaining macroeconomic stability is vital to a country as it establishes the basis for the long-term economic well-being of the people. Sustained instability impoverishes countries as was seen in the case of Zimbabwe in 2009 (Koech 2011). In view of this, countries have established institutions to maintain economic stability; these institutions use macroeconomic policies—mainly fiscal and monetary policy—to maintain economic stability. The institutions are expected to be constantly vigilant on the potential economic shocks that can bring about instability, and design policies to counter any destabilizing forces. The broad objectives of such policies are to achieve a certain set of medium-term targets; high economic growth, full employment, low inflation, stable exchange rates, and sustainable fiscal and current account balances.

The design of macroeconomic policies takes into account potential domestic and external economic developments. However, when economies face major domestic and external "shocks," the policy design and conduct becomes challenging. Sri Lanka found itself in such a situation in the aftermath of the war in 2009. Indeed, over the 70 years of its post-independence, the Sri Lankan economy has been buffeted by several major external shocks, as a result of which the country has suffered from macroeconomic instability from time to time. During some episodes, macroeconomic policies have been able to contain the impact of shocks, while in some other cases, macroeconomic policies lost maneuverability in responding to shocks.

This chapter reviews Sri Lanka's macroeconomic stability in the aftermath of the "end of conflict shock." In order to compare and contrast and draw comparative lessons, the analysis also examines another positive exogenous shock—i.e., the liberalization of the Sri Lankan economy in 1977 after seven years of closed economic policies. This episode is discussed as the "the liberalization shock." Both shocks are positive economic shocks that greatly enhanced investment opportunities and returns to such investments in the country. However, although the shocks are favorable, their impacts can lead to instability in the economy if prudent macroeconomic policies are not implemented.

The remainder of the paper is structured as follows. Section 2 presents an overview of the two shocks—i.e., the "liberalization shock," and the "end of conflict shock." Section 3 describes the global economic environment. Section 4 outlines the assistance to Sri Lanka from international agencies to maintain economic stability. Section 5 provides an analysis of the impact of the two shocks. Stability in the aftermath of the shocks is analyzed in Sect. 6. Section 7 discusses the policy response and Sect. 8 concludes.

2 Overview of the Liberalization Shock and the End of Conflict Shock

Though both the liberalization and the end of conflict shocks are favorable, their impacts could have generated instability in the economy if prudent macroeconomic policies were not implemented. To measure the impact of the shocks, and the efficacy of macroeconomic policies, three types of variables are used—i.e., impact variables, indicator variables, and policy variables.

Impact variables measure the size of shocks. The major impact variables are foreign direct investment (FDI), foreign debt of the government, government expenditure on public investment, and overall government expenditure. The impact variables affect overall output growth, inflation, exchange rate movements and current account and fiscal sector balances. Hence, these are considered as the indicator variables of the shocks. These variables also respond to stabilization policies.

Stabilization policies are fiscal and monetary policies; their usage depends on the nature of shocks and the state of the economy. Before the two positive shocks of interest explored in this chapter, the Sri Lankan economy was on a low growth path. After the positive shocks, fiscal policy was mostly used to facilitate the expansion of the economy with increased government expenditure via higher public investment. One of the major tools of fiscal policy—the “tax rate”—cannot be used as an effective policy tool in Sri Lanka due to the under-developed nature of the tax system. The major drawbacks are low tax compliance and an insufficient tax base. The International Monetary Fund (IMF) argues that the aim of the fiscal policy is also to reduce high budget deficits which can act as a destabilizing factor (IMF 2010, 2013a).

In the case of Sri Lanka, Athukorala et al. (2017) suggest that there is insufficient fiscal policy space in Sri Lanka for countercyclical policy measures that can bring about stability after a major exogenous shock. Thus, monetary policy is the sole policy tool available to restore stability in the short and medium terms after a major shock. The objectives of monetary policy are to contain inflation arising from an expanding economy at a rate consistent with “price stability” and to stabilize any volatile movements in the nominal exchange rate that would destabilize the real exchange rate.[1] Two policy variables—i.e., money supply and interest rates—are used in this study to assess the monetary policy stance.

2.1 *Liberalization Shock*

Sri Lanka regained independence from the British in 1948. The country was granted Dominion status under the Ceylon Independence Act of 1947, with the Governor

[1]Price stability is defined as the inflation rate which does not interfere with investment decisions of economic agents. In many countries, this is regarded as a core inflation rate of 2% (Thenuwara 2015).

General representing the British Monarch as the head of state (Central Bank of Sri Lanka 1998).

The Central Bank of Sri Lanka (CBSL) highlights that at the time of regaining independence, Sri Lanka, was an open economy with a predominant agriculture sector, with a contribution of about 40% to the economy (CBSL 1998). After independence, successive governments gradually began to promote inward-looking policies, imposing barriers to international trade to meet several objectives. Among them attempted to ease balance of payment (BOP) difficulties that Sri Lanka began to experience at the time, as well as attempts to raise government revenue from import taxes. Other objectives included government attempts to appease populist demands in the form of opposition to "alien capitalism" that was in place during the colonial era, in favor of statist and nationalist economic policies (Moore 1997). Such a policy shift was seen in other South Asian countries that gained independence during the same period (Moore 1997).

In response to the above nationalist demands, and to fulfill political promises, many private enterprises began to be "nationalized"—a term used to ascertain government ownership of such enterprises. The management of these enterprises was handed over to government bureaucrats (Kelegama 1992). This trend continued and peaked during the period 1970–1977. In addition to nationalization, the government that came to power in 1970 made a conscious decision to embrace stringent closed economic policies with the primary aim of achieving "self-sufficiency," instead of maintaining an open-economic policy regime and harnessing Sri Lanka's comparative advantages. According to Athukorala (2016), by the mid-1970s, Sri Lanka had adopted most inward-oriented economic policies and regulations outside the communist-bloc.

The years following the shift to a closed economic regime were witness to shortages of goods and services to meet basic human needs such as food and clothing, whereby the government itself has become a significant supplier of such goods and services. Considerable time and effort were wasted by the people during this period on such mundane activity such as waiting in "queues" to purchase government-supplied low-quality food and clothing. In addition to an import embargo on basic goods and services from foreign countries, the government also imposed barriers to restrict trade in essential food items such as rice between the different districts of Sri Lanka. As the country's economic difficulties intensified over time, the government loosened up its policies of self-sufficiency and permitted a limited amount of imports to trickle into the country. Despite these efforts, the government was swept out of power in 1977 by a disgruntled voting public that saw the entry of a new government committed to a great degree to introduce a liberal, open-economic policy regime.

The liberalization measures introduced subsequently in 1977–1978 included the adoption of freer trade policies, an opening up of the economy to FDI and constitutional guarantees against the nationalization of foreign assets without compensation, a unification of the existing dual exchange rate followed by a sharp devaluation of the currency, and a much more limited direct public sector participation in the economy (Athukorala 2016; Athukorala et al. 2017).

Unlike most other adjustment cum stabilization programs of the day, Sri Lanka's economic liberalization program was also accompanied by an expansionary fiscal policy stance. Higher government expenditures were directed at accelerating a vast irrigation and hydro-power program that spanned for over a decade from 1977 onwards. Despite the promising start made, Sri Lanka could not enjoy the fruits of economic liberalization as a result of an escalation of ethnic conflict in the country from 1983.

2.2 *End of Conflict Shock*

Sri Lanka did not have an "ethnic conflict" at the time of independence. At that time, the country was widely regarded as a "plural society" composed of clusters of different communities living in close proximity to each other. In fact, there was a considerable degree of sociopolitical stability all across Sri Lanka during this time (De Silva 2005). However, evidence of conflict between the Sinhala and Tamil communities began to appear within the first decade of independence (Furnivall 1948; Kearney 1985). It could well be argued that the conflict would have been further fueled by the low rate of economic growth that Sri Lanka began to experience in the years following independence. As suggested by Athukorala et al. (2017, p. 6), the reasons for slow economic growth are primarily the result of "successive administrations turning away from a private-sector led, outward-oriented development strategy in favor of state-led inward-looking policies." This phase of slow economic growth resulted in high rates of unemployment as well (Table 1). The prominence of the state sector in the Sri Lankan economy resulted in insufficient employment opportunities in the private sector. This created ample opportunities for rent-seeking behavior, whereby employment opportunities in the public sector could be more easily handed down by politicians running the government to those known to ruling party members.

Owing to a multitude of complex socioeconomic and sociopolitical reasons, the conflict between the Tamil minority population and the government became

Table 1 Unemployment rates in Sri Lanka 1963–1985

Year	Male	Female	Total
1963	15.3	20.0	16.6
1968	11.2	20.1	14.3
1971	14.3	31.1	18.7
1973	13.7	26.8	18.3
1975	14.3	33.1	19.7
1978	9.2	24.9	14.8
1981	13.3	31.0	17.9
1985	10.8	20.8	14.1

Source Based on Annual Report of CBSL (2017)

increasingly violent throughout the 1970s and 1980s (Kearney 1985). The watershed in this violent conflict was the killing of 13 government soldiers by Tamil rebels in 1983 (DeVotta 2000). Since then, the conflict became increasingly more brutal until it was crushed in May 2009, bringing an end to a 30-year armed separatist conflict.

The end of the conflict brought in a heightened sense of political stability to Sri Lanka. The uncertainties of the war years had deterred private investment, both local and foreign, and diverted much-needed attention away from the economy. Thus, as expected, Sri Lanka's post-war euphoria stimulated all components of aggregate demand in the economy. At the same time, however, the world economy was entering the worst recession of recent history.

3 The Global Economic Environment in the Aftermath of the Two Shocks

The integration of economies through closer trade and investment links mean that the global economic environment affects the economic well-being of any country. A favorable global economic environment can promote FDI and exports, and thereby help countries to reap the full benefits of a positive domestic economic shock. However, in the aftermath of the two shocks experienced by Sri Lanka as discussed above, the global economy was not experiencing boom conditions. Rather, it was recovering from a recession, or going into a recession.

In the time since Sri Lanka's independence, the global economy has experienced a large number of recessions. Table 2 provides the dates of recessions that have occurred globally, as well as those experienced by Sri Lanka's major trading partners at the time of the two major shocks being examined in this paper. Kose and Terrones (2016) have recorded four major global recessions that occurred in 1975, 1982, 1991, and 2009. The National Bureau of Economic Research (NBER 2018) has recorded five recessions in the USA during the time periods under consideration. The Economic Cycle Research Institute (ECRI) has recorded several recessions that have been experienced by other major economies that also happen to be major trading partners for Sri Lanka.

Tables 3 and 4, respectively, summarize the GDP growth rates and inflation rates in the world, in Sri Lanka, and in Sri Lanka's major trading partners in the aftermath of the two domestic shocks under discussion. The tables reveal that Sri Lanka's major trading partners have had a higher GDP growth rate in the aftermath of the liberalization shock than at the end of conflict shock. At the same time, their inflation rates were much higher in the aftermath of liberalization than the end of conflict.

Table 2 Time periods of recessions in the world and select countries in the aftermath of the Liberalization and the end of conflict in Sri Lanka

Country/region	After the liberalization	After the end of conflict
World	1975, 1982, 1991	2009
USA	Nov. 1973–Jul. 1975 Jan. 1980–Jul. 1980 Jul. 1981–Nov. 1982 Jul. 1990–Mar. 1991	Dec. 2007–Jun. 2009
Germany	Aug. 1973–Jul. 1985 Jan. 1980 Oct. 1982 Jan. 1991	Apr. 2008–Jan. 2009
UK	Jul. 1973–Jun. 1975 Aug. 1979–Jun. 1980 Apr. 1982 Dec. 1984 Feb. 1992–Aug. 1993	May 2008–Jan. 2010
Japan	Nov. 1973–Feb. 1975	Feb. 2008–Mar. 2009 Aug. 2010–Apr. 2011 May 2012–Jan. 2013
India	Jun. 1972–May 1973 Nov. 1973–Feb. 1975 Apr. 1979–Mar. 1980 Mar. 1991–Nov. 1991	

Sources World: Kose and Terrones (2016), US: NBER (2018), Others: ECRI (2018)

Table 3 GDP growth rates (%) in the world and selected countries after the liberalization and the end of conflict in Sri Lanka

	t	t + 1	t + 2	t + 3	t + 4
After the liberalization shock: t = 1977					
World	4.0	4.0	4.1	2.0	1.9
USA	4.6	5.6	3.2	−0.2	2.6
EU	3.1	3.1	3.8	2.2	0.5
Japan	4.4	5.3	5.5	2.8	4.2
China	7.6	11.7	7.6	7.8	5.2
Malaysia	7.8	6.7	9.3	7.4	6.9
India	7.3	5.7	−5.2	6.7	6.0
Sri Lanka	4.2	8.2	6.3	5.8	5.8
After the end of conflict: t = 2009					
World	−1.7	4.3	3.2	2.4	2.6
USA	−2.8	2.5	1.6	2.2	1.7
EU	−4.5	2.1	1.6	−0.9	−0.2
Japan	−5.4	4.2	−0.1	1.5	2.0
China	9.4	10.6	9.5	7.9	7.8
Malaysia	−2.5	7.0	5.3	5.5	4.7
India	8.5	10.3	6.6	5.5	6.4
Sri Lanka	3.5	8.0	8.2	6.3	7.2

Source World Bank, https://databank.worldbank.org. Accessed on 10 May, 2018

Table 4 Inflation rate (%) in the world and selected countries after the liberalization and end of conflict in Sri Lanka

	t	t + 1	t + 2	t + 3	t + 4
After the liberalization shock: t = 1977					
World	11.4	8.9	..	14.0	12.7
USA	6.5	7.6	11.3	13.5	10.3
EU	10.0	7.6	9.5	13.5	12.0
Japan	8.1	4.2	3.7	7.8	4.9
China	..	..	..	..	..
Malaysia	4.8	4.9	3.7	6.7	9.7
India	8.3	2.5	6.3	11.4	13.1
Sri Lanka	1.2	12.1	10.8	26.1	18.0
After the end of conflict: t = 2009					
World	2.9	3.5	5.0	3.8	2.7
USA	−0.4	1.6	3.2	2.1	1.5
EU	0.4	1.5	3.3	2.5	1.4
Japan	−1.4	−0.7	−0.3	−0.1	0.3
China	−0.7	3.3	5.4	2.6	2.6
Malaysia	0.6	1.7	3.2	1.6	2.1
India	10.9	12.0	8.9	9.3	10.9
Sri Lanka	3.4	5.9	6.9	7.6	6.9

Source World Bank, https://databank.worldbank.org. Accessed on 10 May 2018

4 External Assistance to Sri Lanka in the Aftermath of the Two Shocks

Sri Lanka has been a regular recipient of assistance from foreign countries and international organizations to achieve both its development objectives as well as economic stability objectives. Assistance to meet the development objectives have come mostly from the Asian Development Bank (ADB), the World Bank, and countries such as Japan, China, and India. The IMF has provided assistance to meet the country's economic stability objectives. IMF assistance has come usually in three forms—financing, technical expertise and the imposition of stability criteria that Sri Lanka must meet to continue to receive financing.

Since independence, Sri Lanka has been at the receiving end of 16 programs of assistance from the IMF (Table 5). At least three of them were received in the aftermath of the two shocks. Thus, Sri Lanka's efforts to maintain macroeconomic stability were greatly facilitated by the financing, technical assistance, and the enforcement of stability criteria by the IMF.

After the liberalization, Sri Lanka received a Standby Arrangement (SBA) in 1977 that lasted till end 1978, and a second such arrangement from 1979 to 1981. This helped Sri Lanka's efforts to stabilize the economy. Similarly, after the end of

Table 5 History of lending arrangements to Sri Lanka from the IMF as of 30 June, 2016 (In thousands of SDRs)

Type of facility	Date of arrangement	Expiration date	Amount agreed	Amount drawn	Amount outstanding
Extended fund facility	Jun. 2016	Jun. 2019	1,070,780	119,894	119,894
Standby arrangement	Jul. 2009	Jul. 2012	1,653,600	1,653,600	310,050
Extended credit facility	Apr. 2003	Apr. 2006	269,000	38,390	0
Extended fund facility	Apr. 2003	Apr. 2006	144,400	20,670	0
Standby arrangement	Apr. 2001	Sep. 2002	200,000	200,000	0
Extended credit facility	Sep. 1991	Jul. 1995	336,000	280,000	0
Structural adjustment facility commitment	Mar. 1988	Mar. 1991	156,170	156,170	0
Standby arrangement	Sep. 1983	Jul. 1984	100,000	50,000	0
Extended fund facility	Jan. 1979	Dec. 1981	260,300	260,300	0
Standby arrangement	Dec. 1977	Dec. 1978	93,000	93,000	0
Standby arrangement	Apr. 1974	Apr. 1975	24,500	7,000	0
Standby arrangement	Mar. 1971	Mar. 1972	24,500	24,500	0
Standby arrangement	Aug. 1969	Aug. 1970	19,500	19,500	0
Standby arrangement	May 1968	May 1969	19,500	19,500	0
Standby arrangement	Jun. 1966	Jun. 1967	25,000	25,000	0
Standby arrangement	Jun. 1965	Jun. 1966	30,000	22,500	0
Total			4,426,250	2,990,024	429,944

Source International Monetary Fund, History of Lending Arrangements as of 30 June 2016
SDR: Special Drawing Rights https://www.imf.org/external/np/fin/tad/extarr2.aspx?memberKey1=895&date1key=2016-06-30, Accessed on 12 May 2018

the conflict, Sri Lanka received a SBA from the IMF that lasted from 2009 to 2012. This facility helped Sri Lanka to regain a measure of economic stability, whilst playing a catalytic role in strengthening international investor confidence in the formerly war-torn economy.

5 Impact of the Shocks

Economic stability and efforts to maintain stability are measured using three types of variables—impact variables, policy variables, and indicator variables. Impact variables will allow the relative impact of the shocks to be measured. Policy variables are used to assess the policy response. Indicator variables indicate the resulting stability of the economy.

Both shocks evaluated in this analysis are positive economic shocks on the Sri Lankan economy. Thus, the impact of the shocks is seen in variables such as FDI, government foreign debt, government capital expenditure and net lending, and overall government expenditure. Tables 6, 7, 8, 9, and 10 provide the details of these impact variables, in terms of values and as indices. The indices are the values standardized at 100 at the start year of both shocks.

Table 6 shows that the US Dollar values of FDI have increased after both shocks, but that the extent of the increase is far greater after the liberalization shock. Government expenditure and government debt (Tables 7 and 8) also show a relatively higher increase after the liberalization shock than after the end of conflict shock. A major reason for the relatively lower inflow of FDI is the slowdown in the global economy as it was coming out of the great recession of 2007–2008.

Table 6 Foreign direct investment

Year	FDI value USD Mn.		FDI index year t = 100	
	Liberalization t = average 1977 and 1978	End of conflict t = average 2009 and 2010	Liberalization value at t = 100	End of conflict value at t = 100
t	0.25	409.6	100	100
t + 1	47.0	895.9	18,800	219
t + 2	42.9	871.4	17,160	213
t + 3	50.2	867.5	20,080	212
t + 4	63.6	877.4	25,440	215

Source Based on Annual Report of CBSL (2017)

Table 7 Total government expenditure

Year	Gov. Exp. Value Rs. Mn.		Gov. Exp. Index year t = 100	
	Liberalization t = average 1977 and 1978	End of conflict t = average 2009 and 2010	Liberalization value at t = 100	End of conflict value at t = 100
t	13,251	1,241,066	100	100
t + 1	19,192	1,433,182	145	115
t + 2	28,388	1,556,499	214	125
t + 3	28,014	1,669,396	211	135
t + 4	33,512	1,795,865	253	145

Source Based on Annual Report of CBSL (2017)

Table 8 Government foreign debt

Year	Gov. For. Debt value USD Mn.		Gov. For. Debt index year t = 100	
	Liberalization t = average 1977 and 1978	End of conflict t = average 2009 and 2010	Liberalization value at t = 100	End of conflict value at t = 100
t	1,028	16,601	100	100
t + 1	1,017	21,066	99	127
t + 2	1,345	21,687	131	131
t + 3	1,515	22,930	147	138
t + 4	1,695	23,844	165	144

Source Based on Annual Report of CBSL (2017)

Table 9 Government capital expenditure and net lending—values and indices

Year	Gov. Cap. Exp. Value Rs. Mn.		Gov. Cap. Exp. Index year t = 100	
	Liberalization t = average 1977 and 1978	End of conflict t = average 2009 and 2010	Liberalization value at t = 100	End of conflict value at t = 100
t	4,973	332,732	100	100
t + 1	8,367	408,276	168	123
t + 2	16,069	425,476	323	128
t + 3	13,365	464,216	269	140
t + 4	15,171	472,967	305	142

Source Based on Annual Report of CBSL (2017)

Table 10 Shares of government capital expenditure and net lending

Year	As a share of total expenditure %		As a % of GDP	
	Liberalization t = 1977	End of conflict t = 2009	Liberalization t = 1977	End of conflict t = 2009
t − 4	23.3	24.2	6.4	5.8
t − 3	22.6	23.2	5.5	5.6
t − 2	28.3	26.0	7.6	6.1
t − 1	35.8	25.3	10.3	5.7
t	30.2	26.8	7.3	6.7
t + 1	41.2	26.8	17.1	6.1
t + 2	43.6	28.5	16.0	6.2
t + 3	56.6	27.3	24.2	5.6
t + 4	47.7	27.8	15.7	5.4

Source Based on Annual Report of CBSL (2017)

Yet another reason for poor showing with regards to attracting FDI is Sri Lanka's relatively weak standing in international competitiveness indices which point to some deep-rooted problems in the investment climate prevailing in the country. For example, the World Bank's Ease of Doing Business Index ranked Sri Lanka at 105 out of 183 countries in 2010 (World Bank 2010).[2] This ranking was lower than that of Pakistan, but above that of all the other South Asian countries. By 2018, the ranking had risen to only 111 out of 190 countries, whilst India, Nepal, and Bhutan had moved above Sri Lanka (World Bank 2018).[3] Thus, resolving the conflict has not proved to be sufficiently attractive to encourage foreign investments with the country appearing to suffer from many other problems that hinder FDI. In the absence of sufficient foreign investment, governments may choose to accelerate

[2]A lower ranking indicates a better investment climate.

[3]Pakistan has fallen below Sri Lanka to 147.

Table 11 Defense expenditure as a share of total expenditure

Year	Defense exp. %	Year	Defense exp. %
2002	9.0	2010	11.5
2003	8.8	2011	10.4
2004	8.8	2012	10.7
2005	8.4	2013	10.5
2006	8.3	2014	10.4
2007	10.0	2015	10.4
2008	10.2	2016	10.4
2009	10.8	2017	9.3

Source Based on Annual Report of CBSL (2017)

their public investment and capital expenditure programs in order to provide a stimulus for economic growth.

Government capital expenditure and net lending in Sri Lanka show a marked difference between the two shocks (Table 10). After the liberalization, capital expenditure increased dramatically from about 30–35% of total expenditure to about 40–57% of total expenditure. The comparable ratios after the end of conflict were much less and did not show a significant difference before or after the end of the conflict. Furthermore, defense expenditure did not show any significant decline even after the end of conflict (Table 11).

The net result of relatively less FDI and government capital expenditure in the aftermath of the conflict vis-à-vis the liberalization episode is lower than expected economic growth and somewhat muted pressures on inflation. Thus, policymakers may have faced a lesser challenge in maintaining stability after the end of the conflict shock than after the liberalization shock.

6 Policy Response to Shocks

The main policy tools used to stabilize the Sri Lankan economy in the aftermath of the shocks were the monetary policy tools. These policy efforts were supplemented by the presence of the IMF financial and technical assistance. Tables 12, 13 and 14 provide data on the growth in reserve money, broad money, and interest rates, respectively, in the aftermath of the two crises.

The growth in money supply in the aftermath of the liberalization shock was considerably high, suggesting the adoption of a loose monetary policy stance. However, interest rates were held high as well. A possible reason for this is monetary accommodation of government expenditure. Sri Lanka's fiscal policy was expansionary as noted earlier, with the government-financing large infrastructure projects. As a result, the economy went through a turbulent period of high inflation and a rapidly depreciating currency. At the same time, global economic conditions too were not conducive to maintaining economic stability.

In contrast to this, the Sri Lankan economy after the end of conflict was more stable. The monetary policy stance was tighter, and interest rates and growth rates of monetary aggregates were lower than in the previous period. However, a closer examination of both monetary and fiscal policies reveals that the macroeconomic policies adopted were inadequate to address both development and stability needs of the country.

Table 12 Developments in reserve money

Year	Reserve money Rs. Mn.		Reserve money index year t = 100		Growth rate %	
	Liberalization t = average 1977 and 1978	End of conflict t = average 2009 and 2010	Liberalization value at t = 100	End of conflict value at t = 100	Liberalization	End of conflict
t	3,840	303,537	100	100		
t + 1	4,262	360,511	111.0	118.8	11.0	18.8
t + 2	5,299	439,504	138.0	144.8	24.3	21.9
t + 3	6,286	484,362	163.7	159.6	18.6	10.2
t + 4	7,505	488,586	195.4	161.0	19.4	0.9

Source Based on Annual Report of CBSL (2017)

Table 13 Developments in broad money

Year	Broad money Rs. Mn.		Broad money index year t = 100		Growth rate %	
	Liberalization t = average 1977 and 1978	End of conflict t = average 2009 and 2010	Liberalization value at t = 100	End of conflict value at t = 100	Liberalization	End of Conflict
t	8,717	1,536,755	100	100		
t + 1	10,891	1,813,000	124.9	118.0	24.9	18.0
t + 2	15,057	2,192,603	172.7	142.7	38.3	20.9
t + 3	19,860	2,593,185	227.8	168.7	31.9	18.3
t + 4	24,447	3,058,793	280.5	199.0	23.1	18.0

Source Based on Annual Report of CBSL (2017)

Table 14 Call money rates (%)

Year	After liberalization t = 1977	After end of conflict t = 2009
t	7.00–9.50	7.00–9.50
t + 1	7.00–9.50	7.00–8.35
t + 2	9.00–11.00	8.00–9.75
t + 3	21.50–25.00	9.50–10.60
t + 4	15.00–18.00	7.50–7.80

Source Based on Annual Report of CBSL (2017)

Table 15 Bilateral real exchange rates—SL goods/US goods

Year	Liberalization t = 1977	End of conflict t = 2009
t	100	100
t + 1	167.12	92.55
t + 2	161.96	86.06
t + 3	151.67	95.21
t + 4	169.95	91.99

Source Based on Annual Report of CBSL (2017)

Sri Lanka's entry into a SBA with the IMF-placed limitations on pursuing an expansionary fiscal policy to finance public investment for a growth acceleration. The IMF (2013b) reveals that "thanks to a commendable level of expenditure control by the authorities through most of the program, headline and primary fiscal deficits declined after a large initial slippage. However, the fiscal adjustment was unbalanced—relying completely on expenditure cuts—while revenues continued their long-term decline, straining the future ability to sustain much-needed (and growth-inducing) capital expenditure" (IMF 2013b, p. 1). This non-expansion of public investment was seen in Table 10 where capital expenditure and net lending as a share of total expenditure remained almost static before and after the end of conflict. Capital expenditure as a percentage of GDP remained at about 5–6% immediately before and after the conflict, but it was much less than the percentage of 16–24% experienced after the liberalization.

The IMF (2013b) further notes a deviation in monetary policy from its primary commitment to domestic economic and price stability. The IMF observes that defending the exchange rate was a major preoccupation of the CBSL in the immediate aftermath of the end of the crisis.[4] The CBSL obsession in maintaining an over-valued US dollar (USD) to the Sri Lankan rupee (LKR) exchange rate is seen in the appreciating bilateral real exchange rate during 2009–2013 in contrast to the experience in the aftermath of the liberalization (Table 15). In this regard, it should be noted that over-valued nominal exchange rates are not perceived as indicators of economic stability. It is indeed a latent force of economic crises as was seen in Thailand in 1997 and Latin America throughout the 1990s (Thenuwara 2015).

[4]The IMF notes that "once the exchange rate began to come under pressure, however, it became clear that the authorities were once again tempted to defend the currency. From September 2010 onward, the CBSL's net absorption of foreign exchange began to turn into net sales; from that month until June 2011 net sales totaled USD 570 million. Yet during this same period, rather than allow the exchange rate to depreciate in line with the balance of payments pressures, the authorities oversaw a slight appreciation of the rupee against the dollar from 112.5 to 109.6. In the latter half of 2011, the pressure on the exchange rate to depreciate increased with the surge in imports. With net foreign exchange sales averaging USD 440 million per month in the second half of the year, the authorities missed the Net International Reserve (NIR) targets by a large margin in their efforts to keep the exchange rate stable". IMF (2013b), p. 13.

7 Stability in the Aftermath of the Shocks

Economic stability can be captured by several major variables. Those include indicators such as the rate of inflation, GDP growth, exchange rate depreciation, fiscal deficit, current account deficit, government debt, and international reserves. Tables 16, 17, 18, 19, 20, 21, and 22 capture the behavior of these variables in relation to the liberalization and end of conflict shocks in Sri Lanka. It should be noted that the behavior of these variables is likely to be muted by the policy actions taken to counter the impact of shocks.

The trends in the rate of inflation show that after the end of conflict, inflation remained relatively low; in fact, it was considerably lower than historical inflation rates in Sri Lanka. By contrast, high rates of inflation prevailed during the period after the liberalization episode. But in both cases, inflation has been much higher than the inflation rate of about 2% that is considered to be widely consistent with the definition of price stability.

Sri Lanka's rate of GDP growth has been higher than global GDP growth after both shocks, although not as high as that experienced by fast-growing countries like China (Table 17). Thus, Sri Lanka did manage to reap short-term benefits of a "peace dividend," but GDP growth could have been significantly higher and sustained with more prudent management of the economy.

All the other macroeconomic indicators show relatively greater stability in the aftermath of the end of conflict, with the exception of nominal and real exchange rates. It appears from Tables 18 and 15 that the nominal USD to the LKR exchange rate did not depreciate after the end of the crisis, but it appreciated in real terms. This was a result of the CBSL's deliberate attempts to maintain an over-valued USD exchange rate for some reasons. Main reasons are to maintain a lower debt to GDP ratio—by not increasing the rupee value of foreign debt—and to provide a reasonable return for those who have invested in Rupee securities. This could have been a potential source of instability or crisis, if not for the BOP support that Sri Lanka received from the IMF through a SBA.

There were major reasons for the relative economic stability in the aftermath of the end of the conflict, irrespective of CBSL's continuous efforts to maintain an over-valued currency as seen in summary indicators presented in Table 22. First, the expansion of the economy was limited by the less than expected inflow of FDI into the country, and by necessity, a lower level of capital expenditure. Second, the IMF assistance initiated in 2009 acted as a catalyst for stability.[5] Third, the CBSL's aggressive pursuance of commercially priced foreign borrowing provided support for its exchange rate policy from time to time, releasing monetary policy tools to focus on maintenance of domestic economic stability. Fourth, the global economy

[5]IMF (2013b, p. 1)—"The program provided a catalytic effect to confidence at a crucial time. The balance of payments pressures not only ebbed, they reversed decisively within a few months of the program's inception in recognition a potential 'peace dividend' that the country might reap, as well as the Fund's reassuring presence."

Table 16 Sri Lanka's inflation rate based on Colombo consumers' price index and the deviation from the global inflation rate

Year	Sri Lanka inflation %		Sri Lanka inflation—Global inflation %	
	Liberalization t = 1977	End of conflict t = 2009	Liberalization t = 1977	End of conflict t = 2009
t	1.2	3.4	−10.1	0.6
t + 1	12.1	5.9	3.3	2.7
t + 2	10.8	6.9	2.0	1.7
t + 3	26.1	7.6	12.2	3.8
t + 4	18.0	6.9	5.2	4.2

Source Based on Annual Report of CBSL (2017) and World Bank, https://databank.worldbank.org. Accessed on 10 May, 2018

Table 17 Sri Lanka's GDP growth and the deviation from the global GDP growth

Year	Sri Lanka GDP growth %		Sri Lanka GDP growth—global GDP growth %	
	Liberalization t = 1977	End of conflict t = 2009	Liberalization t = 1977	End of conflict t = 2009
t	4.2	3.5	0.2	5.2
t + 1	8.2	8.0	4.2	3.7
t + 2	6.3	8.2	2.2	5.0
t + 3	5.8	6.3	3.8	3.9
t + 4	5.8	7.2	3.9	4.6

Source Based on Annual Report of CBSL (2017) and World Bank, https://databank.worldbank.org. Accessed on 10 May, 2018

Table 18 Nominal US dollar—rupee rate and the rate of depreciation

Year	Nominal exchange rate Rs./USD		Rate of depreciation %	
	Liberalization t = 1977	End of conflict t = 2009	Liberalization t = 1977	End of conflict t = 2009
t	8.87	114.94		
t + 1	15.61	113.06	76.0	−1.6
t + 2	15.57	110.57	−0.3	−2.2
t + 3	16.53	127.60	6.2	15.4
t + 4	19.25	129.11	16.5	1.2

Source Based on Annual Report of CBSL (2017)

was also conducive to maintaining stability in Sri Lanka; by the middle of 2009, major developed countries were coming out of the great recession (see Table 2). In the ensuing years, global inflation was very low, and monetary policy in almost all of the major advanced countries was expansionary to support the economic recovery.

Table 19 Gross official reserves

Year	Gross official reserves USD Mn		Gross off res index year t = 100	
	Liberalization t = 1977	End of conflict t = 2009	Liberalization value at t = 100	End of conflict value at t = 100
t	278.4	5,357.4	100.0	100.0
t + 1	397.3	7,196.5	142.7	134.3
t + 2	516.1	6,749.3	185.4	126.0
t + 3	245.5	7,105.9	88.1	132.6
t + 4	334.7	7,495.3	120.2	140.0

Source Based on Annual Report of CBSL (2017)

Table 20 Current account deficit and foreign assets

Year	Current account deficit (% of GDP)		Total foreign assets in months of imports	
	Liberalization t = 1977	End of conflict t = 2009	Liberalization value at t = 100	End of conflict value at t = 100
t	3.5	−0.5	5.9	8.3
t + 1	−3.4	−2.2	5.6	7.7
t + 2	−6.8	−7.8	5.2	4.7
t + 3	−16.4	−6.7	2.2	5.4
t + 4	−10.0	−3.9	2.9	5.7

Note Current Account Deficit is shown as a negative number
Source Based on Annual Report of CBSL (2017)

Table 21 Fiscal deficit and government debt as a % of GDP

Year	Fiscal deficit % of GDP		Government debt % of GDP	
	Liberalization t = 1977	End of conflict t = 2009	Liberalization t = 1977	End of conflict t = 2009
t	−4.5	−9.9	68.6	86.2
t + 1	−12.5	−8.0	72.5	81.9
t + 2	−11.1	−6.9	67.7	78.5
t + 3	−19.2	−6.5	77.2	79.2
t + 4	−12.4	−5.9	76.1	78.3

Source Based on Annual Report of CBSL (2017)

Table 22 Summary indicators of stability: minimum and maximum values during four years since the year of the shock

Indicator	Liberalization	End of conflict
GDP growth	5.8–8.2	6.3–8.2
Unemployment	14.1–17.9	4–4.9
Inflation	10.8–26.0	6.2–6.9
Fiscal deficit (% of GDP)	(12.4)–(19.2)	(5.9)–(8)
Government debt (% of GDP)	67.7–77.2	78.3–81.9
Real exchange rate (SL/US) t = 100[a]	152–170	86–95
Current account deficit (% of GDP)	(3.4)–(16.4)	(2.2)-(7.8)
Total foreign assets (months of imports)	2.2–5.6	5.4–7.7

a. Real exchange rate larger than 100 shows higher export competitiveness and lower than 100 shows lower export competitiveness

8 Conclusion

Sri Lanka has been able to maintain stability in the economy in the aftermath of the end of its long-drawn separatist conflict relatively better when compared with the post-1977 economic liberalization. Economic policies to manage the post-conflict shock benefitted from several factors. The impact of the end of conflict shock was not too expansionary owing to the relatively low level of FDI inflows, low levels of government capital expenditure, controls imposed by the IMF as conditionalities of a SBA, and several deep-rooted problems that affects the ease of doing business in Sri Lanka. The IMF financial and technical assistance helped to mitigate any adverse expectations on the BOP difficulties, and helped to foster confidence in the economy. The benign global economic environment in terms of financial liquidity and low interest rates, and a tighter domestic monetary policy stance helped Sri Lanka to maintain a low inflation rate, and higher economic growth. The effectiveness of the monetary policy stance on inflation and the external sector would have increased if the CBSL did not follow an additional objective of maintaining an over-valued USD-LKR nominal exchange rate from time to time.

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Ensuring Sustainable Development in Post-conflict Sri Lanka

Athula Senaratne

Abstract When liberal economic reforms were first introduced to Sri Lanka in the late 1970s, the approach was forward looking, introducing appropriate policies to tackle possible adverse environmental impacts too. Legislative enactments such as the National Environment Act of 1980 and the Marine Pollution Prevention Act and the Coast Conservation Act of 1981 covered terrestrial and marine coastal environments. However, the path toward sustainable development has since been marred by numerous shortcomings and failures, reflected in the erratic progress on economic reforms. Sri Lanka's environmental challenges are closely connected to the economic policies pursued by successive governments. While many of the current environmental issues can be traced to liberal economic policies adopted in the late 1970s, an accumulated burden carried over from the early period of colonial rule has also contributed its share of damage even today. Adverse environment conditions are intensified by key underlying drivers of population growth, urbanization, industrialization, agricultural modernization, commercialization of rural economies, and rising uncertainty of climate change in post-conflict Sri Lanka. Prospects of accelerated economic growth call for greater attention to issues of sustainability. Its success depends largely on identifying and implementing innovative policies for effective management of a country's natural capital stock. This chapter charts Sri Lanka's path to achieve sustainable development in the post-conflict era, and argues that achieving that objective remains an elusive goal as ever in the country.

1 Introduction

The end of Sri Lanka's prolonged conflict in 2009 opened up the possibility of accelerated economic growth in the country. At the same time, a pressing problem of environmental sustainability had also to be addressed. Sri Lanka has increasingly

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become more vulnerable to climate-induced disasters in the form of floods, landslides, and droughts; in fact, in 2018, the country was ranked second in the global climate risk index (CRI) due to massive losses caused by disasters within a relatively short time period.[1]

Aside from climate-induced disasters, declining trends in Sri Lanka natural capital stock such as land degradation, deforestation and degradation of forests, rising air and water pollution, growing problems of solid waste, and waste water management have also been observed. These have a cumulative negative impact on economic performance, although the losses may not be as distinctly visible as those incurred from disasters. The upshot is that the combined effects of ongoing degradation of environmental assets, frequent incidence of natural hazards, and various slow-onset impacts of climate change such as increasing air temperature, erratic changes in rainfall, and sea level rise has the potential to generate substantive economic losses as Sri Lanka strives to accelerate socio-economic development in the post-conflict era.

Nevertheless, this is not a challenge faced by Sri Lanka alone; experiences from around the world indicate that the growing threat of environmental issues has become a major development challenge. A major milestone in the global march toward sustainable development was achieved in 2015—i.e., the Agenda 2030 for Sustainable Development Goals (SDGs) and the Paris Climate Accord (PCA). These agreements aim to achieve a climate resilient, sustainable future for all through a path of low-carbon development. Sri Lanka too welcomed these agreements, becoming a signatory to both pacts within a short period.

Sri Lanka's environmental concerns are closely linked to economic policies pursued by successive governments. The transition to a market-oriented, export-driven growth strategy in 1977 from an inward looking, import-substitution strategy followed prior to that for nearly two decades, marked a major change. While many of the current environmental issues can be traced to the liberal economic policies adopted in the late 1970s, Sri Lanka's environmental footprint also contains the residue from economic policies and strategies adopted in the early period of colonial government. Aside from national policies which are not responsible for environmental issues of global origin such as climate change and ozone depletion, these external influences also impact a country's capacity to face global environmental threats.

As such, the complex interrelationship between the economy and environment is getting more and more intricate over time. Global efforts to grapple with this multifaceted relationship gave rise to the concept of sustainable development. One of its essential aspects is to integrate environmental dimensions into the realm of economic policy making.

[1]The CRI published annually by German watch is based on annual number of fatalities and economic losses attributed to climate-induced disasters. It is an index that ranks on descending order, the lowest CRI for the country with highest risk. CRI of Sri Lanka for 2017 was estimated as 11.50.

This chapter reviews Sri Lanka's experience in integrating environment into economic development with a view to charting a post-conflict agenda for mainstreaming sustainable development. Section 2 begins with a brief conceptual overview of the economy-environment nexus, elaborating on a few key environmental economic concepts. Section 3 examines the past experience and current practices on environment policy in Sri Lanka. Section 4 discusses the impact of conflict on the environment. Section 5 focuses on Sri Lanka's post-conflict environmental challenges in pursuing sustainable development. Section 6 discusses broad options and priority areas that policy makers should focus on to mainstream SDGs into national development policy. Section 7 concludes.

2 Environment-Economy Nexus: Key Concepts

A key to understand the complex interrelationship between the environment and economy is provided by the ecosystem services (ES) approach. The ES has become a widely used conceptual framework for analyzing the role, contribution, and value of the environment for economic and social welfare. Its essence is to model the environment as a combination of diverse ecosystems and analyze the benefits arising from them as ES.

The UN Millennium Ecosystem Assessment (2005) classified numerous ES under four major categories—provisioning, regulating, supporting, and cultural services (Fig. 1). While certain types of ES (mainly provisioning services) are transacted through markets as private goods, many regulating, supporting, and cultural services are public goods by their very nature. Unsustainable use may lead to trade-offs among different ES, and even the partial substitutions may come at a significant opportunity cost. For instance, overexploitation of timber from forest ecosystems (provisioning service) may decrease their capacity to clean the air and protect water sources (regulatory and protecting services). Such trade-offs can even lead to irreversible losses, rendering economic growth unsustainable. Economists have made numerous attempts to assess the economic value of ES around the world. According to Costanza et al. (1997), the annual value of ES from major ecosystems in the world could even surpass the annual value of global GDP.

Environmental policies are introduced to safeguard ES and ensure their sustainable use. Compared to long-established branches of policy such as macroeconomics or industrial policy, environment policies can be considered as a relatively new area, even in developed countries. A strong theoretical foundation has been built upon economics concepts on market failure such as externalities, public goods, and common pool resources to support policy applications in environment (Sterner 2003). Several methods of valuing ES have also been developed to complement the application of environmental policies using efficiency-based criteria such as extended cost-benefit analysis (ECBA) and payments to ecosystem services (PES). There are three major types of environmental policies, namely suasive policies, command and control policies, and market-based policies (economic instruments).

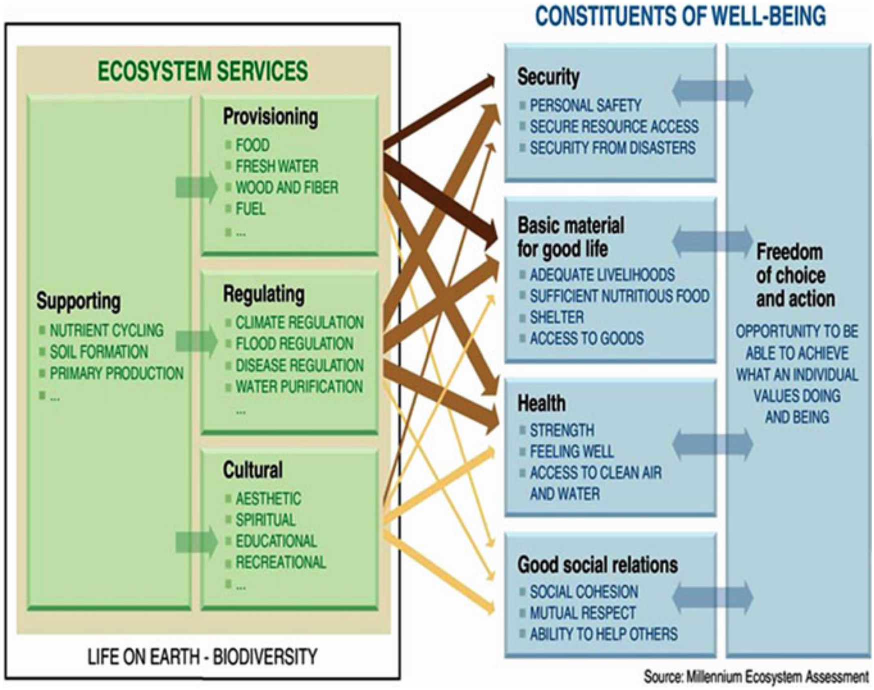

Fig. 1 Ecosystem services and their contributions to social welfare

Suasive policies refer to horizontally applied soft instruments without hierarchical arrangements such as creating awareness on conservation, dedicated global days for environment/natural resources, eco-labeling (informational measures) or codes of conducts, environmental charters (voluntary commitments), etc. They are the least coercive type of instruments that depend on encouragement of individuals/firms, enlightened self-interest or heightened sense of social responsibility. They are usually a part of an overall portfolio of policy instruments that complement command and control or market-based instruments.

Command and control policies (C&C) involve applying coercive measures (penalties) against "environmental offenses" or non-compliance of standards. There are two major forms of C&C instruments, regulations, and standards. Regulations impose controls/restrictions over activities that lead to environmental degradation. For instance, banning substances which harm the environment and humans, controlling the transport of hazardous substances, declaring protected areas for conservation of forests and wildlife, and prohibitions on endangered species. Another widely used C&C instrument is standards. These are usually applied in connection with regulatory measures to control pollution and maintain environmental quality. These can include ambient environmental quality standards, emission/effluent standards, process standards, product standards, and technology standards.

The main challenge of C&C measures is ensuring compliance. For this, institutional mechanisms with legal powers are necessary, where significant capital and recurrent expenditures have to be spent on developing and maintaining them as well.

Market-based instruments (MBI), also known as "economic instruments," aim to create incentives through market mechanism so that "polluters" or "exploiters" of resources bear the cost of environmental damage through taxes/payments and/or adjustments to ownership/use rights. In essence, MBIs attempt to correct market failures by introducing "prices" for ES and/or create "ownership" to conserve and control their abuse. More widely applied MBIs include taxes and charges, property right adjustments, pollution markets (e.g., tradeable permits), payments for ecosystem services (PES), and deposit/refund systems.

3 Sri Lanka's Environmental Policies: Past Experience and Current Practice

Sri Lanka's transition from import-substitution to an export-driven economy involved deep structural changes. Alongside the commitment to liberal economic reforms, policy makers were also forward looking to introduce measures to address possible environmental impacts of expected changes to the economy. The introduction of a National Environment Act (NEA) in 1980 was soon followed by a Marine Pollution Prevention Act (MPPA) and a Coast Conservation Act (CCA) Act in 1981 covering terrestrial, coastal, and marine ecosystems. A Central Environmental Authority (CEA) was established and environmental impact assessment (EIA) procedures adopted under the NEA.

Environment policy in Sri Lanka continues to be dominated by C&C approaches, involving a multiplicity of regulations and standards. Broadly, these can be divided into two categories of policy instruments—i.e., those for overall management of the environment and those to address issues involving specific ecosystems (e.g., forests, wildlife, coastal, and marine) and economic sectors (e.g., agriculture and irrigation).

3.1 Policy Instruments for Overall Management of the Environment

The NEA is the key legislative enactment that provides the overall legal protection to environment as a whole, implemented by the CEA under the supervision of the ministry entrusted with the subject of environment. Thus, the NEA, together with several regulations introduced under it constitutes the structural framework of C&C policy used in environmental management in Sri Lanka. A number of regulatory standards have been prepared to control environmental issues such as air pollution, noise pollution, and waste management. A scheme of Environmental Protection Licenses (EPL) is in place for managing industrial pollution. Another important instrument is the EIA procedure which enables screening of project investments at the planning stage before implementation.

With the adoption of SDGs, Sri Lanka also passed a Sustainable Development Act (SDA) in 2017. It enabled the establishment of a Sustainable Development Council (SDC) as the national coordinating body for implementing SDGs. The SDC is vested with powers to prepare the National Policy and Strategy for Sustainable Development (NPSSD), issue guidelines on sustainable development, direct all public entities to prepare "Sustainable Development Strategies (SDS)" within the scope of their subjects in line with the NPSSD, and call for progress reports on SDS within specified periods and carry out environmental and social audits for new development projects.

3.2 Policy Instruments to Address Issues Related to Specific Ecosystems

An accumulated body of acts, ordinances, and regulations introduced since the colonial period is available to address sector-specific issues. The implementation responsibility of these policy instruments are scattered across several line agencies coming under a number of ministries. There are a number of legislative enactments and regulations that deal with specific ecosystems or sector-specific environmental issues. A summary of key instruments and agencies responsible for implementation of them are given in Table 1.

With implementation responsibilities scattered across several ministries, line agencies, and local government bodies, the institutional arrangement to implement environment policies in Sri Lanka involves a complex structure. For instance, the responsibility of managing solid waste is vested with local government authorities by three legislative Acts—i.e., the Municipal Ordinance, the Urban Council Ordinance, and the Pradeshiya Sabhas Act. Their mandates cover collection, transporting, disposal/treatment of garbage, and disposal of wastewater. Currently, there are 335 local government bodies that fulfill this mandate around the country.

Besides the accumulated body of environment legislations, there are also a number of national policies relating to environment. These policies also propose complex institutional mechanisms for implementation. The Ministry of Mahaweli Development and Environment currently oversees ten national policies on different areas of environmental governance (Table 2).

Sri Lanka has some experience of MBIs too. These include selective cases where taxes/charges and subsidies were applied. Steele (1999) and the Ministry of Environment and Natural Resources (2008) have reviewed existing and potential applications of MBIs for environmental management in Sri Lanka (Table 3). The taxes, charges, and pricing schemes applied in different sectors that may have

Table 1 Key policy challenges, important legislative enactments, and line agencies in major natural resource sectors

Area of the legislation	Key policy challenges	Key legislative enactments	Main responsible agency
Land resources	Land degradation Soil erosion Decline of fertility Non-agricultural land degradation Land fragmentation and tenure issues	Soil Conservation Act	Department of Agriculture
		Land Settlement Ordinance	Department of Land Settlement
		Land Development Ordinance	Department of Land Commissioner General
		Land Surveys Act	Department of Survey
		Land Reform Act	Land Reforms Commission
		National Environment Act	Central Environment Authority
Water resources	Rising water scarcity Destruction of critical watersheds Overexploitation of groundwater Water pollution	Irrigation Ordinance	Department of Irrigation
		Water Resources Board Act	Water Resources Board
		National Water Supply and Drainage Board Act	National Water Supply and Drainage Board
		Mahaweli Authority Act	Mahaweli Authority of Sri Lanka
		Agrarian Development Act	Department of Agrarian Development
		National Environment Act	Central Environment Authority
Biodiversity, forestry and wildlife	Deforestation Degradation of forests Threatened species and ecosystems Loss of habitats Invasive alien species Human–wildlife conflict	Forest Ordinance	Forest Department
		Fauna and Flora Protection Ordinance	Department of Wildlife Conservation
		National Zoological gardens Act	Department of National Zoological Gardens
		Botanic Gardens Ordinance	Department of National Botanic Gardens
		National Environment Act	Central Environment Authority

(continued)

Table 1 (continued)

Area of the legislation	Key policy challenges	Key legislative enactments	Main responsible agency
Coastal and marine resources	Coastal resource degradation Coastal erosion Coastal pollution Destruction of coastal habitats Marine pollution	Coast Conservation Act	Coast Conservation Department
		Marine Pollution Prevention Act	Marine Environment Protection Authority
		Fisheries and Aquatic Resources Act	Department of Fisheries and Aquatic Resources
		National Aquaculture Development Act	National Aquaculture Development Authority
		National Environment Act	Central Environment Authority
Waste management	Municipal solid waste Hazardous waste Urban wastewater Accumulation of e-waste	National Environment Act	Central Environment Authority
		Municipal Ordinance	Municipal Councils
		Urban Council Ordinance	Urban Councils
		Pradeshiya Sabhas Act	Pradeshiya Sabhas
Air pollution	Decline of air quality Health impacts of air pollution	National Environment Act	Central Environment Authority
		Factories Ordinance	Department of Labour
		Motor Traffic Act	Department of Motor Traffic
Mineral resources	Overexploitation of resources Land and forest degradation Deepening of river beds and river bank erosion	Mines and Minerals Act	Geological Survey and Mines Bureau
		National Environment Act	Central Environment Authority
Disaster management	Rising incidence of disaster events Increased economic losses and social and health issues Damage to ecosystems and loss of ES	National Disaster Management Act	Disaster Management Centre

(continued)

Table 1 (continued)

Area of the legislation	Key policy challenges	Key legislative enactments	Main responsible agency
Climate change	Mitigation of greenhouse gas (GHG) emissions Adaptation to impacts of climate change Overcoming losses and damages due to climate-induced disasters	No legal coverage at present. National Climate Change Act has been proposed and is in draft stage	Climate Change Secretariat (Ministry of Environment)

Source Based on author's observations

Table 2 National policies for environmental governance

Subject of the policy	Year of introduction
National forest policy	1995
National policy on wildlife conservation	2000
National air quality management policy	2000
National environment policy	2003
Cleaner production policy	2004
National policy on wetlands	2005
National biosafety policy	2005
National policy on elephant conservation	2006
National policy on sand as a resource for the construction industry	2006
National policy on solid waste management	n/a

Source Ministry of Mahaweli Development and Environment

environmental consequences suggest the following: (i) the major purpose of certain taxes and levies is to raise government revenue (e.g., taxes for imported vehicles and petroleum fuel) and have not been designed to create incentives to control pollution or conserve resources; (ii) block tariff schemes applied for electricity and domestic water supply encourage conservation to a certain extent. However, government monopolies offering these services are making losses regularly and run on Treasury transfers—i.e., they are cross-subsidized from revenues earned from other sectors; (iii) some environment-related services are offered free of charge or at subsidized rates (e.g., solid waste/sewerage). The quality and level of supply of such services remain at a very low level and environmental problems associated with them have become progressively worse; and (iv) no taxes or levies have been applied to control resource degradation in land, water, and fisheries resources, except certain nominal charges for licensing/registering of boats, etc.

Table 3 Applications of MBIs in Sri Lanka

Sector	Taxes/charges/ subsidies	Perceived outcomes (direct/indirect; negative/positive)		
		Fiscal revenue/cost	Environmental	Poverty/ livelihood
Energy				
Electricity	Increasing block tariff with variable and fixed charges	Partial cost recovery at undercharged rates	No direct environmental benefit	Subsidized rates for small users
Petroleum	Excise duty	Income for government	No direct environmental benefit	
Transport				
Vehicles	Import and excise taxes Cess Luxury vehicles tax Revenue license	Income for government	No direct environmental benefit. Indirect due to increased vehicle prices	No direct impact on poor
Roads	No user charges involved Toll fee collected from highways	Financed by national and local budget	Poor state of repair and maintenance	Free use of road facilities
Water				
Domestic pipe – borne water	Increasing block tariff with variable and fixed charges	Partial cost recovery at undercharged rates	Health cost of non-users due to slow expansion of services	Subsidized rates for small users
Irrigation	No user charges involved.		Overuse of water	
Pollution and waste				
Emissions	Fees for environmental protection licenses/ mandatory vehicle emission tests	Partial cost recovery	Pollution control	No direct impact on poor
Effluents	Environmental protection license fees	Partial cost recovery	Pollution control	No direct impact on poor
Solid waste	No user charges involved	Financed by national and local budget	Poor service quality due to low investment	Low-income neighborhoods to suffer due to poor service
Sewage	No user charges involved	Financed by national and local budget	Poor service quality due to low investment	Low-income neighborhoods to suffer due to poor service

(continued)

Table 3 (continued)

Sector	Taxes/charges/ subsidies	Perceived outcomes (direct/indirect; negative/positive)		
		Fiscal revenue/cost	Environmental	Poverty/ livelihood
Agriculture				
Land	Acreage tax	Proceeds to agrarian development	No direct environmental benefit.	Nominal taxes. Benefits back to farmers
Fertilizer	Fertilizer subsidies	Financed by national budget	Environmental degradation due to overuse of fertilizer	Subsidized prices for small farmers
Fisheries				
Boats and gear	Annual license fees for boats, gear, and fishing	Partial cost recovery		Nominal rates for small operators
Fuel	Fuel subsidies (discontinued)	Partial cost recovery		

Source Steele (1999) and the Ministry of Environment and Natural Resources (2008)

4 Impact of Conflict on the Environment

The impact of Sri Lanka's long-drawn conflict on the environment is relatively less explored area in the literature. The direct physical impacts of the conflict on the environment were mainly confined to Northern Province (NP) and the Eastern Province (EP) with spillover effects on surrounding coastal and marine ecosystems. However, the economic and social impacts of the conflict affected all spheres of activity throughout the country. Hence, two broad categories of environmental impacts can be identified as (i) direct damages on terrestrial, coastal, and marine ecosystems in the conflict zone and surrounding areas; and (ii) indirect countrywide impacts due to economic and social disturbances caused by the conflict.

During the 30-year conflict, many forests and coastal and marine stretches in the conflict areas of the NP and EP remained battle grounds for guerilla and conventional warfare. In addition, combatting parties had occupied these ecosystems for extended periods of time and constructed combat-related structures such as bunkers. As a result, these ecosystems underwent direct damages due to combat operations resulting in degradation of resources. Given the duration of the conflict, the level of damage to local ecosystems can be considered to be substantial.

On the other hand, the conflict also restricted civil activities in these areas that would otherwise have led to the gradual conversion of ecosystems to agricultural purposes and exposure to heavy use of chemical pollution as observed in other non-combat areas. This may well have saved certain ecosystems from permanent conversion for economic and residential purposes. Fernando et al. (2015) indicate that deforestation in the NP has been rather low as reported by the Strategic Environment Assessment (SEA) carried out for post-conflict rehabilitation programs, in spite of damage and degradation caused by combat-related activities.

Moreover, coastal and marine fishing activities in the NP and EP had been restricted for an extended period owing to security reasons. As a result, livelihoods of the fisher community in these areas, as well as those in the South of the country who used to migrate North and East seasonally, were adversely affected. Subsequently, heavy poaching in Sri Lanka's northern fishery areas by South Indian fishers has become a major issue. Besides recurrent losses of income to local fishermen, the activities of Indian fishers cause long-term damages to Sri Lanka's northern fisheries and associated ecosystems due to use of unsustainable fishing methods (e.g., bottom trawling).

Underinvestment on ecosystems due to crowding out of public funds as a result of high defense expenditure is also likely to have had a countrywide indirect impact. Not only the environment, but other economic and social sectors such as education and health too suffered due to the same reason. The associated economic losses resulting from increased damage to ecosystems as a result can be presumed to be substantial, even though reliable estimates are not available. This can also be identified as one major reason behind Sri Lanka's poor performance and effectiveness in implementing plans, programs, and projects on environment, despite the introduction of early forward looking measures to address the country's environmental issues along with liberal economic reforms.

5 Post-conflict Environmental Challenges for Sustainable Development

At present, many ecosystems in Sri Lanka face serious sustainability issues owing to overexploitation and degradation. The key economic drivers responsible for these problems include growth-driven processes such as urbanization, commercialization and modernization of agriculture, development of infrastructure/industrial facilities, as well as encroachments induced by chronic poverty. These drivers became more relevant as Sri Lanka pursued a course of accelerated economic growth, heavily dependent on large-scale infrastructure development in the post-conflict era. Against this backdrop, the major environmental challenges faced by Sri Lanka are (i) overexploitation of provisioning services of ecosystems (e.g., degradation of land resources, biodiversity and ecosystems, and coastal and marine resources); (ii) decline of protective and supporting services of ecosystems due to pollution (e.g., air pollution, solid waste, and wastewater); and (iii) rising risks from climate change and disasters.

5.1 Overexploitation of Provisioning Services (Productive Natural Assets)

Land Resources: Sri Lanka's population growth has decreased the per capita availability of land resources from 1.8 ha in 1900 to 0.30 ha in 2010 (Ministry of Environment and Renewable Energy 2014). About 65% of the land area is covered by some form of agricultural land uses—i.e., homestead gardens (15.7%), paddy (12.7%), and plantation crops (10.5%) being the major ones (Jayananda 2017).

Land scarcity is most acute in the wet zone areas; rapid degradation of lands is reducing per capita land availability further. Agricultural land uses are mainly responsible for land degradation while mining and construction activities also cause significant damage (Ministry of Environment and Renewable Energy 2014). Land degradation has both on-site and off-site impacts. Soil erosion, decline of fertility, and landslides are the critical on-site impacts (Stocking 1986; Natural Resources, Energy and Science Authority of Sri Lanka (NARESA) 1991). Most erosive agricultural land uses include potato, tobacco, tea, vegetables, and cardamom in up and mid-country wet zone areas, while seasonal highland crops (e.g., maize, vegetables, chili, onion) in the low country dry zone are responsible for degradation of reservoir catchments. The intensification of cropping systems and increased soil erosion are leading to a decline in soil fertility, compelling the government to maintain costly fertilizer subsidies (Ministry of Finance 2015). Besides the fiscal burden, excessive use of fertilizer is also leading to various health and environmental issues. Land degradation is also responsible for a rise in hazardous landslides; as a result, several locations in Nuwara Eliya, Badulla, Kegalle, Ratnapura, Kalutara, Galle, and Matara districts have been declared as landslide-prone areas by the National Building Research Organization (NBRO).

Water resources: Sri Lanka receives a relatively abundant annual supply of water from monsoon and inter-monsoon rains (Imbulana et al. 2006). However, spatial and temporal distribution (inter-annual and intra-annual) of rainfall (and therefore availability of water) is highly uneven, and the groundwater potential is also limited (Imbulana et al. 2006; Panabokke 2007; Survey Department 2007). The dry zone is the most affected area due to uneven spatial and temporal distribution of water availability. Increased demands from households, irrigation, energy, and industrial sectors compete for this uneven supply as the population grows and economic activities pick up. Projections on climate change suggest that increased anomalies in rainfall distribution are likely in the future (Jayawardena et al. 2017).

Both rising demand for water, as well as increasing anomalies in rainfall is likely to lead to rising water scarcity. The highest demand for water comes from irrigation in the dry zone areas where the major agricultural areas are located. But, demand from domestic and industrial sectors is also gradually rising. Some studies indicate that severe water scarcity can be expected in at least one season in 13 out of 16 dry zone districts by 2025, while severe scarcity is indicated for both seasons in five districts (Amarasinghe et al. 1999). Issues around water scarcity are heightened further by the destruction of watersheds and increased water pollution from household, industrial, and agricultural sources. The upper watersheds in Sri Lanka's central highland areas play a critical role in ensuring water supply to the country. The destruction of watersheds lead to loss of supporting and regulating ES due to disturbances to stream flow, high soil erosion, increased sediment loads, and capacity loss in reservoirs due to rapid siltation. Urban areas also are affected due to hazardous floods as demonstrated by many such events recently. Water pollution increases the risk of health hazards and is a primary suspect for chronic kidney diseases (CKDs) reported from several dry zone areas.

Biodiversity and ecosystems: Sri Lanka has a rich endowment of biodiversity —covering terrestrial, aquatic as well as marine ecosystems—and has been listed as a global biodiversity hotspot. Over 9,400 described species of fauna and flora are to be found (Ministry of Environment and Renewable Energy 2012). Of this, 2,678 species are listed under some form of threatened category. A key feature of Sri Lanka's biodiversity is a high degree of endemism (Weerakoon 2012). Lowland rain forests in the south-western areas are the richest sources of biological diversity. Forests are tropical multi-species ecosystems that offer a range of ES covering provisioning, protecting, cultural, and supporting services. Sri Lanka has a total forest cover of 29% of land area and recent assessments (1992–2010) indicate that the rate of deforestation has decreased compared to the earlier period of 1956–1983 (Fernando et al. 2015).

The key current drivers of deforestation in Sri Lanka are infrastructure development, commercial farming ventures, encroachment by small farmers for agriculture and housing/rehabilitation, and resettlement activities in the former conflict zone (Fernando et al. 2015). Destruction of critical wetland habitats, spread of invasive alien species (IAS), and human–wildlife conflict also are major biodiversity-related challenges faced by Sri Lanka in addition to deforestation. Reports indicate that around 250 elephant deaths occur annually as a result of human–elephant conflict (Department of Wildlife 2015).

Coastal and marine resources: Sri Lanka has a coastline of over 1,700 km which is rich in numerous coastal and marine ecosystems (Coast Conservation Department 2004, 2016). The coastal zone accommodates about one-third of the population, and several townships are located along the coastline.[2] Currently, there are three major environmental issues faced by the coastal zone, namely accelerated coastal erosion, pollution of coastal waters, and degradation of costal habitats (Coast Conservation Department 2004, 2016).

The average land loss due to coastal erosion is estimated in the range of 200,000–300,000 m^2 per year. Fifteen major erosion-prone areas and 11 singular sites highly vulnerable to coastal erosion have been identified. The key drivers that accelerate erosion are sand mining, destruction of coral reefs, poorly designed/sited costal protection structures, and removal of coastal vegetation. Urbanization and growing industrial activities in the coastal zone are leading to pollution of coastal

[2]In this context, coastal zone refers to all Divisional Secretariat (DS) divisions which has coastline as one boundary.

waters and degradation of costal habitats. Fishing and aquaculture operations (i.e., prawn farming) are mainly concentrated in the coastal zone. The rising incidence of marine pollution due to oil and chemical spills caused by marine accidents has been reported from several locations around the island.

5.2 Decline of Protective and Supportive Services

Air pollution: The two major forms of air pollution are outdoor air pollution (OAP) and indoor air pollution (IAP). OAP is mainly concentrated in urban areas while IAP is prevalent in rural areas. Emissions from a growing fleet of vehicles are the major source of OAP. Sri Lanka's vehicle fleet has increased from 3.1 million to 6.3 million during 2007–2013 alone (Department of Motor Traffic 2016). In contrast, firewood—a major source of domestic fuel used by rural households—is the main cause of IAP.

Several studies have identified positive associations between air pollution and adverse health effects that include a broad range of acute and chronic health conditions (Nandasena et al. 2010). Limited air-quality monitoring facilities indicate that the level of particulate matter (PM_{10}) in Colombo has exceeded World Health Organization (WHO) standards. According to the WHO, deaths attributable to IAP is significantly higher than deaths attributable to OAP in Sri Lanka, implying IAP is a greater risk to health even more so than OAP.

Solid waste and wastewater: Municipal solid waste and wastewater are major environmental problems in urban areas. While local government authorities are mainly responsible for waste management in Sri Lanka, observations suggest both solid waste and wastewater are being poorly managed. The major form of solid waste disposal is open dumping which has severe health and environmental consequences.

Recent estimates indicate that over 10,000 tons of waste is generated in Sri Lanka on a daily basis of which only one-third is collected by local authorities (JICA 2016). The existing system of municipal solid waste management is highly inefficient. It leads to haphazard disposal and burning of uncollected garbage, open dumping of collected garbage, and accumulation of garbage in low-lying and wetland areas. Except in certain areas of the Colombo Municipal Council (CMC), there are no centralized wastewater disposal facilities in the country, and households are left to rely on on-site disposal of wastewater using domestic pits. On-site disposal in congested urban areas creates risks of groundwater pollution. Industrial waste, healthcare waste, persistent organic pollutants and e-waste are the major types of hazardous waste in Sri Lanka. Hazardous wastes need special procedures for collection, transportation, and disposal which are under the control of the Central Environmental Authority (CEA).

5.3 Rising Risks from Climate Change and Disaster Incidents

Climate change: Sri Lanka is a vulnerable country to impacts of climate change due to several reasons. Being a small tropical island located in the disaster-prone region of the Bay of Bengal is the foremost among them. Observed changes in climate indicate that mean ambient air temperature has been rising faster in recent years, along with mean daytime maximum and nighttime minimum air temperatures, while the variability of rainfall too has increased.

Evidence also suggests that the intensity and frequency of floods and droughts have increased recently. Recent projections predict that Sri Lanka's climate pattern will become more polarized in the future—i.e., the dry zone getting drier and the wet zone becoming even wetter (Jayawardena et al. 2017; Punyawardena et al. 2013). The densely populated low-lying coastal belt is naturally vulnerable to a sea level rise. One study has predicted that these changes can lead to potential losses of up to 6% of GDP for the period 2010–2050 (Ahmed and Supachalasai 2014). Major impacts can be expected in food security (food crops, livestock, and fish), water, export agriculture, coastal and marine resources, biodiversity and ecosystems, and human settlements and health sectors. The frequency and intensity of weather-related natural disasters such as droughts, floods, and cyclones are on a rising trend, creating losses and damages to livelihoods of communities and economic infrastructure. A Post-Disaster Needs Assessment (PDNA) conducted for major floods experienced in May 2016 estimated the losses to be approximately Rs. 99 billion for this disaster event alone (Ministry of Disaster Management 2016).

Challenges associated with ecosystems and their services are likely to act as barriers for sustainable development in the post-conflict era. As in the case of conflict, environmental challenges too can unravel the gains accumulated over several years of development in the event of a sudden shock. Unmistakable signs that such a challenging scenario is emerging is visible in recent disaster experiences.

While all of the above challenges have the potential to create significant impacts on the economy, some of them merit priority attention when the differential nature and time horizon of impacts on the economy and urgency of corrective measures are considered. The rising frequency of disaster shocks naturally comes out as a top priority due to their acute, short-term, and widespread impacts on the economy.

Given the threat of a sudden and widespread disturbance to lives, assets, and livelihoods, action to deal with disaster risk reduction and preparedness are in demand politically also. Next in terms of priority is dealing with environmental related health hazards such as air pollution, water pollution and solid waste pollution. While ongoing degradation of ecosystems (e.g., land, forests, coastal, and marine) can potentially create significant impacts on the economy in the long run, the impacts are chronic in nature and action against them may also require long-term interventions. Some of them have the potential to become structural problems for growth unless addressed through appropriate measures. Hence, Sri Lanka needs a long-term strategy to address these structural challenges, while making short- and medium-term arrangements to address acute shocks associated with disasters and health-related challenges.

6 Achieving Sustainable Development in the Post-conflict Era

The global march toward sustainable development—evidenced by the adoption of the SDGs and the PCA—can support Sri Lanka's overall strategy in this direction by providing a broad framework to organize the country's overall strategy.

Increasing Sri Lanka's disaster preparedness and adaptation to climate change impacts is a priority. Recent shocks to the economy as a result of natural hazards have heightened the sense of urgency among the public as well as policy makers on the need to take remedial measures. Sri Lanka's institutional setup and policy frameworks to address disaster management and climate change issues are still evolving. A National Disaster Management Plan 2018–2030 (NDMP) has been formulated; a National Adaptation Plan for Impacts of Climate Change in Sri Lanka 2016–2025 (NAP-CC) was also launched in 2016. The NAP-CC identifies five major gaps in adaptation to climate change impacts, namely: information gaps, technology gaps, policy gaps, institutional gaps, and resource mobilization gaps. Implementing the NDMP and NAP-CC to overcome these gaps is an urgent priority to achieve the goal of sustainable development in Sri Lanka.

Sri Lanka also needs to take urgent action to address potential health hazards associated with declining environmental quality due to air pollution, water pollution, and solid waste pollution by way of promoting cleaner production and enhancing enforcement of existing regulations. The rising incidence of health issues associated with a decline in environmental quality has encouraged a worldwide search for alternative products/materials, energy efficient technologies, reuse/recycling of products, and utilization of waste and substitute materials that have given rise to cleaner production/construction practices. Cleaner production and construction are fast becoming best practices; these are also moving from voluntary approaches to mandatory standards. Sri Lanka has already established the National Cleaner Production Centre and declared a national policy on same. Additionally, the Urban Development Authority (UDA) recently introduced green building guidelines.

To enhance the effectiveness of enforcement in Sri Lanka, the existing system of C&C instruments must be examined. Several agencies deal with pollution issues at national and sub-national levels. In spite of that, the level of enforcement is poor and ineffective. Many plans and policies also have little effect in arresting the ongoing degradation in environmental quality. Proper enforcement needs guidance from unambiguous policies, correct and timely information, adequate facilities, trained manpower, and coordination among relevant line agencies and law enforcement bodies such as judiciary and police. It appears that more than the absence of laws, plans and policies, having too many of them with overlapping, confusing, and outdated mandates with scattered responsibility among agencies is a major source of enforcement failure. Poor surveillance and monitoring capacity are also responsible for this situation. Thus, a comprehensive evaluation of the existing C&C instruments for ecosystem governance is needed, so that the real sources of enforcement failures are identified and rectified. Thereafter, the necessary capacity building measures should be provided to increase the efficiency of enforcement of the updated system of ecosystem governance.

Another area that needs attention is ensuring the compliance of environmental safeguard measures applied to development projects. Some encouragement to relax environmental safeguards on the pretext of facilitating rapid growth can be observed in the post-conflict period. This is complemented by less stringent safeguard measures adopted by commercial lenders that gained prominence post-2009. In the long run, such trends can be immensely counterproductive in efforts to achieve sustainable development. Thus, strengthening environmental safeguard measures to cover possible loopholes in the existing system is a must.

Additionally, attention should focus on safeguarding ecosystems as an integral part of Sri Lanka's long-term economic development strategy. Two broad options are open to avoid further losses to ecosystems by adopting the lessons (both positive and negative) from fast-growing economies around the world, and ensuring the recovery of critical ecosystems damaged over the years due to past interventions. This requires careful balancing of trade-offs among ES. A few priority areas include adopting measures to prevent critical ecosystems from further degradation, adopting participatory management of ecosystems, and promoting eco-friendly practices for conservation and sustainable use of ES.

There are certain critical ecosystems such as upper watersheds in the central highlands, wetland ecosystems, coastal and marine ecosystems, and reservoir catchments which need urgent protection. Measures should aim to prevent encroachments, promote best practices through participatory approaches, and restore and stabilize degraded areas. Adopting a participatory management approach with the inclusion of relevant stakeholders from the designing stage to implementation and monitoring stages is an essential condition for successful management of ecosystems. Different models of participatory management such as community management, co-management, or adoption of best practices as private individuals can be used according to the nature of issues and ecosystems involved. Finally, eco-friendly practices should be promoted. A growing demand for eco-friendly products and services can be observed throughout the world with rising awareness on health and ecosystems damages associated with declining environmental quality. Examples are organic food products and ecotourism. This creates market incentives for suppliers. In Sri Lanka too, a slow but steady growth in niche markets for organic agriculture and ecotourism can be observed. If wisely handled, these opportunities can be used to arrest ES losses in the long run.

7 Conclusion

After nearly a decade, since the end of the conflict, Sri Lanka has reached an important juncture on sustainable development. The lengthy conflict had been the major factor that overshadowed all development efforts in the three decades prior to 2009. In the post-conflict era, Sri Lanka faces new opportunities and challenges for sustainable development; among others, environment-related challenges are becoming more critical. At the same time, environment policies are also burdened by gaps and inefficiencies.

Limited financial, administrative, and institutional capacity to address environmental challenges requires a prioritization of policy actions. At the same time, certain environmental challenges demand priority attention owing to the nature and time horizons of their impacts on the economy. The demand for priority attention on environmental challenges and the government's capacity to deliver them in the post-conflict development agenda have to be reconciled through the adoption of a strategy based on short-, medium-, and long-term policy interventions.

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Part II
Post-conflict Development in a Transforming Global Economy

Debt Financing for Development: The Sri Lankan Experience

Dushni Weerakoon and Sisira Jayasuriya

Abstract Throughout the first six decades of the post-independence era, Sri Lanka relied on traditional forms of foreign financial assistance, albeit at fairly modest volumes, from multilateral and bilateral donors. But, beginning with its debut issue of a five-year USD 500 million international sovereign bond (ISB) in 2007, the composition of Sri Lanka's outstanding external debt stock has transformed swiftly from concessionary to non-concessionary loans obtained on commercial terms, with maturity periods of 5–10 years. This is the result of both demand and supply factors for international borrowings. On the demand side, external financing needs rose sharply post-war, for both economic and political reasons to fund a huge infrastructure development programme and provide a peace dividend. On the supply side, the adoption of unconventional monetary policy in advanced economies as a response to the global financial crisis resulted in an unprecedented lowering of interest rates, prompting private and institutional investors to search for higher yields in emerging economies. Second, China emerged as a major source of development finance, with Sri Lanka seen as a particularly attractive destination due to its strategic position at the tip of South Asia. This chapter examines the drivers of this dramatic transformation of Sri Lanka's debt financing strategy and discusses the implications for macroeconomic management in a global context where there are rising concerns about the vulnerability of emerging economies to financial and economic shocks, particularly interest rate increases in developed economies that can reverse capital flows into developing countries. We argue that as some of these favourable conditions begin to change and the global context becomes more challenging, the resilience of the Sri Lankan economy will be severely tested as it prepares to amortise a dramatic spike in external debt settlements during 2019–2022.

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1 Introduction

A historic shift with far reaching implications has occurred in Sri Lanka's debt financing strategies during the past decade. In this chapter, we examine the drivers of this dramatic transformation of the country's debt financing strategy and discuss the implications for macroeconomic management in a global context where there are rising concerns about the vulnerability of emerging economies to financial and economic shocks, particularly interest rate increases in developed economies that can reverse capital flows into developing countries.

Throughout the first six decades of the post-independence era, Sri Lanka relied on traditional forms of foreign financial assistance, albeit at fairly modest volumes, from multilateral and bilateral donors such as the Asian Development Bank (ADB), the World Bank and Japan. These were largely obtained as concessionary, long-term arrangements. But, beginning with its debut issue of a five-year USD 500 million international sovereign bond (ISB) in 2007 that marked its first foray into direct borrowings from the international capital markets, the composition of the country's outstanding external debt stock has transformed swiftly from concessionary to non-concessionary loans obtained on commercial terms, with maturity periods of 5–10 years. Non-concessional loans that accounted for just 7% of total outstanding external debt in 2006 rose to 50% by 2012, and now accounts for more than 55% of total external debt.

This is the result of both demand and supply factors for international borrowings. Beginning with the need to finance a major expansion of the military expenditures, the demand for external financing rose sharply at the end of the separatist war in 2009 for both economic and political reasons, to fund a huge infrastructure development programme, and provide a peace dividend to a population battered by three decades of war and conflict. On the supply side, two international developments transformed the financing landscape. First, the adoption of an unconventional monetary policy in advanced economies as a response to the global financial crisis resulted in an unprecedented lowering of interest rates, prompting private and institutional investors to search for higher yields in emerging economies. This more than compensated for diminished capacity and willingness on the part of many traditional sources (Western governments and multilateral institutions) to provide development finance. Second, China emerged as a major source of development finance, with Sri Lanka seen as a particularly attractive destination due to its strategic position at the tip of South Asia.

Thus, Sri Lanka found itself the beneficiary of an unusually favourable international situation for accessing external financing outside the traditional sources (Multilateral Financial Institutions (MFIs), Japan and Western countries) that served to at least partially offset the adverse effects of a global economy that was experiencing the most serious economic recession since the 1930s. Easier access to international finance enabled the country to lift its growth rate and generate optimism about longer-term development prospects. This was obviously attractive to the government. It seemed to have a found a way to generate economic development, employment expansion and living standards without the need to undertake any painful economic restructuring or policy reforms. Engaging in this kind of 'facility shopping' has become a common approach where countries are able to raise large amounts of funds from these new sources, minus the prescriptive MFI conditionalities (Triggs 2018).

But as some of these favourable conditions begin to change and the global context becomes more challenging, the resilience of the Sri Lankan economy is likely to be severely tested as it prepares to amortise a dramatic spike in external debt settlements during 2019–2022.

In the following sections, we elaborate more on these developments that have brought Sri Lanka to a position of being an economy with high dependency on external borrowings and increasing vulnerability to sudden exogenous shocks. We review the changes in the international financing landscape and show that Sri Lanka's increasing dependence on non-traditional external financing sources has not been an isolated and unique development; it paralleled developments which were seen on a global scale in many developing and emerging market economies not only of Asia and Africa, but also of Latin America (CNN 2018). This also means that issues of shocks, crises, international contagion and so on may deserve more recognition in policy debates. We conclude with some brief observations on the macroeconomic challenges as the country enters hitherto unchartered waters.

2 A New Global Financing Landscape for Emerging Economies

Sri Lanka's ability to access non-traditional financing sources in the post-war period was part of a major change in global financial market conditions during the past decade. This period has seen emerging economies throughout the world enjoy access to investment funds from global capital markets at historically low rates. This was the result of unconventional monetary policy initiatives adopted by central banks of the advanced economies including those of the UK, Japan, US and EU in the immediate aftermath of the global financial crisis. The practice of quantitative easing (QE)—i.e. expanding their balance-sheets by creating new money in order to buy assets—saw the injection of ample liquidity into markets, accompanied by sharp falls in interest rates, with official rates falling to zero (or, in some cases even below zero). But, despite these monetary policy measures, economic growth in advanced economies has remained sluggish.

This climate of low returns on investments and weak output growth in much of the developed world prompted investors to seek higher yields elsewhere. The appeal of expanding emerging economies was not confined to Asia alone. There was interest in diverse countries with a geographic spread across Asia, Africa, Latin America, Europe and the Middle East. In the run up to the global financial crisis of 2007/2008, international capital markets had begun to witness the entry of first time international bond issuers from emerging economies. After a brief hiatus, when investors retreated from risky assets at the onset of the financial crises, debut Eurobond issuances—a bond in a currency other than that of the country issuing it—resumed once again, prompted by a slew of both demand- and supply-side factors.

A second equally important development was the emergence of a new non-traditional source of development finance, China, flushes with the world's biggest foreign-exchange reserves. A rapid increase in development assistance from China to African, South American and Asian economies took place, driven by a desire to secure natural resources as well as extend its geopolitical and economic influence.

On the demand side, the prospect of graduating from low-income to middle-income status for many emerging economies galvanised a search for funding other than traditional concessionary soft window development finance. For the most part, the quantum of finance necessary for investments in infrastructure was a critical factor in nudging these countries towards international capital markets (Guscina et al. 2014). With underdeveloped domestic capital markets, many resorted to international capital market borrowing to bridge a rising financing gap. Indeed, in the face of ample global liquidity and favourable interest rates, international capital market borrowing was also cheaper for some emerging economies, albeit with additional risks arising from currency mismatches. The availability of development finance from China has provided a new source of non-traditional funds, particularly for long-term investments in infrastructure that developing countries have been looking for.

While a paucity of reliable data has generated mixed evidence on the scale of investments and lending by China that there was rapid growth in such finance is not disputed. China's development assistance in overlooked areas like infrastructure, and its efforts to fund new multilateral lending agencies has changed the international development finance architecture. In response to the growing demand for resources for infrastructure projects, Chinese funding saw the establishment of the Shanghai-based BRICS Development Bank in 2014 (with financial contributions also from Brazil, Russia, India and South Africa) and the Asian Infrastructure Investment Bank (AIIB), also in 2014.

In addition to these multilateral channels, China's role as a new source of development finance has played out primarily at a bilateral level. From 2013, the launch of a revived Silk Road—'One Belt, One Road (OBOR)', or the Belt and Road Initiative (BRI)—has been the linchpin around efforts to underwrite infrastructure investment in countries along the route. For China, the BRI contains not only land routes linking China to markets in the West, but also vital sea lanes in the Indian Ocean along which a large share of its imports and exports pass. So far, the BRI has allowed China to scale up its loan assistance and make inroads in its strategic rivalry with the USA. Indeed, the 70 strong memberships of AIIB include every G7 country except Japan and the USA.

The attractions of these new funding sources—bilateral loans from China and/or tapping international capital markets for hard currency—to governments are clear in that these sources have the advantage of volume, ownership, alignment and speed of project delivery (Greenhill et al. 2013). Such funds are particularly attractive to recipient countries, being free of conditions and lengthy processes that typically govern multilateral funding. Thus, governments can access larger volumes of funds more quickly and disburse according to their own priorities as lenders follow a policy of non-interference in national economic strategies, without raising questions about the fundamentals of the country's policy framework.

Some studies suggest that China has emerged as Africa's most important economic partner, with a significant presence in the top four across five measures of economic connection adopted by the study—i.e. trade, investment stock, investment growth, infrastructure financing and aid (Sun et al. 2017). Conversely, there are others who argue that China's investments and lending to Africa may be overestimated. The sums quoted are said to add up to pledges only, rather than actual flows, lending to a substantive over-estimation of China's economic presence. In fact, some studies suggest that only a half of announced Chinese loans to Africa have actually materialised in reality (Brautigam and Hwang 2016).

This new and complex financing landscape can hold significant risks for countries with inadequate institutional and bureaucratic structures to manage these flows strategically. There is ample scope for avoidance of rational analysis of investment choices when financing is available to governments without any questions or conditions. This is the case when the lenders follow a policy of non-interference in national economic strategies when making loans (as in the case of most bilateral loans from China), and the question does not arise at all in the case of ISBs. In such circumstances, countries can fall into the trap of 'over-borrowing' and subsequent debt distress or crises when global economic conditions change, sentiment towards emerging markets turns negative or returns on big infrastructure investments fail to live up to expectations. Thus, presence of new sources of development finance may have heightened the possibility for poor investment choices by recipient governments. Indeed, there is some evidence to suggest that infrastructure projects implemented in partnership with multilateral agencies perform relatively better than those efforts managed solely by governments (ADB 2016).

3 Sri Lanka's Investment Boom and Consequences

How can we characterise the investment boom in post-war Sri Lanka? Public investment shot up to an average of 5–6% per annum in the war years (2006–2009) from a relatively low average of around 4% during the preceding decade, partly in response to rebuilding and reconstruction related work following the December 2004 Asian tsunami that led to a devastating loss of life and property in Sri Lanka. Even after the tsunami-related reconstruction efforts were nearly completed, by historical standards, public investment remained relatively robust in the post-war years as the government launched and maintained a large investment programme as soon as the war ended.

These caused fiscal deficits to widen sharply as tax revenues (as a percentage of gross domestic product (GDP)) had been steadily declining for many years. Sri Lanka ran fiscal deficits in the range of 6% of GDP during this period, indicating that nearly all of its public investment was generated through borrowings. According to the International Monetary Fund (IMF 2010, p. 4), government spending on 'faster than programmed, lumpy disbursements for a couple of large foreign-financed infrastructure projects and for their counterpart funds' was responsible for the failure of the government to achieve deficit reduction targets. As a result, net foreign financing which averaged at around 1.2% of GDP in the decade prior to 2006 shot up to an average of 2.5% of GDP thereafter. The change was not only in the magnitude of foreign financing, but also in its composition as discussed earlier.

Robust GDP growth rates in the immediate post-war years instilled a sense of complacency. GDP growth shot up to over 8% per annum during 2010–2012 compared to a historical average of around 5% pre-war. The boom, however, was short-lived. From 2013 onwards, Sri Lanka's GDP growth plummeted to an average of less than 4.5% per annum, falling to a low of 3% in 2017—the lowest GDP growth since 2001.[1]

Clearly, the quality of Sri Lanka's post-conflict growth was questionable. The growth strategy that relied heavily on an infrastructure push through foreign financing also led to persistent upward pressure on the real exchange rate and thereby eroded the competitiveness of the export sector to elevate Sri Lanka's vulnerability to exogenous shocks and debt distress over time. Growth of GDP was heavily dependent on construction and related non-tradeable activities to generate a consumption driven boom, helped by loose monetary policy (Institute of Policy Studies of Sri Lanka (IPS), various years). The contribution of net exports to growth remained marginal, reflected by a progressive decline in Sri Lanka's export share of GDP, including losing its global share of merchandise exports to competitors such as Bangladesh and Vietnam.

The attraction of a large-scale public infrastructure investment strategy is not difficult to understand given the belief in a positive relationship between infrastructure investment and growth, especially in poorer countries. Infrastructure investments can spur future growth through a longer-term boost to productivity while also delivering immediate employment gains and higher economic growth, generating popular support and buttressing the political standing of the government. Debt financing of infrastructure is also not necessarily a high-risk activity. If infrastructure investments raise a country's long-term growth prospects, higher volumes of fiscal revenue can be generated to settle debt obligations. Indeed,

[1]Sri Lanka's Department of Census and Statistics revised its national accounts in 2015 with a new base year of 2010. Under the old series with a base year of 2002, GDP growth jumped to an annual average of 7.5% during 2010–2012 and remained at a high 7.3% on average even during 2013–2014.

infrastructure investment to boost growth and reduce poverty is often advocated by the MFIs. The IMF (2016) argued recently that public investment, from amongst an array of different tools of fiscal stimulus, has the largest impact on GDP (IMF 2016).[2] As the global economic downturn dragged on without relief in sight, an infrastructure push as a cyclical stimulus to revive growth was pushed explicitly by MFIs (IMF 2014).

But infrastructure investments will yield such longer-term growth benefits only if they are 'efficient' (socially profitable) investments, undertaken with properly formulated infrastructure planning and prioritisation of projects, something that is not by any means guaranteed. The quality of public investment—i.e. its effectiveness and efficiency—is linked amongst others to the quality of government. These institutional factors include elements such as the quality of project selection, management and evaluation, and of the regulatory and operational frameworks (Ghazanchyan et al. 2017). Inefficiency and corruption issues in large-scale public investment projects have a long history and are well documented (Tanzi and Davoodi 1998). If the projects are economically inefficient and generate poor returns—as is the case with many 'mega-projects' driven primarily by short-term political considerations—then the country will face a significant debt-overhang and weak growth, with the potential for a debt-crisis, particularly if the debt has been externally financed. According to various measures of capturing the efficiency of public investment—such as the IMF's Public Investment Management Assessment —Sri Lanka is deemed to be faring better than the average for emerging and developing Asia (Ghazanchyan et al. 2017), though the economic rationale for some of the large projects have been questioned.

But even if the projects are efficient, there can be several problems with extensive use of debt finance for long-term infrastructure projects. First, the country can face severe liquidity problems if debt is relatively short term and repayments need to be made before the economy generates the long-term returns. Second, repaying debt can become problematic in the absence of effective fiscal mechanisms that ensure that tax revenues are adequate to meet financing obligations. Third, there are other macroeconomic impacts of large-scale investment programmes that can have adverse long-term effects, unless carefully managed. Even when largely foreign funded, such investments pull in substantial domestic resources (including counterpart funding by the government) and contribute to larger fiscal deficits. These deficits in turn tend to appreciate the real exchange rate, place downward pressure on net exports, widen current account deficits, and increase the need for external funds to finance the current account deficits (Athukorale and Jayasuriya 2013). Unless carefully managed, these 'Dutch Disease'-type effects of large-scale infrastructure projects may undermine the positive productivity effects of better

[2]At the beginning of 2016, gross international reserves were short of gross foreign-currency claims coming due in the year (International Monetary Fund (2016) Staff report for the 2016 article IV consultation, p 6. Washington D.C.).

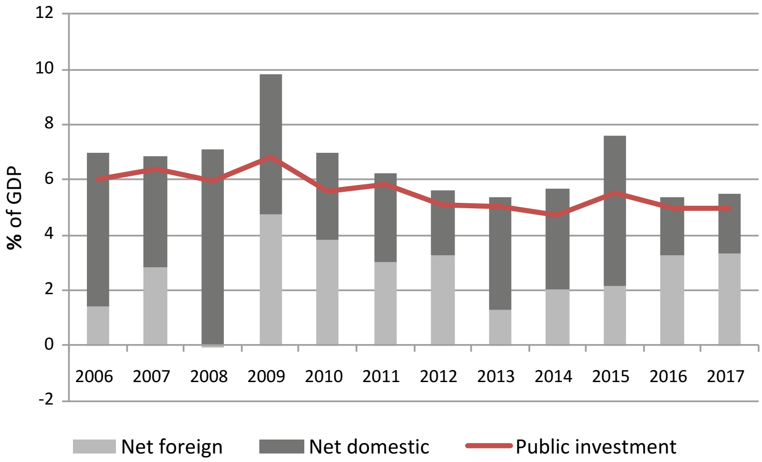

Fig. 1 Public investment and financing of the fiscal deficit. *Source* Various Reports of CBSL

infrastructure, cause long-term harm to tradeable industries and net exports, and entrench trade and current account deficits.

This is why there is also a cautionary view for governments amidst emerging evidence that question the presumed acceleration in the GDP growth following a public investment push. For example, Warner (2014) finds that slumps rather than booms have followed major public investment drives in infrastructure (IMF 2014). The study finds poor analysis of investment projects, incentive problems and interest group influenced investment choices add to the risks of generating a weak positive association between investment spending and economic growth. When spending is debt-financed and unproductive, the outcomes can be slumps, even crises and subsequent weaker growth.

Sri Lanka has past experience, during the 1977–1984 period, with the negative effects of large-scale investment programmes. At the time, some of the negative effects were mitigated by substantial nominal exchange rate adjustments and other measures that offset the erosion of competitiveness of exportable. Similar effects were also clearly visible from 2010 onwards. With persistent real exchange rate appreciation as evident in Fig. 1, the export-to-GDP ratio fell from 26% in 2005 to 17.8% in 2011, and the current account deficit widened from 2.2% of GDP in 2010 to 7.8% of GDP in 2011.

The Central Bank of Sri Lanka (CBSL) attempted to maintain a 'strong rupee'—a policy partly designed to enable dollar denominated debt to be more manageable—but this resulted only in the depletion of much of the foreign reserves, and when international reserves fell rapidly to a precarious level it was forced to let the rupee depreciate by some 25% against the US dollar by August 2012. But, expansionary fiscal and monetary policies continued, despite some attempts to rein in deficits under pressure from the IMF with predictable consequences: persistent pressure on the current account deficit and reserves, and continuing need for external borrowings in the absence of non-debt creating capital inflows. Sri Lanka's record in attracting foreign direct investment (FDI), for example, is one of the worst amongst similar economies, and it has also failed to attract substantial equity investments.

4 Sri Lanka's Debt Binge: A Casualty of Chinese Largesse?

Sri Lanka's debt-financed infrastructure investment choices have come in for their share of criticism. Not surprisingly, much of this has focused on Chinese bankrolled large infrastructure projects that have caught global attention because of their wider economic, political and strategic implications, and seen as part of China's so-called 'debt diplomacy' (Thorne and Spevak 2017).

China's loan commitments to Sri Lanka have been primarily for investments in energy, highways, sea ports and airports. They have been criticised on several grounds, and some of them are similar to those voiced internationally in relation to Chinese projects elsewhere:

1. Project selection not based on good economic criteria
2. Absence of proper environmental impact assessments
3. Low employment impacts
4. High interest rates
5. Exporting the Chinese model of development

Many criticisms about project selection are linked to the concerns about the opaque nature of Chinese-funded infrastructure projects—with much of bilateral loan assistance negotiated on government-to-government terms with contracts often awarded to Chinese construction companies without formal competitive bidding processes. If project selection is poor, then it becomes harder for governments to repay loans. Indeed, some evidence of debt distress related to Chinese loan advances is beginning to emerge (Hurley et al. 2018). In Sri Lanka, while the economic rationale for some projects was clear, the commercial viability of others has been the subject of much debate. Some China-funded projects have been criticised also for insufficient attention to potentially adverse environmental impacts. Several have been viewed as supporting political prestige or vanity projects—i.e. 'white elephant' projects that served as conduits for dispensation of political patronage providing lucrative rent-extraction possibilities.

Amongst these, the most contentious have been a seaport (Hambantota Port) and an international airport (Mattala International Airport), situated in the hometown of the incumbent President of the day. Their commercial viability was questioned primarily on the choice of location, as the need for a second international seaport and airport was long identified. The decision to locate both in Southern Sri Lanka was widely perceived to be a politically influenced choice. The launch in 2014 of the ‘Colombo Port City’ project—the reclamation of a large tract of land adjacent to Sri Lanka’s primary seaport of Colombo—renewed such criticism. The project, with all costs of land reclamation borne by China, was undertaken not on the basis of a loan advance, but as Chinese FDI into Sri Lanka. In return, Sri Lanka undertook to vest a share of the reclaimed land with China on a freehold basis.

A frequent criticism of Chinese loan-funded projects is the argument that they generate limited benefits to the local economy by way of employment or skills transfer, and restricted opportunities for domestic private sector participation in development projects. Chinese government-backed corporate entities typically are handed contracts in government-to-government negotiated projects, without formal competitive bidding processes where Chinese companies are selected as the project contractor. In project procurement, priority is most often given to equipment, materials, technology or services from China. Many Chinese firms use a high proportion of imported semi-skilled and skilled Chinese labour, and employment of local labour and other inputs has been much lower than is normally the case with mega-projects of this size; for example, some of the mega-projects are estimated to have employed around 26,000 Chinese semi-skilled and unskilled workers (Kelegama 2014).

However, the allegation that Chinese loans carry inordinately high interest rates is not supported by available data. The USD 300 million loan for the construction of the Hambantota Port is estimated to have been raised in 2007 at a fixed interest rate of 6.3% with a maturity of 15 years and grace period of four years. The terms, negotiated at the height of Sri Lanka’s war and before the global financial crisis was to hit, do appear to move unfavourably against Sri Lanka in the post-financial crisis environment. As a portfolio, however, interest costs on the totality of China’s loans are estimated to average out to much less. According to the Department of External Resources, for the period up to 2017, Chinese loans, with an average maturity of 15–20 years, have been raised primarily on concessional terms from the EXIM Bank of China at interest rates of 2% (Department of External Resources of Sri Lanka (ERD) 2018). The remainder is said to have been obtained at market rates, and account for 20% of such high cost foreign borrowing made by Sri Lanka . By 2017, China had come to account for a limited 9% share of Sri Lanka's total foreign debt.

As evident from Table 1, the financing terms of Chinese loans are higher than other traditional donors such as Japan, and multilateral agencies such as the ADB or the World Bank, but are less costly than ISBs. Arguably, with Chinese loans there is also more room for any rescheduling of debt repayments should the need arise.

As Sri Lanka’s post-war economic strategising saw a heightened role for the state, there has been some speculation that this may be linked to the ideological influence of China. The enhanced role of the state in post-war development policy occurred through three main channels: (i) a massive public investment programme in infrastructure; (ii) a reverting to the government of previously privatised state-owned enterprises (SOEs) such as Sri Lankan Airlines and Sri Lanka Telecom; and (iii) military involvement in economic activities, including in vital post-war growth areas such as tourism. This shift towards expanding the role of the

Table 1 Comparative financial terms of foreign loans signed in 2014

Source	Sector	USD Mn.	Interest p.a.	Other payments	Maturity
EXIM Bank of China	Expressways	1,840	Fixed, 2.00%	Commitment fee of 0.25% and management fee of 0.25%	20
China Development Bank	Roads	400	Variable, 6-month LIBOR +2.95% margin	Management fee of 0.5%	15
Government of Japan	Bridges, digitalisation	475	Fixed, 0.10%	Front-end fee of 0.2%	40
ADB	Skills, roads, water, power	310	Variable, 6-month LIBOR +0.60% margin	Commitment fee of 0.15%	25
ADB	Skills, roads, water, power	200	Fixed, 2.00%		25
IDA	Climate resilience, cities, skills	440	Fixed, 1.25%	Commitment fee of 0.50% and service fee of 0.75%	25

Source Various reports of CBSL

state in economic enterprises was accompanied by rising protectionism in the trade regime with widespread application of para-tariffs; these raised the levels of effective protection in the economy reversing previous progress with trade liberalisation and insidious anti-export bias creeping into Sri Lanka's international trade regime, and imparted an anti-export bias into trade policy (Garry and Ahsan 2011; Kaminski and Ng 2013).

This policy shift towards a more nationalist–populist state-centred economic strategy was certainly an unviable solution to meet Sri Lanka's post-war development challenges (Athukorala and Jayasuriya 2013). But can this shift be attributed to the ideological influence—the 'export' of China's own state-guided development strategy? While China's economic success on a global scale strengthened the ideological influence of opponents of economic liberalisation, the resurgence of economic nationalism in the aftermath of the victory over the LTTE had deep domestic historical, political and ideological roots. The governing party and its leadership had never been enthusiastic proponents of a liberal economic policy programme, and there were powerful political motivations that pushed the government towards an economic strategy that centralised economic power in the hands of the ruling political and military elite. More plausibly, it can be argued that large-scale Chinese financing enabled the government to implement its own preferred strategy of economic nationalism, one reflecting its ideological inclinations and closely aligned with its political objectives.

Thus, the evidence suggests that it was not Chinese funding that was the driver of Sri Lanka's debt binge; rather, it was the outcome of its own development strategy and policies. Sri Lanka used, not always wisely, the favourable funding opportunities in both global capital markets and from Chinese sources to implement a large investment and spending programme. But there are serious questions about the viability of some of the investment choices and the sustainability of those levels of spending.

5 Political and Policy Shifts, and Changing Attitudes to Chinese Finance

Not surprisingly, as Sri Lanka faced fresh elections in January 2015, China's role in Sri Lanka became a political issue around a much broader strategising of Sri Lanka's economic and foreign policy relations, alongside soul searching on fundamental questions of democracy, governance and corruption. If governance and corruption were the domestic issues around which Sri Lanka's decisive electoral outcome was fought, the country's overwhelming tilt towards China appeared to provide the grounds for external geopolitical strategising. The cracks in Sri Lanka's strained post-war relations with Western powers and India continued to widen. A US resolution against Sri Lanka at the United Nations Human Rights Council (UNHRC) calling for an accountable judicial mechanism to probe 'war crimes' received the backing of India in 2012 and 2013, the first occasion on which the latter voted for a country-specific charge at a multilateral forum.

The concerns of the Western powers and India about China's influence in Sri Lanka are easily explained. It weakened the leverage and influence of those traditional donors over the country's strategic positioning. This dilution of their geopolitical and strategic influence was clearly of concern to them. China's strong economic connections and political relationships in Sri Lanka, and more widely in South Asia, have been clearly a source of growing concern to India, which views the subcontinent as firmly under its sphere of influence. Beyond India's immediate geographic concerns are those of the USA as it plays out its own strategic regional and global rivalries with China. Suspicions of China's intentions in corralling all manner of infrastructure projects appear to have crystalised with the China-funded Hambantota Port in particular. The port, situated along strategically vital shipping routes linking East Asia to Middle East and Europe, is regarded in some quarters as a part of China's 'string of pearls'—a network of port facilities developed by China along the Indian Ocean between the Chinese mainland and Port Sudan.

In opposition, Sri Lanka's new government-in-waiting made election promises to review development finance obtained from China. More specifically, it pledged to halt the Colombo Port City project. The message clearly was that Sri Lanka intended to rebalance its foreign relations, lessening its economic and political dependence on China while repairing those same relationships with the USA, EU

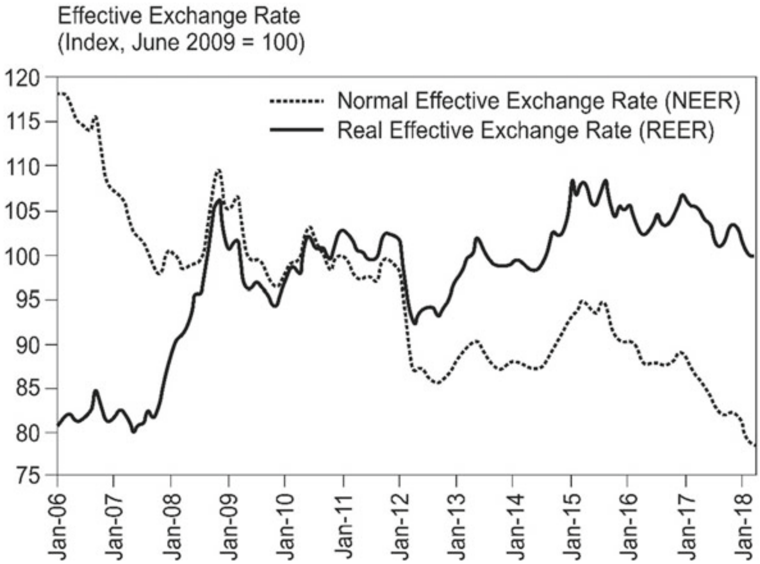

Fig. 2 Real and effective exchange rate, 2006–2018. *Source* Various Reports of CBSL

and India. A surprising final electoral vote for a change of government was thus interpreted as a vote not only for better governance, but also for a repositioning of Sri Lanka's state-led economic development strategy, alongside a realignment of the country's international relations. Not surprisingly, there was a widespread view that Sri Lanka's newly elected government had come to power with the blessings, if not active involvement, of Western powers and India.

Immediately after assuming office in January 2015, the government did indeed suspend the Colombo Port City project and impose a temporary halt to many other ongoing Chinese-funded infrastructure projects with a view to reviewing the terms of conditions of loans taken (Fig. 2).

A halt to Chinese-financed projects, however, had immediate adverse consequences on the economy, with knock-on impacts more broadly. Election-related populist fiscal spending measures had already begun to adversely impact business sentiment when Chinese loan inflows dried up to add to the ballooning fiscal deficit financing requirements. In 2015, Sri Lanka saw no fresh loan commitments from China for the first time in seven years. As total bilateral loan commitments to the government tapered off as a result, Sri Lanka was also to witness the sharp exit of foreign investors from the government securities market (Fig. 3). Initially, the exit was prompted by concerns on the exchange rate front in view of thin buffer stocks of reserves to deal with sudden shocks. The momentum of exits accelerated following rate hikes in the USA towards the latter part of 2015.

On the domestic front, the combination of expansionary fiscal and monetary policies and an unofficial pegged exchange rate (a 'strong rupee')—set to make

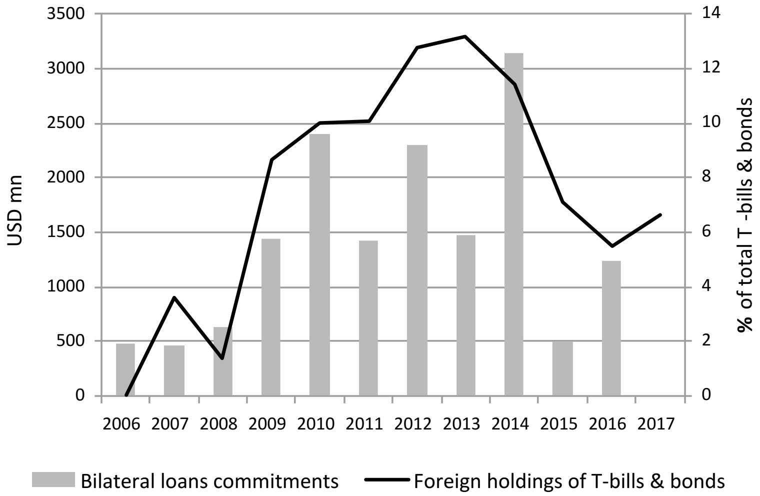

Fig. 3 Multilateral loan commitments and foreign holdings of government securities. *Source* Various Reports of CBSL

dollar denominated debt more manageable—exacerbated current account deficits. As was inevitable, use of reserves to prop up the currency precipitated a sharp fall in reserves and saw Sri Lanka forced to course correct under an IMF programme from mid-2016.[3] The programme envisaged macroeconomic policy adjustment under a three pronged approach aimed at revenue-based fiscal consolidation, a soft inflation targeting framework, and a flexible exchange rate regime to provide the foundation for addressing issues of medium term debt sustainability (IMF 2016).

In as shorter a time as six months, Sri Lanka's new policy towards China began to undergo a rapid U-turn. Starved of funds by mid-2015, overtures were made to China, inviting the resumption of its infrastructure projects, including efforts to re-start negotiations on a China–Sri Lanka Free-Trade Agreement (FTA) initiated in 2014. After a lengthy stand off on compensation for work disruption, the controversial Colombo Port City project was given the nod to proceed in early 2016. The only change was a revision to the earlier agreement to divest China's share of the land on a 99-year lease as opposed to the original offer of a freehold land. Sri Lanka turned to China from a weakened position, which clearly limited the concessions that it could obtain. Chinese loan commitments to Sri Lanka resumed in 2016 as its projects were once again given the go ahead, but at much reduced volumes.

The remedies for debt sustainability under the standard IMF prescriptions of fiscal consolidation can help long-term debt restructuring, but often fail to address immediate refinancing pressures. In any case, the political constraints to implementing a conventional IMD 'austerity' package are severe. As fiscal austerity exerted the expected drag on output, with GDP growth moderating to a 16 year low

[3]Sri Lanka's previous IMF-induced policy corrections were in 2012 and 2009.

Table 2 Post-2015—slow down of growth

	2012–2014 (ann. average)	2015	2016	2017
GDP growth, % change	5.8	5.0	4.5	3.1
Export earnings, % change	2.0	−5.2	−2.2	10.2
FDI, % of GDP	1.3	0.9	1.1	1.6
Exchange rate, % change	4.8	9.9	4.0	2.0
Public external debt, % change	4.2	9.3	6.6	11.4
Public external debt, % of GDP	31.0	32.4	34.0	35.5
Total public debt, % of GDP	70.3	77.7	78.8	77.6

Source Various reports of CBSL

of 3% in 2017, albeit with contributions from poor weather conditions as well, political pressures and frictions within the government itself built up. The post-2015 combination of currency depreciation and moderation in GDP growth saw debt ratios climb steadily (Table 2).

In the interim, the CBSL had availed itself of short-term swap arrangements in 2015 from the Reserve Bank of India (RBI) to the tune of USD 1.5 billion, in addition to USD 2,150 million raised as ISBs. These went towards the settlement of a maturing USD 500 million ISB and government securities. Pending foreign debt settlements in 2016, including the remaining USD 1.1 billion of the outstanding swap arrangement with the RBI—prompted a fresh round of borrowing from international capital markets of USD 2,200 million. In fact, the share of non-concessionary external debt rose steadily post-2015 to 55% by end 2017. At the same time, the growth in outstanding external debt accelerated, doubling from 4.2% per annum during 2012–2014 to 9% per annum during 2015–2017.

As external sector conditions weakened in 2016, and domestic growth slowed down, Sri Lanka approached China with an offer of a debt-to-equity swap on the Hambantota Port. The final outcome was that China was handed a 70% equity stake on a 99-year lease for a sum of USD 1.1 billion in 2017. The sale was interpreted as a 'forced sale' in the face of Sri Lanka's inability to meet its growing debt servicing obligations to China, and received global attention, particularly following an article in the New York Times (2018) that portrayed Sri Lanka as a victim of Chinese loan diplomacy that has ended up with an economically unviable port and a huge debt.

In fact, there were no immediate debt servicing pressures during 2015–2016, and the settlement of project loans had shown no notable change during 2015–2016. The divesting of the government's majority holding in the Hambantota Port was actually part of a broader push to make some infrastructure projects public–private partnerships. Aside from the port, the Mattala International Airport, an oil refining facility in Eastern Sri Lanka, a terminal in the Colombo Port, amongst others were also put forward for possible divestiture by the state. But the sale of the Hambantota Port certainly also provided immediate relief from debt servicing, as well as generating an injection of much needed non-debt creating foreign capital inflows.[4]

Thus, Sri Lanka's post-war shift in debt financing points to multiple causes rather than a single factor. The accumulation of debt has been driven by government objectives of rapid economic growth, employment generation and an improvement in living standards in the short-run, and rebuilding and enhancing the country's infrastructure in an accommodating external environment for accessing debt finance from both global capital markets and China. As a result of Sri Lanka's appetite for cheap and easy finance in the post-war period, and its failure to attract non-debt creating foreign capital inflows, it had been swept up in a high-risk strategy of debt refinancing and an expanding stock of accumulated debt in an increasingly volatile domestic and global economic environment (Aguiar and Gopinath 2006; Alesina and Tabellini 1990).[5]

6 Implications and Conclusions

Sri Lanka's immediate challenge is to prepare for a sharp rise in external debt settlements from 2019. A bunching up of ISB settlements of USD 5 billion and USD 1.7 billion in syndicated loans over 2019–2022 is largely responsible for the spike. Sri Lanka's declining debt service ratio post-2015—primarily the result of lower debt settlements rather than an increase in foreign-exchange earnings to service the debt—is expected to rise sharply from 2019. In the absence of sustained export earnings, the enactment in 2018 of an Active Liability Management Act allows the government to borrow in excess of its annual Parliamentary approved limits to provide more flexibility in debt management. By the first half of 2018, Sri Lanka had already raised an additional USD 2.5 billion towards this end by way of ISBs, and an additional USD 1 billion as a syndicated loan. ISBs have continued to be heavily oversubscribed in the presence of low interest rates in advanced economies; in turn, oversubscribed issues for riskier ISBs such as Sri Lanka's below investment-grade-rated bonds have become almost normal, instilling a deceptive sense of infallibility in issuers.

This accommodating external environment is unlikely to continue for much longer. If that were to be the case, Sri Lanka is likely to face serious problems in coping with its external financing needs, including the management of payments of both interest and principal of existing short-term debt. It is noteworthy that a

[4]Amidst growing domestic opposition to the sale of so-called strategic assets, there was considerable foot dragging on taking these forward since the sale of the Hambantota Port.

[5]Such behaviour by governments and politicians is of course by no means unique to Sri Lanka; there is a huge body of analytical literature on debt and financial crises that highlights how the limited horizons of politicians and high discount rates of governments result in unsustainable debt-driven spending booms followed by catastrophic crises. See, for example, Aguiar and Gopinath (2006), Alesina and Tabellini (1990).

comparison of sovereign bond spreads—widely considered a comprehensive measure of a country's overall risk premium—show that Sri Lanka is seen as a much higher risk than other Asian emerging markets, paying a premium of over 200 basis points in mid-2018, a gap that is wider than a few years ago.

Major challenges lie ahead. In the past, Sri Lanka has never had to face the experience of sharp and sudden capital outflows, and a drying out of access to international credit markets. But international experience suggests that Sri Lanka is about to enter a period where it cannot be complacent about the potential for such shocks and crises. As Reinhart and Rogoff (2009) point out, it is easy to believe that financial crises are something that happen to other people in other countries at other times; crises do not happen here and now to us (Reinhart and Kenneth 2009). Unfortunately, an economy with chronic payments deficits, sluggish export growth, weak FDI inflows and a significant accumulated stock of short-term debt is highly vulnerable to external shocks, whether these be trade shocks, global interest rate hikes, adverse currency movements, drying up of capital inflows or natural disasters.

Sri Lanka is now much more exposed to cross-border capital movements sensitive to changes in market expectations. Even with stringent regulatory restrictions on capital outflows in place, sharp capital outflows occurred in 2001 and 2009, and the ability of market agents to move capital out is arguably much greater now. While existing capital controls and stocks of forex reserves can stop massive capital outflows from occurring in the very short term, Sri Lanka's ability to avoid major payments crises should not be overestimated. If present trends continue, the realities of being a highly indebted country in a volatile global economy may be brought home suddenly and sharply.

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Using RCEP as a Stepping Stone to East Asia: Case Studies of Sri Lanka and India

Ganeshan Wignaraja

Abstract This paper explores the economic implications of the globally important Regional Comprehensive Economic Partnership (RCEP) for South Asia through case studies of post-conflict Sri Lanka and India. The results of model-based studies suggest that, as a member, India is the only country in South Asia to potentially gain, but its gains depend on the depth of the RCEP agreement. Excluded Sri Lanka, however, will likely see losses from trade diversion and erosion of preferences from the RCEP. Sri Lanka is attempting to use the recent free trade agreement (FTA) with Singapore as a stepping stone to East Asia. But both Singapore and Sri Lanka need to do more to ensure that the benefits flow to Sri Lanka. Further afield, Sri Lanka could learn useful lessons from India's long experience of the RCEP negotiations including liberalizing goods and services trade and adopting new intellectual property rules. A renewed partnership between Indian businesses and government will help prepare for market opening under the RCEP.

1 Introduction

There is growing academic and policy interest in the potential economic impacts of mega-FTAs—such as the RCEP and the Trans-Pacific Partnership (TPP) (see Baldwin, 2014; Wilson, 2015)—on economies inside such agreements and those

Parts of this chapter draw on and update Wignaraja (2018).

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outside them. Several model-based studies of mega-FTAs exist, but little research exists on South Asia, either using models or country case studies.[1]

Sri Lanka and its larger and faster-growing South Asian neighbour—India—have had different FTA strategies with dynamic East Asia. Sri Lanka—a classic small open economy—has historically not sought FTAs with East Asia with the exception of membership of the Asia-Pacific Trade Agreement (APTA). The election of a new national government in 2015, six years after the end of a 30-year civil war, altered Sri Lanka's approach. Remedying a persistent trade deficit in post-conflict Sri Lanka has been equated with attracting export-oriented foreign direct investment (FDI) and providing rules-based norms through FTAs. The National Trade Policy of 2017 emphasized FTAs with Asia and the West alongside unilateral trade liberalization, trade facilitation and other measures.[2] The Sri Lanka–Singapore FTA (SLSFTA), which took effect in May 2018, is one concrete outcome of the National Trade Policy. Sri Lanka is also ambitiously negotiating bilateral FTAs with three economies (China, India and Thailand) and has indicated interest in the RCEP. However, the country is excluded from the RCEP talks and lacks a formal East Asia policy.

Meanwhile, India has long pursued FTAs under its 1991 'Look East Policy' in a bid to expand economic ties with East Asia. India has bilateral FTAs with ASEAN, Korea and Japan. India is also in the RCEP negotiations which cover about three billion people across 16 Asian economies making it the world's largest FTA.[3]

This chapter seeks to contribute to the sparse literature on South Asia by exploring the economic implications of the RCEP on Sri Lanka (an outsider economy) and India (an insider economy). It undertakes three tasks. First, as background, it discusses the aims of the RCEP and progress in the negotiations. Second, it reports the findings particularly for South Asian economies from computable general equilibrium (CGE) model-based studies of the RCEP. Third, it explores the national-level economic implications of the RCEP through case studies of Sri Lanka and India. The Sri Lankan case explores the potential costs of being omitted from the RCEP, the benefits of future membership and ways of leveraging the bilateral FTA with Singapore. The Indian case focuses on its hesitancy in liberalizing trade further and the views expressed by some RCEP members that India is a stumbling block to the RCEP negotiations.

Section 2 discusses progress in the RCEP negotiations. Section 3 discusses how the agreement could contribute to Asian economic integration. Section 4 discusses the results of CGE studies. Sections 5 and 6 analyse the Sri Lankan and Indian cases. Section 7 concludes.

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[1]These include Mohanty and Prohit (2007) and Rahman and Ara (2015).

[2]Please refer http://modsit.gov.lk/images/pdf/NTP_-_ENGLISH.pdf.

[3]The RCEP economies accounted for 32.3% of the world's population in 2016 compared with 6.9% for the European Union (EU), 6.7% for the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP or TPP-11) and 6.5% for the North American Free Trade Agreement (NAFTA). The RCEP economies also had 32.2% of world GDP in 2016 which is a larger world share than the other groupings. See Wignaraja (forthcoming).

2 Progress on the RCEP Negotiations

The RCEP was launched at the East Asia Summit in November 2012 in Phnom Penh, Cambodia (Basu Das 2012). While the partnership would expand ASEAN's role in coordinating regional trade, the RCEP's key aim is to reconcile two long-standing proposals into a large, region-wide trade agreement. The two proposals being joined are: (1) the East Asian Free Trade Agreement (or ASEAN+3), which includes the ten ASEAN members, China, Japan and Republic of Korea (henceforth, Korea); and (2) the Comprehensive Economic Partnership (or ASEAN +6), which has added Australia, New Zealand and India. The first was backed by China, and the second by Japan. The RCEP neatly bridges the two proposals by adopting an open accession scheme so that any party that meets the template can join. Furthermore, ASEAN is accorded the coordinating role for the RCEP process, which means better inclusion of the interests of smaller ASEAN economies.

The good thing about the RCEP is that it is a step-by-step process, so any economy that meets the template can join. The parties have stated that their goal is to achieve a modern and comprehensive trade agreement, and the negotiations are supposed to be guided by several key principles (RCEP Ministers 2012), including:

- maintaining consistency with World Trade Organization (WTO) rules, such as the General Agreement on Tariffs and Trade (GATT) Article XXIV and General Agreement on Trade in Services (GATS) Article V;
- providing improvements over existing ASEAN+1 FTAs;
- reflecting different levels of development of participating economies and allowing for special and differential treatment for least-developed countries (LDCs); and
- ensuring an open accession clause to enable participation of any ASEAN FTA partner, as well as other external economic partners, at a future date.

The core of the RCEP negotiating agenda will cover trade in goods, services trade, investment, economic and technical cooperation and dispute settlement. More specifically, the RCEP seeks to achieve the following:

- gradually reduce tariff and nontariff barriers on most trade in goods to create a free trade area;
- largely eliminate restrictions and discriminatory measures on trade in services for all sectors and modes of services;
- create an open and facilitative climate for investment;
- address the special needs of less-developed ASEAN economies through early elimination of tariffs on products of interest to them and through the provision of development assistance to narrow development gaps; and
- provide for a dispute settlement mechanism to effectively resolve trade disputes.

The ambitious three-year timeline for concluding the RCEP negotiations has slipped with the negotiations turning out to be more protracted than expected. During May 2013 to May 2018, 22 rounds of working-level RCEP talks were held. The 23rd round took place in July 2018 in Bangkok. Little official information is available on progress in the RCEP negotiations as these talks are being conducted secretly in keeping with a trend followed internationally.[4] Conflicting information can be gleaned from media reports. The China Daily reported already four years ago that the RCEP parties reached preliminary agreements on tariff reduction schedules, rules of origin, customs procedures and other trade facilitation measures (China Daily, 31 March 2014). However, the Straits Times recently reported that the RCEP agreement "consists of 18 chapters, of which just two have been concluded. These are in the areas of economic and technical cooperation and in small and medium enterprises" (The Straits Times 1 July 2018).

The RCEP negotiations are likely to have been slow and contentious in the more difficult areas of barriers to services trade, investment rules and intellectual property rights (IPRs). This reflects differences in levels of development of the parties, their negotiation positions and the influence of domestic lobbies. The India case study below explores these issues.

Political pressure was ratcheted up on trade negotiators amidst concerns about rising protectionism and an ongoing trade war between the USA and China. One expectation was that the RCEP agreement would be signed in November 2018 during the ASEAN Leaders Summit in Singapore. The joint leader's statement at the first ever RCEP Leaders Summit in Manila in November 2017 instructed ministers and officials to intensify work in 2018 to conclude the RCEP negotiations (RCEP Leaders 2017). Unfortunately, this deadline has slipped, and there is some expectation of the core of an RCEP agreement being agreed to in 2019. If this is to happen, seven years for concluding the RCEP seem reasonable by the standards of the TPP and the WTO Doha Round.[5]

[4]However, some like the European Union (EU) attempt to keep their citizens more informed about FTA negotiations to reinforce public trust and accountability. Before launching negotiations, the European Commission (EC) conducts a comprehensive impact assessment and carries out a 3-month public consultation process. During the negotiations, the EC publishes online proposals for legal texts and progress reports after each negotiation round. At the end of the negotiations, the negotiated text is also published before full legal revision is undertaken. See https://www.oecd.org/tad/events/ec-trade-comms-statement.pdf.

[5]It would similar to the six years it took to conclude the ambitious TPP agreement among 12 parties, dating from the formal start of negotiations in March 2010 to signing the TPP agreement in February 2016. However, the USA withdrew from the TPP in January 2017 and the remaining 11 economies reached a partial agreement in November 2017, popularly termed the TPP-11. The WTO Doha Round began in November 2001 and has been virtually abandoned after over 15 years of talks, among 164 members.

3 Contribution to Asian Economic Integration

The RCEP comprises a heterogeneous group of economies. A handful of commodity-rich economies (like Brunei, Malaysia and Indonesia) coexist among several largely resource-poor economies. As Table 1 shows, disparities exist in world shares of GDP and trade as well as per capita incomes. The RCEP includes some of the world's largest economies (e.g. China, Japan and Korea) as well as smaller ones (e.g. Brunei, Laos and Myanmar). Furthermore, the grouping includes a mix of high-income economies (Australia, Brunei, Korea, Japan, New Zealand and Singapore), middle-income economies (China, Indonesia, Malaysia, the Philippines and Thailand) and low-income economies (Cambodia, India, Laos, Myanmar and Vietnam).

Table 1 Selected economic characteristics of RCEP members

	GDP per capita (PPP, current international USD) 2016	Share of global GDP % (2016)	Share of global trade % (2016)	MFN tariffs, simple average applied rates[a]	No. of FTA's as of 2018[b]
North-East Asia					
Japan	41,470	6.54	7.60	4.0	15
China	15,535	14.82	20.20	9.9	16
South Korea	35,751	1.87	5.34	13.9	16
ASEAN					
Brunei	77,441	0.02	0.05	1.2	8
Cambodia	3,736	0.72	0.70	11.2	6
Indonesia	11,612	1.23	1.70	7.9	9
Laos	6,186	0.02	0.05	8.5	8
Malaysia	27,681	0.39	1.85	5.8	14
Myanmar	5,773	0.09	0.14	5.6	6
Philippines	7,806	0.40	0.96	6.3	7
Singapore	87,856	0.39	4.60	0.0	21
Thailand	16,916	0.54	2.44	11.0	13
Vietnam	6,424	0.27	1.82	9.6	10
Other					
India	6,572	3.00	4.39	13.4	13
Australia	46,790	1.59	2.35	2.5	12
New Zealand	39,059	0.24	0.47	2.0	11

Note [a]MFN Tariffs are the most recent figures available, [b]FTA's that have been signed and enforced

Source Authors calculations based on World Bank: World Development Indicators, https://data.worldbank.org/data-catalog/world-development-indicators; Asian Development Bank: Asia Regional Integration Centre, https://aric.adb.org/beta; World Trade Organization: Tariff and Trade Map, https://www.wto.org/english/res_e/statis_e/statis_maps_e.htm. Accessed June 2018

Levels of trade opening and FTA strategies also vary (see Table 1). Singapore has virtually no import tariffs; some have low tariffs of less than 10%, while others have tariffs above 10%. Approaches to FTA-led integration differ too, with very active economies maintaining bilateral and regional FTAs (e.g. Singapore, Japan, China and Korea) alongside more passive economies (e.g. Cambodia, Laos and Myanmar) which rely on ASEAN regional FTAs.

There are several *a priori* reasons why an RCEP agreement can contribute to Asian economic integration. First, the RCEP can help insure against rising protectionist sentiments in the global economy, if the new regional rules align with the WTO agreements on goods and services. Nontariff measures (NTMs)—e.g. import quotas, various government subsidies, arbitrary customs regulations, technical barriers to trade (TBT) and sanitary and phyto-sanitary regulations (SPS)—have been rising since the global financial crisis, including in Asia. The Trump Administration's 'America First' approach seems to be tilting the USA towards isolationism and protectionist tendencies. Painstakingly collected data on NTM counts by Evenett and Fritz (2017) show that the US administration's approach is becoming more discriminatory towards the G-20 and that others are beginning to resort to murky trade distortions. At present, there is tit-for-tat protectionism involving the USA, China, EU and India which could descend into a full-scale trade war.

Second, the RCEP can help the spread of sophisticated global supply chains that make Asia the world's factory. If a comprehensive agreement can be reached, trade barriers impacting goods and services among RCEP members will fall. Rules governing the entry and operation of foreign firms should become more transparent and predictable. Market size will expand beyond national borders, and a larger regional market will facilitate the realization of economies of scale in production.

Third, in the area of investment rules—where there exists only a rather basic WTO agreement (the Trade-Related Investment Measures, or TRIMs)—the RCEP promotes easier FDI flows and technology transfers by multinational corporations (MNCs). Reducing barriers to investment and supporting a regional, rules-based FDI regime will further facilitate regional supply chain trade.

Fourth, by simplifying trade rules, the RCEP will also reduce the overlap among Asian FTAs and the risk of an Asian 'spaghetti bowl' of multiple trade rules (Bhagwati 2008). Rules of origin, in particular, could be rationalized, made more flexible, and better administered through electronic means. This would reduce transaction costs for business, including small and medium-sized enterprises (SMEs).

4 Quantifying Economic Impacts

Simulation modelling using CGE models is useful in quantifying the income effects of eliminating import tariffs on trade in goods and liberalizing cross-border trade in services through the formation of trade agreements. CGE models can trace economy-wide effects of policy changes and point to unintended economic consequences. CGE studies show that significant economic gains can arise from the RCEP.

Gilbert et al. (2016) provide long-run estimates of the gains from RCEP but assuming only full liberalization of import tariffs in their CGE analysis. They show that full liberalization of goods trade under RCEP results in significant income gains to the world economy of USD 127 billion. The RCEP would also increase GDP in ASEAN's more dynamic economies—Malaysia, Singapore, Vietnam and Thailand—by more than 1%. Korea sees even larger gains of over 4% of GDP. Interestingly, India (0.4%) gains more than China (0.2%) but less than Japan (0.8%). However, this study does not provide economic estimates for excluded South Asian economies.

Rahman and Ara (2015) studied the potential economic impact of tariff elimination on excluded South Asian economies under the RCEP. Their CGE analysis revealed that if the RCEP countries completely eliminate import tariffs with each other, excluded South Asian countries could face economic pressures of declines in exports and welfare. These are symptoms of trade diversion and loss of preferences. As India is a member of RCEP, it is likely to benefit from the agreement with its GDP increasing by 0.8%. In terms of real GDP, Nepal (−3.6%) could suffer the most in South Asia, followed by Sri Lanka (−1.3%), Pakistan (−0.8%) and Bangladesh (−0.6%). Indian exports could also increase by 6.6%, while Nepal (−2.1%) and Bangladesh (0.1%) may experience a fall in exports.

Going beyond tariff elimination provides a different magnitude of gains. Using a slightly different regional unit of analysis, Mohanty and Pohit (2007) show welfare gains for members of an ASEAN+3–IndiaFTA ranging from USD 52 billion for a simple FTA (involving only tariff liberalization), to USD 114 billion for a more comprehensive FTA (involving tariff liberalization as well as reducing barriers to investment and services).

Factoring in reducing import tariffs, services barriers and trade costs as well as Australia and New Zealand into a CGE model gives larger long-run estimates of the global gains from the RCEP. Kawai and Wignaraja (2014) show that such a comprehensive RCEP scenario can offer large income gains to the world economy, reaching USD 260 billion (or a 0.5% change from baseline income). Thailand (12.8%), Vietnam (7.8%) and Singapore (5.4%) gain the most in ASEAN. Korea sees a 6.4% gain, while that for Japan and China is under 2%. India sees a 2.4% gain but excluded South Asian economies experience losses.

Petri et al. (2017) use a CGE model with tariffs and NTMs but are more pessimistic about the capacity of RCEP to deliver significant changes in openness and assume smaller non-discriminatory spillover effects of NTMs in the RCEP. They also report large global gains of USD 280 billion from the RCEP and suggest that this reflects a combination of the large economic scale of RCEP as well as the relative weakness of RCEP provisions. India could see a smaller long-term increase in income of only 1.0%.

However, fully realizing the gains from the RCEP will depend on addressing several risks during the negotiations and afterwards (Basu Das 2012; Hiebert and

Hanlon 2012; Kawai and Wignaraja 2013; Wignaraja forthcoming). First are the twin risks arising from RCEP negotiating partners having different levels of development, global importance and interests. This brings the politically difficult challenge of respecting the central role of smaller ASEAN economies in driving the RCEP negotiations, amidst the presence of Japan and rising Asian economies (China, Korea and India). The related economic challenge is that granting exclusions to protect sensitive sectors will ultimately limit the scope of preferential liberalization and gains from the RCEP. This risk seems more likely if low-income members press for differential speeds of opening up certain sectors.

Second, like all forms of trade liberalization, implementing the RCEP preferential liberalization will bring gains and losses at the sectoral level within members. The discussion of model-based studies below sheds light on potential gainers and losers from the RCEP. With wages and jobs at risk, adjustment costs may be higher than expected in declining economic sectors and new economic sectors may take time to emerge. The risk of significant losses in some sectors and economies could diminish public support for the RCEP and prompt a backlash against Asian economic integration.

Third is the risk that firms, particularly SMEs, may underuse RCEP tariff preferences due to a lack of international competitiveness and a poor understanding of its legal provisions. Unless SMEs could become subcontractors or suppliers to large firms, MNCs and large firms could gain disproportionately from the RCEP. Fourth is the risk that the spread of mega-regional FTAs like the RCEP and the TPP-11 may exacerbate the divergence between regional and WTO trade rules, with the continuing erosion of WTO's central role in global trade governance.

5 Leveraging Singapore for Sri Lanka in RCEP

Sri Lanka was the first country in South Asia[6] to embark on a gradual economic reform programme in 1977 and is probably its most open economy today. According to WTO, in 2015, the country's simple average most favoured nation (MFN) applied tariffs were 9.3%, with agricultural tariffs of 23.7% and industrial tariffs of 6.9%. Trade with the RCEP economies, particularly China, has grown rapidly during the 2000s and account for an increasing share of Sri Lanka's trade. The share of RCEP economies in Sri Lanka's global exports increased from 25% to 30% between 2010 and 2017, while their share of global imports rose from 81% to 84% (see Table 2). Until recently, Sri Lanka did not express interest in joining the RCEP, but this is changing as policymakers are becoming concerned about the economic effects (e.g. trade diversion and preference erosion) of being left out of the large Asian integration group.

[6]This section draws on and updates the discussion in Wignaraja and Hundlani (2018).

Table 2 Sri Lanka's trade with RCEP economies

	Values (USD millions)				Member shares			
	Exports		Imports		Exports (% Share of Sri Lanka's Total Exports)		Imports (% Share of Sri Lanka's Total Exports)	
	2010	2017	2010	2017	2010	2017	2010	2017
China	70	430	1,995	4,111	3	12	17	24
Japan	176	210	640	877	7	6	6	5
Korea, Republic of	33	66	246	284	1	2	2	2
ASEAN	757	922	2,446	3,382	32	26	21	20
Brunei Darussalam	0	0	0	0	0	0	0	0
Cambodia	3	5	0	1	0	0	0	0
Indonesia	64	430	298	293	3	12	3	2
Lao PDR	0	0	0	0	0	0	0	0
Malaysia	72	56	465	575	3	2	4	3
Myanmar	0	3	1	14	0	0	0	0
Philippines	9	38	19	22	0	1	0	0
Singapore	513	234	1,199	1,828	21	7	10	11
Thailand	73	54	402	445	3	2	3	3
Vietnam	22	102	62	204	1	3	1	1
India	474	790	3,314	4,380				
Australia	108	190	186	215	5	5	2	1
New Zealand	18	28	215	285	1	1	2	2
Sri Lanka's Total RCEP Trade	2,392	3,557	11,489	16,916	25	30	81	84

Source IMF, Direction of Trade Database. Accessed June 2018

Since 2015, Sri Lanka has adopted a new macroeconomic stabilization and structural reform strategy to tackle a high level of external debt, a percieved anti-export bias in the trade regime, and other residual economic distortions that prevailed in the immediate post-war years. An important element of the new economic strategy was a more active FTA policy targeting East Asia and India to increase market access and to attract export-oriented FDI.[7] A flurry of activity has followed

[7]In his Economic Policy Statement in October 2017, Prime Minister Wickremasinghe reiterated "We have obtained good results from the steps we have taken to stabilize the economy. Therefore, we should now focus on adopting an export-led economic growth strategy and policies by providing high-value and diversified products and services. A key part of this policy will be entering into free trade agreements with partner countries around the world. We are making great progress towards mutually beneficial free trade agreements with Singapore, China and India. These deals will give our economy a massive boost by opening huge new markets to our entrepreneurs" (Wickremasinghe 2017, p. 6).

with some success. FTA negotiations are currently ongoing with China, Thailand and India. Also, FTAs with Indonesia and Malaysia were raised during visits by their heads of states to Sri Lanka in 2018. In more concrete terms, a bilateral FTA with Singapore was swiftly concluded in 2018 and Sri Lanka's Ministry of Economic Development and International Trade said that "…we envisage this as a first step towards closer integration with ASEAN and potentially be part of the RCEP in the future".[8]

In spite of the two islands' decades of warm diplomatic relations, economic relations between Sri Lanka and Singapore are limited. Singapore comprised of 2.0% of Sri Lanka's global exports and 6.1% of global imports in 2017.[9] Singapore also only accounted for only 1.0% of foreign aid to Sri Lanka and 0.9% of inbound tourists. In a bid to strengthen economic relations, the SLSFTA was signed on 23 January 2018 in under two years with eight rounds of negotiations.

The agreement underlines Singapore's serious search for trade and investment partners beyond East Asia, and it shows Singapore's recognition of Sri Lanka's potential as a trading hub in the fast-growing Indian Ocean region. The agreement is also an outcome of Sri Lanka's post-conflict trade policy to boost flagging growth and to strengthen ties with East Asia.

This is Sri Lanka's first FTA since 2005 and the most comprehensive among its handful thereof. It covers goods, services, investments, trade facilitation, intellectual property rights, and government procurement.[10]

Market access to Singapore has not been a barrier for Sri Lanka, even before the FTA. Singapore is one of the world's most open economies, with 99% of all goods imports entering duty-free and few banned imports. Meanwhile, Sri Lanka will eliminate tariffs on 80% of goods over 15 years under the FTA—a relatively long adjustment period for firms in Sri Lanka.

Somewhat unusually perhaps, it seems that a joint feasibility study including a cost-benefit analysis was not undertaken for the agreement. A priori reasoning suggests that the FTA likely benefited Sri Lanka through cheaper consumer goods and inputs, FDI, technology transfer and competition, and higher technical and quality standards. At the same time, opening up to Singapore may also mean adjustment costs to local industry caused by cheap imports and the entry of foreign firms. However, the two countries should address several crucial areas in order to maximise the benefits flowing to Sri Lanka (Wignaraja and Hundlani 2018).

[8]The statement reported in January 2018 stated: "The Singapore-Sri Lanka FTA is part of a broader strategy of looking East to renew our trade relationships in the process of diversifying our markets towards Asia and focus on plugging into Asian supply chains. This FTA is our first agreement with a South East Asian country—and we envisage this as a first step towards closer integration with ASEAN, and potentially be part of the RCEP—Regional Comprehensive Economic Partnership in the future" Daily News, 24 January 2018. http://www.dailynews.lk/2018/01/24/local/140786/slsfta-renew-trade-relations-asia.

[9]The data for trade, aid and tourists are from the UN COMTRADE Database, the Ministry of Finance Annual Report 2017 and the website of the Sri Lanka Tourism Development Authority.

[10]Please see Sri Lanka–Singapore Free Trade Agreement (SLSFTA).

Otherwise, there is a risk that potentially affected parties in Sri Lanka may lobby to derail or even cancel the agreement.

First, Singapore—who will be the 2018 ASEAN chair—should be asked to support Sri Lanka's eventual participation in the RCEP. Joining the RCEP offers Sri Lanka the prize of simultaneous access to an enormous regional market and dynamic Asian FDI. Participating in the RCEP is also arguably simpler and less draining on Sri Lanka's scarce negotiating capacity than separately negotiating 16 bilateral FTAs. Sri Lanka is already a member of the ASEAN Regional Forum, but the Forum's main purpose is discussion on security issues, not on economic ones. Attaining ASEAN observer status is an imperative next step to Sri Lanka's joining the RCEP. Enhanced diplomatic engagement with Singapore and other ASEAN economies would help. Sri Lanka presently has embassies in seven ASEAN countries but not in Brunei, Cambodia and Laos. Existing ambassadors to ASEAN countries should be given a clear mandate and resources to lobby for Sri Lanka's inclusion in the RCEP process.

Second, increasing Singaporean FDI to Sri Lanka is a priority: only 5.3% of Sri Lanka's FDI during 2014–2017 came from Singapore as per data from Central Bank of Sri Lanka. The investment climate has improved for Singaporean firms: the FTA rightly includes safeguards against expropriation of and discrimination against Singaporean investments, Singaporean firms can bid for large government procurement projects in Sri Lanka and Sri Lanka's Board of Investment (BOI) is targeting Singaporean FDI in infrastructure, IT services, tourism and education. Despite these improvements, Sri Lanka's investment climate remains challenging. Opening a business in Sri Lanka in 2017 takes an average of nine days, compared to 2.5 days in Singapore.[11] Streamlining redundant colonial-era business regulations and demonstrating consistency in economic policy would help gain the confidence of risk-averse Singaporean investors. It will also lay the foundation for attracting inward investment from other RCEP economies.

Third, Sri Lanka should additionally seek Singaporean expertise in sustainable FDI-led development. Singapore's Economic Development Board (EDB) is famous for its network of well-staffed overseas offices of which the sole aim is to market Singapore as an investment destination. Tapping into its expertise to restructure Sri Lanka's BOI and to improve its investment promotion strategy, including its FDI incentives in a highly competitive international environment for FDI flows, makes sense. Singapore could assist the BOI to establish its first overseas office in Singapore, which would help the BOI to step away from managing export-processing zones and instead to refocus its capacity on investment promotion. Sri Lanka could also harness the 'know-how' of Singaporean firms in climate-friendly urban planning and transport, export-processing zones and logistics services. Improved investment promotion capabilities would also help to market Sri Lanka as an investment destination in other RCEP economies.

[11]Please see World Bank's Doing Business Report.

Fourth, Sri Lanka should also use this opportunity to address its substantial trade deficit with Singapore, amounting to USD 1.1 billion in 2017.[12] Sri Lanka's exports to Singapore are concentrated in gems, refined petroleum, textiles and boats; agriculture, fisheries and services exports are lagging. Sri Lankan business is concerned that the FTA will lead to 'round-tripping' of state-subsidised imports from ASEAN and China via Singapore. They hope that the agreement's rules of origin, which require at least 35% of value added to occur in Singapore, will be sufficient. In order to alleviate these and other concerns, Sri Lanka has strengthened laws for temporary trade remedies like WTO-compatible safeguards and anti-dumping policies. But rather than lobby for prolonged protection, Sri Lankan firms should improve their knowledge of standards and quality such that they can export to Singapore's high-income market.

Fifth, the experience of the SLSFTA suggests that better stakeholder consultations in Sri Lanka are crucial to success in implementing agreements including the RCEP. There have been protests from professional lobbies in Sri Lanka (including doctors, lawyers and engineers) against the SLSFTA who falsely claim that the agreement allows for free movement of natural persons into Sri Lanka, i.e. skilled professionals from third countries. However, a careful reading of the text of the agreement shows that it only provides for controlled entry of a few foreign managers and technical manpower per project which usually accompany FDI internationally.[13] This FTA experience underlines the importance of building a strong pro-trade constituency for the RCEP to clarify issues and dispel myths. It is also essential to do the prior homework of assessing the benefits and costs of an RCEP agreement for Sri Lanka.

The Sri Lanka–Singapore FTA will undoubtedly bring economic benefits for Singapore. It could also be beneficial for Sri Lanka and act as a welcome step in improving the country's outward orientation and ties with East Asia—but the benefits will not flow automatically. Sri Lanka should take advantage of Singapore's influence to gain ASEAN observer status and eventual RCEP membership. Additionally, Sri Lanka should seek Singaporean expertise on investment promotion and sustainable development. This will ensure that the FTA delivers substantial long-term dividends for Sri Lanka's growth. In mapping its future road map, Sri Lanka can learn some useful lessons from the experience of India in negotiating with ASEAN and the RCEP process.

[12]Estimated from the UN COMTRADE Database.

[13]Please see Sri Lanka–Singapore Free Trade Agreement (SLSFTA).

6 India's Experience of RCEP Negotiations

India is regarded as the new frontier in Asia's economic miracle story. Already accounting for 3% of global GDP in 2016 (Table 1), the country has emerged as one of the world's fastest growing economies with an increasing middle class in the post-global financial crisis era. According to the WTO, the initiation of gradual trade and economic reforms in 1991 has resulted in a relatively open economy with simple average MFN applied tariffs falling to 13.4% in 2016. However, agricultural goods (32.7%) enjoy significantly higher tariff protection than industrial goods (10.2%). India's trade with RCEP members has increased significantly. The share of RCEP economies in India's global exports rose from 20% to 33% between 1990 and 2017, while their share in India's global imports increased from 28% to 46% (Table 3). This reflects growing India–East Asia trade, particularly with China and ASEAN.

Since 2013, India has been involved in the RCEP negotiations as an ASEAN dialogue partner. The country's involvement in building closer ties with East Asia dates to the Rao government's 1991 'Look East Policy' to develop strategic and economic relations with the economically important region. However, critics suggest that subsequent Indian governments emphasized forging strategic foreign policy partnerships and security cooperation with East Asian economies (particularly Japan and Vietnam) at the expense of building economic relations. Eventually, efforts at fostering closer economic relations bore fruit. During the 2000s, India concluded several FTAs with East Asia including a regional FTA with ASEAN in 2010, as well as bilateral agreements with Singapore in 2005, Korea in 2010, Japan in 2011 and Malaysia in 2011. Bilateral FTA negotiations are also ongoing with Australia, New Zealand, Indonesia and Thailand.

In 2014, Prime Minister Narendra Modi announced a new 'Act East Policy' as a signature element of his government's economic strategy (Wignaraja 2016). Modi's bold move signalled a more pro-active approach to strengthening economic ties with dynamic East Asia. This soon translated into intensified Indian engagement in the RCEP negotiations. The Modi government felt that the RCEP would fill in critical, missing FTA links between India and RCEP members by providing for India–China trade and India–Australia/New Zealand trade. In turn, Indian business would have greater opportunities to access a larger Asian market, to exploit India's relative strength in services with its vast pool of qualified professionals (including from sectors such as information technology) and to better integrate Indian manufacturing into global supply chains centred on East Asia (including in automotives, electronics and consumer goods).

However, three challenging issues have emerged during the RCEP negotiations. First is liberalization of tariffs on goods trade. Relative to India, other RCEP members typically have a comparative advantage in key areas of goods trade. Several members have requested that import tariffs on agricultural and industrial goods be eliminated for more than 92% of tariff lines (Sen 2017). Furthermore, some members have suggested reducing tariffs to 5% on an additional 7% of tariff

Table 3 India's trade with RCEP economies

	Values (USD millions)								Member shares							
	Exports				Imports				Exports (% of India's Total Trade)				Imports (% of India's Total Trade)			
	1990	2000	2010	2017	1990	2000	2010	2017	1990	2000	2010	2017	1990	2000	2010	2017
China	18	758	17,519	12,579	173	1,569	40,880	68,143	1	8	24	13	3	8	27	35
Japan	1,656	1,767	4,813	4,512	1,711	2,488	9,052	8,853	46	20	7	5	27	12	6	5
Republic of Korea	164	457	3,641	4,467	436	1,326	11,435	14,822	5	5	5	5	7	7	8	8
ASEAN	760	2,749	23,015	35,288	1,771	6,849	37,049	45,131	21	31	31	37	28	34	25	23
Brunei	0.3	3	21	54	–	0.1	495	541	0	0	0	0	0	0	0	0
Cambodia	1	8	61	124	–	0.1	8	25	0	0	0	0	0	0	0	0
Indonesia	92	386	4,572	3,684	60	1,151	9,915	14,084	3	4	6	4	1	6	7	7
Lao PDR	0	5	8	25	0.3	–	19	218	0	0	0	0	0	0	0	0
Malaysia	126	568	3,551	5,941	478	1,925	6,517	7,995	4	6	5	6	7	10	4	4
Myanmar	1	48	273	1,072	44	225	958	708	0	1	0	1	1	1	1	0
Philippines	21	188	804	1,620	2	64	410	509	1	2	1	2	0	0	0	0
Singapore	308	826	9,094	10,943	1,103	2,871	13,341	11,016	9	9	12	11	17	14	9	6
Thailand	201	510	2,145	3,646	63	566	4,395	6,414	6	6	3	4	1	3	3	3
Vietnam	8	208	2,485	8,178	20	47	992	3,621	0	2	3	8	0	0	1	2
Australia	183	405	1,653	3,899	491	1,055	15,029	11,370	5	5	2	4	8	5	10	6
New Zealand	21	64	189	330	67	71	650	464	1	1	0	0	1	0	0	0
India's RCEP Trade (total/as a % of world trade)	3,562	8,950	73,845	96,364	6,420	20,208	151,143	193,914	20	21	33	33	28	36	42	46

Source IMF, Direction of Trade Database. Accessed June 2018 lines taking total coverage of goods trade to as much as 99%. This implies gradually phasing out tariffs in India and exposing both agriculture and industry to competition from RCEP members. Australia and New Zealand have demanded that India lower tariffs on dairy and wheat in particular and that tariff elimination should occur on items of significant trade value rather than just a large number of items.

The major concern for India is significant trade liberalisation with China, where cheap imports are thought to have adversely affected import-substituting manufacturing sectors in India (Mishra 2013). Some argue that, due to pervasive state subsidies, Chinese firms have prices that few Indian firms can match. Concerns have also been expressed about opening up sensitive economic sectors and infrastructure to inward investment from China, particularly by state-owned enterprises (SOEs) that unfairly benefit from government subsidies.

India's counter-offer was tariff elimination based on a three-tier system with 42.5% of tariff lines for China, Australia and New Zealand, 65% for Japan and Korea and 80% for ASEAN (Sen 2017). However, other RCEP members rejected India's offer in favour of a single offer for all RCEP members. Despite fierce opposition from its farmers and industrialists, India made a new offer of eliminating tariffs on 70–75% of goods with some deviations for China, Australia and New Zealand which are not FTA partners. But this has not satisfied other RCEP members, particularly Australia and New Zealand, which are insisting on increased market access for dairy and wheat.

Agriculture remains a difficult area for RCEP negotiations as India wishes to protect the livelihoods of the rural poor who are electorally important. However, some Indian manufacturing exports have grown (including pharmaceuticals, the automotive sector, textiles and food processing), and this trend is likely to continue under the RCEP. As discussed above, the CGE projections indicate that India can achieve potential income gains of 0.4% under a full tariff elimination scenario which can rise up to 2.4% under a more comprehensive RCEP scenario. Indian businesses should prepare for market opening under the RCEP by investing in price, quality and delivery systems that meet international standards. Speeding up implementation of second-generation structural reforms will also help improve competitiveness. Furthermore, WTO-compatible trade remedies such as temporary safeguards and anti-dumping measures are available to tackle import surges from China.

Second is the liberalization of services trade. The RCEP offers inroads for Indian services to China and the rest of East Asia, where India has achieved a comparative advantage on world markets (Wignaraja 2011). These advantages include information technology (IT), professional services, law, banking and educational services. Moreover, India has seen increasing tourism arrivals from the Asia-Pacific region, and tourism services offer further opportunities for Indian businesses. India has been arguing for services trade liberalization in return for opening up of goods trade in the RCEP negotiations. In particular, India has been suggesting easing visa restrictions on the movement of skilled workers across the RCEP boarder for short-term work (Arun 2017).

Emulating the APEC Business Travel Card, it has proposed an RCEP Travel Card to facilitate visa-free travel for movement of skilled workers in areas such as information technology (IT), engineering, training and investment banking. However, there have been few offers from RCEP members in this area (Sen 2017). ASEAN members have refused to offer even the limited level of openness that exists among the ten members of the grouping. Members of ASEAN are concerned that a temporary movement of Indian skilled workers could become permanent with a loss of local jobs. Discussions are continuing over this issue.

Third is IPRs rules. India has an internationally competitive pharmaceutical sector with strengths in manufacturing cheap generic drugs. It is also a global leader in using the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) safeguards to balance the rights of inventors with the health rights of the population. Leaked text from a 2015 draft of the RCEP agreement showed that Japan and Korea were seeking strengthened protection for intellectual property raising concerns about reduced access to cheap generic drugs, high prices for non-generic drugs and adverse consequences for public health in low-income RCEP members (Amin 2017). Civil society groups in India argue that the so-called TRIPS-plus standards in the RCEP would increase protection for patent monopolies of MNCs and enforcement mechanisms, while simultaneously removing the ability of RCEP members, including India, to use TRIPS health safeguards.

In spite of various challenges, India appears committed to supporting closer Asian economic integration through the RCEP. According to Fukunaga and Isono (2013), there seem two options for the way forward for the RCEP negotiations. One is to take the best features of existing ASEAN+1 FTAs and to use them as a basis for negotiations to maximize the quality of an RCEP agreement and to quickly conclude the talks. Another is to treat India as an LDC like the Cambodia, Laos, Myanmar and Vietnam (CLMV) economies and give it some time to adjust to trade opening (Urata 2014).[14]

The RCEP can be achieved for India because it has the more ambitious India–Japan and India–Korea FTAs. Indian businesses, then, should embrace the RCEP, as it includes all the ASEAN economies, as well as others. The Modi government has implemented a flurry of pro-growth measures since 2014, including investment climate reforms, a 'Make in India' initiative, and fiscal reforms, and has boosted public sector accountability and increased public infrastructure investment. It has upset some parts of business with two other measures—demonetizing large currency notes to fight corruption and introducing a general sales tax (GST). But the economy is recovering from these shocks and the sales tax lays the basis for healthier public finances.

Gradual and systematic domestic reforms over the next few years will make it easier for India to lock in the gains from trade by concluding an RCEP agreement. Afterwards, significant business support services would be needed for SMEs to improve their international competitiveness and lower the costs of using the

[14]Based on viewpoints of Masahiro Kawai.

RCEP. Enhancing domestic structural reforms, investing in cross-border infrastructure and streamlining trade facilitation would also help elicit a private sector response to the RCEP. Furthermore, adjustment assistance and social safety nets can help mitigate the negative effects of trade liberalization under the RCEP on affected sectors and jobs.

7 Conclusion

This chapter examined the economic implications of the RCEP, focusing on the Sri Lankan and Indian cases. This is a difficult undertaking as patchy official information exists on the state of play in the RCEP talks. The timeline has slipped, but there is some expectation that the core of an RCEP agreement could be agreed in 2019.

The RCEP is globally important as a trading bloc, and CGE studies suggest that a comprehensive RCEP can potentially generate global economic gains. Accordingly, arguments for and moves towards RCEP are supported by CGE modelling. As a member, India is the only country in South Asia to potentially gain, but the magnitude of its gains will depend on the depth of the final RCEP agreement. Excluded South Asian economies—Bangladesh, Nepal, Pakistan and Sri Lanka—will likely to lose from the agreement.

As an outsider, post-conflict Sri Lanka risks losses from trade diversion and erosion of preferences from the advent of the RCEP. The country is forging closer economic ties with ASEAN, and its recently concluded FTA with Singapore offers a stepping stone towards this end. But both Singapore and Sri Lanka need to do more to ensure that the benefits flow to Sri Lanka. Otherwise, there is a risk that potentially affected parties in Sri Lanka may lobby to derail the agreement. Key issues include asking Singapore to support Sri Lanka's eventual participation in the RCEP, to help Sri Lanka increase FDI from Singapore and ASEAN, address the trade deficit with Singapore and improve stakeholder consultations on Sri Lanka's FTAs including the RCEP. Further afield, Sri Lanka could learn useful lessons from India's experience of the RCEP negotiations.

India has long emphasized building closer economic ties with East Asia through a formal policy towards East Asia and the RCEP. But various challenges for India have emerged during the course of the RCEP talks including liberalizing goods and services trade and adopting new intellectual property rules. Closer review suggests that some of the concerns expressed in Indian business and policy circles seem overstated. India stands to gain from the RCEP owing to strengths in services and manufacturing and a large, rapidly growing domestic market. A renewed partnership between Indian businesses and government will help prepare for market opening under the RCEP.

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Balancing Economic Partnership for Growth in the Post-conflict Sri Lanka

Janaka Wijayasiri

Abstract Sri Lanka sits at the centre of the Indian Ocean straddling major shipping routes. Its geostrategic position has led to courting by players in the region including China and India. For decades, India was Sri Lanka's principal economic partner, in terms of trade and investment, development cooperation or defence. Over the past decade, there has been a significant change, with warming of ties between Colombo and Beijing, especially during the height of Sri Lanka's war years (2006–2009) and thereafter. Even with the change of government in 2015, Sri Lanka has shown no hesitation in making an adjustment to pro-China policy, despite early claims to 'rebalance' the country's strategic relations. In the post-conflict period therefore, Sri Lanka is on a precarious course: seeking economic assistance from China while maintaining relations with India. In examining Sri Lanka's political and economic relationship with India and China in the post-conflict period, and how Sri Lanka is attempting to balance the interests of these rising two economic powers in Asia, the chapter argues for a more strategic approach by Sri Lanka to take advantage of the opportunities to meet its own development agenda and vision to become an economic hub in the Indian Ocean.

1 Introduction

Sri Lanka sits at the centre of the Indian Ocean straddling major shipping routes. Its geostrategic position has led to courting from regional players including China and India. In the post-conflict period (2009 onwards), Sri Lanka is walking a tightrope: seeking assistance from China and maintaining relations with its closest neighbour, India, which have been Sri Lanka's traditional development partners. Under the Belt and Road Initiative (BRI), China has provided much-needed investments in improving connectivity in the country and the region. Over the last decade, China has been channelling funds into roads, airports and seaports in the country; the

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Hambantota Port and the Colombo Financial City (or the Port City) Project are two examples of high-profile Chinese initiatives to date. This has raised concerns of both India and the USA of Sri Lanka's growing ties with China. Japan is also concerned with the growing Chinese presence in the island as evident from recent high-level visits from Japan to Sri Lanka.

Under the government of President Maithripala Sirisena and Prime Minister Ranil Wickremasinghe, which came into power in 2015, Sri Lanka has tried to balance the strategic interests of China, India and the West. Under President Mahinda Rajapaksa (2005–2015), Sri Lanka's relations with India came under significant strain, and Sri Lanka sought China for economic, military and diplomatic backing when the West was exerting pressure on Colombo for alleged crimes committed during the war. India sees China's growing presence in the country and rest of South Asia as a threat to its own security and ambitions in the region. As such India looks upon China as a threat and is therefore likely to continue to exert pressure on Colombo for a greater role and presence in Sri Lanka.

This chapter examines Sri Lanka's political and economic relationship with India and China focusing on the post-war period and how Sri Lanka is attempting to balance the interests of these rising two economic powers in Asia while trying to meet its own development agenda and vision to become an economic hub in the Indian Ocean. Section 2 will discuss the emergence of India and China in the international stage while Sect. 3 will detail Sri Lanka's relations with India and China; the latter has a long-standing relationship with Sri Lanka with the expected ups and downs associated with a close neighbour while the former has maintained close but distant relationship till recently. Section 4 examines Sri Lanka's economic relations with India and China after the end of the war in 2009 by examining flows in trade, investment and development assistance from India and China. Going forward Sri Lanka should seek to balance its relationship with India and China, which will be discussed in the concluding Sect. 5.

2 Rise of India and China as Superpowers

The economic rise of China and India is one of the most remarkable phenomenons in Asia in the twenty-first century. The prominence of China and India in the global economy cannot be overlooked today. These two nations have not only broken into the rank of the world's largest economies but also building their military power and exercising their diplomatic clout in institutions of global governance. Following the phenomenal growth rates achieved by the two nations in the recent decades, they have been termed the 'rising dragon' and the 'crouching tiger' to indicate their growing global prominence and influence.

China, since initiating market reforms in 1978, and shifted to a market-based economy from a centrally planned system, it has experienced rapid economic and social development. China has experienced one of the fastest sustained growth rates in recorded history, becoming a global player in a short period of time. As of 2016,

Loan Commitments

	2009	2010	2011	2012	2013	2014	2015	2016
India	0.00%	15.42%	0.00%	15.89%	5.39%	0.00%	0.00%	0.00%
China	62.01%	26.19%	40.34%	37.86%	22.50%	52.00%	0.00%	17.00%
Japan	0.00%	12.64%	25.71%	18.24%	18.64%	11.00%	15.76%	15.00%
Other	38.07%	45.76%	33.95%	28.01%	53.48%	37.00%	84.24%	68.00%

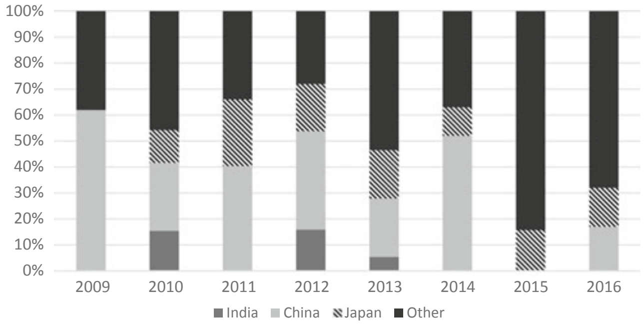

Fig. 1 Loan commitments. *Source* Based on data from IPS (2014) and CBSL (2017)

China is the second largest economy in terms of GDP in the world after the USA, with a population of over 1.4 billion (World Bank 2018). In the not-too-distant future, it will become the largest economy in real terms.

Since the onset of major economic reforms in 1991, India has emerged to become the seventh largest economy as measured by GDP (at current USD), as of 2016 (World Bank 2018). India has been one of the fastest-growing economies in the recent past, even eclipsing China in 2015, with one of the largest growing service sectors in the world. According to the UN estimates, it will overtake China as the most populous country by 2022 (Ayres 2018). Although growth has lifted millions out of extreme poverty, India remains home to the largest number of the world's poor while being vulnerable due to its diverse population, religious strife and location in a tough neighbourhood (Fig. 1).

Both countries have been contributing positively to world economic growth and its transformation in the recent decades, even during the global financial crisis. Over the years, China and India have also expanded and modernised their military capabilities, fielding the world's largest militaries after the USA and ranking amongst the world's top five spenders in defence. There are only nine nations in the world to possess nuclear weaponry; China and India are two of them (Ross 2018).

Both China and India have pressed for greater representation and role in global institutions (UN Security Council and Bretton Woods Institutions). Also New Delhi and Beijing have been working together to develop alternative institutions and groupings of governance not dominated by the West (i.e. the Asian Infrastructure Investment Bank (AIIB), BRICS, the New Development Bank (NDB), etc. (Ayres 2018).

Despite a long history of mistrust and waging a war in 1962, China and India have begun to forge stronger economic links. Bilateral trade, which was less than

Grant Commitments

	2009	2010	2011	2012	2013	2015	2016
India	7.19%	0.00%	6.95%	70.97%	0.00%	11.66%	1.00%
China	0.86%	6.07%	0.00%	0.00%	0.00%	0.00%	33.00%
Japan	6.97%	34.22%	17.56%	4.20%	33.41%	6.29%	15.00%
Other	84.98%	59.71%	75.50%	24.83%	66.59%	82.06%	51.00%

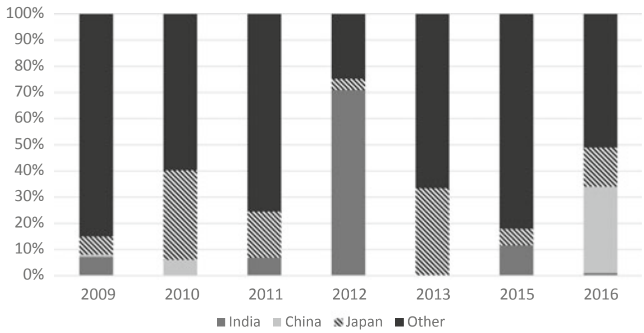

Fig. 2 Grant commitments. *Source* Based on data from IPS (2014) and CBSL (2017)

USD200 million in 2010, has increased to more than USD14 billion; the amount is expected to surge to more than USD50 billion in another five years (Sheth Jagdish 2016). Already a number of Indian companies have invested in China and located manufacturing operations in sectors such as software and drugs. Also, India is opening up to Chinese investments in infrastructure projects (Fig. 2).

With the emergence of China and India in the world economy, the interactions between the Asian giants and others are bound to intensify. *'The gradual rise of China and India to their natural roles as major economic and political superpowers [is] not only the best news for global human welfare in a generation but promise[s] to raise a variety of geopolitical challenges which yet remains unpredictable'* (Golley and Song 2012, p. 1).

China's rise has important and far-reaching ramifications for India (Raghavan 2012). India's geopolitical space is increasingly being encroached by China. The prospect of having another power in India's immediate neighbourhood is unnerving to India, especially the growing profile of China in South Asia. In the recent decade, China has intensified economic and commercial cooperation in South Asia and this will continue to grow with the Belt and Road Initiative (BRI), which combines overland routes with maritime routes. The former ('Belt') connects Asia to Europe through a network of interconnected roads and rail lines, while the latter ('Road') links Africa, Asia and Europe to China through a series of sea hubs and ports in the Mediterranean, the Indian, Atlantic and Pacific Oceans (Emmanuel 2017).

With China making serious headway in infrastructure projects in South Asia (Bangladesh, the Maldives, Nepal, Pakistan and Sri Lanka), India, in turn, has recently upped its aid to its neighbours while focusing becoming more efficient in the implementation of development projects (Times of India 2018). While China

Total Disbursements

	2009	2010	2011	2013	2014	2015	2016
China	19.71%	39.80%	17.00%	27.79%	29.21%	28.44%	38.18%
India	3.14%	0.00%	11.00%	13.74%	15.20%	7.32%	3.82%
Japan	20.61%	15.70%	20.00%	14.63%	18.30%	12.21%	6.44%
Other	56.55%	44.50%	52.00%	43.85%	37.28%	52.03%	51.55%

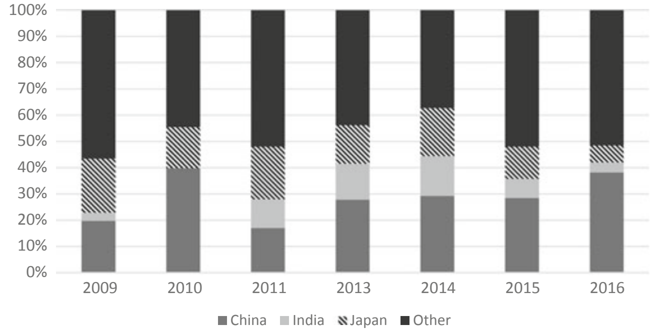

Fig. 3 Total disbursements. *Source* Based on data from IPS (2014) and CBSL (2017)

and India face the critical challenge of managing their rise which will be acceptable to the world community, and its neighbours including Sri Lanka must find ways to accommodate them as well as be cognisant of their interests in the region and beyond (Fig. 3).

3 Sri Lanka's Relationship with India and China

3.1 Sri Lanka's Relations with India

India is Sri Lanka's closest neighbour—Sri Lanka is just 32 km from India's southern coast. India has deep and long historical and cultural, religious ties with Sri Lanka. The relationship spans more than 2,500 years (Ministry of External Affairs 2017). It was only after a long period of colonial rule that both countries became independent—India in 1947 and Sri Lanka in 1948. The British ruled the two nations—India and Sri Lanka (then Ceylon)—as separate entities unlike the case with Myanmar (then Burma) which was administered as part of British India (Sathiya Moorthy 2018). In the post-independence period, bilateral relations have been '*friendly and cordial with their expected ups and downs, closeness and distance, suspicion and cooperation as happens between immediate neighbors'* (Gooneratne 2000, p. 2). For Sri Lanka, bilateral relations with India form an important building block for its diplomatic and economic engagement with other countries.

With the outbreak of ethnic conflict in Sri Lanka since the 1980s, bilateral relations became unusually strained due to '*brazen Indian political and military* *intervention to settle the Tamil question in the island*' (Balachandran 2016, para 1). History of Indian intervention—both covert and overt—in Sri Lanka ranged from encouraging, funding and training of the main separatist movement, Liberation Tigers of Tamil Eelam (LTTE), sending a peacekeeping force, Indian Peace Keeping Force (IPK), to disarm the LTTE, and the 1987 Indo-Sri Lankan Accord, which proposed a political solution to Sri Lanka's conflict through devolution of power and establishment of a provincial council system. All of these interventions became a source of nationalist anger and resentment in Sri Lanka and left general public in the country cautious and suspicious about India, feeding into fear of domination by its neighbouring 'Big Brother'.

Sri Lanka's bilateral relations with India improved in the 1990s, and India supported the peace process during this time. Relationship with India drifted during the Rajapaksa era when India became reticent to openly provide assistance to Sri Lanka as the latter fought its final battle against the LTTE from 2006 to 2009. While India provided valuable intelligence, weapons and ammunition supplies to Sri Lanka were provided by China and Pakistan to defeat the LTTE as supplies of arms and ammunition dried up from traditional sources from the West.

Reconciliation efforts emerged to the forefront of Indo-Lanka relations in the post-war period. India supported the Sri Lanka's reconciliation initiatives by making significant contributions towards reconstruction and resettlement in the war zone areas through projects like the rebuilding of the Pallai–Kankesanthurai railway line, building of houses, rehabilitating the Kankesanthurai Harbour, donating 10,000 bicycles to internally displaced persons (IDPs), to uplift socio-economic conditions of individuals in the north and the east (Harjani 2013).

China gained considerable influence over Colombo after the end of the war, and this fed into a growing fear in India of encirclement by its long-time competitor in South Asia. *'Long accustomed to perceiving the Indian Ocean as its own sphere of influence, India has been rattled at China's growing presence in the region'* (Basu 2017, para 7). When Chinese submarines docked in 2014, New Delhi lodged its concerns with Colombo. Also, the relationship with Sri Lanka deteriorated when India voted against Sri Lanka at the US-sponsored United Nations Human Resource Council (UNHRC) resolutions in 2009, 2012 and 2013 to investigate alleged human rights violations during the war. Although India abstained from voting on a UNHRC resolution in 2014, it called for a probe into alleged war crimes while China voted against the resolution.

With the change of government in Sri Lanka in 2015, and increasing focus on South Asia under Prime Minister Narendra Modi's *Neighbourhood First Policy*, which aims to improve relations, connectivity and promote trade between India and its neighbours, there was an improvement in Indo-Sri Lankan relations. '*Due to the evolution of new thinking in New Delhi and the change of regime in Colombo brought about by the Presidential and parliamentary elections of 2015, the two countries appear to have broken away from the past and moved towards mutual understanding*' (Balachandran 2016, para 1). Since 2015, Sri Lanka has reached out to New Delhi and sought to rebalance its relations with India, which has been eager to reciprocate. There have been frequent exchanges of high-level visits in 2015/2017 involving Sri Lankan President Sirisena, Prime Minister Modi and Prime Minister Wickramasinghe, with a view towards resetting bilateral relations. Some observers have stated that Prime Minister Modi has purposely enhanced India's engagement with Sri Lanka given China's growing influence in the island (Outlook India 2017).

The two countries now recognise the legitimacy of each other's concerns based on their historical dealings in the recent past, and they are now try to address them in a 'spirit of give and take'. Mindful of New Delhi's security concerns, Sri Lanka declined a request by China to dock one of its submarines in Colombo. India–Sri Lanka relationship warmed in 2016 and 2017 with high-level of exchanges and signing of bilateral agreements despite over poaching by Indian fishermen in the Sri Lankan side of the maritime boundary and concerns over Chinese acquisition of the strategic port of Hambantota. Sri Lanka has continuously assured that the port would not be used for any foreign military activity, but Chinese presence in the port is still a worrying factor to India. Sri Lanka has also recognised Indian concerns over Chinese investments in strategic projects like Colombo Port City and Hambantota Port by inviting India to take part in projects like port development and upper oil tank farm in Trincomalee. In the meanwhile, India has aligned itself with the USA and Japan to counter growing Chinese influence in the Indian Ocean. Despite China's growing presence in Sri Lanka, India's importance to Sri Lanka can never be overlooked.

3.2 Sri Lanka's Relations with China

Sri Lanka's relationship with China is centuries old and has been historically strengthened by religious ties and cultural values in addition to trade and commerce. For many centuries, Sri Lanka had been at the centre of the maritime Silk route connecting Europe and China. Although the initial Silk routes were over land, following the fall of the Mongol Empire in the fourteenth century, China shifted its approach to include a stronger emphasis on maritime trade (Seneviratne 2016). Sri Lanka has been part of the maritime trade route of China since then.

Modern-day bilateral relations can be traced to the Rubber-Rice Pact between Sri Lanka and China, which was signed in December 1952. This was considered to be one of the first agreements that China has signed with a non-communist country (Kelegama 2014). In fact, it was signed five years before the two countries established formal diplomatic relations (Li 2017). Under this Pact, Sri Lanka was guaranteed annual supply of 270,000 metric tons of rice while China bought 50,000 tons of rubber for a five-year period. This Pact was renewed every five years until the year 1982. It is considered to be the most useful trade agreement negotiated by Sri Lanka in the past, as China paid 40% more than the market price for rubber while Sri Lanka bought rice for less than a third of its market value (Kelegama 2014). Moreover, this Pact paved the way for increased formal diplomatic relations which were established in February 1957. Thereafter in 1962, the two nations signed the first agreement on Economic and Technological Cooperation which was followed by a maritime agreement guaranteeing Most Favoured Nation (MFN) status to all commercial vessels engaged in cargo and passenger services between the two countries and a third country.

Another milestone in the Sri Lanka–China relationship was the state visit to China of the then Prime Minister Sirimavo Bandaranaike in 1972. This resulted in a gradual increase in Chinese assistance starting with the construction of the Bandaranaike Memorial International Conference Hall. Since then there have been numerous high-level visits to China from Sri Lanka. The Chinese side reciprocated, and some notable high-level visits include Premier Chou En Lai visit in 1957 and 1964, and more recently the first-ever visit by a Chinese President, Xi Jinping, to Sri Lanka in 2014. These visits further nurtured decades-long friendship and cooperation.

Sri Lanka's relationship with China reached a significant milestone in the post-2005 period, especially during the war, when China emerged as an 'all-time friend of Sri Lanka' and provided arms and equipment in time of need while India could not due to internal politics. '*Without the Chinese backing, the government would have had neither the money nor the will to ignore the world opinion in its offensive against LTTE towards the end of the war*' (Kingsbury 2012, p. 151).

Since then both China and Sri Lanka have increasingly converged in their strategic interests in the Indian Ocean Region. During President Rajapakse's visit to China in May 2013, a Strategic Cooperative Partnership (SCP) agreement was signed. The SCP covered trade, investment, financial assistance and strategic cooperation. Sri Lanka also became one of the first countries to lend support to the Belt and Road Initiative (BRI) since it was aligned to the country's national development strategy. Sri Lanka has positively responded to China's BRI to strengthen Sri Lanka's vision to emerge as a maritime and financial hub of the Indian Ocean. At the same time, China hopes to improve its presence in the region with investment in ports like Hambantota (Sri Lanka), Chittagong (Bangladesh) and Gwadar (Pakistan) and legitimise its role in the Indian Ocean.

Under the tenure of President Rajapaksa, Sri Lanka accepted Beijing's development assistance while providing China with a presence in the island. In the post-war period, China attended to Sri Lanka's huge financial needs for the rebuilding of infrastructure. China generously extended loans on commercial terms. Though India's economic aid was on much better terms (grants), China helped to finance and carry out large-scale projects despite questions surrounding feasibility of these projects. These included Hambantota Port and Mattala Airport; the former was built as a secondary port in the coastal town of Hambantota, a stronghold of Mahinda Rajapaksa while the latter is the second international airport in Sri Lanka, also located in Hambantota and built with Chinese money. Also, China has been strictly adhering to its policy of non-interference in the internal affairs of other countries. Such a stand has enabled China to consistently back Sri Lanka in the United Nations Human Rights Council (UNHRC) over war crime allegations levelled against Sri Lanka. In contrast, India's support to Sri Lanka has been hesitant at best and subject to internal pressures from Tamil Nadu.

Relations with China continue to remain strong with the current administration, which is interested in balancing both interests of China and India in Sri Lanka. After coming to power, however, the new administration suspended some projects where China was involved as they were allegedly financed on burdensome terms. With the country's worsening economic situation, the projects resumed with some amendments. However, recent developments have shown a 'pro-China' stance, as demonstrated by the further Chinese investments in Sri Lanka and the country's support of China's position in the South China Sea dispute. Moreover, President Sirisena and Prime Minister Wickramasinghe have expressed their willingness to engage in the BRI and leverage Sri Lanka's geographical position to become an economic hub in the Indian Ocean.

4 Sri Lanka's Economic Relations with India and China in the Post-conflict Period

4.1 Trade

As a small island economy, trade plays an important albeit declining role in Sri Lanka's economy (Institute of Policy Studies of Sri Lanka (IPS) 2015). Sri Lanka's exports are still concentrated in few products (garments and agriculture), and traditional markets, with the EU-28 and USA together accounting for over 50% of Sri Lanka's exports (IPS 2015). In this context, both India and China have emerged as important trading partners of Sri Lanka in the post-war period. In fact, India is one of Sri Lanka's largest trading partners—a position which it has held for some time. Currently, India is the second largest import market of Sri Lanka (after China) with USD 3,824 million worth of Indian goods brought into the country in 2016, and accounting for one-fourth of Sri Lanka's total import requirement (Table 1). In terms of exports, India is now the third largest export destination of Sri Lanka (after the USA and the UK), absorbing 7% of total exports of the country in 2016. While exports to India have grown, Indian imports into Sri Lanka have been rising at a faster pace, leading to a widening of the trade deficit with India over the years. Trade between Sri Lanka and India has grown rapidly since the implementation of the Indo-Sri Lanka Free-Trade Agreement (ISFTA) in March 2000. Under the Agreement, Sri Lanka could export more than 4,000 product lines to the Indian market on a duty-free basis and this has helped to diversify the basket of products from Sri Lanka.

On the back of the success of the ISFTA, which was the first bilateral trade agreement for both India and Sri Lanka, they have been negotiating a comprehensive economic cooperation arrangement to deepen bilateral economic relations. While the existing bilateral FTA only covers trade in goods, the proposed arrangement will be comprehensive encompassing trade in services, investment and economic cooperation. Negotiations have been going on for a while, the

Table 1 Sri Lanka's top ten export and import markets, 2016 (USD thousand)

	Exports		% of exports	Imports		% of imports
	World	10,545,893	100	World	19,500,757	100
1	USA	2,810,220	26.6	China	4,270,756	21.9
2	UK	1,045,080	9.9	India	3,824,968	19.6
3	India	753,481	7.1	UAE	1,067,273	5.5
4	Germany	509,881	4.8	Singapore	1,030,316	5.3
5	Italy	428,902	4.1	Japan	949,829	4.9
6	Belgium	338,187	3.2	Malaysia	642,030	3.3
7	UAE	292,867	2.8	USA	539,987	2.8
8	China	215,493	2	Thailand	514,463	2.6
9	Netherlands	208,334	2	Taiwan	495,929	2.5
10	Japan	203,819	1.9	Hong Kong	465,914	2.4

Source Based on ITC (2018)

Comprehensive Economic Partnership Agreement (CEPA) was almost signed in 2008 but fuelled by fears of Indian domination and lobbying by protectionist fractions, and the Rajapaksa government called off the deal at the last moment.

With the change of government in 2015, an Economic and Technical Cooperation Agreement (ETCA) was proposed by Prime Minister Wickremesinghe, who wants to fast-track negotiations with India. Since the mood in New Delhi has been to have a closer engagement with its immediate neighbours, India readily agreed to the Sri Lankan proposal. Unlike the previous regime, the incumbent government wants to forge closer links with India, especially the four South Indian states (Balachandran 2016). However, some Sri Lankans are still nervous about India and deepening of the trade agreement especially with regard to services. There have been protests against ETCA and its negotiations by protectionists groups over concerns that the country would lose out to larger Indian businesses and influx of workers under the proposed agreement.

Similar to India, the amount of trade between Sri Lanka and China, particularly imports by Sri Lanka, has grown significantly over the last decade. In the year 2016, China surpassed India to become the largest source of imports to Sri Lanka; in that year, Sri Lanka imported goods valued at USD 4,270 million, which is about one-fourth of Sri Lanka's total imports (Table 1). As an exporting market, however, China is still small but growing, making up only 2% of Sri Lanka's exports by value in the year 2016 (USD 215 million). China has broken into the ranks of a top export market of Sri Lanka since 2010 and is now placed the eighth place as an export market of Sri Lanka in 2016. While exports have grown at a modest rate over the last few years, imports from China into Sri Lanka have grown at a faster pace, leading to a growing trade deficit with China. Weak export performance relative to imports from China and India is due to Sri Lanka's overall weak export performance. Although China is not a key market for Sri Lankan exports, there are still certain export sectors which have not entered the Chinese market, providing a potential market for Sri Lanka to diversify its markets. Such export opportunities could provide some scope in addressing the growing trade deficit with China, which stands at USD4 billion. The trade deficit with China has been growing year on year since 2000 although it has widened substantially from 2009.

In November 2014, Sri Lanka and China began negotiations on an FTA on the back of closer relations, and so far a number of rounds have been completed. From the point of view of Sri Lanka, the FTA with China would provide better access to the biggest export market in the world with a population of over 1.3 billion as well as attract export-oriented investments into the country, which would help Sri Lanka to penetrate the Chinese market. However, progress of trade negotiations has been slow due to change of administration in Sri Lanka as well as differences between Sri Lanka and China regarding the coverage of the agreement, with China's insistence that it should cover substantially all trade with Sri Lanka finding it difficult to commit to such high levels of liberalisation.

4.2 Foreign Direct Investment

The ending of war removed one of the biggest impediments to foreign direct investment (FDI). Although Sri Lanka recognises the importance of attracting foreign direct for rebuilding of the country after the war, it has failed to capitalise on peace, evident from the relatively poor performance of FDI flows in the post-2009 period (IPS 2015). Despite a general increase over the post-war period, with the exception of 2014/2015 when there was a dip in numbers, FDI inflows to the country stood at about 2% of GDP, below the Government's expectation (World Trade Organization (WTO) 2016). In terms of sectors, telecommunications sector has attracted the largest share of foreign investment followed by manufacturing, infrastructure and services (WTO 2016).

In the year 2017, China, Singapore, India, Hong Kong and the UK were amongst the top five foreign investors in Sri Lanka (Table 2). In 2017, Indian investments alone amounted to USD 181 million—about 14% of FDI flows in that year (Central Bank of Sri Lanka (CBSL) 2017). India has been amongst the top five foreign investors in Sri Lanka during the post-conflict period. In the last five years (2013–2017), Indian FDI into Sri Lanka increased from USD52 million in 2013 to USD181 million (CBSL 2017). Sri Lanka has long been a favoured destination for Indian direct investments in South Asia. While the portfolio of Indian investments in Sri Lanka is very diverse, much of the initial flows were in manufacturing before shifting in favour of service sectors helped by the removal of restrictions on outward FDI by India, opening up of a number of services to foreign ownership in Sri Lanka and the overall improvement in investment climate with the end of the war (IPS 2014). Indian businesses have invested in sectors in Sri Lanka such as petroleum, hospitality and tourism, banking and financial services, IT, real estate, telecommunication, food processing, metal, tires, cement, glass manufacturing and

Table 2 Major sources of foreign direct investment in Sri Lanka, 2008–2017

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
1	Malaysia	Malaysia	India	Mauritius	Hong Kong	Mauritius	Singapore	China	Malaysia	China
2	India	UK	Malaysia	India	UAE	UAE	Netherlands	Netherlands	India	Singapore
3	Netherlands	India	UAE	Hong Kong	China	Singapore	Hong Kong	India	Netherlands	India
4	UK	Netherlands	UK	Malaysia	India	Hong Kong	UK	UAE	China	Hong Kong
5	Luxembourg	Hong Kong	Singapore	British Virgin Islands	Singapore	Malaysia	India	British Virgin Islands	UAE	UK
6	Hong Kong	Luxembourg	Hong Kong	Singapore	Mauritius	Japan	Malaysia	Hong Kong	Singapore	Japan
7	USA	Singapore	Netherlands	UAE	Netherlands	India	Canada	UK	Canada	Netherlands
8	Sweden	USA	Mauritius	UK	Malaysia	Netherlands	Mauritius	Canada	UK	Australia
9	China	Sweden	USA	Netherlands	UK	China	Australia	Singapore	Australia	UAE
10	Singapore	China	Japan	Japan	Luxembourg	USA	UAE	Mauritius	Japan	Sweden

Source Based on data from IPS (2014) and CBSL (2017) infrastructure development. Also a number of new Indian investments are in the pipeline or underway, especially in the real estate development. At the same time, there has also been an increasing trend of Sri Lankan investments into India in the recent years in sectors such as garment manufacturing, hotels and freight servicing and logistics sector.

Since 2011, a significant portion of FDI has come from China (as part of the Belt and Road Initiative). FDI flows from China accounted for USD 407 million or one-third of the total FDI in 2017, and China was the largest investor in the country in that year. Chinese investments in Sri Lanka have been in logistics, transport and real estate (American Enterprise Institute and The Heritage Foundation n.d.). With an initial investment of USD 1.4 billion in the first phase of the Colombo International Financial City (CIFC) project, which includes reclaiming 269 hectares of land, it is the largest FDI project in Sri Lanka to date. The CIFC, previously known as the Colombo Port City, is an instrumental part of BRI. It aims to build a new city and financial centre along the existing Colombo coastline and become Sri Lanka's financial and business district by 2030. This development is meant to support the main port and provide ancillary services that support the shipping industry including insurance, financial and logistical services (Ministry of National Policies and Economic Affairs (2017). The project is expected to create more than 80,000 jobs.

4.3 Development Assistance

With the rise of China and India, the global aid landscape is fast changing, especially over the last decade. Contribution by countries like China and India are most visible within the Asian region including Sri Lanka. These developments have provided Sri Lanka with more choices in funding sources at a time when Sri Lanka's access to concessional financing has declined due to being classified as a lower middle-income country while Sri Lanka traditional donors, namely the USA and EU, reduced their support during and after the end of the war amid charges of human rights violations (IPS 2014).

Development assistance from India to Sri Lanka has come in the form of loans, grants and technical assistance, focusing primarily on the improvement of economic infrastructure, livelihood development, education, health care, capacity building and economic renewal (Department of External Resources of Sri Lanka (ERD) 2016). As of 2016, India was the third largest provider of bilateral development assistance to Sri Lanka, behind China and Japan (Ministry of External Affairs of India 2017). Presently, Indian loan assistance is provided by the Export–Import (EXIM) Bank of India while the grant assistance is provided by the Government of India through the scheme of Special Development Projects and Small Development Projects (ERD 2016). In comparison to China and other international bodies, India's bilateral development assistance in the form of loans is smaller compared to grants. However, India's disbursements taking into account both grants and loans account for 4% of the development assistance Sri Lanka have received in the year 2016. India has assumed an important role in the reconstruction of the Northern Province since the end of the war in 2009. At a cost of USD 270 million, it is constructing 50,000 houses while Kankesanthurai harbour and the Palaly airfield have been upgraded and the Jaffna–Colombo railway link restored. Additionally, India has provided assistance to SMEs, established an industrial estate in Jaffna, and built hospitals, clinics, and funded water supply projects. Some 10,000 houses in the plantation areas are also being built with Indian assistance. A large segment (almost half) of Indian funding has gone towards the development of transport particularly railways while one-fourth of funding from India has been channelled to the water supply and livelihood development in the Northern and Eastern provinces (ERD 2016). While Chinese's projects to date focused on the southern parts of Sri Lanka, it is making inroads more recently into the north and central highlands where the rubber, tea and coconut plantations are located, which are populated predominantly by Tamil-speaking people who have strong linguistic, cultural and kinship ties with India (Ramachadran 2018). India's influence in the island has been the strongest in these areas.

Development assistance from China has come in three major forms, namely loans, grants and interest-free loans. Loans are made out by the state-owned enterprises such as the EXIM Bank, the China Development Bank (CDC) and Industrial and Commercial Bank of China (ICBC). Grants and interest-free loans are provided directly by the Government of China through the Ministry of Commerce of China.

In the post-war period, China has emerged as the largest provider of bilateral development assistance, overtaking Japan in 2010. Till 2010, Japan was the single largest bilateral lending partner of Sri Lanka (Jayasundara 2017); the position has since then been taken over by China. The total commitment made by China for the last five-year period from 2012 to 2016 was USD 4,217.7 million (ERD 2016). In 2016, the highest commitment by a bilateral donor was China, followed by France and Japan. Annual disbursement by China amounted to over USD400 since 2012. Out of the total disbursement recorded from bilateral development partners during the year 2016, the major portion of the fund was disbursed by China (USD 440.8 million), followed by Japan and India, which contributed USD 74.4 million and 44.1 million, respectively. Projects financed by China through loans include power generation, irrigation and water supply, port, airport, railways, expressways and highways.

China has also became the leading contributor of grants in the year 2016 with one-third of the total grants received by Sri Lanka being provided by China, followed by European Community and Japan with a share of 18% and 15%, respectively. The grant assistance from China mainly focuses on the non-revenue generating projects such as public sector services (i.e. health sector and also other projects that are of historical importance to the relationship between the two countries such as Bandaranaike Memorial International Convention Hall, Nelum Pokuna National Performing Arts Theatre and Superior Courts Complex). However, as a result of the substantial financial assistance provided for the implementation of various development projects, 10% and 3% of Sri Lanka's outstanding debt are to China and India, respectively, as of 2017 (ERD 2016). Also, it is interesting to note that Japan still accounts for 12% outstanding debt of Sri Lanka despite the media attention on Sri Lanka's growing debt to China.

5 Conclusion and Way Forward

For decades, India was Sri Lanka's foremost partner, with regard to trade investment, development or defence cooperation. Over the past decade, this has undergone significant change, with warming of ties between Colombo and Beijing ties especially during President Rajapaksa's term (2005–2015). Increasingly, China has stepped up its role and become indispensable to Sri Lanka. Beijing provided military hardware in the final years of the civil war, while in the immediate post-war years, it defended the government at the UNHRC on war crimes. Importantly, China has played a major role in post-war Sri Lanka's infrastructure development.

India has watched with concern about the inroads made by Chinese in South Asia. As China seeks to revive the ancient Silk Road route under the BRI, major investment and infrastructure projects in the region have added to growing concerns of Indian policymakers. New Delhi has been cautious about growing Chinese investments and infrastructure development projects in Sri Lanka. India sees the BRI as part of China's so-called 'String of Pearls' policy to encircle India while Sri Lanka has enthusiastically supported this initiative. India's growing concern of Chinese presence was aggravated by the docking of Chinese submarines in Colombo twice in 2014. Despite both China and Sri Lanka stating the commercial nature of these investments, there is concern on the part of India that these activities would further China's strategic presence and security in the Indian Ocean. To address Indian concerns over the growing relationship between Sri Lanka and China, the Chinese President Xi Jinping has suggested a trilateral partnership between China, India and Sri Lanka. A similar suggestion has been made in connection with India and China's relations with Nepal but India's response was not clear.

With the change of government in 2015, the new administration has shown no hesitation in making an adjustment to its foreign policy and relations with China, and looking to repair the damage done to Sri Lanka's ties with India and the West. One of the initial moves of the new administration was to temporarily suspend the Colombo Port City project. In addition, other mega-projects funded by China were halted and tenders cancelled. The Sri Lankan government has since re-approved the Port City project paying a fine for the suspension and delay. Sri Lanka also handed over the Hambantota Port to the Chinese in 2017 on a 99-year lease, as it was unable to pay back the loan to China as the port failed to attract business. While this alarmed in New Delhi given the its security implications for India, Prime Minister Wickremesinghe has stated that he will not allow China to use the harbour for militarily purposes and contain India.

At the same time, Prime Minister Modi has been an enthusiastic supporter of the new government in Sri Lanka, and India has enhanced cooperation with Sri Lanka at all levels over the last three years. India has countered Chinese presence by focusing on Trincomalee Port together with Japan and number of deals to boost Indian investments in industrial and energy projects in the port.

It is important to note that both Indian and Chinese attempts to engage more closely with Sri Lanka have met with domestic resistance in the country. There have been violent protests and parliamentary opposition to the Hambantota project while petroleum workers went on strike against Indian takeover of Trincomalee oil tanks. There have also been questions regarding the viability of these projects regardless of where the money is coming from as well as criticism against selling off assets to China and India. Nonetheless, Sri Lanka sees a benefit from engaging with both countries towards transforming the island into a hub in South Asia. However, it is a difficult task to strike a balance between the competing interests of India and China in the country while addressing domestic concerns of their increasing presence in the island.

Going forward Sri Lanka has to carefully balance its relationship with India and China in the light of growing economic ties and easing of tensions between India and China, as recently demonstrated by the informal meeting between President Xi and Prime Minister Modi in Wuhan Province. '*India while having ambitions of regional dominance has also ceded to the fact that it still is not in a position to continue to have adversarial relations with China*' which will create more instability in the region and harm its own economic prosperity (Vidanage 2018, para 20). Moreover, India has come to realise that it cannot stop the growing influence of China in the Indian Ocean including Sri Lanka. Thus, it has come together with Japan and the USA to counter the presence of China in the region including Sri Lanka. More recently, for example, Japan has joined hands with India in the Colombo South LG project as well as to develop oil tanks in Trincomalee.

In this context, Sri Lanka should engage and partner with many countries as possible and desist from using rivalries for short-term benefits—that is, adopt a policy of 'multi engagement' (Vidanage 2018). Both India and China are important for Sri Lanka's development as both countries are emerging as economic powerhouses. A foreign policy which is balanced would facilitate friendly relations with both Beijing and New Delhi without being lopsided. This provides Sri Lanka the space to refrain from getting caught up with bilateral disagreements and disputes between the two emerging powers. Also, it allows Sri Lanka to seek economic assistance from both powers but remain non-aligned whenever a crisis emerges between India and China. At the same time, given Sri Lanka's participation in the BRI, India should also take advantage of the increased opportunities which would stem from it rather than being always suspicious of the initiative while China should engage with local communities before embarking on projects under the BRI to gain public trust and support.

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Export Expansion in a Changing Global Order: Challenging Times for Post-conflict Sri Lanka

Prema-chandra Athukorala

Abstract This chapter examines Sri Lanka's experience with manufacturing exports expansion, placing emphasis on opportunities and policy priorities in a rapidly changing global context in which global production sharing has become the prime mover of cross-border production and trade. There is compelling evidence that liberalization reforms initiated in 1977 helped transform the classical export economy of Sri Lanka inherited from the colonial era into a one in which manufacturing plays a significant role. Had not political instability that adversely affected the investment climate during Sri Lanka's long conflict taken place, export performance would have been much more impressive. In a context in which factors of production—capital, technology and marketing and managerial know-how—are increasingly mobile across national boundaries within production networks, the nature of the existing manufacturing base is not a prerequisite for export diversification. Trade-cum-investment policy reforms can set the stage for the emergence of exporting firms de novo. In sum, the findings make a strong case for redressing policy backsliding and continue with the market-oriented reforms agenda that was left incomplete in the late 1990s and set up institutional safeguards to avert further backsliding.

1 Introduction

The economic liberalization reforms initiated in 1977 and sustained for the ensuing three decades dramatically transformed the economic landscape of Sri Lanka. The export structure of the economy underwent a remarkable shift from land-intensive, plantation exports to labor-intensive manufacturing, ending the economy's historic

This chapter draws on Athukorala (2017a).

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dependence on three primary commodities (tea, rubber, and coconut products). Export-oriented manufacturing emerged as the major generator of employment opportunities in the economy, accounting for over half of total employment growth. The World Bank's Sri Lanka Development Policy Review 2004 noted that 'It would be hard to find a more convincing case of trade and industrial transformation of a small island economy through market-friendly policy reforms' (World Bank 2005, p. 6).

Notwithstanding the notable economic achievements, there was a backsliding on liberalization reforms from about 2005, in particular following the ending of Sri Lanka's separatist conflict in May 2009 (Pursell and Ahsan 2011; Athukorala 2012; Kaminski and Ng 2013). In spite of the official commitment to 'moving toward further integrating Sri Lanka into the world economy' (Government of Sri Lanka 2010, p 53), in practice the development strategy began to reemphasize the role of the state in 'guiding the markets' with a view to redressing perceived untoward effects of economic globalization. Public enterprise reform was explicitly ruled out, while conspicuously avoiding any reference to trade policy reforms. The policy backsliding, coupled with real exchange rate appreciation underpinned by the emphasis on debt-financed infrastructure development, was reflected in a massive contraction in exports as a share of gross domestic product (GDP). Sri Lanka's share in world exports and in exports from developing countries declined sharply. Largely due to the sluggish export performance, the current account deficit widened and the total outstanding external debt almost doubled.

A change of government in 2015 marked a departure in economic policy direction for Sri Lanka. But, the policy dilemma for the new regime is how to redirect policy changes to restore the economy's international competitiveness and to contain debt dependency. The purpose of this chapter is to inform the policy debate by specifically focusing on trade and investment policy reforms needed to improve the overall investment climate for promoting manufacturing exports and assessing the potential for export expansion. This chapter aims to identify policy priorities for fully exploiting the country's export potential in a rapidly changing global context in which global production sharing has become the prime mover of cross-border production and trade.

The chapter is structured in four sections. Section 2 provides a typology of the emerging patterns of manufacturing exports from developing countries, against the backdrop of the ongoing process of global production sharing and the resultant expansion of trade within global production networks, in order to set the stage for the ensuing analysis. Section 3 examines trends and compositional changes in exports using disaggregated trade data in order to identify Sri Lanka's achievements in and prospects for integrating into global manufacturing production networks. Section 4 presents the results of an econometric analysis of the determinants of manufacturing exports and findings of field research on constraints faced by exporting firms. The final section summarizes the key findings and policy inferences.

2 Analytical Framework

Cross-border dispersion of production processes within vertically integrated global industries, with each country specializing in a particular stage of the production sequence, has been an increasingly important structural feature of economic globalization in recent decades. This phenomenon, which we call 'global production sharing' in this chapter,[1] opens up opportunities for countries to participate in a finer international division of labor within given products, instead of producing the product from beginning to end within its national boundaries. Consequently, parts and components, and final assembly traded within global production networks —'interwork trade' or 'vertical trade'—have been growing at a much faster rate in world trade than have goods wholly produced within countries—'horizontal trade' (Yeats 2001; Helpman 2011; Athukorala 2014a; Antras 2016). Global production sharing has been the prime mover of a notable structural shift in world manufacturing trade from developed countries to developing countries over the past four decades (Krugman 2008).

With the rapid expansion of global production sharing, the conventional approaches to trade pattern analysis, which are based on the conventional trade theoretical assumption that international trade takes place in goods produced entirely (from start to finish) in just one country, have become increasingly irrelevant for understanding emerging export opportunities for developing countries. When it comes to analyzing trade patterns of developing countries, this approach is basically relevant only for domestic-resource-based manufacturing and standard consumer goods that are made to local specifications (such as handicrafts), which together account for a shrinking share of total world trade.

Production sharing enables countries to specialize in a given slice of the production process because parts and components, capital and production technology are mobile within global production networks. Workers in a given country may tend to have different skills from those in another country, or the skills required in each production block differ (as in the Ricardian model). Alternatively, the production blocks may differ from each other in the proportion of factors required, enabling firms to locate labor-intensive production blocks in countries where productivity-adjusted labor cost is relatively low (as in the Heckscher–Ohlin model). But the ability of a given country to link the value chain does not depend on the availability of labor and relatively low wages alone. Cross-border spread of production activities involves new fixed costs of establishing 'services links'—arrangements for connecting and coordinating activities into a smooth sequence, resulting in the production of the final good. Thus, a whole range of factors impacting the business climate are important in attracting foreign direct investment (FDI) and other mobile inputs (Jones and Kierzkowski 2004; Helpman 2011).

[1]Other terms used in the recent international trade literature include international production fragmentation, intra-process trade, vertical specialization, slicing the value chain, and offshoring.

Global production sharing is, however, not a homogenous phenomenon. In terms of the organizational structure, production networks based on global production sharing take two major forms: buyer-driven production networks and producer-driven production networks. Understanding the difference in the governance structure of the two forms of production networks is vital for formulating policies to link the manufacturing industry in a given country into global production networks.

Buyer-driven networks are generally common in diffused-technology-based consumer goods industries such as clothing, footwear, travel goods, toys, and handicrafts. In these networks, the 'lead firms' in the value chain are international buyers (large retailers such as H&M, Marks and Spencer, and Walmart or brand manufactures such as Gap, Nike, Victoria's Secret, and Zarah). Global production sharing in these networks takes place predominantly through arm's length relationships, with global sourcing companies (value chain intermediaries, such as Hong Kong, China-based Li & Fung, and Mast Industries Far East) playing a key role in linking producers and the lead firms. Therefore, there is room for local firms to engage directly in exporting through links established with foreign buyers (Gereffi 1999; Schmitz and Knorringa 2000).

Producer-driven production networks are common in vertically integrated global industries such as electronics, electrical goods, automobiles, and scientific and medical devices. In a producer-driven production network, the 'lead firm' is a multinational manufacturing enterprise (such as Apple, Intel, and Motorola). Global production sharing takes place predominantly through the lead firms' global branch network and/or its close operational links with established contract manufacturers. In these high-tech industries, production technology is specific to the lead firm and is closely protected in order to prevent imitations. Also the production of final goods in these industries requires highly customized and specialized parts and components whose quality cannot be verified or assured by a third party; it is not possible to write a contract between the final producer and input supplier that would adequately specify product quality. The bulk of global production sharing, therefore, takes place through intra-firm linkages rather than in an arm's length manner. However, as the production unit (affiliated company) becomes well established in a given country and it forges business links with private- and public-sector agents, arm's length subcontracting arrangements with local firms can develop, leading to upgrading of technology and management capabilities of local firms.

Mindful of these considerations, the discussion in the subsequent sections is based on a commodity classification system that explicitly focuses on export opportunities opened up by global production sharing. For the purpose of the analysis, export data based on this classification system were compiled using trade data at the 5-digit level of the Standard International Trade Classification (SITC).[2]

[2]For details on the data classification system, see Athukorala (2017b), Appendix 2.

3 Sri Lanka's Export Performance

The colonial export structure of Sri Lanka dominated by the 'traditional trio' (tea, rubber, and coconut products) remained virtually unchanged during the first three post-independence decades. By 1977, manufacturing (excluding petroleum products) accounted for a mere 3% of total merchandise exports.[3]

Following the 1977 policy reforms, the export composition shifted from primary products toward manufactured goods. Exports of manufactured goods, in current US dollar terms (USD), grew at an annual compound rate of over 30% during 1978–2000, lifting their share in total exports to over 70%. However, since then, the rate of expansion of manufacturing exports has lagged behind that of primary commodity exports, with the share in total exports varying in the range of 70–68%. Sri Lanka's share in world manufacturing exports increased from 0.05% in the mid-1980s to about 11% in 1999, then declined, reverting to the level in the 1980s. This overall pattern suggests that slowing of the export growth during the last two decades has been driven primarily by domestic supply-side factors.

The percentage composition of manufacturing exports is summarized in Table 1. Products exported within global production networks (henceforth, referred to as GPN products) account for over three-fourths of total manufacturing exports from Sri Lanka, a figure comparable to the East Asian average (Tables 1 and 2). But, unlike the dynamic exporting countries in East Asia, Sri Lankan GPN exports are heavily concentrated with buyer-driven networks. Within this product category, apparel accounts for the lion's share. There was some diversification since the late 1980s into other labor-intensive products, such as leather goods, footwear, toys, plastic goods, and diamond cutting and jewelry.

Sri Lanka's lopsided engagement in global production sharing mirrors the country's lackluster performance with attracting foreign investors into assembly production in high-tech industries (particularly electronics), despite the country's intrinsic comparative advantage in this area of international production. The investment promotion campaign of the Greater Colombo Economic Commission (GCEC) (later renamed as the Board of Investment, BOI) aimed during the early stage at attracting FDI into electronics and electrical goods assembly. But Sri Lanka seems to have missed the opportunity to become an electronics hub because of the increase in political risk—first from cabinet reshuffling in the early 1980s—and subsequently aggravated by the eruption of the separatist conflict (Athukorala and Rajapatirana 2000; Snodgrass 1998). Foreign firms involved in vertically integrated assembly activities, unlike those involved in light consumer goods industries, view investment risk from a long-term perspective because output disruption in a given location can disturb production plans for the entire production chain. In fact, two electronics multinationals—Harris Corporation and Motorola—abandoned plans to set up assembly plants in Sri Lanka in the early 1980s as the political climate begun

[3]Unless otherwise stated, the data reported in the paper are from UN Comtrade database.

Table 1 Sri Lanka: commodity composition of manufacturing exports (%, 2-year averages)

Product group/product (SITC coded in brackets)	Year				
	1990–1991	2000–2001	2005–2006	2010–2011	2013–2014
GPN products (buyer-driven + producer-driven)	70.87	81.12	74.30	73.00	75.66
Buyer-driven exports	66.35	74.33	66.13	63.06	67.18
Garments (84)	64.99	70.03	65.20	62.47	66.08
Footwear (83)	0.93	1.16	0.35	0.30	0.80
Producer-driven exports	4.52	6.79	8.17	9.93	8.48
Electronics and Electrical Goods (SITC 75 76 and 77)	1.62	4.37	3.90	3.36	2.83
Transport equipment (SITC 78 and 79)	1.14	1.28	2.58	3.24	1.98
Traditional (horizontal) Products (mostly domestic resource based)	29.13	18.88	25.70	27.00	24.34
Essential oil (SITC 551)	0.27	0.10	0.10	0.22	0.35
Activated carbon (SITC 59864)	1.16	0.44	0.45	0.99	1.16
Tires (SITC 625)	1.19	2.46	6.08	7.34	7.88
Other rubber-based products (SITC 62–SITC 625)	0.74	0.74	1.02	1.70	1.97
Porcelain (SITC 666)	1.17	0.97	0.80	0.52	0.45
Diamonds, Gems, and Jewelry (667)	13.26	4.32	7.59	7.39	5.30
Total exports	100	100	100	100	100
USD million	1,093	3,723	4,546	6,167	7131

Note GPN = global production network, SITC = Standard International Trade Classification, UN = United Nations
Source Compiled from UN Comtrade database using the classification system described in Appendix A

Table 2 Share of global production network products in manufacturing exports, 2012–2013 (%)

Economy	Buyer-driven GPN	Producer-driven GPN	Total
Developing East Asia	19.2	57.2	76.4
People's Republic of China	20.5	57.3	77.8
Taiwan	7.2	72.6	79.8
Republic of Korea	8.3	69.9	78.2
ASEAN	14.0	61.2	75.2
Indonesia	23.2	14.2	37.4
Malaysia	6.3	69.3	75.6
Philippines	13.2	64.1	76.3
Singapore	2.3	92.3	94.6
Thailand	12.4	59.4	72.3
Vietnam	23.5	34.3	57.8
South Asia	12.2	21.2	23.5
India	12.3	9.9	22.2
Sri Lanka	67.2	8.5	75.7

Note GPN = global production network
Source Compiled from UN Comtrade database using the classification system described in Appendix

to deteriorate.[4] There is evidence of a 'herd mentality' in site selection by multinational electronics firms, particularly if the 'first comer' is a major player in the industry. If the Harris and Motorola projects had succeeded, other multinationals would have followed suit. Moreover, the entry of large players in vertically integrated global industries naturally sets the stage for the emergence of local small and medium-scale firms supplying ancillary components and services (Athukorala 2014b).

Despite the departure of Motorola and Harris Corporation, a sizeable number (over 30, according to BOI records) of fully export-oriented-medium-scale foreign-invested enterprises (FIEs) are currently successfully operating in electronics, electrical, and automotive industries.[5] A study by the Sri Lanka Export Development Board (SLEDB 2015) indicates that these firms employ over 20,000 workers. The firms' exports account for only a small share (about 3%) of total manufacturing exports, but data show a continued increase in the exports' value, from USD 247 million in 2000 to over USD 470 million in 2014 (Table 3).

Among the non-GPN products (horizontal exports), rubber-based products, in particular pneumatic (airless and solid) tires, have shown impressive growth. Sri Lanka's share in world exports of pneumatic tires (SITC 62594) increased from

[4]On signing the investment agreement with the Greater Colombo Economic Commission in 1980, W.D. Douglas, a vice-president of Motorola stated: 'Political stability is number one on our list wherever we go' (quoted in Wijesinghe 1976).

[5]According to SLEDB (2015), these firms currently employ over 20,000 workers.

Table 3 Parts and components of industrial electronics and electrical goods exported from Sri Lanka, 2000–2014

SITC code	Product	2000	2005	2010	2011	2012	2013	2014
74492	Lift truck parts	–	–	15.0	34.1	31.2	43.6	57.1
77313	Vehicle ignition wire	–	–	37.0	40.6	37.2	36.1	36.1
77119	Other elec. transformers	13.1	16.4	50.0	36.7	28.4	28.4	24.5
77282	Switchgear parts	0.3	12.1	26.7	38.3	33.8	21.7	28.6
77261	Switchboards etc. < 1000v	0.7	6.1	11.1	13.2	6.9	20.0	27.3
77281	Switchboards etc. unequal	8.1	14.2	12.4	17.3	11.8	12.6	17.2
77220	Printed circuits	14.8	5.9	22.7	28.6	26.6	16.7	10.9
77812	Electric accumulators	0.3	0.4	0.2	0.3	0.8	6.0	18.4
	Other	207.9	247.8	161.2	204.8	182.1	193.1	227.3
	Total parts and components	246.8	307.5	346.4	429.2	377.1	399.4	472.1

Source Compiled from UN Comtrade database

6.0% in 1990/1991 to 22.3% in 2013/2014. Two Sri Lankan joint ventures, with Camso (a Canadian multinational enterprise) and Trellebrog (a Swedish multinational enterprise), account for the country's entire production of pneumatic tires. The share of natural rubber (Sri Lanka's second largest traditional export) in total exports has declined sharply as a result of the rapid growth of rubber-based manufacturing industries. In 2014, more than 80% of the country's total natural rubber production was absorbed by the export-oriented industries.

An important issue in the contemporary trade and industrial policy debate is whether an import-substitution phase is a precondition for an economy's successful transition to an export orientation. Related to this issue, the composition of the structure of manufacturing production at the time Sri Lanka embarked on liberalization reforms and the commodity composition of manufacturing exports during the subsequent years fails to suggest any direct link between emerging export patterns and the structure of production inherited from the import-substitution era. On the contrary, the evidence suggests that most manufacturing exports emerged de novo after the liberalization reforms. Most of the new exporting firms—both those with FDI participation and purely local ones—emerged as exporting ventures independently of the industries formed during the import-substitution (IS) era in the earlier period. In the apparel industry, a few firms established during the IS era have successfully ventured into export business. However, as shown in the next subsection, their new operations were based on know-how and management inputs obtained though foreign collaboration and/or marketing links established with foreign buyers.

3.1 The Special Case of Apparel

In Sri Lanka,[6] commercial production of apparel began in the early 1960s (Kelegama 2009). However, expansion of the industry remained severely constrained during the ensuing two decades by a highly interventionist trade and industrial policy regime. The apparel industry started to grow only after the liberalization reforms were initiated in 1977. From 1992, apparel has been Sri Lanka's single largest export product. Over the years, the composition of manufactured exports has diversified into other labor and resource-based products, but apparel still accounts for over 42% of total merchandise exports and over 62% of manufacturing exports.

In the lead up to the abolition of the Multi-Fiber Agreement (MFA) quotas, Sri Lanka was grouped with countries expected to experience significant contraction in the post-MFA free era (Nordås 2009). This gloomy prediction has not materialized: Average annual Sri Lankan apparel exports during 2005–2014 amounted to USD 3.6 billion, up from USD 2.8 billion during the preceding five years (2000–2004)

[6]This section draws on Athukorala and Ekanayake (2018).

recording a 26% increase. Sri Lanka's share in world apparel exports did decline, from about 1.10% during 2000–2004 to 1.01% during 2005–2007, but has increased since to reach 1.17% in 2015.

The post-MFA performance of Lanka's apparel industry is particularly impressive considering that two important impediments operated during this period. First, unlike many of its competitors, Sri Lanka does not enjoy preferential access to the major markets in Europe and North America. Second, Sri Lanka is no longer a low-wage production base when compared with many other apparel-producing countries in the region.

In February 2010, the European Union (EU) suspended the Generalized System of Preferences plus (GSP+) concessions to Sri Lanka granted in 2005 due to concerns about the violation of human rights during the 2006–2009 war effort.[7] In addition to loosing preferential access to the EU markets, the Sri Lankan apparel exporters had to compete in the US market with exporting countries that enjoyed handsome tariff preferences under the African Growth Opportunity Act (AGOA) and regional trading agreements with countries in Latin America. The erosion of relative price competitiveness resulting from trade preferences has been compounded by an increase in wages in recent years. Sri Lanka's average hourly wage is now much higher than that in Bangladesh, Cambodia, and Vietnam (and possibly in India and Indonesia) and is approaching the levels in China and other East Asian countries that produce clothing (Athukorala and Ekanayake 2018).

The remarkable resilience of Sri Lankan apparel exports to the MFA abolition under these constraints has been underpinned by a compositional shift in exports from 'basic apparel' to 'fashion-basic apparel' (Table 4).[8]

The degree of concentration of exports in the top 20 products has increased over time, from 79.8% in 2000/2001 to 90.2% in 2013/2014. Among these products, the share of women's apparel, which generally contains a higher fashion content, increased from 44% to nearly 60%. The two most rapidly expanding categories within this product group are brassieres (SITC 84551) and panties (SITC 84482). In 2013/2014, Sri Lanka accounted for 8.2% of total world exports of women's and girls' panties, up from 2.2% in 2003/2004. Sri Lanka's world market share of brassiere increased from 3.2 to 7.4% in the same interval. Products that generally

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[7]Under GSP, Sri Lanka is eligible for an average non-reciprocal preference margin of about 2.2% on clothing exports (the average GSP rate of 9.0% compared to an average Multi-Fiber Agreement tariff rate of 11.2%). In July 2005, Sri Lanka became eligible for additional tariff concessions under the newly introduced GSP + scheme, which offered duty-free access for 7,200 products (including most clothing items).

[8]The discussion here follows the three-way classification of apparel proposed by Abernathy et al. (1999): fashion products, basic products, and fashion-basic products. Fashion products are high-end products, such as dresses from Paris and Italian made suits, the demand for which is largely driven by social status and deep-rooted cultural values. These products are not typically imported from developing countries. Basic apparel products remain in a retailer's or a manufacturer's collection for many seasons, such as men's shirts, trousers, and underwear. Fashion-basic products are variants on basic products that contain some fashion element (such as stone-washed jeans, pants with pleats or trim, and fashion lingerie and intimate wear).

Table 4 Sri Lankan clothing exports: Top 20 SITC-5 digit products, 2000–2001 and 2012–2014

2000–2001			2013–2014		
SITC code	Product	Export share (%)	SITC code	Product	Export share (%)
84260	Women's/girls' trousers, woven	9.6	84551	Brassieres	9.9
84140	Men's/boys' trousers, woven	8.9	84140	Men's/boys' trousers, woven	9.7
84270	Women's/girls' blouses, woven	7.3	84260	Women's/grls' trousers, woven	9.8
84540	T-shirts/singlets, knit	5.6	84540	T-Shirts/singlets, knit	9.4
84530	Jerseys/pullovers	5.4	84482	Women's/girls' panties, knit	9.2
84130	Men's/boys' jackets, woven	5.2	84691	Gloves, knit	4.7
84551	Brassieres	4.8	84426	Women's/girls' trousers, knit	4.6
84151	Men's/boys' trousers, cotton woven	4.7	84822	Women's nightwear, woven	4.4
84230	Women's/girls' jackets, woven	3.4	84151	Men's/boys' trousers, cotton	3.5
84371	Men's/boys' trousers, cotton knit	3.2	84530	Jerseys/pullovers	3.2
84250	Women's/girls' skirts, woven	3.2	84270	Women's/girls' blouses, woven	3.2
84240	Women's/girls' dresses, woven	3.0	84240	Women's/girls' dresses, woven	3.0
84482	Women's/girls' panties, knit	2.7	84381	Men's/boys' underwear, knit	2.8
84282	Women's nightwear, woven	2.6	84512	Baby clothes, knit	2.3
84512	Baby clothes, knit	2.4	84564	Women's/girls' swimwear, knit	2.2
84470	Women's/girls' blouses, knit	2.0	84424	Women's/girls' dresses, knit	2.3
84691	Glove, knit	1.9	84250	Women's/girls' skirts, woven	1.7
84511	Baby clothes, woven	1.7	84483	Women's/girls' skirts, woven	1.5
84423	Women's/girls' jackets, knit	1.1	84371	Men's/boys' trousers, cotton	1.5
84159	Men's/boys' trousers, woven	1.1	84423	Women's/girls' jackets, knit	1.2
Total		79.8	Total		90.2

Note Two-year averages
Source Compiled from UN Comtrade database

have no fashion content (such as men's business shirts and normal men's and women's trousers) have virtually disappeared from the export product mix.

In basic apparel products, labor cost is the major determinant of international competitiveness; low-wage nations, especially those with access to inexpensive textiles, have the potential for major market share gains in the post-MFA era. By contrast, in fashion-basic products, exporting is more than a simple price–cost game; speed and flexibility are crucial capabilities for firms wrestling with product proliferation. What explains Sri Lankan apparel industry's success at meeting these requirements?

In the post-MFA era, the Sri Lankan apparel industry has settled into a smaller core of firms, which are presumably well prepared to take advantage of changing future demand. Customs records indicate that Sri Lanka had 817 exporting firms in 2004 (using an export value of USD 10,000 as the minimum cutoff point). The number declined to 671 in 2008 and to 450 in 2011, and the size distribution of the surviving firms has become increasingly skewed, with larger farms accounting for the bulk of exports. At the upper end, the three largest firms accounted for over 35% of total exports in 2011, up from over 13% in 2004. In 2011, more than two-thirds of exports originated from the top 20 firms, compared with 39% in 2004. The industry had a well-developed customer base, including well-known brand names such as Abercrombie and Fitch, Gap, Hunkemoller, Liz Claiborne, Marks and Spencer, Nike, Pierre Cardin, Ralph Lauren, Sainsbury's, Tesco, Tommy Hilfiger, and Victoria's Secret. Large apparel firms (at least the top ten companies) have established their own design centers that worked closely with design teams of brand owners. Most large companies (in particular the top ten) have invested in computer-aided design and manufacturing, and in electronic fitting, which enables design decisions by visualizing the garment digitally, skipping fit-on sessions with models. Some of the large firms are now multinational enterprises in their own right with subsidiary companies in other apparel exporting countries, such as Bangladesh, India, Jordan, Kenya, Madagascar, and Vietnam. These firms have the ability to coordinate production within their global production networks to meet orders from their strategic buyers, reminiscent of the triangular manufacturing practices of the East Asian firms during the MFA era.

A key determinant of a firm's success in manufacturing flexibly is the domestic availability of high-quality inputs, which reduces the transport costs of inputs, delays, and the management time needed to coordinate a fragmented supply chain. Until about the mid-1990s, the domestic content of apparel exports from Sri Lanka was basically equivalent to the labor content: about 20% (Kelegama and Foley 1999). Since then, the three largest firms (MAS Holdings, Brandix and Hidramani, in that order) have set up plants to produce textiles (mostly knitted fabric and elastic) and ancillary inputs (hangers, brassier mounding, packaging material, labels, and buttons) to be used mostly in their own apparel plants, but also to meet the requirements of other apparel producers in the country. Currently, about 60% of fabric used in apparel production (about 80% of fabrics used in knitted apparel and about 20% of woven apparel) and the bulk of the ancillary inputs are produced domestically.

Given Sri Lanka's long-standing commitment to providing universal free education, the labor force also had a much higher level of formal education (on average 10.3 years of schooling) than in most other apparel exporting countries (Savachenko and Acevedo 2010). Therefore, a worker who joined the labor force as a 'helper' in an apparel factory takes only two to three months to become a machine operator, versus three to six months taken by a Bangladeshi counterpart.[9] In addition, the managerial and technical capability of Sri Lanka's apparel industry has improved notably during the past four decades, with public–private partnerships playing a pivotal role. Initially, the Sri Lankan apparel industry was heavily dependent on textile technicians from Hong Kong, China. The dependence on foreign textile technicians had virtually disappeared by the dawn of the new millennium. Sri Lanka has also become a supplier of textile technicians and managers to other apparel-producing countries in the region and beyond (Staritz 2011).

As the Sri Lankan apparel industry expanded, the country's major apparel-producing firms placed greater emphasis on ethical employment practices than in the case in many of its Asian competitors (Fernando and Almeida 2012; Ruwanpura and Wrigley 2011; Friedman 2000). The 'Garment without Guilt' campaign launched by the Joint Apparel Association Forum (JAAF) played a pivotal role in strengthening corporate social responsibility commitments among apparel exporting firms and promoting Sri Lanka as an ethical clothing manufacturer destination (JAAF 2012; Amalean 2001). Most large firms provide workers with transport facilities, free breakfast, subsidized meals, medical care, and engage in community services in rural area where the factories are located. Some firms produce 'fair trade' clothing and invest in building 'green' factories. The impressive record of compliance with ethical employment practices and internationally agreed environmental standards have enhanced Sri Lanka's attractiveness as a source of procurement for the leading brand marketers and specialty stores.

Finally, the data suggest that production disruption resulting from trade union action is much less of an issue in the clothing industry in Sri Lanka than in other industries.[10] Employment conditions, particularly in large firms, had improved significantly, leaving little room for trade union action. Moreover, the predominance of women in the work force is an important source of industrial peace.[11] The macho orientation of political trade unionism in Sri Lanka has deterred women from participating in trade unions. Female workers do not have a compelling reason for joining unions because of the short-term nature of their employment; they typically remain in the labor force for about five years before returning to their villages to other forms of employment and marriage (Gunawardana 2007).

[9]Based on an interview with a Sri Lankan firm that has a large branch plant in Bangladesh. See also Savachenko and Acevedo (2010).

[10]According to the data on number of strikes and lost man days reported in Department of Labor (2010).

[11]Young women from the rural areas make up approximately 85% of all workers in the garment industry.

4 Determinants of Export Performance

This section reports the results of an econometric analysis that aims to delineate the impact of international competitiveness (as measured by the real exchange rate) and export-oriented FDI on export performance, while allowing for the impact of regime shifts and world demand.

The methodology involves estimating the following reduced form equation using data for the period 1970–2015:

$$QX = F(RER, PCAP, FIEX, WD, TDPLB, DMFA, DNUR, DPWR, TIME) \quad (9.1)$$

where QX is real exports (export at 2005 prices). The explanatory variables are listed below with the expected sign of the regression coefficient in brackets

RER (+)	Real exchange rate
$FIEX$ (+)	Real investment in foreign-invested enterprise
$PCAP$ (+)	Production capacity, measured by real manufacturing output
$WEXD$ (+)	Export demand, proxied by real manufacturing exports from developing countries
$DPLB$ (−)	Pre-liberalization dummy variable, which takes the value 1 for years 1970–77 and 0 otherwise
$DMFA$ (−)	A dummy variable to capture the impact of MFA phase-out (1 for 2005–2015 and 0 for other years)
$DNUR$ (−1)	A dummy variable to capture production disruption caused by the youth uprising during 1987–1989
$DPWR$ (?)	Post-civil war dummy that takes the value 1 for the period 1999–2015 and 0 otherwise
$TIME$ (+)	Time trend

Among the explanatory variables, RER is expected to capture the impact on export performance of changes over time in the relative profitability of exporting and selling domestically. The RER is measured as the Rupee price of the export destination country currency multiplied by the foreign price to domestic price ratio. The role of foreign-invested enterprises (FIEs) in export expansion is presented by the $FIEX$. This variable is measured as the total real investment in BOI-approved projects.[12] The $PCAP$ is included to capture the impact of production capacity expansion in manufacturing on export performance. In the absence of a direct measure of production capacity, this variable is proxied by the average real manufacturing output during the three preceding years. The $WEXD$ is included to capture the impact of world demand on export performance. Foreign currency prices faced by Sri Lankan exporters are determined exogenously. However, the ongoing process of shifts in world demand toward developing countries driven by

[12]Total investment, rather than foreign investment, better capture the impact of foreign-invested enterprises on export performance because there has been a clear shift in the ownership structure of these firms from full foreign ownership to joint venture (with minority ownership in most cases).

global production sharing in overall world demand is relevant for explaining export performance.

The export equation is estimated separately for total manufacturing goods (*TMFX*), textiles and garments (*TGEX*), and other manufacturing exports (*OMEX*).[13] It is necessary to treat *TGEX* as a separate category to allow for special market conditions faced by apparel exports until 2005, due to the market quota system under the MFA. The country-specific export quotas under the MFA, by segmenting the textile and garment market country-by-country, created market power on behalf of exporters, which would otherwise have not existed. In other words, the MFA quotas made the export demand schedules facing exporters less elastic than they would have otherwise been.

The *RER* series relates to Sri Lanka's six major export destination countries (the US, UK, India, Germany, France, and the Netherlands). The data on producer price indices for these countries are extracted from the World Development Indicators (WDI) database of the World Bank. The data on manufacturing exports from developing countries to construct the *WEXD* series were compiled from the Comtrade database. The data on all other variables are from various issues of the Annual Report of the Central Bank of Sri Lanka (CBSL).[14]

All data series (except dummy variables) were used in logarithmic form.[15] The estimation was commenced by examining the time series properties of the data series using the Augmented Dicky-Fuller test. In terms of this test, all data series were found to be nonstationary (i.e., the test did not reject the null hypothesis of unit-root nonstationary, $I[1]$). Thus, in order to guard against the possibility of estimating spurious relationships, it was necessary to estimate the export equation using an estimator that is appropriate for $I(1)$ variables. Of the alternative estimators, the Phillips-Hanses fully modified ordinary least squares (OLS) method was employed, which is applicable to data samples of the size typical in economics (47 in this case). The fully modified OLS is an optimal-single equation technique, which is asymptotically equivalent to maximum-likelihood estimators. This estimator applies a semi-parametric correction to the OLS estimator to eliminate dependency on nuisance parameters, and give medium-unbiased t-statistics that follow a standard normal distribution asymptotically.[16]

The summary statistics of the variables are reported in Table 5. The results are reported in Table 6. The CAP was dropped because its coefficient turned out to be

[13]It is preferable to separate the other manufacturing exports into GPN products and non-GPN products, but disaggregated price (unit value) data are not available.

[14]The author is grateful to S.D. Nilanka for permitting him to use some of the data series from the database she constructed for the Masters research essay (Nilanka 2016).

[15]The log-linear specification of the model was tested against the simple liner specification using the standard functional form choice tests (Pesaran and Pesaran 2009, Sect. 11.9). None of these tests favoured one over the other. The results are reported for the log-linear specification because it has the added advantage that the estimated coefficients can be directly interpreted as elasticities.

[16]These corrections works effectively for sample sizes as small as 50 (Philips and Hansen 1990; Pesaran and Shin 1999).

Table 5 Summary statistics of the variables used in estimating the export equation

	Log TMEX	Log TGEX	Log OMEX	Log RER	Log FIEX	Log WEXD
Maximum	13.27	12.99	12.35	5.17	12.39	15.40
Minimum	6.68	6.00	5.98	4.20	1.10	10.74
Mean	11.79	10.90	11.11	4.64	9.35	13.37
Std. deviation	1.69	2.13	1.48	0.27	3.63	1.54
Skewness	−1.39	−1.08	−1.78	0.35	1.36	−0.24
Kurtosis	1.29	−0.11	2.97	−0.62	0.36	−1.44
Coeff. of variation	0.14	0.20	0.13	0.06	0.39	0.11

Table 6 Determinants of manufacturing exports

	Total manufacturing export (TMEX)	Textiles and garments (TGEX)	Other manufacturing exports (OMEX)
Constant term	−7.88 (2.27)	−3.33 (1.21)	−12.82 (2.76)**
Real Exchange Rate (RER)	1.55 (3.54)***	0.68 (2.08)**	1.58 (2.78)**
Investment in Foreign-Invested Exporting Firms (LFIEX)	0.16 (3.76)***	0.30 (9.58)***	0.20 (3.78)***
World Export Demand (WEXD)	0.83 (5.15)***	0.61 (5.07)***	1.26 (6.01)***
Pre-liberalization Dummy (DPLB)	0.54 (1.24)	−0.21 (0.71)	0.73 (1.31)
Post-MFA Dummy (DPMFA)	−0.40 (2.68)**	−0.27 (2.56)**	
Post-Civil War Dummy (DPWAR)	0.24 (1.25)	0.04 (0.16)	0.15 (0.61)
Southern Youth Uprising Dummy (DUPR)	−0.30 (2.44)**	−0.03 (0.34)	−0.64 (3.90)***
Trend	0.67 (0.00)	0.01 (0.39)	−0.09 (3.46)***
LRER*DPMFA		−0.51 (0.61)	
R-Bar Squared	0.93	0.98	0.84
ADF	−4.09***	−6.52***	−3.53**

***, **, and * indicate statistical significance at 1%, 5%, and 10%, respectively. Standard errors are shown in parentheses

statistically insignificant (in some cases with the unexpected sign) in experimental rules. This is consistent with the fact that during the reform era, export-oriented manufacturing grew as an FDI-centered subsector side-by-side with the domestic-market-oriented sector. An interaction variable (*LRER*MFA*) is also included in the export equation for textile and apparel to test whether the relative price effect on apparel exports has changed following the MFA abolition. All three equations pass the Augmented Dickey-Fuller test for residual stationarity. Hence the regression coefficients can be interpreted as long-run (steady state) elasticities.

The real exchange rate (RER) variable is by far the most important determinant of export performance in all three equations. For total manufacturing exports and apparel exports, the results suggest a statistically significant RER elasticity of 1.50 and 1.56, respectively. The magnitude of the RER elasticity of apparel is much smaller (0.68), although statistically significant at the 5% level. This result is consistent with our prior analysis relating to the impact of the market segmentation effect of MFA quotas. Interestingly, the coefficient of *LRER*MFA* is not statistically significant. This result is consistent with the earlier inference that, as part of the adjustment process in the post-MFA era, the Sri Lankan exporting firms have carved out niches at the upper end of the apparel value chain.

The coefficient of *FIEX* is statically significant at the 1% level in all equations, supporting the hypothesis that FDI played a vital role in the expansion of manufacturing exports. Interestingly, in the equation for textile and apparel, the coefficient of *FIEX* is much larger than that of *RER*. This is consistent with the analytical narrative of the pivotal role played by foreign-invested enterprises in the expansion of Sri Lanka's apparel exports.

The coefficient of the 'world demand' variable is statistically significant with the expected positive sign in all three equations. This result is consistent with the view that world demand is important even for small countries in a context where the ongoing structural shifts in world export demand toward developing countries is not only determined by relative price competition. However, the coefficient of the variable l is much smaller in all equations than that of *RER*. The important inference is that, while world demand shifts toward developing countries play a role, 'international competitiveness,' which captures supply-side developments, is far more important in determining export success.

5 Concluding Remarks

Trade and investment policy reforms initiated in the late 1970s have brought about far-reaching changes in the structure and performance of the Sri Lankan manufacturing sector. The achievements are all the more remarkable when we allow for the fact that the country failed to capture the full benefits of reforms because of the protracted separatist war that damaged the investment climate and undermined macroeconomic stability.

The Sri Lankan experience supports the view that trade-cum-investment policy reforms can set the stage for new exporting firms to emerge. In a global context in which factors of production—capital, technology, and marketing and managerial know-how—are mobile across national boundaries, the nature of the existing manufacturing base is not a prerequisite for export diversification in the ongoing process of economic globalization. Developing human capital and building the country's innovative capabilities should be certainly among the government's long-term policy priorities, but there is no need to wait to achieve these objectives in order to link domestic manufacturing into global production networks. The findings make a strong case for redressing backsliding in policy, continuing the market-oriented reforms agenda that was left incomplete in the late 1990s, and setting up institutional safeguards to avert further backsliding.

The Sri Lankan experience highlights the complementary role of investment liberalization for exploiting the potential gains from trade liberalization: Trade liberalization increased the potential returns to investment by capitalizing on the country's comparative advantage, while liberalization of foreign investments permitted international firms to take advantage of such profit opportunities. There is compelling evidence that the entry of foreign firms is virtually essential for a 'late comer' to export successfully. In addition to foreign-invested enterprises' direct contribution to export expansion, their positive spillovers have contributed to the success of local firms at exporting.

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Part III
Smarter Development for Sustaining Peace

Tourism in Post-conflict Development: Making Use of New Opportunities in Sri Lanka

Jayatilleke S. Bandara

Abstract Developing countries emerging from protracted civil wars and conflicts very often experience post-conflict tourism booms. Sri Lanka is no exception. The end of conflict has offered new opportunities, particularly in the tourism sector. In order to make use of these new opportunities, the previous government launched the "Tourism Development Strategy 2011–2016" by recognizing the key role of tourism that tourism can play in post-conflict development. It has been followed up by the current government of Sri Lanka by launching its own "Sri Lanka Tourism Strategic Plan 2017–2020". The purpose of this chapter is to examine the nature of the post-conflict tourism boom and explore new opportunities that have emerged in terms of creating employment opportunities and reducing regional disparities. Furthermore, the chapter attempts to examine the impact of the tourism boom on the overall economy and to highlight how Sri Lanka has given priority to developing the tourism sector and positioning it as a key growth pillar in the economy. This chapter also demonstrates that tourism is not a "silver bullet" in addressing all economic ills in the Sri Lankan economy, despite the optimism about the development of the tourism sector to create further opportunities. The use of tourism as a tool to stimulate the economy should be synchronized with a raft of other policies such as improved transport infrastructure facilities, sound macroeconomic management, eliminating corruption and inefficiencies in government institutions, and reducing barriers to trade and FDI.

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1 Introduction

It is well documented that protracted conflicts and political violence have detrimental effects on economic growth, particularly within the tourism sector. For this reason, developing countries emerging from protracted wars very often experience post-conflict tourism booms. Sri Lanka is no exception; the end of the conflict offered new opportunities, particularly in the tourism sector. In order to make use of these new opportunities, the then government launched the Tourism Development Strategy 2011–2016 (TDS) to recognize the key role that the sector can play in post-conflict development (Ministry of Economic Development 2011). With the change of government in 2015, it has been followed by the launch of the Sri Lanka Tourism Strategic Plan 2017–2020 (TSP) in order to position tourism as a central pillar of the economy and to support efforts to achieve the United Nation's Sustainable Development Goals (SDGs) on tourism according to the Ministry Of Tourism Development and Christian Religious Affairs (MTDCRA) as stated in 2017. Both governments have seen the potential tourism has to stimulate economic growth. Although the recent tourism boom has provided new opportunities in post-conflict development in Sri Lanka and the government is trying to spread the benefits of the boom to the broader community, particularly in former conflict areas, it has faced challenges and problems.

The purpose of this chapter is to examine whether Sri Lanka's post-conflict experience has been a success in creating new employment opportunities, increasing export earnings, and providing opportunities to bring about ethnic harmony among communities through tourism-related activities. The chapter is structured into seven sections. Section 2 provides a brief overview of tourism in Sri Lanka by highlighting stylized facts. Section 3 focuses on the overall economic impacts of tourism. A descriptive micro-level analysis is undertaken in Sect. 4 to highlight the rise of informal tourism in Sri Lanka. Section 5 examines whether broader communities, particularly those in former conflict-affected areas have benefited from the tourism boom. Section 6 focuses on challenges the Sri Lankan tourism sector is facing at present, while the final section presents policy implications and concluding remarks.

2 Post-conflict Tourism in Sri Lanka: Stylized Facts

Sri Lanka is blessed with an abundance of tourism assets ranging from "sun, sea and sand" to nature and historical heritage. However, over a number of decades, since the early 1980s, tourism has suffered due to internal political conflicts and violence. Following the end of nearly three decades of conflict in May 2009, the country has witnessed a significant rise in international tourist arrivals similar to post-conflict tourism booms experienced by other countries in the region such as Vietnam, Cambodia, and Laos.

International tourists are very sensitive to conflict and violence in destination countries. When peace prevails as in post-conflict Sri Lanka, it is not surprising that the tourism sector experiences a boom. There is a large body of literature on recent trends in tourism in Sri Lanka (see, e.g., Fernando et al. 2013; Institute of Policy Studies of Sri Lanka (IPS) 2017), and we do not intend to repeat the available literature. As shown in Fig. 1, the number of international tourist arrivals increased sharply after 2009, breaking all previous historical annual and monthly figures. The total number of arrivals nearly doubled within two years after the end of conflict and grew by nearly four times within six years. The number of arrivals further increased, reaching 2,116,407 by the end of 2017. Although the annual growth rate in Sri Lanka's tourist arrival figures continuously exceeded the growth rate of global tourist arrivals until 2016 (over 20%), it fell to 3% in 2017 in contrast to a 6.8% global growth rate as well against higher regional growth rates in Asia and the Pacific (8%), Europe (7%), and Africa (6%) (see UNWTO 2018).

Sri Lanka has traditionally depended on sources such as the UK and Germany for tourists (Fig. 2). Until about year 2000, the proportion of arrivals from Western European countries was about two-thirds of total arrivals, while the proportion from Asia, particularly India and China, contributed around 20–30% (IPS 2017, p. 130). This trend has changed over the last 15 years with India becoming the main source, while tourists from China also increasing sharply (see Fig. 2). Rapid economic growth in both India and China, India's proximity close economic relations with Sri Lanka and growing Chinese involvement in Sri Lanka through infrastructure and other development projects have been the main reasons for these changes.

Although the arrival numbers from Europe, particularly from the UK and Germany, have not increased at a similar rate, these still continue to be important in terms of guest nights as shown in Fig. 3. The average duration of a tourist's stay in the country has been around 10 nights, and this has not changed much over the last

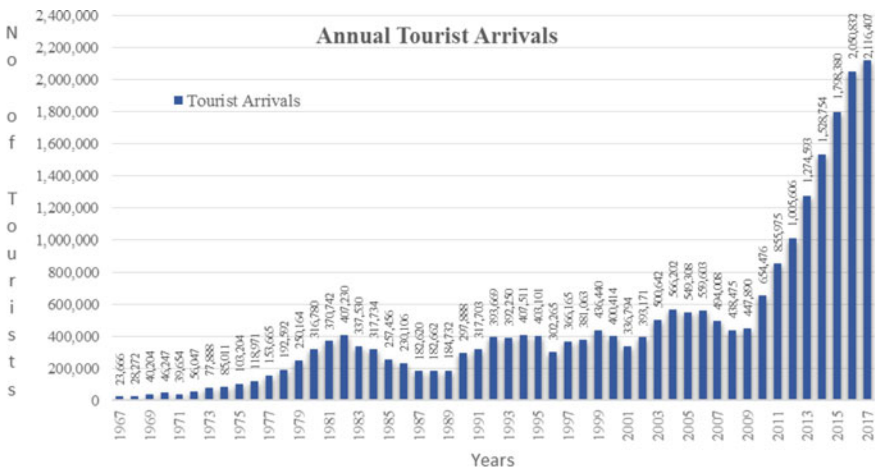

Fig. 1 Targets and Achievements in tourist arrivals of the TDS. *Source* Sri Lanka Tourism Development Authority

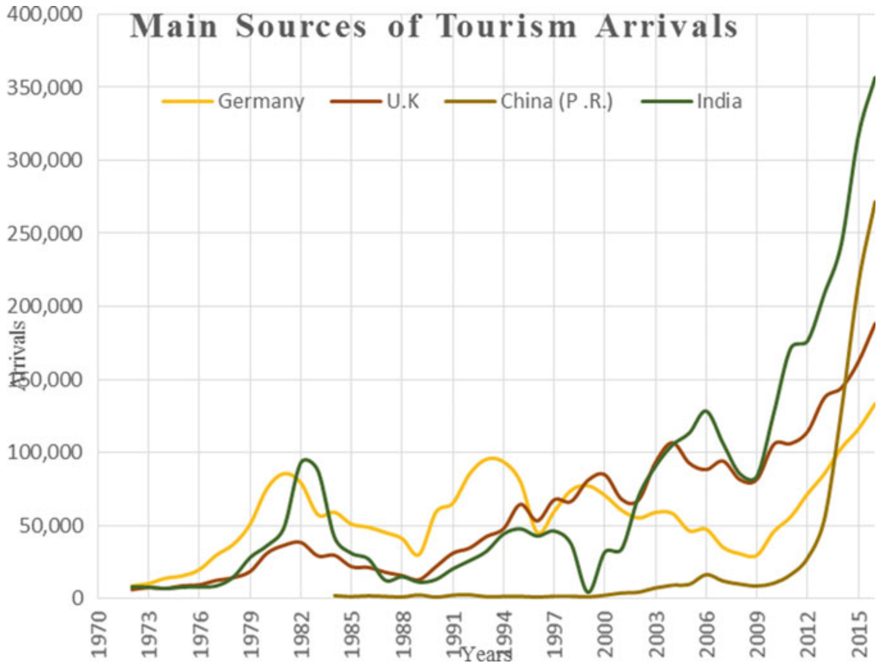

Fig. 2 Main sources of tourist arrivals. *Source* Sri Lanka Tourism Development Authority

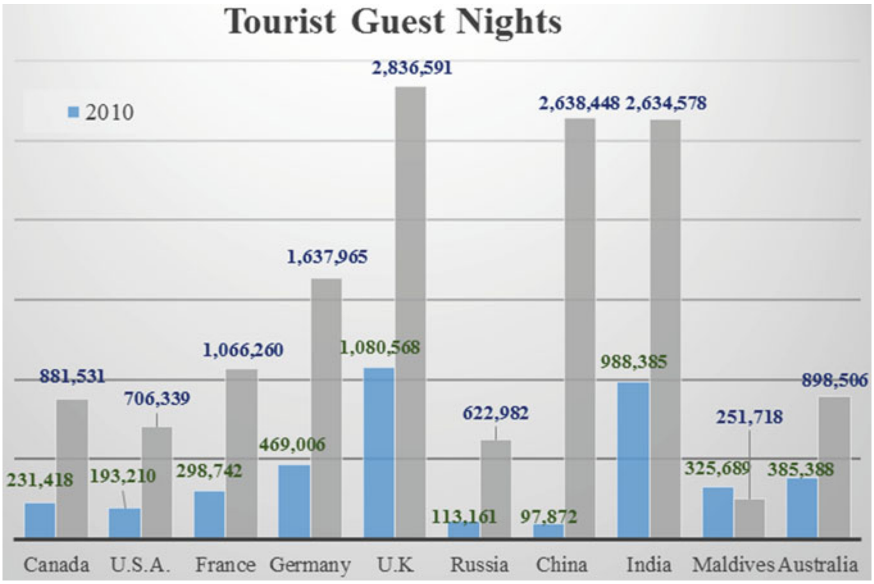

Fig. 3 Tourist guest nights—different sources. *Source* Sri Lanka Tourism Development Authority

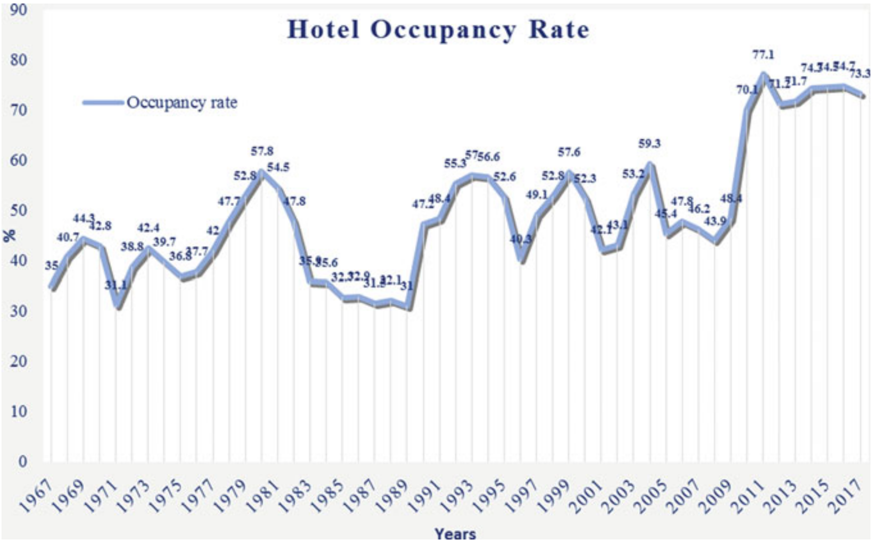

Fig. 4 Hotel occupancy rates 1967–2017. *Source* Sri Lanka Tourism Development Authority

two decades or so according to data published by the SLTDA. Thus, traditional tourism sources are still important to Sri Lanka.

With the post-conflict tourist boom after 2010, the hotel occupancy rate has increased sharply as shown in Fig. 4. During the period of conflict, the occupancy rate fluctuated between 30 and 60% depending on episodes of violence; during the last stages of the conflict, the occupancy rate was below 50%. During the period of post-conflict, the rate increased immediately to over 70% and reached a peak level of nearly 75% in 2016 (Fig. 4).

The number of total employees in the tourism sector, including direct and indirect employment, increased sharply after 2009 (Fig. 5). Foreign exchange earnings from tourism also increased significantly after the end of conflict (Fig. 6). Earnings increased from USD 0.6 billion in 2010 to USD 3.9 billion in 2017. Overall, tourism has become the third biggest foreign exchange earner for Sri Lanka, after migrant remittances and garment exports.

With the growth in the tourism sector after the end of conflict, foreign direct investment (FDI) into the hotel industry has also increased rapidly (Fig. 7). FDI in this sector was around USD 6 million in 2010, but it increased to USD 216 million by 2011. Although FDI declined after 2011, it picked up again in 2015 (USD 182 million).

The above-stylized facts demonstrate that the Sri Lankan economy is currently experiencing a tourism boom. This is evidenced by a record-breaking number of international tourist arrivals, foreign exchange earnings, employment generation, and investment in the tourism sector. However, as correctly identified in its TSP 2017–2020, growth in the sector "has taken place predominantly organically, without a definite vision and without coordinated planning" (MTDCRA 2017, p. 3). The TSP

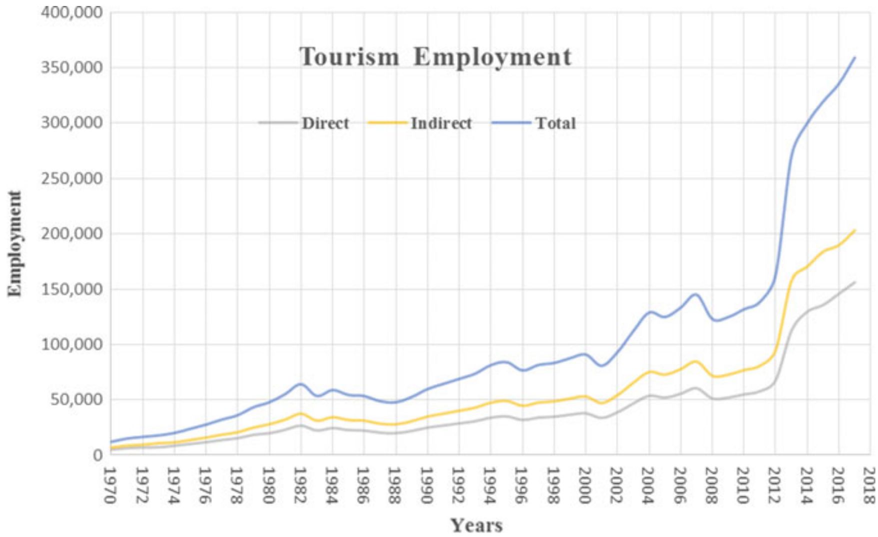

Fig. 5 Tourism boom and employment generation. *Source* Sri Lanka Tourism Development Authority

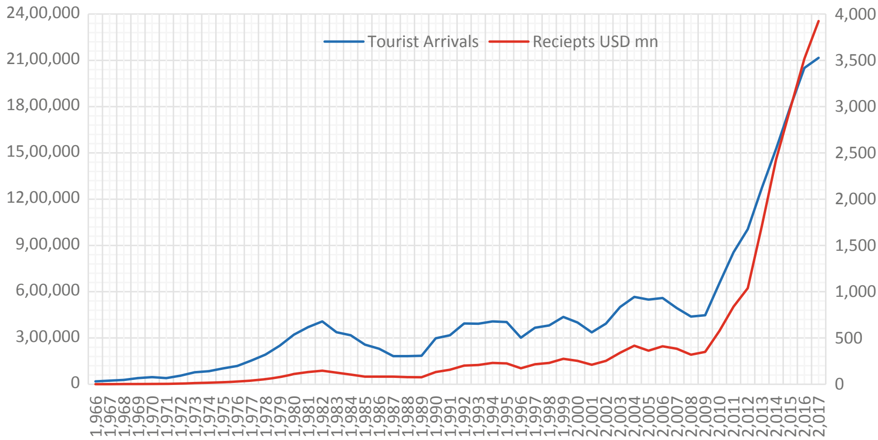

Fig. 6 Foreign exchange earnings from international tourism. *Source* Sri Lanka Tourism Development Authority

further states that Sri Lanka's current tourism sector "lies along the continuum from exploration to development, depending on the destination" by using Butler's (1980) concept of tourism life cycle (Fig. 8). The government has identified that the tourism sector "has not fully captured its true potential and thus has not reaped the expected benefits" (MTDCRA 2017, p. 4). That is why the current government is labelling tourism in Sri Lanka as "A Story of Untapped Potential" in its TSP (MTDCRA 2017).

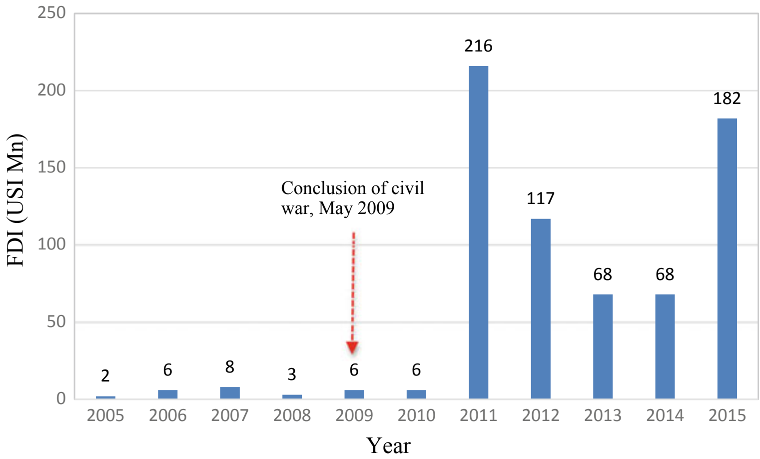

Fig. 7 Post-conflict FDI in Sri Lanka's hotel industry. *Source* Adapted from Sirisena (2016)

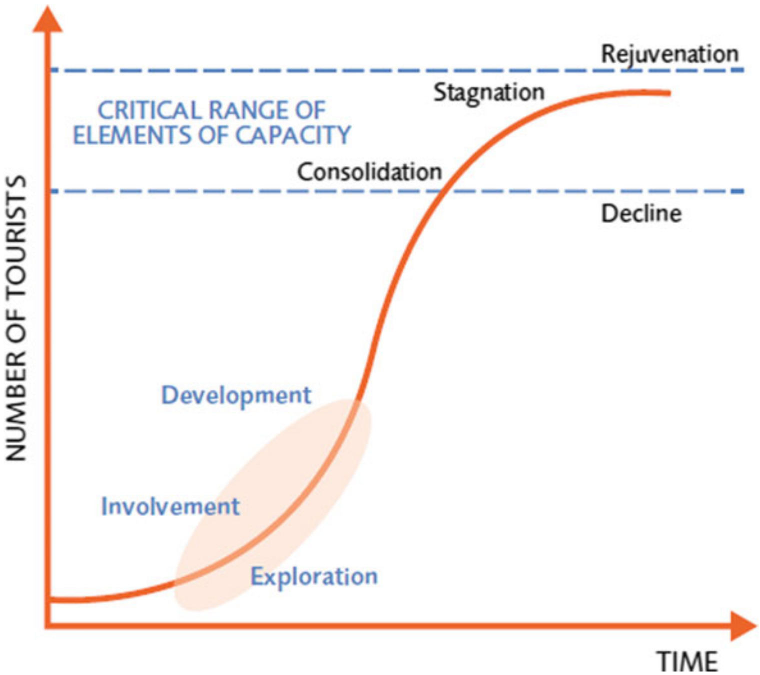

Fig. 8 Sri Lanka's tourism life cycle. *Source* Bulter (1980) and adapted from TSP (MTDCRA 2017)

3 Economy-Wide Impacts of the Tourism Boom on the Sri Lankan Economy

Stylized facts on the post-conflict tourism boom shown in the previous section demonstrate that it has contributed significantly to the economy as expected in any country recovering from a decades-long conflict. In this section, the impact of the tourism boom in detail is examined further, using an economy-wide framework.

In comparison with other industries in an economy, tourism is not a single industry but it is a composite commodity which is an aggregation of tourism-related products and services such as food, accommodation, air, rail and road transport, trade, and other services (Smith 1989). Therefore, it is difficult to analyse the impact of tourism on the rest of the economy by considering tourism as a single output produced in an economy, and examining the relationship between tourism and other sectors of an economy is complex (Fletcher 1989).

The main contribution of tourism is invisible foreign exchange earnings generated by international tourism expenditure (Archer 1982). Similar to many forms of visible foreign exchange earnings through exports of commodities, invisible foreign exchange earnings generated by international tourists in a destination country lead to a creation of employment opportunities and an increase in household income, incomes of owners of tourism-related business activities, and government revenue through taxation on tourism-related activities (Stynes 1997). This process creates multiplier effects on an economy. As well established in the literature, the multiplier effects of international tourism expenditure can be identified under direct or initial effects, production-induced effects, and consumption-induced effects.

The initial effects on output, income, and employment as a result of purchasing goods and services directly related to tourism such as accommodation, travelling, and entertainments by international visitors in an economy can be considered as the direct effects of tourism expenditure. These initial increases in demand for goods and services through tourism expenditure create flow-on effects on other sectors of the economy through "linkages" since tourism-related goods and services sectors need to purchase goods and services from other sectors as inputs to increase their output levels. This process stimulates other sectors which provide inputs to tourism-related sectors. Output, income, and employment of these other sectors may increase as a result of the first round, the second-round, the third-round effects, etc. The sum of the effects of all these different rounds is known as production-induced multiplier effects. Households' income increases as a result of both direct and production-induced effects of tourism expenditure through the expansion of the economy. Therefore, household demands for consumption of goods and services increase in an economy. An extra increase in household demand generates further increase in production of goods and services and creates new employment opportunities. These effects are known as consumption-induced effects.

The total effects of tourism expenditure on an economy in terms of direct, production-induced, and consumption-induced effects are summarized in Fig. 9

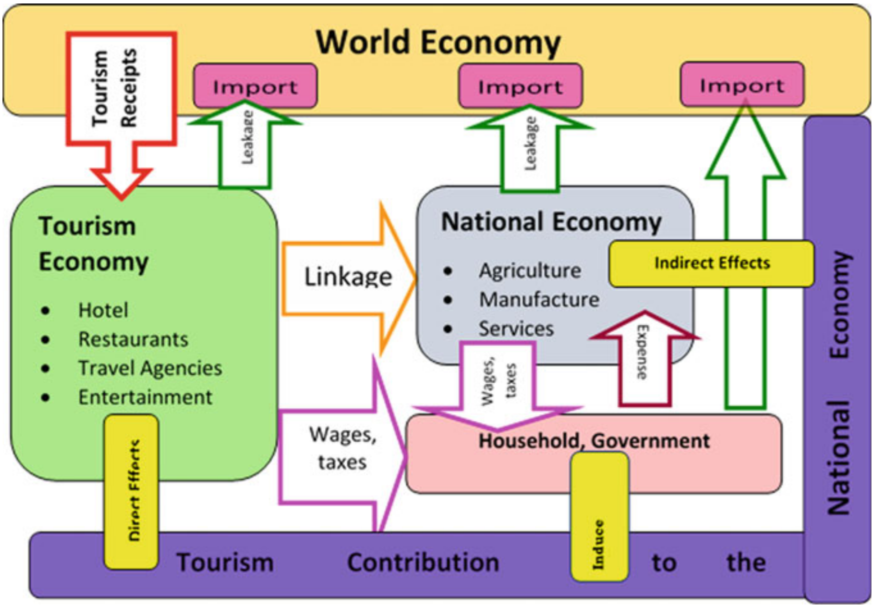

Fig. 9 Flow of international tourism receipts into the economy. *Source* Adapted from Fernando (2015)

following Fernando (2015). As illustrated in Fig. 9, all expenditures incurred by international visitors in terms of injection of invisible foreign exchange do not remain in a domestic economy because some tourism-related industries use imported inputs to produce goods and services as well as households, business owners, and government use additional income generated from tourism to purchase imported goods and service. Therefore, a portion of initial injection of foreign exchange through international tourism expenditure flows back to the rest of the world in terms of expenditure on imports. The magnitude of this portion of expenditure depends on the nature of the production structure and consumption patterns in an economy. Overall, the contribution of tourism directly and indirectly is significant even after considering leakages of foreign exchange in terms of imports resulting from a tourism-led stimulation to an economy.

The above-mentioned direct, production-induced, and consumption-induced effects of tourism expenditure can be captured in practice by using simple output and employment multipliers related to the hotel and restaurant sector. These effects have been calculated by using an input-output table for Sri Lanka (Bandara 2015). In this study, the above-mentioned three types of effects have been identified using an example of Rs. 1 million worth of expenditure on the hotel and restaurant sector in the economy. The results have been summarized in Table 1.

As summarized in Table 1, the total output multiplier in the hotel and restaurant sector is around 2.192, indicating that any increase in demand for the sector by Rs. 1 million creates Rs. 2.2 million worth of output in the whole economy. Similarly,

Table 1 Hotel and restaurant sector multipliers

	Initial effects	First-round effects	Industry support effects	Production-induced effects	Consumption-induced effects	Total multiplier
Output	1.000	0.423	0.166	0.589	0.603	2.192
Employment	4.550	0.854	0.297	1.151	0.918	6.620

Source Bandara (2015)

any increase in Rs. 1 million worth of demand for the sector creates 6.6 employment opportunities. Output and employment multipliers in tourism-related sectors are relatively high since their backward and forward linkages with the rest of the economy are very strong (Bandara 2015).

Following a similar framework, the World Travel and Tourism Council (WTTC) has developed an economy-wide approach to calculate the total contribution of tourism to GDP, foreign exchange earnings, and total employment in an economy (both directly and indirectly). According to WTTC (2017, 2018) and, as summarized in Table 2, while the direct contribution of the tourism and travel sector was about 5.3% of GDP in 2017 with this predicted to increase up to 5.7% by 2028, the total contribution (both direct and indirect) to GDP was about 11.6% of GDP in 2017. This is predicted to increase up to 12.3% by 2028. Similarly, the total direct employment in the sector was around 404,000 (5.1% of total employment), and total employment (direct and indirect) was around 875,000 (11.0% of total employment) in 2017. Total employment due to an expansion in tourism is predicted to increase up to 898,000 and 1,037,000 (12.8% of total employment) by 2028. Total foreign exchange earnings from tourism were around USD 4.7 billion (25.3% of total export earnings) with this predicted to increase up to USD 9.4 billion (30.2% of total export earnings) by 2028. It is important to note here that the WTTC estimations on employment and export earnings are much higher than figures given in the SLTDA and TSP. It is mainly because the WTTC is using a standardized method to make projections for many countries, which is different from that of the SLTDA.

Table 2 Overall contribution of tourism and travel to GDP, employment, and export earnings

Variable	2010	2017	2018 (estimates)	2028 (projections)
GDP Direct contribution Total contribution	2.8% n.a.	5.3% 11.6%	5.3% 11.7%	5.7% 12.3%
Employment Direct contribution Total contribution	180,000 (2.4%) n.a.	404,000 (5.1%) 875,000 (11.0%)	419,500 (5.3%) 898,000 (11.3%)	522,000 1,037,000 (12.8%)
Export **ear**nings (USD billion)		4.7		9.4

Source WTTC (2017, 2018)

When considering the impact of a tourism boom on the economy, it is important to consider the possible “Dutch Disease” type effects. The post-conflict Sri Lankan economy has already been subjected to the Dutch Disease effects of a large inflow of migrant remittances and foreign capital related to a construction boom. As a result, there has been an appreciation of the real exchange rate, with the tradeable sector, particularly the manufacturing sector, being indirectly affected (Athukorala et al. 2017). A tourism boom can further aggravate this. For instance, Afandiyev (2013) has shown that countries that depend heavily on tourism such as Spain have suffered from Dutch Disease type effects.

The well-known Dutch Disease model demonstrates the effects of a booming sector on an economy in terms of the resource movement effect and the spending effect. A booming sector causes an increase in demand for labour; an increase in wages in the sector in turn attracts labour from non-booming sectors, particularly from tradeable sectors. This is the resource movement effect. In addition, the booming sector raises income and creates a spending effect. Overall, the real exchange rate appreciates as a result of the booming sector, while the tradeable sectors contract, sometime causing a process of de-industrialization.[1]

Using a computable general equilibrium (CGE) model focusing on tourism in the Sri Lankan economy, Fernando (2015) has examined the possible Dutch Disease effects of the post-conflict tourism boom, under two policy scenarios.[2] In order to understand the impact of a tourism boom, the results from Fernando (2015) are summarized in this section. In his study, two policy simulations have been carried out with a CGE model using following two scenarios.

- BASE scenario—under this scenario a simulation has been carried out using normal growth of tourism without the tourism boom in order to capture the “business as usual” condition.
- BOOM scenario—in order to capture the impact of the tourism boom another simulation has been carried out using a high growth of tourism.

In order to evaluate the impact of the tourism boom on the Sri Lankan economy, the results of two simulations have been compared in this study.[3]

Fernando (2015) has used definitions and categorizations of industries employed in other recent studies to present and evaluate the results of his study (e.g. Dwyer et al. 2014; Pham et al. 2015; Wattanakuljarus and Coxhead 2008). As categorized by Wattanakuljarus and Coxhead (2008), Fernando (2015) has presented the results of his study using three main categories of industries, namely export-oriented industries (EOI), import-substituting industries (ISI), and domestic-oriented industries (DOI). Export earning of industries in the first category is greater than

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[1]See Corden and Neary (1982) and Corden (1984) for the details on the theoretical literature on the Dutch Disease and Bandara (1989) for the way in which CGE models can be used to analyse the Dutch Disease effects of a booming sector in an economy.

[2]See Fernando (2015) for details on the CGE model developed to capture Dutch Disease impacts of the tourism boom in post-conflict Sri Lanka.

[3]For detailed macro and sectoral results see Fernando (2015).

Table 3 Sectoral effects on trade aggregation: BASE scenario and tourism boom scenario simulations

Sectors	Total outputs		Employment	
	BASE	Boom	BASE	Boom
Export-oriented industries (EOI)	−0.0691	−0.1724	−0.1386	−0.347
Import-substitute industries (ISI)	−0.0046	−0.0117	−0.0515	−0.1309
Domestic-oriented industries (DOI)	0.0466	0.1193	0.2757	0.6626

Source Fernando (2015)

30% of their total sales' revenue. Industries in the second category have imports greater than 60% of total domestic demand. Industries in the last category are nondurables.

The results shown in Table 3 illustrate that non-tradable sectors, mainly trade and services sectors, in the third category are projected to expand as a result of the tourism boom. This category of industries is directly benefited from an increase in tourist arrivals mainly because non-tradeable sectors such as hotels and restaurants, trade, and transport are directly related to tourism. As a result of the expansion of these sectors, employment in these sectors is projected to increase.

While non-tradeable sectors in the economy are projected to expand as a result of the tourism boom, industries in the first and second categories (EOIs and ISIs) are projected to contract as shown in Table 3. This is mainly due to the appreciation of the real exchange rate (the ratio of domestic prices to international prices), and labour is free to mover between sectors according to the model specification. As a result of the expected contraction of the output of EOIs, manufacturing exports are projected to fall. The output levels of ISI industries are also projected to fall because of the appreciation of the real exchange rate. These results may lead to the Dutch Disease effects. Therefore, it is important to focus on the overall macroeconomic impacts of a tourism boom in terms of the Dutch Disease effects, while focusing on positioning tourism as a main pillar of economic growth.

4 New Opportunities and the Rise in the Informal Sector

Sri Lanka's post-conflict tourism boom generated rapid demand for accommodation and other tourism-related activities, leading to a rise in the number of established accommodation units and room availability (Table 4). The number of graded hotels increased from 242 in 2009 with 14,461 rooms to 382 in 2016 with 22,336 rooms; the number of supplementary units registered with the SLTDA increased from 629 with 5,946 rooms in 2009 to 1,558 units with 11,535 rooms in 2016. The total number of rooms in both sectors increased from 20,407 in 2009 to 33,871 in 2016. The total number of available rooms in the formal sector had further increased to 36,133 by end March 2018.

Table 4 Accommodation capacity and guest nights 2009–2016

Accommodation capacity and guest nights		2009	2010	2011	2012	2013	2014	2015	2016
Tourist hotels	Units	242	253	252	269	304	334	354	382
	Rooms	14,461	14,714	14,653	15,510	16,655	18,078	19,376	22,336
	Beds	28,344	28,978	28,844	30,399	34,840	36,883	38,370	46,414
Supplementary establishments	Units	629	530	654	930	1,021	1,265	1,409	1,558
	Rooms	5,946	5,895	6,141	8,207	8,513	9,916	10,702	11,535
	Beds	11,654	11,210	11,601	13,347	16,105	18,340	20,211	23,970
Tourist nights (Foreign)	Tourist Hotels	2,818,487	4,126,544	5,011,480	5,038,066	6,969,239	7,982,110	8,945,380	10,595,118
	Supplementary	779,317	1,249,146	2,241,407	2,372,266	2,728,607	3,596,548	4,349,313	5,404,602
	Others	477,995	1,169,070	1,306,863	2,645,718	1,211,204	3,540,157	4,868,945	4,918,766
Tourist nights (Local)	Tourist Hotels	1,163,220	1,464,098	1,607,393	1,457,063	1,439,483	2,072,886	1,588,223	1,727,292
	Supplementary	471,730	425,350	574,958	682,374	639,275	512,017	636,644	812,188

Source SLTDA

Table 5 Listed Sri Lankan properties on "https://www.booking.com"

Type	Mid-2016	Mid-2018
Hotels	1,269	2,574
Guest houses	1,240	3,077
Bed and breakfast (BB)	530	980
Homestays	494	1,467
Villas	433	1,095
Resorts	418	715
Apartments	354	925
Vacation homes	319	570
Inns	104	–
Lodges	98	243
Hostels	91	314
Chalets	50	78
Country houses	41	97
Camp grounds	41	132
Resort villages	17	–
Luxury tents	12	–
Motels	5	12
Farm stays	5	18
Boats	2	–
Capsule hotels	1	
Economy hotels	–	28
Total	5,524	12,325

Source https://www.booking.com and Porras (2016)

However, Table 5 does not include supplementary accommodation units not registered with SLTDA or other accommodation facilities in the informal sector. The role of the informal sector in Sri Lankan tourism has become significant with the emergence of "Airbnb" tourism and online travel operators (OLOs) such as Booking.com, Trip Advisor, and Agoda. These developments in online booking and technology provided new opportunities in the informal sector in Sri Lanka's post-conflict tourism boom.

In examining the role of the informal sector, it is important to identify the difference between formal and informal sectors in Sri Lanka. The formal tourism sector includes graded establishments (conventional star class hotels and boutique hotels) and supplementary establishments (small guest houses and homestay units) registered with the SLTDA. The informal sector includes supplementary accommodations not registered with SLTDA such as unregistered guest houses, holiday bungalows, rest houses, rental apartments, and homestays (popularly known as "Mom and Pop" BB). These establishments are operated completely outside the formal sector regulated by SLTDA (Porras 2016; Miththapala and Tam 2017). As stated in Sri Lanka: State of the Economy 2017 "although it is difficult to determine the size of this sector, it is safe to state that this proportion is escalating" (Institute of Policy Studies of Sri Lanka 2018,

p. 143). As reported in Miththapala and Tam (2017), over 50% of all international arrivals to Sri Lanka are staying in the informal sector.

Other evidence suggests that entities such as Airbnb which started its operation in Sri Lanka in 2011 with 10,080 booking have seen a rapid increase in numbers to 126,000 in 2016.[4] The growth is argued to be "because tourists increasingly want new, adventurous, and local experiences when they travel". While these developments have provided new income-generating opportunities in the informal sector, it is not clear that the benefits of tourism have trickled into broader communities. In particular, whether communities in the former conflict areas are benefiting from the tourism boom in a significant manner or not is yet to be proved.

Another way of looking at the significance of the informal tourism sector in Sri Lanka is to assess listed properties using a popular online travel operator (OTO) such as Booking.com. These listings include both formal (the SLTDA approved accommodation facilities) and informal (not registered with the SLTDA) sectors. The growth in listed properties since mid-2016 and mid-2018 clearly demonstrates that all informal sector accommodation units have seen very high growth rates (Table 5). Many of these units are available in traditional tourism clusters and corridors in the south of Sri Lanka, in the cultural triangle and hill country.

Miththapala and Tam (2017) have carried out a study on accommodation providers in Sigiriya, Habarana, and Dambulla (cultural triangle) using the listings on "Agoda". According to their findings, the number of the SLTDA approved providers (listed on Agoda) ranges from 11.5 to 17% of total providers in the three locations; only 68 out of 463 providers (14.7%) listed on Agoda in the three areas are approved by the SLTDA. In other words, around 85% of providers in the three locations are operating in the informal sector. It shows how significant the informal sector is even in a traditional tourism area. Although there is a rapid rise in the informal sector, some have raised concerns over government policies that may confer an advantage to big tourism operators and developers in the formal sector, at the expense of small providers in the informal sector (Buultjens et al. 2016).

5 Has the Broader Community in Conflict Areas Benefited from the Post-conflict Tourism Boom?

One of the main objectives of the government's TDS and TSP was to pass on the benefits of the tourism boom to the broader communities and promote inclusive economic growth through tourism. This leads to the question of whether Sri Lanka been successful in achieving this objective?

As has been correctly identified in the TSP, at present, tourist visitors and major investments are concentrated in clusters and corridors around Colombo as a

[4]see http://www.sundaytimes.lk/170507/business-times/airbnb-bookings-saw-126000-stay-in-homestay-segment-in-sri-lanka-239085.html).

Table 6 Regional distribution of hotel rooms and tourist guest nights

Regions	Hotel rooms			Tourist guest nights		
	2010	2016	Change %	2010	2016	Change %
Colombo city	3,141	4,319	38	1,089,205	2,212,592	103
Greater colombo	2,640	3,184	21	938,555	1,559,869	66
South coast	5,099	8,437	65	1,231,932	4,024,155	227
East coast	258	1,121	334	54,786	427,136	680
High country	847	1,178	39	153,710	524,817	241
Ancient cities	2,749	3,990	45	676,356	1,821,096	169
North region	0	107		0	25,253	

Source Sri Lanka Tourism Development Authority

commercial hub, the beaches of the south coast, the Yala National Park, the tea estates and forests of the hill country, and the historical and religious heritage of the cultural triangle (MTDCRA 2017, p. 5). While the corridor of the Eastern beach has become increasingly popular among tourists, the "potential economic benefits are only trickling to other areas of the country, which have untapped tourism assets" (MTDCRA 2017, p. 5).

Although a rapid increase in hotel rooms and tourist nights can be seen in the Northern region and in the Eastern coast, the percentages of rooms and tourist nights are relatively low compared with other regions (Table 6). As noted in the previous section, the rise of the informal sector has provided new opportunities for the broader community in terms of employment and income generation. Considering the district-wise distributions of the SLTDA approved and "Booking.com" listed properties, it is clear that even though there has been rapid rise in the informal sector in traditional tourism districts in Sri Lanka, the number of tourist accommodation units in the former conflict areas has remained relatively small (Fig. 10). The number of providers in districts such as Killinochchi, Mannar, Mullaitivu, and Vavuniya is negligible. It indicates that a large part of conflict areas is yet to benefit from new opportunities provided by the recent tourism boom, except along the Eastern coast.

6 Challenges in Using New Opportunities Provided by the Post-conflict Tourism Boom

While attempting to make best use of the untapped tourism potential in Sri Lanka, the TSP also identifies four systemic failures, namely coordination failures, institutional failures, resource failures, and market failures. Coordination failures include poor coordination and communication between government ministries, tourism-related institutions, and stakeholders in relation to planning, management, and monitoring. Institutional failures include deficient and politicized leadership and management at all levels of government, lack of awareness and participation in

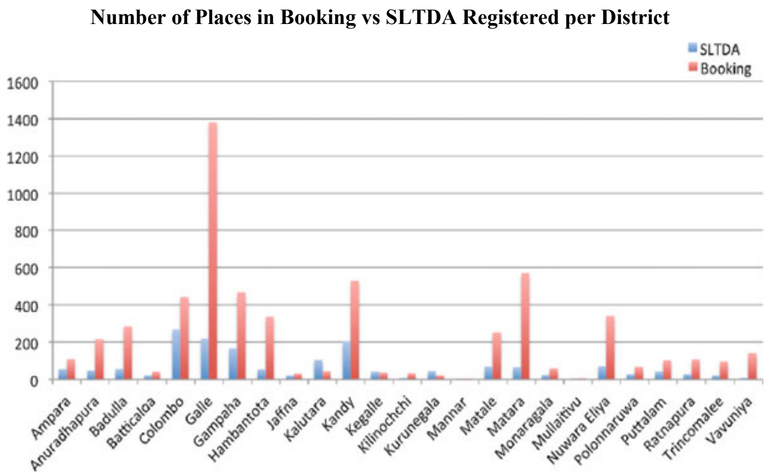

Fig. 10 Number of places in booking versus SLTDA registered per district. *Source* Adapted from Porras (2016)

tourism by local communities, and inadequate attention to cultural heritage and natural habitat preservation. Resource failures include limited emphasis on human capital development in both public and private sectors, lack of comprehensive data collection and research, and lack of access to investment and finance, particularly related to SMEs and women. Market failures include limited attention paid to product differentiation and destination development, and lack of effective mechanism to manage, standardize and enforce best practices and market distortions (MTDCRA 2017).

By formulating strategies to address the above failures, the government has set some ambitious targets to be achieved by 2020 such as increasing international annual tourist arrivals to 4 million, generating 600,000 direct and indirect employment opportunities with women accounting for 10% of the workforce, increasing foreign exchange earnings, and increasing daily spending per visitor to USD 210 from USD 164 in 2015. Within the context of the above-mentioned systemic failures and ambitious targets, we briefly highlight the challenges faced by the Sri Lankan tourism sector.

6.1 Problems with Governance, Coordination, and Regulation

As identified by the TSP, the main problem with the institutional framework responsible for tourism is its fragmented nature. There are four separate institutions responsible for different aspects of tourism under the MTDCRA: the Sri Lankan Tourism Development Authority (SLTDA), Sri Lanka Tourism Promotion Bureau

(SLTPB), Sri Lanka Convention Bureau (SLCB), and Sri Lanka Institute of Tourism and Hotel Management (SLTHM).

The multiplicity of government agencies and lack of coordination, consultation, and corporation have made decision-making and implementation of polices-related tourism difficult. In addition, there has been further fragmentation between different levels of governments ranging from national and provincial levels to the local level. The core strategies formulated in the TSP to address these problems include revitalizing key institutions, improving relationships, communication, and coordination between different institutions, reforming core legislation and regulations, and enabling business and investment. Implementation of these strategies will continue to be a major challenge.

6.2 Insufficient Information and Research on Tourism

In order to understand the determinants of tourism demand from different source countries, identifying the characteristics of tourists from different sources, supply-side constraints, formulating evidence-based tourism policies and plans, formulating effective marketing strategies, and developing niche markets, as well as maintaining a good database for tourism forecasting and economy-wide modelling is important. Although the SLTDA maintains good database on different areas such as arrivals, foreign exchange earnings, accommodation, and employment, it is necessary to have a reliable and detailed database for forecasting and tourism modelling for policy formulation and conducting economic impact studies.

The TSP has clearly identified the need to collect reliable data from international and domestic tourists to estimate and forecast tourism revenues and jobs and the need for a compilation of a Tourism Satellite Account (TSA) which can be used to estimate more accurately the contribution of the tourism sector to the Sri Lankan economy in terms of GDP, earnings from international and domestic tourists and employment generation (MTDCRA 2017). Many other developed and developing countries which are heavily tourism dependent have TSAs and tourism focused CGE models. But compiling a TSA for Sri Lanka has been a major challenge for the SLTDA and the Department of Census and Statistics (DCS) despite ongoing efforts.

6.3 Lack of Systematic Planning and Tourism Modelling

Weaknesses in proper planning and analytical tools can give rise to misleading projections. For example, targets for tourist arrivals in the TDS have fallen short (Fig. 11). Actual tourist arrivals exceeded the expected targets for the first four years of the strategy (2011–2014); however, Sri Lanka failed to achieve the 2.5 million visitor target set for end 2016. This was mainly because the targets for 2015 and 2016 were based on the assumption that hotel accommodation capacity would increase in 2015

Fig. 11 Targets and achievements in tourist arrivals of the TDS. *Source* Fernando (2016, 2017) and Ministry of Economic Development (2011)

and 2016 without looking at the demand side of tourist arrivals and not using proper forecasting techniques in setting targets by planners (Smith et al. 2014).

Recently, there have been some attempts to use simple modelling techniques to forecast tourist arrivals and employment generations based on forecasted arrivals. For example, Embuldeniya (2016, 2017) carried out two modelling exercises to forecast tourist arrivals and employment generation for the period 2016–2020. In the 2016 study, it was predicted that the number of arrivals to Sri Lanka would be 4 million by the year 2020. However, it is unlikely that Sri Lanka can achieve that number by 2020 considering the actual number of arrivals in 2017 (2.1 million) is below the predicted figure for 2017 (2.8 million). Revised forecasts by Embuldeniya (2017)—by using actual arrival figures between 2008 and 2016—predicted the number of arrivals to be 3.9 million by 2020, but this too is unlikely to be achieved.

6.4 Shortage of a Skilled Labour Force

The TDS has identified two types of human resource gaps, gaps in the accommodation industry and gaps in related services. Many trained skilled workers in both types of activities have migrated permanently or temporarily during the conflict and after. The current number of trainees is not sufficient to fill vacancies created by the tourism boom.

Sri Lanka's hospitality-related education and training facilities are not sufficient to train a large numbers of workers or to train workers at the level needed to compete effectively in the high-end tourism sector. The Tourism Skills Committee (TSC) which is an informal association of private sector leaders has prepared a roadmap to address the shortages with the support of related agencies. According to the roadmap, an estimated 25,000–30,000 additional employees will be required each year to provide services to the projected tourist arrivals, the increase in additional rooms (up to 20,720 by 2020) and replace those who are leaving or retiring (the Private Sector Tourism Skills Committee, 2018—based on the SLTDA). Currently, private and government institutions are able to offer only about 10,000 training places annually. Therefore, the TSC has emphasized that the current system does not train sufficient number of people to meet the demand for skilled labour in the tourism sector, and it requests all stakeholders engage in an urgent and concerted effort to solve a possible crisis.

6.5 Attracting High End of Tourists

Although Sri Lanka plans to move away from low-cost tourism and focus on high-end tourism, attracting quality tourists has been a main issue. There have been growing numbers of South Asian tourists and members of Sri Lankan diaspora compared with tourists from Western countries. According to the SLTDA annual statistical reports, the proportion of arrivals under the category of visiting friends and relatives (VFRs) of the total international arrivals was only 5% in 2008. However, it had increased up to 26.3% in 2015. The VFRs category is still high, and many of these visitors are not staying in hotels. Some argue that they are not "real tourists", and they are just visiting family members and staying with them (Miththapala and Tam 2017).

As noted before, India and China have become the two main sources of tourist arrivals to Sri Lanka over the last decade. Some observers believe that this is not a good trend in terms of the per capita tourist expenditure and number of tourist nights. In particular, Indian and Chinese tourists tend to stay a lesser number of days in Sri Lanka relative to western tourists. For example, the average duration of stay of Indian tourists was the lowest (5.8 days) in comparison with the average duration of stay of western tourists (14.3 days) in 2015. Even the average number of days stayed by Chinese tourists was relatively low (9.8 days in 2015).

As identified in TSP, little attention has been paid to product diversification and destination development. As such, there is an opportunity to develop a niche market focusing on a number of areas such as health and well-being, pilgrimages, bird watching, whale and dolphin watching, surfing and kite surfing, scuba and wreck diving, and weddings. Although Sri Lanka is an island, it is yet to promote and accommodate significant overseas tourist arrivals by sea. Tapping into sea travellers (such as the cruise ship market) is at embryonic state. As emphasized by the IPS (2017, p. 139), "authorities are often misled by tourism marketing strategies which usually focus on developing a tourist theme, slogan or logo rather than a strategy for the entire country". Therefore, attracting high-end tourists has been a challenge.

7 Concluding Remarks

In this chapter, the nature of the post-conflict tourism boom and new opportunities that have emerged were explored. The analysis also examined the impact of the tourism boom on the overall economy. As highlighted in the chapter, Sri Lanka has given priority to developing the tourism sector and positioning it as a key growth pillar in the economy. The government itself has identified four types of failures in the current tourism strategy, and it has prepared a vision and strategic plan to rectify those failures and identified future challenges which the sector is facing.

Despite the optimism about the development of the tourism sector to create further opportunities, tourism is not a "silver bullet" in addressing all economic ills in the Sri Lankan economy. The use of tourism as a tool to stimulate the economy should be synchronized with a raft of other policies such as improved transport infrastructure facilities, sound macroeconomic management, eliminating corruption and inefficiencies in government institutions, and reducing barriers to trade and FDI.

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Economic Transformations for Better Lives Through Better Jobs

Nisha Arunatilake

Abstract Until May 2009, Sri Lanka was troubled by a violent separatist conflict, which resulted in widespread damage to human lives, communities, and property. Soon after the ending of the conflict, the government spearheaded a development program in the conflict-affected regions to revive its war-ravaged economies. The development programs aimed to rebuild and modernize damaged or destroyed social and economic infrastructure and facilitate livelihood activities and employment creation to uplift the living standards of people. This chapter examines the success of different strategies adopted by Sri Lanka to improve the labor markets in the aftermath of the war in the conflict-affected provinces. The analysis shows that the development programs have stimulated growth and reduced poverty. However, this was mainly done through the improvement of livelihood activities in the two selected provinces, namely Northern Province (NP) and the Eastern Province (EP). But, labor force participation rates (LFPRs) and employment-to-population ratios remain low in the conflict-affected regions, indicating low job creation and possible labor market imbalances. Further, the analysis shows that the economies of the conflict-affected provinces are not mature enough for the creation of professional and semi-professional jobs. The slow growth of the overall economy, muted attention given to the social sector developments, and unstable macro- and political developments in the country would have contributed to the slow recovery.

1 Introduction

It is often argued that providing access to productive well-paid jobs is the best means of improving the living standards of individuals, while stimulating growth. But, recent literature challenges this premise. According to this new thinking, national and global economic contexts, as well as the performance of different sectors, also influence the impact of employment on poverty and economic growth

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(Holmes et al. 2010). Further, the distribution of employment and the nature of employment created (i.e., wage, duration, and social security coverage) as well as the macro-environment play a critical role in determining to what extent employment affects the lives of people.

Until May 2009, Sri Lanka was troubled by a violent separatist conflict, which resulted in widespread damage to human lives, communities, and property. Soon after the ending of the conflict, the government spearheaded a development program in conflict-affected regions to revive their war-ravaged economies. The government's recovery programs aimed to bring prosperity to the war-affected people, both to improve their lives and to sustain peace. In the immediate aftermath of the ending of the conflict, the focus was on resettling the war-affected population rapidly and safely. Subsequently, the development programs shifted focus to rebuilding and modernizing damaged or destroyed social and economic infrastructure, and facilitating livelihood activities and employment creation to uplift the living standards of the people.

Creating productive employment is difficult in states that are coming out of conflict for several reasons (McLeod and Dávalos 2008; Iyer and Santos 2012). Lack of security for people and property makes returns to investments low and uncertain. Damaged or destroyed infrastructure makes access to markets difficult. Lastly, unstable business environments due to political uncertainties deter businesses from investing in post-conflict societies. Most countries recovering from a conflict have to rely on donor funding to finance development efforts, as the conflicts often leave countries with limited financial resources.

The above-mentioned challenges were especially grim for Sri Lanka, which came out of the separatist conflict in 2009, when the outlook for the world economy was uncertain in the aftermath of the global financial crisis that started in 2007/2008. Despite the global economic downturn, Sri Lanka's economic growth was robust in 2008 at 6%, only marginally lower than its 2007 value of 6.8% (Institute of Policy Studies of Sri Lanka (IPS) 2009). However, maintaining macro-stability amidst a growing external debt and rising inflation was concerning the policy makers (IPS 2009). In addition, the global economic prospects for the next few years were not promising, implying an unfavorable economic outlook for Sri Lanka, a small open market economy. With already high levels of external debt and poor revenue collection, Sri Lanka was dependent on donors for investing in post-conflict development. But, obtaining donor assistance and stimulating growth were difficult for most small economies in the bleak global economic environment that prevailed.

This chapter details the strategies adopted by Sri Lanka to improve access to productive jobs in the aftermath of the separatist conflict, and their successes and failures. Section 2 discusses different ways in which conflicts influence labor markets and best practices in reviving labor markets. Section 3 provides an overview of the war-affected provinces of the country and how these were affected by the conflict. Section 4 describes the policies adopted by the government to create employment. Section 5 examines the impact of those policies on the labor market. Section 6 concludes.

2 How Conflicts Influence the Labor Market

Conflicts affect the labor market both from the demand side as well as from the supply side (Iyer Lakshmi and Indhira Santos 2012). The demand for labor is affected as job creation is slowed down due to the reluctance of firms to invest in new businesses or expand existing business given the insecure environment created by a conflict. Lack of law and order, poor governance of regulations, and uncertainty of the legal entitlements also discourage private firms from investing in conflict-affected regions. Further, conflict-related destructions and damages to infrastructure make the functioning of firms more difficult and less profitable, due to higher transaction costs and lack of access to markets.

On the supply side, conflicts reduce the ability of individuals to supply labor and reduce the quality of labor (Iyer Lakshmi and Indhira Santos 2012). However, given low wages and poor-income earning potential, more members of a family—especially females—may be compelled to work to compensate for lack of income from regular sources. In such instances, conflicts can result in increasing the share of the economically active population. Access to jobs is more difficult in a conflict setting due to security reasons and limited transport. Conflict-related disruptions to education and vocational training programs and the poor quality of available education services due to lack of staff, equipment, and physical infrastructure also reduce the quality of the available workforce. Further, conflict-related displacements reduce labor supply, as families acclimatize to new locations. Disruptions to family structures also can increase or decrease labor supply.

Conflicts change the patterns of employment (Iyer Lakshmi and Indhira Santos 2012). Generally, with development, workers move out of agriculture. But, in high-conflict areas the rate at which workers move out of agriculture is slower. This is partly because of the slow job creation and slower urbanization in conflict-affected areas. Because of the slow creation of wage and salaried work, the share of vulnerable jobs is bigger in conflict-affected areas (Iyer and Santos 2012). However, although high youth unemployment is often linked to greater risk of conflict, there is no clear evidence of conflict resulting in higher levels of unemployment (Iyer and Santos 2012).

2.1 Phases of Post-conflict Employment Interventions

There is a common agreement in the literature that economic recovery and employment creation in post-conflict environments need to happen in different phases using different methods (De Vries and Specker 2009; McLeod and Dávalos 2008; Holmes et al. 2010). This is because with peace, the economies of the war-affected regions change, and along with these changes the needs change, calling for different interventions.

Immediately after the end of a conflict, the focus is on providing relief and reintegrating the war-affected population (De Vries and Specker 2009; McLeod and Dávalos 2008; Holmes et al. 2010). This is achieved usually by creating temporary job opportunities through workfare programs, mainly targeting the rebuilding efforts. At this stage of recovery, attention is also given to disarming, demobilizing, and reintegrating (DDR) those who were engaged in the conflict. This is seen as an important step toward sustaining peace. When the conflict was caused by ethnic differences, such as the one in Sri Lanka, sustaining peace will depend on targeting of employment programs to include all affected groups by the conflict, including the ex-combatants as well as the civilian population. At this stage, much of the economic infrastructure such as roads, railroads, bridges, harbors, and reservoirs are still in disrepair and public services such as education and health, and private job creation is starting to take shape. It is easy to obtain donor interest at this stage of the recovery period. This phase lasts till private sector employment generation picks up (McLeod and Dávalos 2008).

Phase two of the employment interventions is aimed at livelihood generation. These programs start once peace has prevailed for an extended period. Employment assistance at this stage of the recovery process is aimed at promoting private sector job creation and takes form in the provision of micro-credit, job training, job placements, and self-employment training. The main aim at this stage of employment interventions is to promote sustainable employment and self-employment activities. The employment creation during these different phases can be facilitated through a variety of interventions as discussed in the next section (Holmes et al. 2010).

Phase three of the employment interventions is about improving the quality of employment and the 'doing business' environment. This phase is called the safety net and enabling phase. The main objective in this phase is to reduce poverty and to improve the quality of jobs available in the market.

Of the three phases of post-conflict employment creation discussed above, this chapter will focus more on the employment creation in the second and third phases. The chapter will examine how interventions started in the first and second phases have helped with creating jobs and how these interventions have reduced disparities in employment outcomes across provinces.

2.2 Types of Macro-Level Policies to Create Employment

Governments can facilitate job creation through enabling a peaceful environment. Even after conflicts end, the communities which were affected by conflict are at high risk of falling back into a conflict state (Iyer Lakshmi and Indhira Santos 2012). As such, businesses that invest in post-conflict environments need to take additional precautions to face security risks. Government interventions to DDR rebels and reinstate law and order can improve the confidence of the people as well as businesses. Re-establishing civil administration services to effectively provide all public services, including security, is important to win the trust of people, as well as improve their lives.

Reconstructing and rebuilding damaged and destroyed infrastructure and improving connectivity of conflict-affected regions with the rest of the country are necessary for the recovery process (Iyer Lakshmi and Indhira Santos 2012). Damages to roads and railroads and telecommunication services reduce connectivity with other areas of the country and the outside world. Lack of access to electricity and water creates additional costs to firms, as they have to secure these services privately. Further damages to economic infrastructure such as fishing harbors and irrigation tanks also restrict economic activities.

Re-establishing social services is essential to improve the quality of labor supply and productivity of people (Iyer Lakshmi and Indhira Santos 2012). Rebuilding schools and hospitals and staffing them and re-establishing services are essential for improving the quality of the labor supply in conflict-affected areas. Active labor market interventions such as skills development and job search assistance are also needed, especially for long-duration conflicts.

Many conflict states are located in rural agrarian societies. Access to formal employment opportunities is low in such environments. As such, promoting self-employment provides an important means of employment creation (Iyer Lakshmi and Indhira Santos 2012). This is especially needed soon after the conflict ends, as the formal sector employment creation can be slow at this phase of the recovery process.

Lastly, governments may need to provide additional incentives to incite firms to invest in war-affected areas, for creating more permanent jobs. Conflicts leave communities and regions, damaged and destroyed and access to such regions restricted, making it difficult to conduct economic activities and increasing the costs of conducting such activities (Iyer Lakshmi and Indhira Santos 2012). Businesses are reluctant to invest in such environments as the profitability of operating from such places is low. The types of incentives given may include tax holidays or concessions on input taxes.

3 Impact of Sri Lanka's Conflict on the Northern and Eastern Provinces

The separatist conflict that lasted for over three decades in Sri Lanka brought widespread disruptions to the NP and the EP, where the conflict was at its severest, while also holding back development in the rest of the country. The conflict ended in the two provinces at different times. It ended in the EP in July 2007 and in the NP in May 2009. The start of the global financial crisis in 2007/2008, which slowed economic growth globally, also had ramifications on the post-conflict recovery process for the Sri Lankan economy. This section will detail the impact of the conflict on the NP and EP in the context of the Sri Lankan economy at the time.

3.1 Sri Lanka's Economy in the Post-conflict Era

The ending of the separatist conflict in Sri Lanka coincided with the start of the global financial crisis. The global financial crisis resulted in slowing global economic growth from around 5% in 2004–2007 to 3.2% in 2008 (World Bank 2009). Although this mainly affected more developed countries, its repercussions were also felt in other countries, including Sri Lanka. The combined effect of the global financial crisis and the escalation of the separatist conflict saw Sri Lanka's gross domestic product (GDP) growth rate decline from 7.7% in 2006 to 3.5% in 2009 (Central Bank of Sri Lanka (CBSL) 2016). However, since 2009, GDP growth has picked up, mainly due to an infrastructure-led development drive of the government (IPS 2010).

The labor market performance in Sri Lanka was mixed in the post-conflict years. On the positive side, overall unemployment rates which were steadily declining since the early 1990s,[1] continued to decline during the conflict period and beyond (Department of Census and Statistics (DCS) 2012a, 2016). The overall unemployment rate (excluding the NP and EP) which was 6.5% in 2006, dropped to below 4% after 2010. However, the employment-to-population ratio—an indicator which broadly signals the ability of the economy to create jobs—has remained largely constant over the years, indicating a low level of job creation in the economy, relative to population growth (DCS 2012b). Further, the share of employment in the informal sector has also remained largely unchanged over the years, indicating that the quality of jobs created has also not improved much over the years (DCS 2012a).

Employment in the rest of the country has benefitted from the post-conflict development efforts. The industry-wise employment trends in the year's pre- and post-2009 are very different (Table 1). The employed in Sri Lanka (excluding the NP and EP) increased by about the same number in the 2007–2009 and the 2010–2012 periods. However, the main contributors to this change were vastly different in the two periods. In the last couple of years of the conflict, the main contributors to the increase in employment were the agriculture sector and public administration and defense, while employment in transport, storage and communication, construction, and manufacturing declined (Table 1). In the years immediately following the ending of the conflict, the contributors to the increase in employment came from construction, mining and quarrying, and manufacturing, while employment in agriculture declined. The increase in employment in agriculture from 2007 to 2009 is due to the impact of the global financial crisis on the economy. As shown by Otobe (2013), a large number of workers laid off from manufacturing sector jobs found employment in informal agriculture sector and in wholesale and retail services. The increase in employment found in public administration and defense is a direct result of the intensified focus related to the war effort.

[1]Data is for Sri Lanka excluding Northern and Eastern provinces. Labor market data is not available for Northern and Eastern provinces for most parts of the conflict period.

Table 1 Employment trends pre and post-2009, by Select Industry Groups

	% Contribution to total employment			Difference in employment (No.)		Contribution to the difference in employment (%)	
	2007	2009	2012	2009–2007	2010–2012	2009–2007	2010–2012
Overall	100.0	100.0	100.0	97,663	98,990	100.0	100.0
1. Agriculture, forestry and fishery	31.3	32.5	32.9	116,523	(99,877)	119.3	−100.9
2. Manufacturing	18.9	18.2	17.9	(30,101)	86,632	−30.8	87.5
3. Construction, mining and quarrying, electricity, gas and water supply	7.7	7.3	6.9	(21,072)	89,512	−21.6	90.4
4. Wholesale and retail trade and repair of goods	13.2	12.8	13.3	(18,707)	28,994	−19.2	29.3
5. Hotels and restaurants	1.7	1.9	1.8	14,666	(14,520)	15.0	−14.7
6. Transport, storage and communication	6.5	5.9	6.2	(37,177)	11,377	−38.1	11.5
7. Financial Intermediation and real estate, renting and business activities	3.1	3.1	3.6	5,762	4,931	5.9	5.0
8. Public administration and defense, compulsory social security	6.1	6.8	6.8	54,425	16,858	55.7	17.0
9. Education	3.7	4.2	3.8	40,654	13,903	41.6	14.0
10. Health and social work	1.6	1.8	1.6	12,547	11,790	12.8	11.9

Source Own construction based on Department of Census and Statistics (2012a) data
Note Data excludes Northern and Eastern Provinces

Box 1 Overview of NP and EP and their Resources In 2012, a little over one million people resided in the NP. About 93% of them were Tamils.[2] The province covers 8,884 km^2 of mostly flat land divided into five districts, namely: Jaffna, Mannar, Vavuniya, Mullaitivu and Kilinochchi (Northern Provincial Council 2014). Being a peninsula, the province is surrounded by the sea on three sides, except in the south. It boasts of 480 km of coastline (or 36% of the coastal areas of Sri Lanka). The province is dry and hot most months of the year, except in the short rainy season from October to January (Northern Provincial Council 2014). The main economic activity in the province is agriculture, including fisheries and livestock activities. Due to lack of rain and lack of perennial rivers, the province is highly dependent on irrigated water for agricultural activities (Northern Provincial Council 2014).

The EP, situated along the eastern coast of Sri Lanka, covers 15% of the land area and accounts for 7.9% of the population in the country (CBSL 2007). It is divided into three districts: Batticaloa, Ampara, and Trincomalee. It is ethnically the most mixed province in the country, with Tamils and Moors, and the Sinhalese contributing to 40, 38 and 22% of the population, respectively (Eastern Provincial Council 2018). The topology of the land in the province is mostly flat toward the eastern coastal areas, while it rises into rolling hills toward the West. It is a resource-rich province comprising some of the best paddy lands in the country as well as forests, scrublands, wetlands, bays, and lagoons (CBSL 2007). The Trincomalee Harbor, one of the world's largest natural harbors, is situated in this province (CBSL 2007). The EP is situated in the dry zone, receiving rains only during the north-east monsoon from October to February. The main economic activity in the province is agriculture, including fishing and livestock farming. Being a naturally attractive province with a long coastline, it also attracts a large number of tourists. The Trincomalee Harbor has helped to develop commercial activities in the province (CBSL 2007). In addition, the province has benefitted from the mining and the forestry resources.

3.2 How the Conflict Affected the Northern and Eastern Provinces

The conflict devastated the communities of the NP and the EP. A large number of families lost family members, and many were displaced due to the conflict. An estimated 285,000 people were displaced at the end of conflict in the NP alone

[2]Based on Department of Census and Statistics (2012a, b.)

Table 2 Human development index and dimension indices by districts (selected) (2009/2010)

Province/district	HDI	Income index	Education index	Health index
Sri Lanka	0.692	0.552	0.694	0.866
Northern Province	0.625	0.471	0.677	0.766
Eastern Province				
Batticaloa	0.637	0.516	0.610	0.822
Ampara	0.666	0.520	0.655	0.868
Trincomalee	0.656	0.507	0.664	0.839

Source United Nations Development Programme (2012)

(Government of Sri Lanka, United Nations and Partners 2011); and an estimated 150,000 civilians were displaced at the end of the conflict in the EP (Ministry of Finance and Planning 2007). Resettling them in their places of origin was delayed, due to the threat of mines and lack of basic infrastructure. In 2008, 400 million square meters of land was estimated to be dangerous due to the threat of mines in the EP (Ministry of Finance and Planning 2007), and the NP was estimated to be contaminated with 1.3 million land mines at the end of the war in 2009 (Ministry of Finance and Planning 2010).

With the rail and road transportation systems severely damaged and bridges destroyed or damaged, the connectivity of the two provinces with the rest of the country was very limited. The lack of authority and legitimacy in the NP and EP during the conflict limited the ability of the government to extend public services to those provinces effectively. The capacity of the institutions in the war affected areas to deliver public services were exacerbated due to the damages to buildings and the shortages of officials due to migration of workers to other areas of the country or abroad. Further, the displacement of people to various parts of the island and lack of information of their whereabouts presented added problems in delivering services to the war affected populations.

Partly as a result, the human development indicators were lagging behind and remained below that of the country average (Table 2). The human development index (HDI) for the NP was far behind the HDI for the country, mainly due to the poor performance of income and health indices. The HDI values for the districts in the EP were also low compared to the overall index.

The economic activities in the NP and EP were severely hampered during the conflict. The access to large parcels of land was restricted due to land mines. Other areas were taken over by the Liberation Tigers of Tamil Eelam (LTTE), the rebel group, and the army for military purposes. Being in the dry zone, both the NP and EP receive rain only once a year. Thus, they are highly dependent on irrigation tanks and canals to obtain water for their cultivations. Many of these tanks and canals were damaged or destroyed due to lack of maintenance, hampering agricultural activities. The main supply route to the war-affected areas during the conflict was the sea. To restrict supply lines, fishing was restricted in the sea surrounding the NP during the conflict. These severely curtailed fishing activities. Lack of maintenance and neglect deteriorated harbor facilities, further hampering fishing activities. Lack of access to credit, lack of vocational training, loss of assets and tools, and the flight/migrating of managers and professionals also restricted economic activities and the creation of jobs in the region.

4 Policies for Employment Creation in the Northern and Eastern Provinces

Immediately following the ending of the conflict, comprehensive plans were launched to develop both the NP and EP. The 'Nagenahira Navodaya' (NN) or Eastern Revival—a three-year economic development plan for the EP—was launched in 2007 (CBSL 2007). A similar program called the 'Uthuru Wasanthaya' (UW) or Northern Spring was started in the NP in 2009 (CBSL 2009).

4.1 *Financing Post-conflict Development*

The total cost of the NN development plan was estimated to be Rs. 198.5 billion over the three years from 2007 to 2010 (CBSL 2007). The project plan reflects the focus given by the government to infrastructure development. A large part of the budget (42%) was allocated to improve economic infrastructure, and a further 17.1% was to be spent on revitalizing productive sectors and the regional economy. About 11% was on resettlement of returnees and a further 19.1% on human settlements development. The rest was to be spent on strengthening special infrastructure and social services and building capacity of public institutions. More than a half of the funds for this programme (52%) came from donors channeled through the Treasury, while a further 30% was funded by the Treasury using its own funds. The rest came from the private sector and non-governmental organizations (NGOs).

The total investment for the UW development program was estimated to be Rs. 294.9 billion over the 2010–2012 period (CBSL 2009). Of this, nearly 60% was earmarked for improving economic infrastructure, and a further 10% for strengthening social infrastructure and re-establishing social services. In addition, another 15.5% was allocated for resettling the war-affected people. Of the rest, 5% was set aside for social protection and livelihood development and 9.7% for revitalizing the productive sectors. Despite the bleak global environment, there was substantial interest from the donor community in the development efforts of the NP (Government of Sri Lanka, and United Nations and Partners 2011). In 2010, 84% of donor commitments were by the governments of China, India, Japan, Russia, and the Asian Development Bank (ADB) and the World Bank (Ministry of Finance and Planning 2010). A majority of these funds were received as loans, rather than grants.

However, donor commitment for the reconstruction efforts soon declined over the years (Financial Tracking Service of United Nations Office for the Coordination of Humanitarian Affairs as cited in Inter Action (2013). The appeal for funding by the government in 2011 was close to USD 300 million, but the actual funding received was around USD 100 million, and a funding appeal of close to USD 150 million in 2012 met with only actual funding of around USD 25 million. As per the donors, the reasons for the decline in funding support included Sri Lanka's graduation to a middle-income country in 2010, humanitarian crisis in other parts of the world as well as disagreements between the donors and the government on funding priorities (Inter Action 2013). The challenge of raising funds for post-conflict reconstruction efforts was exacerbated by poor revenue collection by the government and poor performance of the external sector on account of the weak global economic outlook.

Sri Lanka's solution to meet the funding gap was to resort to non-concessional loans and commercial borrowings (IPS 2012). The government's ambitious infrastructure development program included not only development projects in the conflict-affected areas, but also ambitious projects outside the NP and EP. Although some of these investments were necessary to balance growth across the country, all identified investments did not promise returns to cover the costs of investments. These policies for development financing have made the macroeconomic environment in the country more unstable. Further, they have limited the ability of the government to invest in health and education, crowded out private investment, increased inflationary pressure, caused the real exchange rate to appreciate and weakened the competitiveness of the export sector (Athukorala and Jayasuriya 2012).

4.2 Ensuring Security and Strengthening Governance

The 180-day rapid resettlement programs launched in the NP and EP had three key objectives: (i) to resettle the displaced communities as rapidly and as safely as possible, and in their places of origin; (ii) to renew and rebuild damaged or destroyed infrastructure; and (iii) to facilitate the restart of livelihood activities.

For safe resettlement of people, clearing land mines from communities and farmlands were essential. Further, to facilitate livelihood development it was necessary to reinstate connectivity of the two provinces with the rest of the country through restoring roads, bridges, and railroads. It was also necessary to re-establish basic services such as education, health, water, sanitation, transport, and financing facilities. Along with the ongoing reconstruction efforts, measures were taken to improve governance and security in the region and re-establish civil administration.

4.3 Improving Infrastructure

At the start of the development programmes in the conflict-affected provinces, emphasis was given to the provision of basic services for the communities such as housing, health, education, electricity, water and sanitation facilities, as well as facilitating livelihood development through services such as transport and irrigation.

By the end of 2009, more than 3,000 km of roads and 30 bridges were reconstructed, which facilitated the linking of major cities and towns in the EP with the rest of the country (CBSL 2009). Several special projects were started to improve the connectivity of the NP with the rest of the country. Some examples of these include the reconstruction of the A9 highway, Vavuniya–Horowpathana road, rebuilding the Northern railway line and the Mannar Bridge. Public buses and railways were also revitalized (CBSL 2009).

The program involved strengthening public services such as hospitals and civil administration to expedite the resettlement of displaced. The NN also envisioned the establishment of industrial zones and the development of the tourism sector in the province.

Along with the above initiatives, the measures adopted aimed to reconstruct economic infrastructure. The Trincomalee Harbor was planned to be developed through a public–private partnership (PPP) and a 10,565 acre area of land surrounding the Trincomalee Harbor was planned to be developed into a port city. A 500-MW coal-fired power plant was also planned for Trincomalee. A fishery harbor at Oluvil, which was in disrepair, was dredged to make allowances for larger boats used in the harbor.

4.4 Support to Livelihood Activities

In the EP, the NN economic revival was aimed to improve crop agriculture, irrigation, fisheries, and livestock (CBSL 2007). The interventions sought to improve the quality of products and increase access to markets. In the North, with nearly 80% of households engaged in agricultural activities, revival of agriculture received focused attention. Government activities in this regard included, provision of subsidized fertilizer, clearing nearly 4,000 acres of overgrown abandoned paddy land, reviving the crop irrigation system by renovating minor tanks and canals, and the provision of agricultural tools, tractors, and water pumps (Government of Sri Lanka, and United Nations and Partners 2011). In collaboration with the Ministry of Agriculture, the Food and Agriculture Organization (FAO) provided livelihood support to farmers, fishers, and others self-employed in the form of paddy and vegetable seeds, fertilizer, and basic agriculture tools. A standard livelihood package with Rs. 35,000 (USD 315) was provided to those engaged in livelihood activities (Government of Sri Lanka, and United Nations and Partners 2011).

The livestock sector is a main economic contributor in the NP. Several initiatives were taken to revive this sector (Government of Sri Lanka, and United Nations and Partners 2011), including assistance for rounding up stray cattle, building fenced fields for the upkeep of livestock, and providing vaccinations for the livestock. Government support to fishers included the provision of boats and canoes and other necessary fishing equipment (Government of Sri Lanka, and United Nations and

Partners 2011). In addition to this, financial assistance was provided for fishers through the Ministry of Fishery to purchase boats and other equipment. Action was also taken to improve the capacity of fishery cooperatives and fishing infrastructure. In addition to these, support was given for different self-employment activities such as tailoring, construction-related activities, retail shops, and bicycle repair shops.

The conflict left many in the affected areas without assets and savings. Improving access to finance in such an environment was difficult without government support. One initiative for improving access to finance was to encourage private and public banks to open branches in the NP. The CBSL also launched a credit guarantee scheme, through which farmers in the Kilinochchi, Mullaitivu, and some areas of the Mannar District were given credit up to Rs. 200,000 (USD 1,800) for defaults arising from land dispute-related issues (CBSL 2009).

4.5 Support for Promoting Longer-Term Employment

To lure investments to the NP and EP, a variety of tax concessions were offered (CBSL 2009). To facilitate business transactions, the CBSL approved the establishment of 137 bank outlets in the NP and EP (CBSL 2009). Further, programs were launched to train youth for various trades.

From 2008 onwards, government plans included the provision of incentives to private sector firms to relocate to the EP by providing tax concessions to companies willing to invest more than Rs. 50 million and providing employment for more than 50 people (CBSL 2009). The incentives provided included income tax concessions for three years following the commencement of a firm, and custom duty waivers and value-added tax (VAT) exemptions for machinery and equipment imported for the factories. In addition, the government proposed the establishment of industrial zones and estates in the EP and took initiatives for developing the tourism sector by rehabilitating tourism infrastructure.

In 2009, the government identified a list of industries to be revived in the NP and EP. These included existing industries such as salt, cement, chemical, sugar and paper industries, as well as new industries such as textiles, light manufacturing, agricultural food processing, dairy products, canned fish, and gas.

5 Impact of Post-conflict Development on the Northern and Eastern Provinces

5.1 Impact on the Greater Economy

The post-conflict development efforts launched by the government with the assistance of the donor community showed commendable impacts on the lives of the people in the NP and EP. The contribution of the EP to Sri Lanka's GDP increased from 4.9% in 2006 to 6.3% in 2012. The contribution of the NP to GDP also increased from 3.2% in 2008 to 3.7% in 2012. Poverty, measured by the poverty headcount index, has come down in the NP and EP since the ending of the conflict. The poverty levels in the NP dropped from 10.9% in 2013/2014 to 7.7% in 2016, and it dropped from 11% in 2013/2014 to 7.3% in 2016 in the EP. However, poverty levels in the EP register an increase from 2006/2007 to 2009/2010. This could possibly be due to the violence and insecurities in the province immediately following the ending of the conflict in 2008, and the drought that prevailed in the country. Further, the decline in poverty in these provinces is sharper, compared to the decline in poverty in the country as a whole. However, after an initial growth spurt of more than 8% from 2010 to 2012, Sri Lanka's economic growth rate dropped to below 5% thereafter.

5.2 Achievements in Livelihood-Related Employment

The initiatives taken to improve livelihood activities in the NP and EP also have shown positive outcomes. For example, the number of hectares sown increased sharply in all districts of the NP from 2009/2010 to 2011/2012 (Table 3). In the Mullaitivu District, the increase was as much as 28,625%. From 2007/2008 to 2016/2017, the gross extent sown in all districts in the NP increased by more than 100%. The number of hectares sown also increased in the Trincomalee, Batticaloa, and Ampara districts of the EP from 2007/2008 to 2011/2012. However, there has been a decline in the extent sown in the Ampara district in 2011/2012 and 2016/2017 periods, partly due to adverse weather conditions.

The fishery sector also shows increased activity in the NP and EP. The number of fishers in the EP increased sharply from 2004 to 2008, and these continued to increase till 2011 (Table 4). The number of fishers in the NP also increased sharply from 2008 to 2011. The number of fishers increased in some of the districts outside the NP and EP as well; this was partly due to the construction of two new fishing harbors in Hambantota and Ambalangoda in the Southern Province (SP) and another in Chilaw in the North-Western Province (NWP) (CBSL 2008).

5.3 Achievements in Long-Term Employment

The long-term employment effects of the NN and UW programs in terms of creating employment and improving the quality of employment are positive in the NP, although these impacts are somewhat mixed in the EP.

Isolating the effects of the post-conflict development programs on the labor markets of the NP and EP are somewhat difficult as the economic context in the country as well as the global economy also influence these outcomes. We are especially interested in seeing if the post-conflict development programs resulted in

Table 3 Gross extent sown (hectares)

District	Year				Growth			
	2007/2008	2009/2010	2011/2012	2016/2017	2007/2008–2009/2010	2009/2010–2011/2012	20011/2012–2016/2017	2007/2008–2016/2017
Galle	14,679	17,156	13,299	8,560	16.9	−22.5	−35.6	−41.7
Matara	14,865	15,908	19,177	9,349	7.0	20.5	−51.2	−37.1
Jaffna	7,566	8,948	59,470	62,836	18.3	564.6	5.7	730.5
Kilinochchi	14,650		71,877	81,458			13.3	456.0
Vavuniya	6,422	483	30,161	29,236	−92.5	6,144.5	−3.1	355.2
Mullaitivu	6,596	218	62,621	46,788	−96.7	28,625.2	−25.3	609.3
Mannar	4,894	8,093	13,181	11,536	65.4	62.9	−12.5	135.7
Anuradhapura	72,717	81,463	89,253	37,853	12.0	9.6	−57.6	−47.9
Polonnaruwa	55,529	60,312	64,512	49,621	8.6	7.0	−23.1	−10.6
Trincomalee	18,987	26,535	27,552	19,793	39.8	3.8	−28.2	4.2
Batticaloa	19,134	54,855	31,985	25,680	186.7	−41.7	−19.7	34.2
Ampara	64,490	69,861	12,948	7,955	8.3	−81.5	−38.6	−87.7
Hambantota	24,234	26,098	7,103	3,691	7.7	−72.8	−48.0	−84.8
Sri Lanka	581,597	646,037	702,075	542,556	11.1	8.7	−22.7	−6.7

Source Department of Census and Statistics, Paddy Statistics for Maha Season, various years

Table 4 Active fishers by district (marine fisheries)

District	Year					Growth			
	2004	2008	2011	2013	2016	2004–2008	2008–2011	2011–2016	2004–2016
Negombo	16,800	11,500	9,510	9,930	10,570	−31.5	−17.30	11.1	−37.1
Colombo	2,800	1,730	1,820	1,910	2,340	−38.2	5.20	28.6	−16.4
Kalutara	4,200	4,810	5,950	6,210	4,820	14.5	23.70	−19.0	14.8
Galle	6,300	5,880	10,260	10,620	12,420	−6.7	74.49	21.1	97.1
Matara	7,100	7,710	11,090	11,720	15,570	8.6	43.84	40.4	119.3
Tangalle	6,100	6,580	10,580	11,060	12,010	7.9	60.79	13.5	96.9
Kalmunai	15,500	20,600	26,040	25,960	22,290	32.9	26.41	−14.4	43.8
Batticaloa	21,600	23,540	29,980	29,330	31,820	9.0	27.36	6.1	47.3
Trincomalee	16,100	22,460	34,620	34,240	32,960	39.5	54.14	−4.8	104.7
Mullaitivu	3,300	2,090	1,480	3,120	5,250	−36.7	−29.19	254.7	59.1
Kilinochchi	3,700	2,180	3,720	4,920	4,190	−41.1	70.64	12.6	13.2
Jaffna	16,800	18,240	22,720	24,220	22,690	8.6	24.56	−0.1	35.1
Mannar	9,400	10,540	18,530	18,220	18,570	12.1	75.81	0.2	97.6
Puttalam	12,100	14,410	16,810	15,720	12,530	19.1	16.66	−25.5	3.6
Chilaw	10,000	10,200	12,320	12,220	10,800	2.0	20.78	−12.3	8.0
Total	151,800	162,470	215,430	219,400	218,830	7.0	32.60	1.6	44.2

Source Statistics Unit—Ministry of Fisheries and Aquatic Resources Development, various years a faster improvement to the labor markets in the NP and EP, relative to other provinces in the country. We examine the long-term employment effects of the NN and UW using difference-in-difference methods. The difference-in-difference (DD) indicator shows the difference in the change of the outcome variable in the conflict region relative to the change in the outcome variable in the no-conflict region. More formally, this is given by:

$$DD = [Y_A|C - Y_B|C] - [Y_A|NC - Y_B|NC] \tag{1}$$

where $Y_A|C$ and $Y_A|NC$ are outcome variables in the conflict and no-conflict regions, respectively, after the launch of the development program, and $Y_B|C$ and $Y_B|NC$ are the outcome variables in the conflict and no-conflict regions, respectively, before the launch of the development program. In Table 5, we compare the change in labor market indicators in the NP relative to the SP as well as all no-conflict provinces (i.e., all provinces except the NP and EP). We chose SP as the comparison province; as historically, the two provinces have been compared given their different ethnic compositions.[3] Ideally, comparisons should be carried out between 2010 and 2014. But, due to lack of data for the NP for 2010, we are compelled to do the comparison for 2011 and 2014. In Table 6, we compare the change in labor market indicators in the EP between 2009 and 2014 with that of the Uva Province (UP) and no-conflict provinces. We chose UP as a comparison province as UP historically has also been a deprived province.

The analysis shows that the labor force participation and the employment-to-population ratio increased in the NP relative to both the SP as well as the no-conflict provinces. Further, the unemployment rate—both the overall, as well as the youth unemployment rate—decreased in the NP compared to the SP as well as the no-conflict provinces. This shows that the labor market and job creation improved in the NP relative to the labor market in the SP and no-conflict provinces.

We next looked at the quality of the work created in the NP. We see that the employment in agriculture has decreased in the NP relative to the SP, although it has not decreased as fast as the average for the no-conflict provinces. Further, the share of vulnerable employment (i.e., self-employed and unpaid family workers) has also decreased in the NP relative to the SP as well as the non-conflict provinces. These results show that the quality of jobs in the NP has improved faster compared to the provinces outside the conflict-affected region. However, the results show a decline in the share of professionals and semi-professionals in the NP relative to both the SP and no-conflict provinces. This suggests that job creation, although good, has not been at the professional or semi-professional level.

The labor market outcomes in the EP are mixed compared to the UP and the no-conflict provinces. The results show that although the unemployment rate and the youth unemployment rate have decreased, labor force participation and the

[3]The Northern Province is largely populated by Sri Lankan Tamils, while the Southern Province is populated mostly by the Sinhalese.

Table 5 Comparison of labor market indicators in the NP with SP and no-conflict provinces

	2011			2014			Difference in difference	
	Northern	Southern	No-conflict	Northern	Southern	No-conflict	Northern versus southern	Northern versus no-conflict
Labor force participation rate								
All	47.7	58.6	58.8	49.8	59.0	58.9	1.8	2.0
Male	75.4	79.3	79.9	75.6	79.6	80.2	−0.1	−0.1
Female	22.9	40.3	40.0	26.5	40.7	40.4	3.2	3.2
Employment-to-population ratio								
All	44.6	55.3	56.3	47.2	55.1	56.2	2.8	2.8
Male	73.3	76.2	77.6	73.4	75.7	77.3	0.6	0.3
Female	19.1	36.9	37.4	23.7	36.9	37.7	4.5	4.3
Unemployment rate								
All	6.4	5.6	4.2	5.1	6.5	4.6	−2.2	−1.8
Male	2.9	3.9	2.9	2.9	4.9	3.5	−0.9	−0.6
Female	16.8	8.5	6.5	10.7	9.2	6.6	−6.8	−6.3
Youth unemployment rate								
All	18.2	23.3	16.9	17.9	28.8	21.6	−5.8	−5.0
Male	10.8	19.6	13.4	12.2	24.4	17.7	−3.5	−2.9
Female	42.7	30.3	23.0	29.8	36.6	28.0	−19.2	−17.9
Employment in agriculture								
All	37.0	37.7	34.0	33.0	34.1	27.6	−0.4	2.5
Male	39.3	38.0	30.8	35.1	32.8	25.1	1.1	1.5
Female	29.1	37.0	40.0	27.0	36.4	32.0	−1.5	5.9

(continued)

Table 5 (continued)

	2011			2014			Difference in difference	
	Northern	Southern	No-conflict	Northern	Southern	No-conflict	Northern versus southern	Northern versus no-conflict
Share of professionals and semi-professionals[a]								
All	21.4	15.8	18.6	18.6	15.6	17.1	−2.6	−1.2
Male	15.9	13.1	17.8	14.3	13.2	15.0	−1.6	1.3
Female	40.4	20.8	20.1	30.6	20.0	20.8	−9.0	−10.4
Share in vulnerable employment[b]								
All	39.6	41.2	41.7	36.3	40.0	38.8	−2.1	−0.4
Male	39.5	38.7	39.9	36.0	38.0	37.0	−2.8	−0.7
Female	39.9	45.9	45.0	37.0	43.8	41.9	−0.7	0.3

Source Own calculations using labor force survey data, various years
Note [a]International Classification of Occupation codes 1, 2, and 3 are assumed to be professionals and semi-professional; [b]Following International Labor Office (ILO) classification, employment in self-employment and unpaid family work are defined to be vulnerable employment

Table 6 Comparison of labor market indicators in the EP with UP and no-conflict provinces

	2009			2014			Difference in difference	
	Eastern	Uva	No-conflict	Eastern	Uva	No-conflict	Eastern versus Uva	Eastern versus no-conflict
Labor force participation rate								
All	50.34	66.90	59.09	47.81	64.91	58.95	−0.54	−2.39
Male	78.54	83.57	79.78	77.75	84.18	80.16	−1.41	−1.18
Female	25.08	52.71	41.00	22.29	48.16	40.37	1.76	−2.16
Employment-to-population ratio								
All	46.10	63.60	55.44	45.33	62.76	56.21	0.07	−1.55
Male	74.92	80.95	76.10	75.37	82.72	77.35	−1.32	−0.80
Female	20.30	48.83	37.36	19.72	45.41	37.70	2.85	−0.91
Unemployment rate								
All	8.41	4.93	6.19	5.18	3.32	4.64	−1.61	−1.68
Male	4.61	3.13	4.61	3.06	1.74	3.51	−0.16	−0.45
Female	19.07	7.37	8.87	11.50	5.71	6.62	−5.91	−5.31
Youth unemployment								
All	24.7	19.1	21.8	16.7	22.4	21.6	−11.3	−7.8
Male	16.1	12.7	17.4	13.5	12.6	17.7	−2.5	−2.9
Female	45.9	27.9	28.5	25.7	39.7	28.0	−31.9	−19.7
Employment in agriculture								
All	33.7	61.3	32.6	28.4	58.3	27.6	−2.2	−0.2
Male	35.8	56.1	29.7	31.7	52.6	25.1	−0.6	0.5
Female	26.6	68.8	37.7	17.7	67.4	32.0	−7.5	−3.2

(continued)

Table 6 (continued)

	2009			2014			Difference in difference	
	Eastern	Uva	No-conflict	Eastern	Uva	No-conflict	Eastern versus Uva	Eastern versus no-conflict
Share of professionals and semi-professionals[a]								
All	21.0	12.4	19.0	16.2	11.3	17.1	−3.7	−2.8
Male	16.6	10.9	17.6	11.7	9.5	15.0	−3.4	−2.2
Female	35.7	14.4	21.5	30.9	14.2	20.8	−4.6	−4.1
Share in vulnerable employment[b]								
All	36.3	57.5	38.7	39.0	57.5	38.8	2.6	2.5
Male	31.4	55.0	36.3	36.2	55.9	37.0	3.9	4.0
Female	52.5	61.1	42.9	48.0	60.1	41.9	−3.5	−3.4

Source Own calculations using Labor Force Survey data, various years
Note [a]International Classification of Occupation codes 1, 2, and 3 are assumed to be professionals and semi-professional; [b]Following International Labor Office (ILO) classification, employment in self-employment and unpaid family work is defined to be vulnerable employment

employment-to-population ratio has not improved in the EP compared to both the UP and the no-conflict provinces. However, employment in agriculture has declined in the EP compared to the SP and the no-conflict provinces. But, the share of employed in vulnerable employment has increased, and the share of professionals and semi-professionals has decreased. These results suggest that job creation has been slower in the EP compared to other provinces, and the created jobs have not been very good. Despite this, the unemployment rate has come down. This could partly be due to lower labor force participation of individuals in the EP.

Despite noted improvements to the labor market indicators, both LFPRs and the employment-to-population rates remain lower by a large margin in the NP and EP relative to no-conflict provinces (Tables 5 and 6 in Chapter "Post-conflict Agricultural Modernization in Sri Lanka"). This is mainly due to the lower labor force participation of females in both provinces. Newhouse and Silwal (2018) analyzing the reasons for the gap in labor force participation in the NP and EP relative to the rest of the country conclude that rather than systematic differences in worker characteristic, weak labor demand, and greater reluctance of women in economic participation are driving lower LFPRs. Further, lower education levels and lower access to finance are slowing female engagement in self-employment activities.

6 Conclusion

This chapter detailed the different strategies adopted by Sri Lanka to improve the labor market in the aftermath of the conflict, the conflict-affected NP and EP in the country. The analysis shows that the development programs have stimulated growth in the NP and EP and reduced poverty. These programs have also resulted in improving livelihood activities, and to a certain extent, the labor market indicators. However, LFPRs and the employment-to-population ratios remain low in the conflict-affected provinces. Further, job creation at the professional and semi-professional levels has not increased in the aftermath of the conflict relatively to the rest of the country. This indicates, that although the post-conflict development activities were able to provide livelihood support and bring people out of poverty, the economies in the NP and EP have still not matured enough to provide a business environment to support good-quality employment opportunities. The slow growth of the overall economy, muted attention paid to social sector developments, and macro-uncertainties arising from development finance choices made by the country would have contributed to the slow recovery of the NP and EP, beyond the livelihood creation phase.

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Post-conflict Agricultural Modernization in Sri Lanka

Manoj Thibbotuwawa

Abstract Sri Lanka's former conflict-affected regions have traditionally been high-potential agricultural areas providing livelihood to a group of hard-working and resilient farmers. During the conflict, a large number of civilians were displaced, and agricultural livelihoods were disrupted affecting agricultural activity in the Northern Province (NP) and Eastern Province (EP) as well as the rest of the country. The cessation of the conflict therefore provided an opening to a large agricultural resource base for production. The government too was keen to revive the rural economy as a means of developing lagging regions, in particular the conflict-affected regions. It placed a high priority on agricultural modernization with a view to improve productivity and competitiveness, enhancing value addition, product diversification, and creating employment opportunities. These efforts delivered some beneficial impacts to rural farm incomes as well as food security. However, this chapter argues despite the post-conflict agricultural developments that the country experienced in general, and the NP and EP in particular, long-standing agricultural development issues remain unaddressed, affecting overall agricultural development in the country. Therefore, a long-term strategy to address these issues, including those of stagnating productivity, land use, inefficient water management, in adequate public spending on agriculture research and technology, climate change, and poor market integration—which collectively result in agrarian poverty and food insecurity in the country—needs to be adopted and implemented.

1 Background

Sri Lankan agriculture, particularly the food crop production sector, has been in a crisis for many decades. Both long-standing endogenous problems as well as more recent exogenous factors that include the separatist conflict of the last three decades contributed to this dilemma. Stagnating productivity, inefficiencies in land markets

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and irrigation water use, low spending on research and technological development (RTD), poor marketing, and climate change constitute the major challenges that affect the role of agriculture in generating rural income and employments, ensuring food security, minimizing rural poverty, and increasing export income (Samaratunga 2010). Moreover, during the conflict, agricultural products from the NP and the EP—which used to be potentially important areas for agriculture traditionally—to the other provinces of the country were obstructed due to factors such as the imposition of bans on trade by the government, taxes imposed by the terrorist groups, and collapse of the transport connectivity (Kelegama 2011).

The cessation of the 30-year armed conflict and the ensuing restoration of civil administration in the NP and EP were thus presumed to increase both the demand and supply of agricultural products not only in the conflict-affected areas, but also in the rest of the country. However, despite faster economic growth in the immediate post-conflict years, the contribution of the agricultural sector to this growth has been small. Sri Lanka has seen mixed results in relation to both food production and consumption. Aggregate consumption of all major food groups has increased over the years; domestic production and food imports too have increased. Domestic production accounts for nearly 80% of aggregate food consumption, while the value of food imports has grown in absolute terms even though its share in total imports has remained constant over time (Institute of Policy Studies of Sri Lanka (IPS) 2016).

While the Sri Lankan economy continues to grow at a steady rate as a lower middle-income country, it needs to grow faster in order to transition to a high-income country. This reflects the gap that needs to be bridged through a rapid acceleration in economic development. In order to accelerate the momentum to catch up with high-income countries, Sri Lanka needs to undertake conducive reforms; in the agriculture sector, these include enhancing productivity by promoting high-tech solutions, channeling resources selectively to high value-added economic activities, promoting value chains, etc., while continuously expanding and modernizing its resource base for sustaining economic development.

Given that the vast majority of Sri Lanka's poor lives in rural and estate sectors, with high dependency on the agricultural sector, any policy reform must be sensitive to issues of equity. At present, agricultural workforce in rural areas exceeds 75% of the rural labor force, and almost 50% of the households among households where the main income earner is employed in the agriculture sector are poor in the country (Kelegama 2011). As such, successive governments see the revival of the rural economy as a means of developing lagging regions, including the conflict-affected regions. At present, the emphasis is on agricultural modernization with a view to improving productivity and competitiveness, enhancing value addition, product diversification, improving rural incomes, and creating employment opportunities as a set of important factors to underpin agricultural development in the country.

2 History of Agricultural Policy in Sri Lanka

Sri Lanka had been a self-sufficient economy, comprising a peasant agricultural sector and little international trade until the commencement of British colonial rule in 1815. Since the British interest was to establish an export agricultural sector consisting of large plantations, a land acquisition campaign was launched by the then government under the Crown Land Ordinance of 1840 (IPS 2004). Establishing large plantations in such acquired lands resulted in a sharp increase in the extent under the 'plantation sector' which is more export-oriented while the neglected 'domestic agricultural sector' stagnated, producing mainly for household subsistence with a little market surplus (Samaratunga 2011). Furthermore, deteriorating prices of domestic food following the promotion of cheap imported food have further marginalized the role of the domestic food production. Following these changes, Sri Lanka's GDP grew faster with export earnings of the plantation sector, while the contribution of the domestic agriculture sector gradually shrank.

The first change in this pattern appeared with the Land Development Ordinance of 1933 which undertook large irrigation projects for the rejuvenation of the agricultural lands in the dry zone as well as for the development of the domestic agriculture sector. With these projects, the developed lands were alienated to the landless from other areas, in order to distribute land among the landless in the wet zone of the country, and to promote domestic food production—especially the production of the main staple food and rice. As a result, domestic food production sector began to grow, which was further supported by the high prices of imported food, mainly rice, during World War II from early 1930s to the mid-1940s (Samaratunga 2011).

Since independence in 1948, growth of Sri Lanka's domestic food production sector picked up some momentum with continued land development and support prices for rice. This domestic food crop production drive was further supported by continuously increasing prices of imported food items, especially from the 1960s. While the agricultural policy strategy adopted by the Sri Lankan government during these years focused more on import substitution and restrictions on imports, periodic price support for domestic food crops that further supported the growth of the domestic food production sector failed to help the country to alleviate its food importation burden. The food imports bill, which has been on a long-run increasing trend in both absolute terms and as a percentage of total exports, highlights the import dependency problem in the agri-food sector of Sri Lanka.

The import substitution development strategy came to an end following an economic reform program in 1977, focused on trade liberalization and adoption of export development. This strategy, which continued since, changed the relative price structure in the domestic agriculture sector and brought about drastic changes in food production and consumption. With all these changes, the agricultural sector is currently dualistic in nature, comprising of a well-developed export-oriented plantation sector and a less developed, partially market-oriented food crop production sector. The former produces tea, rubber, and coconut in medium to large estates, while the latter producers' rice, subsidiary food crops, and vegetables and fruits in predominantly smallholdings. However, agriculture is still a very important sector in the economy through the generation of rural income and employments, export revenue for the country, food for the people, and raw materials for the industries (IPS 2016).

2.1 Conflict Years and a Shrinking Agriculture Sector

While agriculture sector in Sri Lanka was undergoing the above outlines sequence of changes, the eruption of Sri Lanka's separatist conflict had negative impacts on the agriculture sector, particularly in the NP and EP, but also on the country as a whole as well.

With structural changes in the national economy due to pro-market policy reforms of the post-1977 period, the relative contribution of agriculture to GDP declined from 30.7% in 1977 to 7.7% by 2017 (Fig. 1). The services sector experienced the biggest growth from 40.6% in 1977 to 55.8% in 2017, whereas the industry sector remained more or less constant with 28.7 and 27.2% GDP shares in 1977 and 2017, respectively (Central Bank of Sri Lanka (CBSL) 2017).

With increasing overall growth in the country, the slow growth rate witnessed in the agricultural sector compared with higher growth rates of service and industrial sectors contributed to the shrinking of agricultural share of GDP in the economy. After 1977, Sri Lanka's GDP growth averaged approximately 5% per annum, with growth rates in both industrial and service sectors doing better than 5% while agricultural sector growth averaged at just over 2%—while in some years, it has even been negative (Fig. 2).

One important point to note is that the contribution of agriculture to overall economic growth shows a marked decline from 1977 to 1987. Disruption of agricultural activities in the NP and EP with the eruption of the conflict in the early 1980 can be identified as a major reason for this (IPS 2010). Even after 1987, the contribution of the agriculture sector to overall economic growth was not satisfactory, except for a few isolated years when a relatively higher growth rate was

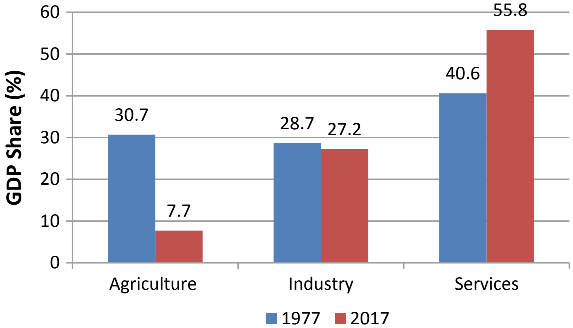

Fig. 1 Shrinking agricultural sector contribution to the GDP from 1977–2017. *Source* Based on CBSL (2017)

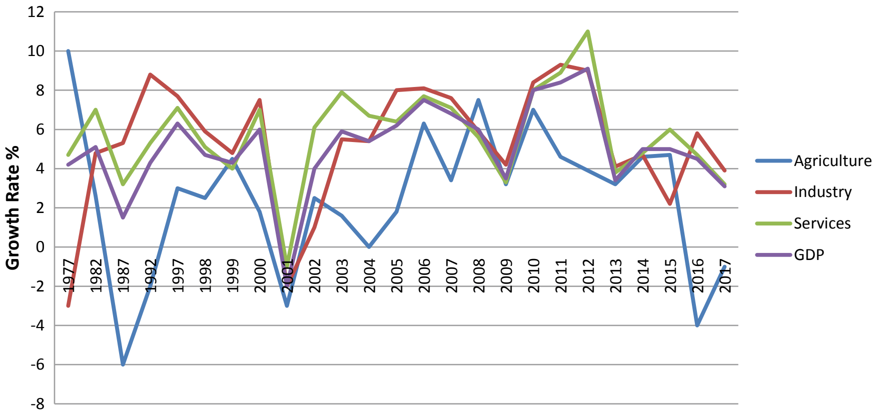

Fig. 2 Stagnating agriculture sector growth rate (1977–2017)

registered. The sector recorded a growth rate of 2.5% on average during the last ten years of the conflict which is exactly a half of the overall economic growth rate achieved during this period.

Most of these negative effects can be largely attributed to the adverse security situation in the country which affected the balance between the demand and supply for agricultural products in the country. The demand for agricultural products was mainly affected by a decline in income as well as a set of non-income factors that include market price volatility, differences in roads and market access, lack of investments, lack of job opportunities, and poor wages. The disparity between per capita income in conflict-affected areas and the rest of the country grew rapidly after 1983, leading to divergences in poverty and food security between the NP and EP and the rest of the country (IPS 2010). As a result, while about 7% of the population was living below the national poverty line in 2012/2013, the incidence of poverty in the main conflict-affected districts such as Mullaitivu (28.8%), Mannar (20.1%), and Batticaloa (19.4%) was much greater than in the rest of the country (Department of Census and Statistics of Sri Lanka (DCS) 2015a).

Moreover, the conflict resulted in severe livelihood depletion in the NP and EP due to the trade embargo imposed by the government, especially on fertilizers and fuel, as well as restrictions on fishing. These, along with a breakdown of the transport connectivity between the north and the south, dysfunction of agricultural research and extension system, along with the general collapse of the security situation, led to lower outputs and increased costs of production. As a result, market opportunities contracted, limiting the supply of agricultural products from the conflict-affected areas to the rest of the provinces in the country to a minimum. Any agricultural production that took place was for consumption, within the same war-affected localities (IPS 2010).

2.2 Agricultural Growth in Post-conflict Sri Lanka

The cessation of the conflict had an immediate impact on food demand in Sri Lanka. With the improvements in mobility of both people and goods within the NP and EP and between these provinces and the rest of the country, one of the major impediments on access to food by the people in the conflict-affected areas was removed. Both public food distribution channels and private marketing agents were able to carry out their operations more efficiently, resulting in a sharp decline in food prices, giving rise to an increase in food consumption in the area. Further, rehabilitation and reconstruction activities in the NP and EP generated new employment and increased family income which also contributed to increased food demand. In addition to these immediate impacts, there were some long-run effects such as reduced general inflation and increased investment, employment and personal income that raised the demand for food in both the NP and EP and the whole country (IPS 2010).

Traditionally, the conflicted-affected areas have had a high potential for trade, especially in agricultural. The NP and EP were the major sources of rice to the rest of the country. Additionally, domestic demand for chili and onion used to be largely met with the produce in the NP. The Jaffna peninsula had been a major supplier of potato to the rest of the island in the Maha season which is the major cultivation season spanning September to February. Pulses and some oilseeds were also among the contributions of the NP and EP to food supply in other areas. The end of the conflict therefore meant an opening up of a large agricultural resource base for production. In the years since, production levels have gone up; for example, rice production and cultivated extents in the post-conflict era have already exceeded those in pre-conflict years era (Table 1). The yield levels have also exceeded the

Table 1 Cultivated extent of rice, production, and yield in NP and EP

		Net extent (Ha)	Production ('000 MT)	Yield (MT/Ha)
Pre-conflict	1979	211,449	587.9	2.8
	1980	232,412	638.7	2.7
	1981	218,801	615.4	2.8
	1982	200,461	603.6	3.0
	1983	253,143	822.3	3.2
	1984	207,978	567.5	2.7
	1985	234,571	762.2	3.2
Post-conflict	2012	307,700	1,322.1	4.3
	2013	343,500	1,353.1	3.9
	2014	250,900	1,060.4	4.2
	2015	347,900	1,470.5	4.2
	2016	349,500	1,465.3	4.2

Source Based on DCS Agriculture Statistics pre-conflict maximum yield levels and are comparable with the average yield levels in other provinces of Sri Lanka.

The impact of additional resource base for agricultural production is reflected in the national-level production indicators as well. Table 2 highlights the growth rates of individual food crops in Sri Lanka during different decades before the conflict and after the conflict. It shows a gradual reduction in growth rates before the conflict and an improved performance in extent cultivated, production, and the yield levels of different crops during the post-conflict era.

Farm budget data in pre-conflict years, published by the Department of Agriculture, show that producers in the NP and EP are more efficient in agriculture than their counterparts in the rest of the country. The addition of more efficient farmers has a positive impact on farm supply and rural income from the producers' point of view. However, the additional supplies from the NP and EP dampened prices substantially in the short run due to low price elasticities of basic food commodities (IPS 2010). Although some of these improvements are beneficial from the consumers' point of view, there is a risk that the producers in other areas who are at the threshold of production inefficiency can face stiff competition. Even with such risks, there are potential positive gains to be had such as shifting from one crop to another; diversifying product portfolio or attempting to improve production efficiency is beneficial for the agricultural development of the country as a whole.

Sri Lanka's post-conflict agricultural growth is further illustrated by relatively higher growth in the sector following the end of the conflict. The agriculture sector grew by 4.7% per annum on average during the immediate post-conflict period of 2010–2015. Negative growth rates thereafter were the result of inclement weather conditions such as floods and droughts suffered in 2016 and 2017. The agriculture sector share of GDP which was on a declining trend throughout the conflict period stabilized after the conflict (Fig. 3).

With all these positive impacts on agriculture and livelihoods in the NP and EP in post-conflict Sri Lanka, these two provinces nonetheless continued to show the highest percentages of poor people since 2009. The poverty head count index was 7.7% and 7.3% in the NP and EP, respectively, compared to the national average of 4.1% in 2016. Further, the minimum Cost of Diet (COD) estimate of the World Food Programme (WFP) finds that more than 57% of households in the EP could not manage to pay for a nutritious diet during the Maha cultivation season in 2014 which is well above the affordability rates in other provinces. The comparative figure in the NP is 35% (WFP 2015).

However, agriculture still continues to be a significant source of employment and livelihood, accounting for 26% of the employed in 2017 (CBSL 2017). The largest shares of employment generation come from rice and tea—the two dominant sectors in the non-plantation and plantation sectors, respectively. Further, the sector utilizes 43.7% of Sri Lanka's total land area and continues to be the backbone of the rural economy in the country (based on World Bank Open Data).[1]

[1]Please refer http://data.worldbank.org/indicator/AG.LND.AGRI.ZS.

Table 2 Decadal growth rates of major non-plantation crops (%)

Major crops	Extent cultivated				Production				Average yield			
	1979–1988	1989–1998	1999–2008	2009–2017	1979–1988	1989–1998	1999–2008	2009–2017	1979–1988	1989–1998	1999–2008	2009–2017
Paddy	0.4	1.7	1.9		3.0	3.0	3.4		2.4	0.8	1.5	
Maize	7.3	0.3	6.7	3.9	6.9	1.1	15.2	11.6	1.5	0.9	7.9	11.5
G. gram	9.2	–4.7	–5.4	2.8	9.6	–2.9	–4.8	6.9	7.9	1.9	0.6	4.1
Cowpea	6.3	–4.7	–0.8	–4.1	6.7	–3.8	–0.1	3.3	0.6	0.9	0.7	3.9
B. gram	17.0	3.8	–0.4	4.6	17.2	4.0	3.9	7.8	0.7	0.2	4.3	0.4
R. onion	–2.1	–5.1	–2.3	1.1	–1.5	–6.8	1.6	4.6	4.3	–1.8	4.0	2.8
B. onion	19.4	6.8	–1.3	4.8	6.8	14.0	–1.0	8.9	4.0	6.7	0.3	2.8
Ground nut	0.7	–1.2	0.0	9.7	0.1	–1.9	5.1	12.5	0.3	–0.8	5.1	8.0
Chillies	–3.1	–1.3	–4.0	0.7	6.6	–0.9	–1.8	5.7	5.1	0.4	2.3	4.9

Source Hector Kobbekaduwa Agrarian Research Institute (HARTI) (2008) and DCS Agriculture Statistics

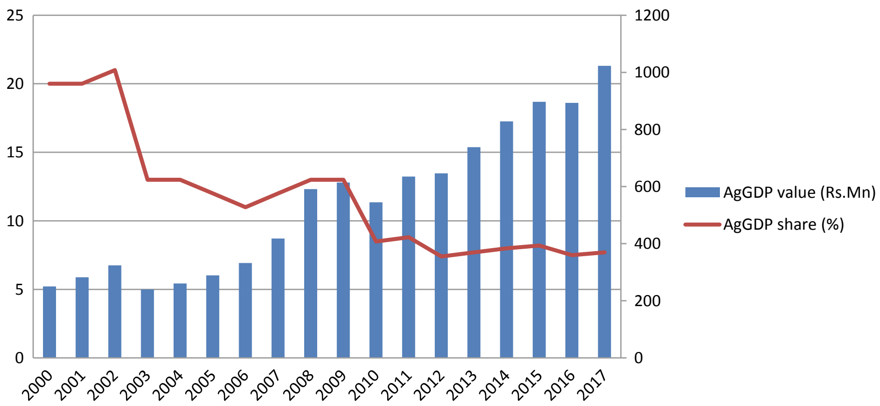

Fig. 3 Shrinking agricultural sector contribution to the GDP (1977–2017)

Domestic agriculture still continues to provide more than 85% of the country's food requirement; with near self-sufficiency in rice, local production of all major food items is noted, with the exception of sugar, pulses, canned fish, and milk powder. These are imported in large volumes and exceed 75% of total available volumes in the country (DCS 2015a, b). In terms of agricultural exports, earnings have not experienced a healthy growth in the past decade, and exports continue to be limited to a few traditional products and others such as spices, vegetables, and fruits, with some processing.

3 Agrarian Distress in Post-conflict Sri Lanka

As discussed above, the end of the conflict resulted in increased agricultural production in Sri Lanka, and reduced prices of traditionally produced food crops. In addition to the restoration of war-damaged infrastructure which is part of the general rehabilitation program, the problems pertaining to agricultural development in Sri Lanka, however, remain unchanged regardless of the conflict or not. These include stagnating productivity, land use issues, inefficient water management, inadequate public spending on agriculture R&D, climate change, and poor market integration, which collectively result in agrarian poverty and food insecurity (Samaratunga 2011). Each of these aspects is discussed below.

As Sri Lanka's population grows at approximately 1% annually and real per capita income rises at around 7.5% per year, the country's national food requirement will be rising constantly in the years to come. The land extent cultivated for major food crops has been stable since 2000 due to the insufficient availability of new arable land for agriculture. Since the resource utilization in the NP and EP too has already returned to the pre-conflict levels in the case of most crops, there is limited scope for further expansion of cultivated extents. Consequently, area expansion will not be a solution to meet the growing food requirement. The yield levels of domestic food crops too have stagnated for more than a decade at average levels which mean the domestic production will not be able to meet national requirements even assuming no change of current per capita food consumption, unless steps are taken to improve current yield levels (IPS 2015).

Imperfections in Sri Lanka's existing land policy and regulations are said to create certain agricultural development problems that include smallholdings, low land productivity, and environmental degradation (Deininger 2003). The limited agricultural land that results primarily from state policy and regulatory environment and lack of secure property rights is likely to prevent land transfers to the most efficient users which are necessary for achieving economics of scale, leading to continued reliance on small land holdings which are not sustainable and economically viable (Deininger 2003). Additionally, lack of integration of scientific land resource management in existing land policies has encouraged unsuitable land use for agricultural purposes, especially on hilly slopes in the up country causing soil erosion, sedimentation, and blockage of waterways (Samaratunga 2011). Also, restrictions on land transfers, especially on ownership and mortgaging, could hamper the investments by the users in improving the quality of land (FAO 2012). Consequently, these reduce the farmers' interest in sustainable and efficient farming activities, leading to the sluggishness in the sector. Since land in the NP and EP is a complicated issue that is closely tied to the ethnic and political situation of the conflict, resolution of land issues is a top priority for post-war agricultural development.

The Sri Lankan agricultural economy has historically been heavily dependent on irrigation, being a rice-based country, endowed with sophisticated irrigation infrastructure. But, water scarcity is a problem; for instance, irrigation schemes in the NP have storage reservoirs which assure supplemental irrigation during dry spells, but water scarcity is a constraint in many parts of the province. Both irrigation infrastructure and water stored and delivered are treated as public goods, supplied free of charge to the farmers. Being considered as a common property with no ownership, no one takes the responsibility for management and maintenance, except in certain cases where the government has sought the participation of farmers. Apart from the fiscal cost, free provision leads to overuse and wastage of water, giving rise to an unaccounted economic loss. The losses are accruing over time, creating a financially and economically unsustainable system in the long run. Currently, the irrigated agriculture sector of Sri Lanka faces two major problems: inefficiency of irrigation water utilization and poor management of irrigation systems owing to a rising budgetary burden of providing irrigation water (IPS 2015).

The major share of agricultural Research and Development (R&D) is still met by public funds in Sri Lanka. Progress in agriculture research in recent decades appears to be slow; major reasons are a lack of investments on research and brain drain. While R&D expenditure has been low to begin with, there has also been a sharp decline in R&D expenditure on agriculture from 0.5% of agricultural GDP in 2000 to 0.3% in 2009 (Girihagama et al. 2012). Public Investment in agricultural R&D dropped from Rs. 3.5 billion (or 90.4 million 2011 PPP dollars) in 2000 to Rs. 2.4

billion rupees (or 61.8 million PPP dollars) in 2009 (all amounts in constant 2011 prices) (Agricultural Science and Technology Indicators (ASTI) 2012). Two main reasons could be identified for the decline in public agricultural R&D expenditures. First, the country's civil war situation pushed the government to divert investments toward confronting terrorism at the expense of other important public causes. Second, revenues from a cess on the export of plantation crops have not necessarily transferred for agricultural R&D (Girihagama et al. 2012).

Rapid and ongoing changes are occurring in domestic and export marketing systems, with increasing number of supermarkets, increased quality consciousness in domestic and global procurement. Moreover, public concern regarding food safety and quality in industrialized countries has resulted in increased and tightened public standards over the past two decades.[2] Sri Lanka lacks sufficient administrative and technical capacities to comply, but the cost of compliance could also weaken its competitive position on agricultural exports. Any failure to comply can result in loss of market for agricultural products. Low quality of most Sri Lankan agricultural products has been a severe challenge in the current environment of high-quality consciousness. A higher proportion of the products sold by the producer is of a quality far below the expected level at the high end of the supply chain due to erratic weather conditions, inferior harvesting and post-harvesting handling, lack of awareness of quality parameters, substandard processing techniques and poor storage and transport infrastructure (Samaratunga 2007). Thus, the evolving markets have a number of repercussions on small-scale farmers who are unable to keep up with emerging product quality trends, leading to a direct loss of possible export revenue.

While agriculture in Sri Lanka has developed in close harmony with the existing climatic conditions of the country, it has been noticed during recent time that the conventional farming experiences and accumulated knowledge on weather patterns have become less useful in the process of agricultural decision making. Sri Lanka's climatic conditions have gradually changed to such an extent that the expected rainfall does not come at the right time of the cultivation season, which places farmers in extremely difficult situations. The rainfall variability has increased drastically during recent decades creating both water scarcity and excess water. Meanwhile, rising air temperature has also resulted in several direct and indirect harmful implications on crop growth (Punyawardena 2012). These changes have implications on agricultural development and food security in the country through its four different constituents: food availability, access, utilization, and stability.

Thus, climate change has become a major threat looming over the economic and social development of the country. Unmistakable signs of climate change are manifested by the growing frequency and intensity of extreme climate events. The country has been experiencing climate-induced disasters on a regular basis recently, incurring immense losses to economic and social life (Wickramasinghe 2017).

[2]Product quality standards such as ISO 9000 and ISO 14000 certification and process quality standards such as HACCP have become essential parameters in the food industry.

The production of domestic crops, including Sri Lanka's staple food rice, has already been affected by gradual changes in climatic conditions d and extreme climate events such as droughts and floods increasingly worsen this. Sri Lanka faced the worst drought in 40 years in early 2016, severely affecting the agricultural production in the country. It is obvious that climate change is resulting in low levels of agricultural output, diminished incomes for farmers, and higher food prices for consumers. Both of these consequences undoubtedly reduce the purchasing ability of people and limit their access to food making especially the rural poor vulnerable (Thibbotuwawa 2018).

3.1 Persistent Agrarian Poverty and Food Insecurity

Agrarian poverty and food insecurity have been the major negative outcomes of the aforementioned agricultural development challenges. The domestic agricultural sector in Sri Lanka is characterized by small-scale farming. Many smallholders do not earn a sufficient income from farming, and poverty is a predominant phenomenon among them. Agrarian poverty and vulnerability are widespread in rural areas where approximately 87% of the identified poor are living (DCS 2015a). More than 81% of Sri Lanka's populations live in rural areas where four-fifths of the country's poor people are located and almost 50% of poor rural people consist of small-scale farmers (International Fund for Agricultural Development 2018).

This implies that the agriculture sector has to make the largest contribution to poverty reduction efforts. The poor basically suffers from a set of common issues such as lack of resources and skills, poor access to technology, inadequate support from institutional settings, and low productivity. Thus, low productivity coupled with non-competitiveness both in the domestic and export markets is mainly responsible for rural agrarian poverty, and it is critical to enhance agricultural productivity and income diversification in rural areas. Because of this clear linkage between agriculture and poverty, agrarian poverty stands out as a serious issue demanding prompt attention at policy level.

A high prevalence of malnutrition is the major outcome concern in terms of achieving food security. The fight against hunger and malnutrition has been a key objective of development efforts. The depth of hunger for Sri Lanka in 2014 was 216 kcal/capita/day, indicating a medium level of food deficit among undernourished children (International Food Policy Research Institute (IFPRI) 2017). However, this is not much improved from the level of 230–240 kcal/capita/day that existed in the early 1990s. The greater the deficit, the greater the susceptibility to health risks related to undernourishment. Average 2015–2017 data indicate that nearly 2.3 million people—equivalent to 11% of the total population in Sri Lanka—are estimated to be undernourished (Food and Agriculture Organization (FAO) 2018). The Global Nutrition Report 2016 ranks Sri Lanka among the countries with the highest wasting (low weight for height) prevalence (21.4%) (IFPRI 2016). The FAO data indicate a comparatively high level of underweight

(26.3%) as well in Sri Lanka. Moreover, severe regional disparities exist in the prevalence of malnutrition, with highly vulnerable agriculture dominated districts in Sri Lanka such as Kilinochchi, Monaragala, Mullaitivu, Polonnaruwa, and Trincomalee showing the highest levels of malnutrition in the forms wasting and underweight (WFP 2017).

One of the major reasons for an imbalanced diet is the dietary concentration of Sri Lanka's population, especially those who are in rural and estate sectors, on a staple commodity (rice) and wheat flour. Even though there is some recent diversification in the dietary pattern in general, the composition of the food basket on average has been more or less static over the years. In the long run, the vulnerability malnutrition can be reduced by improving farm productivity for a diverse set of competitive, sustainable and nutrition-rich crops, and promoting dietary diversification.

4 A Conducive Policy Environment for Agricultural Modernization

Sri Lanka's policy priorities in undertaking agricultural reforms are to minimize food insecurity and create inclusive growth by developing underserved districts and improve environmental protection and disaster management while recognizing the dangers of climate change (WFP 2017). This is in line with overall objectives of modernizing agricultural practices and improving productivity and competitiveness while achieving food security.

A new national agricultural policy is being prepared giving emphasis to achieve three main building blocks: food security, environmental sustainability, and economic opportunities (Weerahewa 2017). A Food Production National Programme (FPNP) 2016–2018 which comprises of crop production and home gardening promotion was introduced in September 2015 to increase food security through increased food crop production and productivity. Furthermore, there are some other programmes that include agriculture 'mega zones,' farm mechanization, fertilizer subsidy, and the renovation of irrigation tanks to improve food availability and productivity (WFP 2017). These programs target to uplift the agriculture sector and farm welfare in the country as a whole. At the same time, several programs have already been completed in relation to irrigation infrastructure development, land settlement and livestock and fisheries sector developments specifically targeting the NP and EP under the 'Uthuru Wasanthaya' and 'Nagenahira Navodaya' programmes.

4.1 Policy Reforms and Their Implications

Even though there is a policy commitment toward agricultural modernization with a view to alleviate persistent agrarian poverty and food insecurity, it is a daunting challenge on its own and needs certain reforms in the current policy structure in order to bring about some innovative solutions, especially in the areas of land, irrigation, technology transfer, and marketing.

The major objective of land policy traditionally is to hold untitled land under government ownership and distribute such lands as smallholdings for agricultural production purposes, while preventing further subdivision of land holdings. There are also restrictions on the use of paddy lands for any other purpose under the Paddy Lands Act of 1956 which was partially and conditionally relaxed under the Agrarian Services Act of 2000 (Samaratunga and Marawila 2006). However, institutional reforms to consolidate private property rights on land and develop a land market have been a key policy concern in recent times. A ‘Land Titling’ project was implemented to make this a reality. The government began to convert permits given through the Land Development Ordinance to various other forms of ownership such as ‘Swarnabhoomi’ and ‘Jayabhoomi’ which granted more rights on the owners of land, though not clear title deeds. Recently, the ‘Bim Saviya’ programme was implemented in an attempt to consolidate private property rights on land (Bastian 2013).

Even though rationalizing land ownership for efficient use of land resource is expected to increase access to land by efficient farmers and to encourage adoption of high-value agriculture instead of low-value agriculture while addressing the twin challenges of low productivity and efficiency, serious thought has to be given to avoid the possible equity implications for marginalized and vulnerable groups. Especially, measures to mitigate the effects of imperfections in rural credit need attention; input and output markets have to be undertaken simultaneously in order to prevent large farmers getting a competitive advantage over small farms. Also, these policy reforms should essentially cover strict enforcement measures of regulations on land use such as limiting agricultural land uses only to suitable land classes, amending regulations on soil conservation to prevent improper land uses, identifying activities leading to degradation of land and initiating conservation practices in susceptible areas, and preventing land encroachment, especially in environmentally sensitive areas.

With new developments, it is obvious that the current water management approaches cannot be continued in the future without a policy thrust toward high productivity and sustainable water resources. The maintenance of all existing irrigation projects and new water resource development activities is under the purview of state institutions. Subsequent governments have already identified the need for a comprehensive policy revision in the water sector and are attempting to develop a new set of policies (IPS 2015).

The National Water Policy of 2000 aimed at transferring the management of irrigation works to farmer organizations. The introduction of irrigation charges has been proposed many times and even attempted at a pilot scale in the past without success. A major factor behind this failure is the sociopolitical setting that strongly believes that water is treated as a free gift of nature or as a public good in an economic sense. The inherent bureaucratic inefficiency of state institutions that collect and utilize the irrigation charges was also partly instrumental in the failure of this initiative (World Bank 2003).

Hence, future policy reforms should essentially deal with these fundamental issues in order to ensure efficiency and long-run sustainability. Participatory Irrigation Management (PIM) in the form of farmers working together with government irrigation agencies taking the responsibility of irrigation systems management was adopted in Sri Lanka for this purpose. The main purpose of PIM is to improve the productivity of irrigated agriculture, making the system perform efficiently and reduce government expenditure. Nevertheless, the problem of irrigation service provision cost cannot be solved without some form of a charge. Hence, the long-run solution to the problems of irrigation water use efficiency, equity, and cost recovery seems to lie with a suitable combination of participatory management and land-based irrigation charges (IPS 2015).

Nevertheless, there are three major areas that need to be systematically looked into before launching such an attempt. These are administrative determination of water charges, determining the suitable institutional arrangement for implementation and evaluating the consequences of such an initiative. This type of policy revision can be coupled with the introduction of water-saving irrigation technologies for marginalized people who would possibly be affected by such a major policy revision. These could include, for example, the introduction of solar-powered drip irrigation, promotion of agro-wells, rainwater harvesting to increase water use efficiency and to enhance the income levels of farmers in water scarce areas. These can also be considered as adaptation strategies to minimize the climate change impacts on the agricultural sector.

Productivity enhancement in agriculture requires the choice and use of appropriate technology—i.e., the technology which is appropriate and adaptable to local conditions with a majority of rural, relatively poor farmers. It also determines to what extent the poor will benefit or lose from integrating into the modern economy. A National Agricultural Research Policy (NARP) was formulated in the early 1980s to foster a public national agricultural system that ensures demand orientation, client orientation, and high quality in its research and dissemination. However, the resulting agricultural research system is also essentially government-centered and not successful in commercializing agriculture and promoting regional specialization and vertical diversification. Enhancing agricultural research and technology by increasing budgetary and human resources allocation, with a focus on much broader aspects like livelihood improvement, rural development, food security, and agro-based industries, is a necessary condition for policy reforms in technology generation. Within the present context of globalization, adaptive research too emerges as very important in buying or acquiring foreign technology and transferring successfully to different locations in the country (IPS 2015).

Both policy and institutional reforms are needed to bring R&D, technology, and extension under one umbrella while strengthening the role of public–private partnerships. Agricultural extension is under increasing pressure to become more effective, more responsive to clients, and less costly to governments. Despite various attempts to improve effective dissemination of agricultural technology, the process of reform has remained incomplete. Technology dissemination through extension has to be customized by strengthening existing extension approaches with adequate budgetary and human resources investments. However, there can be a problem that only rich farmers can afford such technology, especially in the case of embodied technology such as machinery and hybrid seeds rather than disembodied technology such as agronomic practices. Consequently, the state has to play a role in ensuring inclusion of such farmers.

The impact of evolving markets has several implications on small-scale farmers who are unable to keep up with emerging product quality trends. The state marketing policy has historically been limited to ad hoc procurement of few products under a guaranteed price scheme. However, recent developments in agricultural markets indicate that markets are not readily available to absorb the produce at the time of harvesting, and it was left to organized traders to purchase at relatively low prices. This situation motivated the need for am modern innovative practice working with smallholders to improve their ability to emerging marketing trends by delivering knowledge, supporting in accessing capital and advising on food safety and quality standards and enterprise planning. Even though there are few modern innovative practices that fulfill the consumer demands while effectively integrating the farmers in their supply chains (e.g. MAS Food, Cargills), the lack of capacity to accommodate a large number of poor farmers has resulted in exclusion and marginalization. Under a current National Agribusiness Development Programme (NADeP) and Smallholder Agribusiness Partnership Programme (SAPP) private sector entities, farmer-based organizations (FBOs) and government service providers are collaborating to undertake partnership ventures in value chain development and marketing linkages by targeting the smallholder agri-producers. Ensuring a predictable and transparent trade policy instead of ad hoc policy changes is also required to avoid market uncertainties and investor confidence to make this a success.

5 Conclusion

The domestic agricultural sector in Sri Lanka is characterized by small-scale farming. Many smallholders do not earn a sufficient income from farming, and poverty has been a predominant phenomenon among them. Low productivity coupled with non-competitiveness both in the domestic and export market has partly been responsible for rural poverty.

Sri Lanka's conflict-affected NP and EP have traditionally been high-potential agricultural areas providing livelihood to a group of hard-working and resilient farmers. During the conflict, agricultural supplies from these areas to the rest of the country were restricted due to factors such as government-imposed trade bans, taxes imposed by terrorist groups, and breakdown of the transport connectivity with the rest of the country. This situation had severe negative implications on Sri Lanka's agriculture sector. The cessation of the conflict therefore saw an opening up of a large agricultural resource base for production. As expected, it resulted in increased cultivated extent and agricultural production, which in turn had some beneficial impacts on rural farm income as well as food security.

Despite the post-conflict agricultural developments that the country experienced in general, and the NP and EP in particular, long-standing agricultural development issues remain unaddressed affecting the overall agricultural development of the country. Therefore, it is necessary to develop a long-term strategy to address these issues that include stagnating productivity, unproductive and unsustainable land use, inefficient water management, inadequate spending on agriculture research and technology, climate change, and poor market integration which collectively result in agrarian poverty and food insecurity in the country.

While Sri Lanka is off to a good start with recent policy responses that focus on most of the long-term development issues, it is important to eliminate the problem of coordination and inter-agency friction among the different organization. The poor achievements of past agricultural policies, strategies, and programs originate from two sources. Firstly, the lack of congruence between the sectoral policies and political priorities and conflicting priorities of the sectoral policies and macro-economy has been a major source of policy failure in the past. Secondly, many different agencies have been involved in enforcing agricultural policies and implementing the programs under them, resulting in severe problems of coordination. In addition, unclear boundaries of the operations of the different agencies leading to conflicts and overlapping of authority have often resulted in implementation failure in agricultural development endeavors.

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Achieving Equity in Post-conflict Sri Lanka

Ganga Tilakaratna

1 Introduction

Sri Lanka's three-decade-long conflict had a devastating impact on poverty and inequality in the country, resulting in daunting challenges to be faced in its aftermath. The effects were more prominent in the Northern Province (NP) and the Eastern Province (EP) where the conflict occurred. The destruction of infrastructure and transport facilities in these regions hindered access to markets and hampered livelihood activities. The interruption to public service provision led to deprivation of essential services, while the collapse of social networks further heightened the vulnerability and insecurity of the communities. By the end of the conflict, the NP and the EP were much impoverished, with standards of living far below the national average.

Given the devastation of the conflict and the loss and damage to lives and property, future conflict prevention was a national priority in the post-conflict era. The conflict-affected regions needed to be rapidly reconstructed and reintegrated. As part of its approach to reconciliation, the government focused on rapid economic development to improve the standards of living in these regions. For this purpose, several regional development programmes were implemented by the government, focusing on infrastructure development, livelihood development and improving access to basic services/utilities including access to financial services in the NP and EP.

The post-conflict development discourse in Sri Lanka places special emphasis on the development needs of the NP and EP. However, the equity dialogue is not limited to the recovery and rehabilitation of the war-torn regions. There are other regions and sectors that are lagging behind, subject to various forms of vulnerabilities and inequalities. In this context, the government has undertaken several

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national-level initiatives aimed at developing rural economies and ensuring inclusive growth.

In this background, this chapter discusses Sri Lanka's post-conflict development trajectory vis-à-vis poverty and equity. Section 2 opens with a brief discussion of the impact of conflict on poverty, inequality and vulnerability. Section 3 follows with a detailed analysis of post-conflict strategies and initiatives undertaken by the government to enhance equity and development in Sri Lanka. Section 4 discusses the somewhat mixed results and implications of the post-conflict development efforts, with a special emphasis on poverty reduction, livelihood development and access to services/utilities, including financial access. Section 5 concludes.

2 Impact of Conflict on Poverty, Inequality and Vulnerability

The three decades of conflict had devastating effects on lives and livelihoods of many people causing increased poverty, vulnerability and inequality in Sri Lanka. The country's poverty level remained at double-digit levels throughout the conflict period. The poverty headcount index stood at 26.1% in 1990/1991 and increased further to 28.8% in 1995/1996. Despite a gradual decline reaching 15.2% in 2006/2007, significant disparities were observed across sectors (i.e. urban, rural and estate) and districts. The estate (or plantation) sector continued to have over 30% of its population below the poverty line—the highest among the three sectors (Fig. 1). Further, considerable disparities were observed across districts, with a number of districts like Nuwara Eliya and Monaragala recording over 25% of their population as being in poverty.[1] Nevertheless, with the end of the conflict in 2009, the aggregate poverty level fell significantly to a single-digit level (8.9% in 2009/2010), which further declined to less than 5% in 2016. A decline in poverty was observed across all districts and sectors, minimising regional disparities in the post-conflict period.

The reduction in absolute poverty as well as the narrowing of sectoral inequities is linked to factors such as the expansion of armed forces and higher remittance inflows from migrant workers. For instance, Santhiraseragaram (2013) argues that 'military expansion' in Sri Lanka (during mid-1990–2009/2010) contributed to poverty reduction, pointing out that in districts where military employment/recruitment to armed forces was high; there has been notable poverty reduction. Other studies identify international remittances (and domestic transfers) also as contributory factors for poverty reduction during 2002–2012/2013 (Ceriani et al. 2015).

[1] It should be noted that the poverty estimates for many districts in the NP and EP are not available prior to 2012/2013, as they were not covered by the household surveys conducted during the conflict.

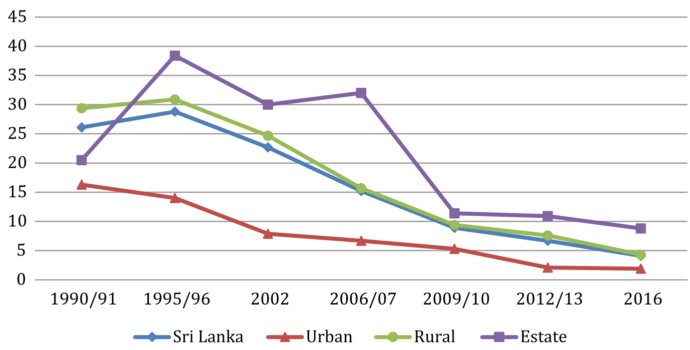

Fig. 1 Poverty headcount index—1995/96–2016. *Source* Department of Census and Statistics (DCS), various years

During the course of the conflict, Sri Lanka also experienced high levels of income inequality and significant regional disparities in access to services. The Gini coefficient of income increased from 0.43 in 1990/1991 to 0.47 in 2002 and further to 0.49 by 2006/2007 indicating rising disparities in income distribution during the conflict period. Moreover, a notable share of households in many districts was deprived of access to basic services like safe drinking water, sanitation facilities, electricity and access to financial services.

Although the consequences of Sri Lanka's three-decade conflict were felt by the entire country, its impact was the most devastating on the NP and EP. Endowed with ample natural resources, these regions were active contributors to the country's gross domestic product (GDP) especially in the paddy, fisheries and dairy sectors prior to the conflict. The NP, rich in fertile land, minerals, forests and wetlands, also accounts for about 40% of the coast of Sri Lanka. The EP too was a major contributor to the country's paddy production prior to the conflict. It had a well-established ancient irrigation system which fell into disrepair during the conflict (Samaratunga 2010). However, by 2009, the contribution of the NP and EP to Sri Lanka's GDP was only around 9%, with the former providing the least provincial contribution to GDP at 3.2% (Central Bank of Sri Lanka (CBSL) 2014).

The three-decade-long conflict affected the lives and livelihoods in the NP and EP in many ways. The damage and destruction of infrastructure in these areas reduced employment opportunities. The inaccessibility to markets and fields disrupted the normal trade patterns. In addition to the damage within these regions, they were isolated from the rest of the country. The A9 road which connects Sri Lanka's northern regions with the rest of the country was closed from 1990 until 2009 due to security concerns. This caused hyperinflation and scarcities (Parameswaran 2009), hampering livelihood activities in the NP and EP. Further, these two provinces—specifically the coastal districts of Ampara, Batticaloa, and Trincomalee in the EP, and Jaffana, Kilinochchi, and Mullaitivu in the NP—were devastated by the Asian tsunami in 2004. But, the post-tsunami rehabilitation activities in these areas were hampered due to the conflict (Samaratunga 2010). The accumulated damage to infrastructure and the consequent decrease of livelihood opportunities was also a key contributor to high levels of poverty and inequality in the NP and EP.

The situation was worsened by the conflict's impact on public service provision in the areas. Households in the conflict-affected regions were deprived of access to public services. Schools and hospitals in the conflict areas were damaged along with the state institutions delivering other essential services. Further, households in the conflict-affected regions were deprived of benefits from the country's social protection system. For example, Sri Lanka's largest poverty alleviation programme, Samurdhi, was not in operation in three of the conflict-affected districts, i.e. Mullaitivu, Mannar and Killinochchi until the end of the conflict. In addition, the government's capacity to provide public services was further eroded as a result of rising military expenses (Institute of Policy Studies of Sri Lanka (IPS) 2010), the effect of which was felt not just by the conflict-affected districts, but the entire country.

By the end of the conflict, the NP and EP were highly impoverished with many segments of the population facing various forms of vulnerabilities. These include internally displaced persons (IDPs), war widows, orphans and disabled persons. Moreover, the issue of reverse entitlements—referring to the consequences of asset transfers and population displacements during a conflict—was seen as another impact of the conflict that led to new forms of social inequality. For example, there has been evidence of destruction/appropriation of assets by powerful groups, causing increased insecurity and vulnerability among the conflict-affected households (IPS 2010).

3 Post-conflict Efforts to Enhance Equity in Development

As a country that suffered from three decades of conflict that took a heavy toll in terms of lives and property, future conflict prevention was considered a national priority in the aftermath of the conflict in Sri Lanka. International literature argues that poverty and inequality have the potential to incite conflict, especially when poverty patterns overlap with ethnic, religious, language or regional boundaries (Goodhand 2003). Through an analysis of all conflicts ending between 1945 and 1996, Walter (2004) also concludes that improving the quality of life is a key post-conflict strategy in minimising the likelihood of recurring conflicts. As such, policy measures directed towards ensuring equity are considered an important tool for post-conflict reconciliation efforts.

Sri Lanka adopted economic development as its path to reconciliation; enhancing equity was considered an integral part of the reconciliation efforts. In particular, accelerating the development of the conflict-affected NP and EP and improving the standards of living in these regions were major components of the government's approach to reconciliation. For this purpose, several regional development plans/programmes were implemented by the government, specifically focusing on the NP and EP. These policies/programmes complemented various national-level initiatives undertaken over the past decade to develop lagging regions and assist vulnerable communities. These initiatives focus particularly on infrastructure development and improving access to basic services/utilities, including financial services.

3.1 Initiatives to Develop the NP and EP

The key government initiatives to accelerate the development of the NP and EP include the 'Nagenahira Navodaya' (Eastern Revival) and the 'Uthuru Wasanthaya' (Northern Spring) programmes and interventions to improve connectivity of the conflict-affected regions.

In 2007, the government regained control over the EP. By this time, the conflict had affected the lives and livelihoods of a majority of the households and had caused considerable damages to public infrastructure and service delivery systems in the province. This required urgent action to expedite resettlement, rehabilitation and reintegration of the province. Consequently, the government launched the 'Three-year Eastern Province Development Plan: 2007–2010', more commonly known as Negenahira Novodaya (NN).

The NN programme was aimed at reviving the EP through ensuring fundamental rights and freedom of the people and re-establishing their livelihoods. In this regard, it had identified six key areas (CBSL 2008):

i. Resettlement of returnees;
ii. Public institutions capacity building;
iii. Human settlement development;
iv. Improving economic infrastructure;
v. Strengthening social infrastructure and fostering social services;
vi. Revitalisation of productive sectors and regional economy.

This three-year development programme started with a 180-day programme immediately after the end of the conflict. This included short-term initiatives to address immediate resettlement and rehabilitation-related concerns by restoring civil administration and service delivery in the EP (CBSL 2008). The restoration of public service delivery was crucial in ensuring well-being and security of those in the region. As such, the NN also focused on clearing landmines, re-establishing the road network, restoring the provision of essential services such as water, sanitation, and electricity as well as establishing hospitals and police stations.

Re-establishment of livelihoods was central to alleviating poverty in the post-conflict regions. As such, the NN aimed at developing the sectors of agriculture, irrigation, fisheries, and livestock through increased productivity, quality and market access. Tourism was seen as another sector with great development potential in the EP. In addition, several investment incentives were introduced, including tax relief measures to investments that provide employment opportunities in the region as well as duty waivers and value-added tax (VAT) exemptions for relevant plants and machinery (CBSL 2008).

The results of these policy measures were such that by the end of 2009, all IDPs in the EP had been resettled (CBSL 2010). In terms of public service provision, by the end of 2007, seven new police stations had been established in the area, while civil administration was also restored (Ministry of Finance and Planning 2008). Further, a revival of livelihoods was also observed, in the agriculture sector, particularly in the case of paddy, other major subsidiary crops as well as dairy production (Ministry of Finance and Planning 2008). This is largely attributed to the increased accessibility to market facilities and replacement of lost livestock, under the NN. Further, this programme was also successful in improving the electrification in the EP.

The year 2009 marked the end of the 30-year long conflict, and the government regained full authority over the NP. In order to ensure the speedy recovery and rehabilitation of the NP, the government launched Uthuru Wasanthaya (UW), also referred to as the Northern Spring. This was the major programme implemented for the development of the NP, addressing both immediate requirements and long-term development needs.

The UW was aimed at speeding up the rehabilitation of the NP by ensuring well-being and living standards of the people, reviving livelihoods and rebuilding public infrastructure. As such, its main components included (CBSL 2010):

i. Social protection and livelihood development;
ii. Improving economic infrastructure;
iii. Revitalisation of productive sectors;
iv. Human settlement development;
v. Strengthening social infrastructure and fostering social services.

Similar to the NN, the UW programme also encompassed a 180-day programme to accelerate the resettlement of the IDPs as well as a two-year programme from 2010 to 2012 to rebuild and develop the province. By the end of the conflict in May 2009, there were an estimated 295,136 IDPs; by April 2011, nearly 95% of them had been resettled under this programme (Ministry of Finance and Planning 2011). Furthermore, the UW programme included infrastructure projects for sectors such as power, water and irrigation, sanitation, transportation, health and education. Livelihood development (through developing relevant infrastructure as well as providing vocational training) was also the main focus under this programme.

Alongside the NN and the UW programmes, improving connectivity of the NP and EP—that had long been isolated from the rest of the country—was given priority in the post-conflict period. Several initiatives were taken by the government in this regard. The A9 road was reopened for civilian traffic in July 2009 (CBSL 2010) while the Sanguppidi Bridge was opened in January 2011, connecting the Jaffna Peninsula to the mainland (CBSL 2011).

In addition to the rebuilding work carried out under the NN and the UW programmes, the Conflict-Affected Area Rehabilitation Project and the North Road Connectivity Project were launched towards the end on 2009, aimed at re-linking the NP and EP with the rest of the country (CBSL 2011). Moreover, three key bus services were launched in 2009: 'Gamiseriya' which aimed at providing reliable transport services to rural population, 'Sisuseriya' aimed specifically to address transportation needs of school children and 'Nisiseriya' which provided nighttime bus services. These were further complemented by daily bus services that started in 2009 connecting Jaffna with various destinations including Colombo and Kandy (CBSL 2010).

3.2 National-Level Initiatives to Improve Infrastructure and Access to Services

Although the development needs of the NP and EP received special attention in the post-conflict era, achieving equity objectives was by no means limited to accelerating the rehabilitation and recovery of these regions alone. As such, while the NN and the UW were implemented as special provincial programmes to address the post-conflict development needs of the NP and EP, the government also undertook various national-level initiatives aimed at developing lagging regions through infrastructure development and improving access to services such as electricity, water and sanitation facilities, as well as access to financial services.

A number of infrastructure development projects, some of them initiated prior to the end of the conflict, were successfully implemented in the post-conflict era, with the aim of improving rural infrastructure facilities and urban–rural connectivity. The Randora National Infrastructure Development Programme, launched in 2006, aimed at providing modern infrastructure to promote nationwide economic development (Ministry of Finance and Planning 2006a). This programme incorporated the development of infrastructure related to transportation, electricity, water, sanitation and irrigation, as well as health, education and industries.

In addition, the Maga Neguma and the Gama Neguma programmes provided the corresponding infrastructure development projects at the district and local authority levels (Ministry of Finance and Planning 2006b). Maga Neguma is a key initiative aimed at improving urban-rural connectivity. By 2018, approximately 12,600 km of rural roads had been rehabilitated under the Maga Neguma (Ministry of Highways and Road Development 2018). The Gama Neguma, on the other hand, was launched in 2006 targeting 119 poorest District Secretariat (DS) divisions as an initiative to empower the poor through an integrated rural development programme. In addition to improving rural infrastructure, this programme also focused on promoting income-generation activities, ensuring access to basic services and empowering poor communities (Ministry of Finance and Planning 2007). The Gama Neguma was expanded to encompass 295 DS divisions covering 23 districts in 2007 (Ministry of Finance and Planning 2008), while by 2010, with the end of the conflict, it achieved all island coverage (Ministry of Finance and Planning 2011). Projects carried out under the Gama Neguma included access roads, community-based water supply schemes, rural electrification, minor irrigation works, child and maternity clinics, sanitary facilities at school, preschool development, community centres, etc.

The above discussed large infrastructure development projects contributed to improving connectivity and access to services across the country, including in the conflict-affected regions. These efforts were further complemented by other government initiatives to improve access to services like financial services.

The three decades of conflict had interrupted the operations of the banking and non-banking financial institutions in the NP and EP, affecting the lives and livelihoods of people in these regions. Hence, improving access to financial services became an important part of the government's post-conflict development strategy. Several initiatives were taken by the government in this regard to support livelihood activities and reduce poverty in the NP and EP.

State-owned and private banks were encouraged to open branches in the conflict-affected regions. Consequently, in the year 2009 alone, 17 bank branches were opened in the EP while ten branches were opened in the NP, accounting for more than a half of new branches opened in the country in 2009 (CBSL 2010). The banking network continued to expand in the NP and EP resulting in an increasing density of banks (bank branches per 100,000 persons) since 2009. In the NP in particular, the density of banks increased by over twofold during 2009–2017 from 10–23, recording the highest bank density among the nine provinces (Fig. 2).

In 2009, the CBSL also introduced a credit guarantee scheme known as 'Awakening North' through the banking network, aimed at providing financial assistance for the revival of economic activities in the NP. Under this scheme, loans up to Rs. 200,000 per borrower were provided for agriculture, livestock, fisheries and self-employment activities. This scheme also provided support to IDPs to restart their livelihood activities after resettlement. A similar scheme was commenced in the EP under which loans up to Rs. 250,000 per borrower was provided for resumption of economic activities (CBSL 2010).

In addition to these government interventions, there was also a significant growth of non-bank financial institutions such as leasing and finance companies and

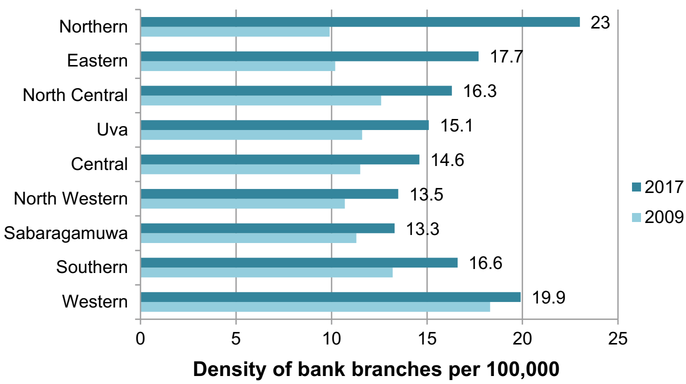

Fig. 2 Density of banks by province—2009 and 2017. *Source* Based on CBSL (2017a, b) Sri Lanka macroeconomic developments in charts—fourth quarter 2017

microfinance institutions in the post-conflict period. The consequences of this influx of financial institutions to conflict-affected regions are discussed in detail later.

Rural electrification was another area that has been given priority in the post-conflict era. By the end of the conflict in 2009, the national electrification level was recorded at 88%; however, there were considerable regional disparities with some districts in the NP such as Kilinochchi and Mullaitivu recording electrification levels of below 6% (Ministry of Finance and Planning 2010). As such, along with several all-island rural electrification schemes, the government also implemented projects specifically aimed at rehabilitating and expanding electricity transmission in the NP and EP such as the conflict-affected Area Rehabilitation Rural Electrification Project which was launched in 2009 (CBSL 2010).

While much of the post-conflict development efforts focused on infrastructure development including, roads, transport and electrification as well as reviving livelihoods of the conflict-affected households, the emphasis on human development, health and education in particular remained relatively low.

Sri Lanka's universal free health and education systems have long been the cornerstone of the relatively high human development enjoyed by Sri Lankans. However, regional disparities in health and education outcomes have highlighted the need for action to improve the quality of and access to these services. The key government initiatives discussed earlier, including the NN and the UW programmes, as well as the Randora and Gama Neguma programmes, included special projects related to the provision of health and education services. Further, several policy initiatives were taken by the government in the recent decade to improve access and address regional disparities with regard to access to health and education services. However, it should be noted that there has not been any significant improvement in government expenditure on health and education over the past decade, both of which have remained at around 1–2% of GDP over the 2008–2017 period.

4 Equity in Development: Implications of Post-conflict Initiatives

The implications of Sri Lanka's post-conflict development initiatives on poverty and equity appear to be somewhat mixed. For instance, while they have had positive impacts on poverty reduction and improving access to services/utilities—thereby addressing regional disparities to some extent—their implications on access to financial services have turned out to be less favourable. This section discusses in detail the implications of post-conflict development efforts particularly on poverty reduction, access to services/utilities, creating livelihood opportunities and achieving financial inclusion.

4.1 Poverty Reduction

The three-decade-long conflict-affected lives, livelihoods and assets of many people, disrupted the country's public service delivery system and caused damages to infrastructure facilities in the NP and EP. These in turn contributed to high levels of poverty and vulnerability in the country. The aggregate poverty level stood at 15.2% in 2006/2007, with all districts recording double-digit poverty levels, including some with over one-fourth of their population falling below the national poverty line (in 2006/2007).

In the aftermath of the conflict, various initiatives by the government, including investment in infrastructure and regional development, and promotion of livelihood opportunities (along with the country's immediate post-war higher economic growth rates) helped reduce poverty levels to a great extent. Moreover, restoring livelihoods and revival of the agriculture sector in the NP and EP also contributed to poverty reduction in the conflict-affected regions.

The aggregate poverty level based on the national poverty line declined from 15.2% in 2006/2007 to 8.9% in 2009/2010 soon after the end of conflict, which further declined to 4.1% by 2016 (DCS various years). The international poverty line of USD 1.90 (2011 PP) too indicated a decline in extreme poverty in Sri Lanka from 2.41% in 2009/2010 to just 0.73% in 2016 (Nanayakkara 2018). Further, a reduction in poverty was observed across all sectors and districts. All three sectors—urban, rural and estate—recorded a steady decline in poverty since the end of the conflict. Further, all districts experienced a decline in poverty, with nearly a half of them showing over 50% reduction between 2009/2010 and 2016 (Fig. 2). Even some of the districts in the NP and EP like Jaffna, Batticaloa and Ampara have experienced a notable decline in their poverty levels (40–80%). However, poverty levels still remain at double-digit levels in some of the conflict-affected districts like Killinochchi (18.2%), Mullaitivu (12.7%), Batticaloa (11.3%) and Trincomalee (10.0%).

Despite the progress in poverty reduction in the post-conflict period, poverty, vulnerability and inequality continue to remain issues of great concern in Sri Lanka. Still, some 'pockets of poverty' are observed even in districts where the poverty levels have fallen over the years. Moreover, there are a considerable number of vulnerable households that are clustered 'just' above the poverty line, facing the risk of slipping into poverty due to shocks like natural disasters. The frequency of natural disasters like floods, droughts and landslides has increased in recent years, affecting lives and livelihoods of low-income households in particular. Furthermore, although the Gini coefficient of household income has declined marginally after the end of the conflict from 0.49 in 2009/2010 to 0.45 in 2016 (DCS, 2011 and 2017), it still indicates high levels of income inequality in Sri Lanka—and indeed, the highest in South Asia (United Nations Development Programme 2018).

4.2 Access to Basic Services and Utilities

Post-conflict efforts to develop the lagging regions and their infrastructure facilities also led to an improvement in access to basic services like electricity, water and sanitation in Sri Lanka. The percentage of households with access to electricity improved notably from 85.3% in 2009/2010 to nearly 97% in 2016, with all sectors and districts showing an improvement during this period. Even districts in the conflict-affected region have shown a significant improvement in terms of access to electricity. By 2016, the majority of the districts in the NP and EP recorded over 90% of their households having access to electricity. The only exceptions are Mullaitivu and Killinochchi, which too have recorded relatively high rates of 85% and 89%, respectively, of households with access to electricity—a notable improvement since the end of the conflict (DCS 2011, 2017a).

The share of households with sanitation facilities has also improved since the end of the conflict. By 2016, nearly 92% of the households in the country reported having access to improved sanitation facilities available exclusively for the household (DCS 2011 and 2017b). All districts recorded over 85% of households with access to improved sanitation facilities including the districts in the Northern and Eastern provinces. This is a notable improvement since 2009/2010. Furthermore, the share of households with access to safe drinking water in the majority of the districts in the North and the East has increased to over 95% in 2016. Nevertheless, three of the conflict affected districts in the North, i.e. Vavuniya (75.1%), Kilonochchi (82.1%) and Mullativu (86.8%) lag behind the others. Moreover, substantial disparities are also observed across the three sectors, with the estate sector having significantly lower (44.7%) share of households with access to safe drinking water[2] compared to urban (98%) and rural sectors (89.3%).

4.3 Livelihood Development

As discussed previously, numerous livelihood development interventions were carried out in the NP and EP in the post-conflict period. Both the NN and the UW—the two key programmes implemented to develop and reintegrate the conflict-affected regions—incorporated livelihood development strategies. Similarly, the rural development programme, Gama Neguma also included a livelihood development component. These programmes had many positive implications on livelihood development and income generation particularly among the conflict-affected communities (Fig. 3).

In the case of the NP, priority was given to reviving the agriculture, fisheries and livestock sectors. In order to revive the agriculture sector, the government took

[2]This is primarily because many estate households tend to use water from springs, streams and directly from rain without purification, which is considered as unsafe by definition.

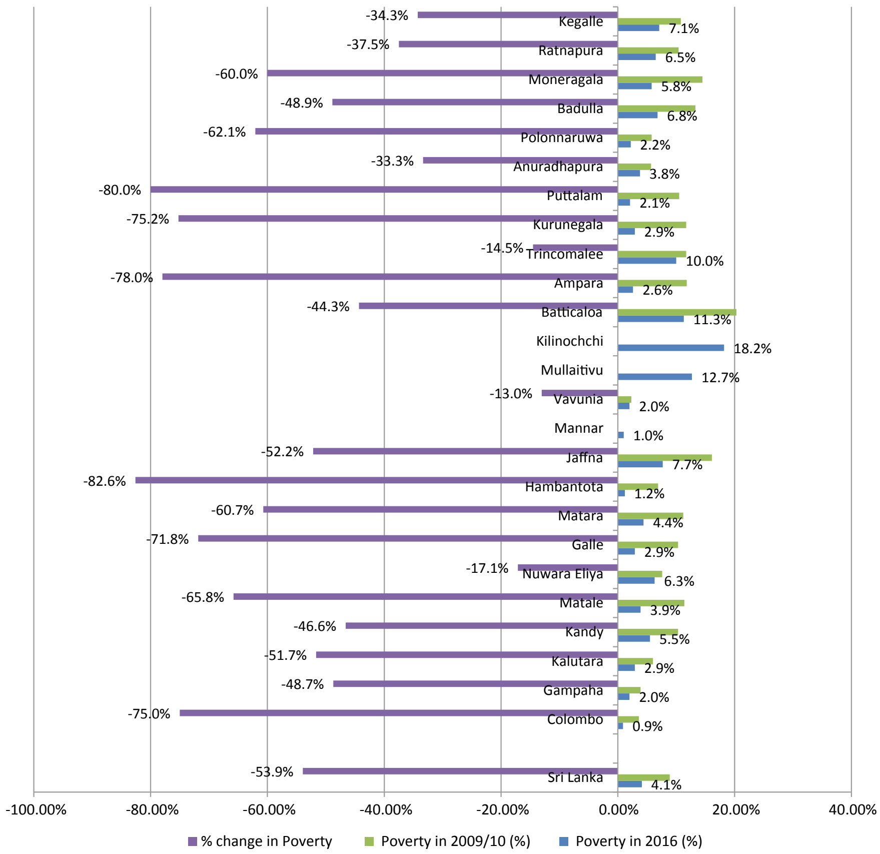

Fig. 3 Poverty headcount index by district—2009/10–2016. *Note* Poverty data for 2009/2010 are not available for districts of Kilinochchi, Mullaitivu, Vavuniya and Mannar. *Source* The DCS (2011, 2017) Household income and expenditure surveys final reports 2009/2010 and 2016. Ministry of Finance and Planning, Colombo

many initiatives: the repair of relevant infrastructure including irrigation systems, clearance of abandoned paddy lands, as well as providing subsidies and agricultural equipment. Several steps were also taken to revive the fisheries sector, which included the provision of boats and other equipment as well as financial assistance. Further, both cash and in-kind support were given to promote livestock and self-employment activities.

In the case of the EP, the sectors that were prioritized for livelihood assistance were similar to the NP: the agriculture sector, the fisheries sector and the livestock sector. Given that, one-sixth of the country's total paddy lands are located in the EP (Ministry of Finance and Planning 2009), various measures were taken to develop the agriculture sector. In particular, the government provided agriculture-related livelihood assistance in the forms of fertilizer, seeds, agricultural equipment and financial support to the farmers (Ministry of Finance and Planning 2009). In terms of promoting the fisheries sector, steps were taken to develop and establish fish landing sites and anchorages along the eastern coast while also providing equipment (Ministry of Finance and Planning 2008). Further, various initiatives were taken to promote the livestock sector, which included providing livestock and increasing accessibility to collection facilities Ministry of Finance and Planning 2008). Another key initiative by the government was the introduction of tax incentives to promote private investment that leads to employment creation in the EP.

The fruits of these livelihood interventions were immediately apparent. By 2010, the collective fish production of the NP and EP grew by a further 40% (CBSL 2011). Similarly, the expansion of paddy production in the NP and EP contributed to the 18% growth in total paddy production from 2009 to 2010 (CBSL 2011). In terms of the livestock industry, the milking cow population and the average daily milk production in the NP recorded a substantial growth in 2011 (CBSL 2012). In this manner, the government initiatives in the post-conflict period helped many conflict-affected households to successfully restore their income-generating activities. Further, new livelihood opportunities were created including self-employment or small business activities as well as employment opportunities in sectors like tourism.

Nevertheless, some argue that these positive effects on livelihood development and income generation among conflict-affected communities would have been higher, in the absence of 'militarisation' of economic activities in the post-conflict period. Since the end of the conflict, armed forces were actively involved in various economic and development activities that included infrastructure and urban development projects, as well as business activities in sectors like tourism and agriculture.

At present, there are several hotels, resorts and restaurants operated by the armed forces in the NP and EP, as well as in the other parts of the country. These businesses are managed by the Sri Lanka Army, Navy or the Air Force and their staffing is almost entirely made up of armed forces personnel. Military involvement has also become significant in the leisure/recreation and travel sectors. Whale watching tours operated by the Sri Lanka Navy is a prime example in this regard. This has prompted some criticism of the military engagement in these economic activities. The South Asian Centre for Legal Studies (2018) argues that the military engagement in economic activities 'creates a distortion in the market, as it is able to enjoy "economic privilege" and thereby create an environment of unfair competition' (p. 22). It further argues that this situation leads to crowding out of private investors which results in a loss of employment opportunities and revenues for the country.

In the case of the agriculture sector, the Sri Lanka Army established a Directorate of Agriculture and Livestock (DAL) in 2011 under which several large-scale and smaller-sized agriculture and livestock farms have been set up in the NP and the EP. Even prior to setting up of the DAL, the armed forces were engaged in selling vegetables to public at prices lower than the prevailing market prices as a relief measure to consumers, particularly at times of increases in vegetable prices. Due to their lower overhead costs (e.g. transport and labour costs perhaps being often born by the government), they were able to (re)sell vegetables at rates lower than those charged by the local vendors. Thus, it has been argued that military engagement in the agriculture and livestock sectors have led to market distortions and have adversely affected the livelihoods and incomes of the local community, particularly in the conflict-affected regions (South Asian Centre for Legal Studies 2018).

Another aftereffect of the conflict was the increase in female-headed households—i.e. largely war widows who are indisputably more vulnerable. In 2012, 23% of households in Sri Lanka were estimated to be headed by women (Department of National Planning 2017). Although a rise in the number of female-headed households is largely due to the conflict, these households are not currently confined to a specific geographical location (Department of National Planning 2017). The government has taken various initiatives over the years to assist these households (e.g. livelihood support and social protection). However, some studies argue that livelihood interventions for female household heads in conflict-affected areas have been short-term and small scale; there is a need for 'systemic, long-term support to initiate, establish, and sustain livelihood activities' for female household heads (Jeyasankar and Ganhewa 2018). Further, many of these livelihood interventions have focused on agriculture, but given its lower earnings and vulnerability to climatic changes, a more diversified approach may be required (Gunatilaka and Vithanagama 2018).

4.4 Access to Financial Services

In contrast to the implications on poverty, access to infrastructure, and livelihood development (where the results have been positive at least to some extent), Sri Lanka's post-conflict experience in improving access to financial services turned out to be negative.

As discussed earlier, government interventions to improve access to financial services in the post-conflict era included opening up bank branches in the NP and EP and the introduction of special credit schemes for the revival of economic activities in the conflict-affected regions. Consequently, the banking sector experienced a significant expansion from the end of the conflict. Along with the growth of the banking sector, there was also an expansion in non-bank financial institutions. The number of branches of Licensed Finance Companies (LFC) and Specialised Leasing Companies (SLC) increased by twofold in the NP and EP during 2009–2017 (CBSL Annual report, various issues). These initiatives were also followed by many microfinance institutions and other unregulated financial institutions that expanded their operations to the NP and EP. The conflict-affected communities who had been deprived of access to financial services for many decades were soon exposed to a wide range of financial products—in particular loans—from multiple financial institutions. This resulted in a significantly high level of multiple borrowing and over-borrowing among the conflict-affected households, leading to high levels of indebtedness in these regions.

A number of factors contributed to high levels of multiple borrowing and widespread indebtedness in the NP and EP in the post-conflict period. The influx of financial institutions that included state-owned and private banks, finance and leasing companies, and microfinance institutions, led to an unexpected level of competition among the providers. In competing for the same set of clients, that was relatively small to begin with, many financial institutions used somewhat aggressive marketing and lending strategies such as 'door-to door' visits for lending money and collecting repayments. A sudden exposure to a range of financial institutions and financial instruments in the aftermath of conflict created a demand and 'greed' among these households. Further, as a community that had little or no access to financial services for a long period of time, financial literacy among these conflict-affected households too was rather low. Many households borrowed from microfinance institutions and finance companies at interest rates of 24–28% per annum, with the effective rates being much higher (40–220%) (Ismail 2018).

Another factor that contributed to over-indebtedness among conflict-affected communities is the aspirations in the post-conflict context to rebuild their assets and to climb the social ladder, which propelled them to purchase consumer durables such as televisions, motor bicycles and kitchen appliances from different vendors on lease (Ismail 2018). Although these goods could be obtained by making an initial down-payment (which is often affordable to these households), payment of the balance amount through weekly/monthly instalments necessitated them to obtain loans from various sources. This also contributed to high levels of multiple borrowing and indebtedness among these households.

In addition, the loan-financed livelihood activities too could not generate sufficient income to repay the loans. This is largely due to increased competition that arose from similar activities being started by several individuals in the same area (e.g. small boutiques, three-wheelers) and crop failures due to adverse weather conditions in consecutive seasons. Faced with difficulty in repaying loans taken from multiple institutions (including state banks), many households either started to borrow from informal lenders at exorbitant interest rates or to pawn gold jewellery and sell/mortgage assets, which further increased their debt levels. There are anecdotes of various negative social impacts of such mounting indebtedness among the conflict-affected communities, such as suicides and harassment by loan officers (Ismail 2018; Wijedasa 2014).

5 Conclusion and Way Forward

Three decades of conflict in Sri Lanka affected the lives and livelihoods of the people, resulting in high levels of poverty, inequality and vulnerability. During the course of the conflict, infrastructure facilities in the NP and the EP were severely damaged, hampering their connectivity with the rest of the country and constraining households' access to markets, while the public service delivery system was disrupted leading to deprivation of essential services and utilities in these regions.

In the aftermath of the conflict, prevention of future conflicts and sustaining peace was considered national priorities. The government adopted economic development as its approach to reconciliation. Enhancing equity was considered an important component of the country's reconciliation approach. Post-conflict development strategies focused on infrastructure development and rebuilding lives and livelihoods of the conflict-affected communities. Special regional development programmes like NN and UW were implemented to accelerate development and uplift the living conditions in the NP and EP. Additionally, various national-level initiatives were taken by the government, focusing on development of infrastructure and improving access to services to help address regional disparities and enhance equity in the country.

Post-conflict development initiatives have led to mixed results. The poverty levels have seen a continuous decline, while access to basic services and utilities like electricity, safe drinking water and sanitation facilities as well as basic health and education indicators have shown an improvement since the end of the conflict. This has also reduced regional disparities in the country. By contrast, Sri Lanka's experience in improving access to financial services, particularly in the NP and EP highlights negative consequences—i.e. widespread indebtedness and further impoverishment, resulting in adverse social implications on the conflict-affected communities. This stresses the need for further intervention by the government to strengthen regulation of the financial sector, in particular non-bank financial institutions (e.g. leasing and finance companies and microfinance providers), to strengthen client protection and improve financial literacy among low-income groups.

Furthermore, the implications of post-conflict interventions on livelihood development have remained rather ambiguous. While government initiatives in the NP and EP helped conflict-affected households to successfully restore their income-generating activities and improve production in agriculture, fisheries and livestock sectors, the military involvement in sectors like agriculture and tourism has been criticised for taking away potential employment and income-generation opportunities from the community. Moreover, many of the livelihood interventions, including those for female household heads in conflict-affected areas, have been short term. Sustaining these livelihood activities require more long-term support to targeted locations in former conflict-affected provinces, in the areas of financial, technical and marketing interventions.

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Transitioning to Middle Income and Beyond: The Urbanization Challenge in Post-conflict Sri Lanka

Bilesha Weeraratne

Abstract Under-urbanization and inadequate urban planning are by-products of suppressed growth and development during the conflict years in Sri Lanka. The end of the conflict in 2009 opened up many opportunities for urban development. Despite a significant contribution to infrastructure development and city beautification, there was growing discontent towards the government that ended the 30-year conflict, due to reasons such as alleged corruption, utilization of armed forces for urban development and over emphasis on rapid beautification of the Colombo city. Learning from the mistakes of the previous government, the new government elected in 2015 proposed a new chapter in urbanization in Sri Lanka with a private investment-led model with public–private partnerships. Nevertheless, both post-conflict governments failed to provide sustainable solutions to long-term urban issues such as unauthorized urban development and settlement, flooding, solid waste disposal, public transportation and congestion. Such unresolved urban issues and socio-economic marginalization and exclusion have the potential to breed future conflicts. As such, well-managed urbanization and efforts to avoid rural–urban disparities are needed to ensure the absence of new forms of conflicts. Lessons from Sri Lanka's post-conflict urban experience show that rapid urban development efforts could have been replaced with well-planned and inclusive urban development that included an appropriately developed institutional framework. Similarly, post-conflict excess military strength would have been better handled with a comprehensive re-integration plan, to adjust into a non-combatant military force that engages in performing civil duties.

1 Introduction

The end of Sri Lanka's conflict established a conductive environment for rapid urbanization. Not only did it free the population of the ever-present threat of violence and insecurity, it also freed up the movement of people, particularly between

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the conflict-affected areas and the rest of the country. The government's adoption of forging economic development as the primary means of post-war reconciliation provided an added impetus for rapid urban development. These sentiments were supported by Sri Lanka's transition to a low middle-income country and the rising aspirations of its population in the euphoria-filled aftermath of the immediate post-war years.

Sri Lanka's narrative of urban development has indeed seen a notable transformation in the intervening years in some aspects. The country's capital city, Colombo, has undergone a rapid transition of beautification with amenities for leisure such as city parks, walkways and waterways opened up in central locations. In fact, Colombo came to be identified as one of the top five fastest growing cities in the world in post-war Sri Lanka.[1]

But, Sri Lanka's post-war experience of managing the transition to a low middle-income country and the process of urbanization that accompanied it have not been without controversy. Institutional arrangements for post-war rapid urban development saw the Urban Development Authority (UDA) brought under the Ministry of Defence. The deployment of armed forces to spearhead the Colombo beautification process, the perceived heavy-handed approach to clear up urban slums and clear illegal occupation of state land, the acquisition of private property for urban development purposes such as road widening, etc., have been mired in controversy. Indeed, in some respects it led to new forms of conflict (Spencer 2016).

At the same time, changing consumption patterns of Sri Lanka's aspiring middle-class put pressure on public services delivery (Institute of Policy Studies of Sri Lanka (IPS) 2013). The government actively encouraged the growth of a middle class by aiming to double the country's per capita income to USD 4,000 within a span of four years; one of the first steps it took after the war was to relax Sri Lanka's high taxes on imported motor vehicles. The surge in imports to meet pent up demand has witnessed a massive growth in vehicle numbers on the roads, without a concurrent improvement in city transport networks. Similarly, Sri Lanka has witnessed a sharp increase in condominium housing in post-war years, without adequate attention to urban planning and provision of services such as waste management.

Thus, Sri Lanka's experience of urbanization in the context of a post-conflict economy has been mixed. On the one hand, rapid beautification and urban development in the capital, Colombo, was instrumental in the larger efforts to draw tourists to the country. Similarly, the government's ambitious infrastructure projects improved road and rail links within the country, facilitating reconciliation through improved people-to-people contacts. Nonetheless, lack of planning for urban development and institutional weaknesses in implementation generated a backlash, often leading to fresh sources of conflict.

In this context, this chapter examines Sri Lanka's urbanization trajectory in the context of the post-conflict scenario, transition into a middle-income status and path

[1]Please see http://www.ft.lk/front-page/colombo-is-fourth-fastest-growing-destination-city-in-the-world/44-569824.

to a high-income country. Section 2 explores the degree of underdevelopment in urbanization due to the conflict, while Sect. 3 narrates the rapid urbanization efforts in the immediate period after the end of the conflict. Section 4 highlights the military involvement in urbanization efforts followed by its consequences in Sri Lanka in Sect. 5. A comparison of urbanization efforts across two regimes is depicted in Sect. 6, while Sect. 7 discusses how urbanization can help avoid a middle-income trap (MIT). The chapter is concluded with a summary and lessons learnt.

2 Conflict and Under-Urbanization

Starting from the early stages of conflict in 1983 till its end in 2009, urban development in Sri Lanka was suboptimal. The outmigration of affected populations from the Northern and Eastern Provinces, destruction to infrastructure and limited investment during the conflict era created a severe lag in urbanization in these areas. Relative to Northern and Eastern Provinces, the Western Province and the main cities in Central and Southern Provinces were well established on their path to urbanization.

Nevertheless, urbanization in rest of the country too was much affected by the conflict. On the one hand, crowded urban areas were often targets of bomb explosions owing to its capacity to create maximum destruction. For instance, on 31 January 1996, the Central Bank of Sri Lanka (CBSL) located in the heart of the financial centre of Colombo city was bombed killing 91 people while injuring over a 1,400 others and blinding over a 100 people (Warunasuriya 2017). Many such similar episodes of attacks on public transport systems, city hotels and army checkpoints dotted around urban centres were a common occurrence.[2] Such conflict-related destruction of lives and property depleted efforts to develop urban infrastructure. The most destroyed was any sense of peace and security in urban areas. Adding to the discomfort was the altered urban landscape, heavily dotted with military checkpoints, concrete walls and road blocks as a means of combatting the threats. The associated lack of investor confidence and necessity to allocate government funds for military and civilian security purposes generated only suboptimal urban development during the conflict years. Had Sri Lanka not been subject to a long conflict, it could well be argued that the counterfactual scenario may have well been urban development comparable to well-developed Asian urban city-states such as Singapore.

[2]Furthermore, many rush hour trains packed with urban commuters were targeted by bombing; these included the Dehiwala Railway station on 4 July 1996, where nearly 70 people were killed and an additional 450 were injured (AP Archive 1996) and suicide bombing in Colombo Fort Railway Station in 2008 that killed 12 people and injured around 100 (Sri Lanka Database 1997). Furthermore, in October 1997 suicide bombers detonated a truck packed with a large quantity of explosives in the parking lot at a leading five-star hotel, named Galadari Hotel, close to the World Trade Center in Colombo killing 18 persons and injuring at least 110 others (Sri Lanka Database 1997).

Table 1 Structural Transformation

	1971	1981	1983	2001	2009	2012	2017
GDP by sectors (%)							
Agriculture	27.1	27.7	23.2	20.1	12.0	11.0	7.7
Industry	24.7	28.0	27.0	26.8	28.6	31.5	27.2
Services	48.2	44.3	48.2	53.1	59.3	57.5	55.8
Employment in agriculture (%)	48.8	44.8		32.4	32.5	29.7	26.1
Population in urban areas (%)	22.4	21.5	18.7	14.6	18.5	18.3	17.4[a]

Note [a]Estimates for 2016
Source CBSL Annual Report, DCS Census Reports, DCS Household and Income Expenditure Survey (HIES) Reports, and DCS LFS reports of various years

Similar to under-urbanization, inadequate urban planning is also a by-product of suppressed growth and development during the conflict years. Deficits in development due to the conflict and the political economy of a conflict environment stunted the development of a robust institutional framework conducive for urban development. Suboptimal growth and development during long conflicts is not surprising as governments tend to lean on "crisis management" mode with limited long-term plans and consistency across institutions.

Sri Lanka had paid little attention to systematic urban planning during the three decades of conflict. The UDA was established by an Act of Parliament in 1978 with a view to promoting integrated planning and implementation of the economic, social and physical development of urban areas. However, even the classification of urban areas adopted by the UDA continued to differ from that adopted by Sri Lanka's data collecting agency—the Department of Census and Statistics (DCS)—for estimation of urban statistics by. For UDA purposes, however, urban areas can be declared by the minister in charge of the subject of urban development, leading to ad hoc decision-making.

At the same time, national statistics on urbanization in Sri Lanka continue to be based on flawed administrative definitions. Areas identified as Municipal Councils (MCs) and Urban Councils (UCs) are defined as urban areas in the country. As a result of the limitations of this administrative definition, which cannot capture the dynamic nature of urban development, "many vibrant areas that reflect urban characteristics still remain classified as rural" in Sri Lanka (Weeraratne 2016, p. 3). Moreover, Sri Lanka does not have sufficient official data to track the transition of Sri Lanka's population across urban and rural areas over the years. As such, the official estimates of around 18% of urban population share as depicted in Table 1 do not reflect the true level of urbanization in Sri Lanka (DCS 2015).[3] Recent alternative

[3]The mismatch in actual urbanization and official estimates not only creates issuing in tracking urbanization in Sri Lanka. It also has implications on funding for urbanization and associated outcomes, for, if targeting and planning for urbanization "is based on an obsolete definition of urbanization, areas with urban characteristics misclassified as rural would be allocated with insufficient funds and inappropriate development plans" leading to unplanned urbanization and its related implications (Weeraratne 2016, p. 13).

estimates based on non-administrative definitions suggest that that approximately 44–48% of Sri Lanka's population lives in urban areas (Weeraratne 2016).

In the context of such a mismatch in definitions adopted by state institutions, it is unclear how urban growth projections are made and related background research carried out to facilitate activities in urban development. The mismatch in actual urbanization and official estimates not only creates issues in tracking urbanization in Sri Lanka, but it also holds implications on funding for urbanization and associated outcomes. If targeting and planning for urbanization "is based on an obsolete definition of urbanization, areas with urban characteristics misclassified as rural would be allocated with insufficient funds and inappropriate development plans", leading to unplanned urbanization and its related implications (Weeraratne 2016, p. 13).

Moreover, change of governments has also meant inevitable changes in policies and priorities for urban development. As such, the absence of consistent long-term development priorities quite often have resulted in many short-term efforts, often not conducive for an optimal urban growth trajectory with sufficient private sector and foreign investor participation. By the end of the conflict in 2009, Sri Lanka's urbanization was under-invested both in terms of financing and planning, despite the massive potential that existed for urban development.

3 Big Push to Urbanize in Post-conflict Sri Lanka

The end of the conflict in May of 2009 and associated absence of a security threat opened up many opportunities for urban development in Sri Lanka. From a "big picture" perspective, the gradual decrease in the number of security checkpoints and barriers in the main cities fostered a greater sense of peace and stability, while the elimination of protective walls around public and private properties contributed to a positive image of the country, creating ripple effects of the peace dividend in urban areas.

In particular, the 30-year-old conflict resulted in under-utilized production capacities and poor investor confidence in the Northern and Eastern Provinces. Hence, the urbanization requirements in the North and East were distinctly different from the rest of the economy. At the end of the conflict, the government expedited and rolled out a "Nagenahira Navodaya" (Eastern Revival) development plan. It was launched initially in 2007 to improve the long neglected economic and social infrastructure in the Eastern Province. In mid-2009, the "Wadakkil Wasantham/ Uthuru Wasanthaya" (Northern Spring) to expedite the resettlement and rehabilitation process in the Northern Province.

In addition to the development needs in the North and East, these areas also suffered from a lack of connectivity with the rest of the economy. As such, infrastructure investments for improved connectivity were a high priority for the

Table 2 Vehicle population in Sri Lanka 2009-2017

	2009	2014	Growth in stock 2009–2014 (%)	2017	Growth in stock 2009–2017 (%)
Motor cars	387,210	566,874	46	756,856	95
Motor tricycle	443,895	929,495	109	1,139,524	157
Motor cycles	1,896,021	2,988,612	58	4,044,010	113
Buses	81,789	97,279	19	107,435	31
Dual purpose vehicles	197,516	325,545	65	408,630	107
Motor lorries	284,847	334,769	18	352,275	24
Land vehicles-tractors	259,634	333,362	28	362,445	44
Land vehicles-trailers	44,156	57,298	30	75,947	102
Total	3,595,068	5,633,239	57	7,247,122	95

Source Ministry of Transport and Civil Aviation (2018)

government. The A9 road, which runs from the central city of Kandy to Jaffna at the Northern tip of Sri Lanka and was closed since 1990, was reconstructed under the Uthuru Wasanthaya programme; the Northern Railway Line that connects Jaffna with Colombo was reconstructed in stages, to go beyond Vavuniya after the end of the conflict. The railway service was extended to Thandikulam by June 2009, with a further extension to Omanthai by May 2011, Kilinochchi by September 2013, to Pallai by March 2014 and finally to Jaffna by October 2014.

Simultaneous to heavy investment in infrastructure in conflict-affected areas, the government also placed emphasis on similar infrastructure projects in the "South" to deliver on the demand for a swift peace dividend. Ongoing work on Sri Lanka's first ever expressway (Southern Expressway) was expedited and a first segmented opened to the public in 2011; the second expressway connecting the international airport to Colombo city was completed in 2013. These developments helped to minimize excessive transportation time in Sri Lanka, supporting tourism and other production sectors. Improvements to road transport included significant investments in the construction of flyovers in urban areas to ease traffic congestions.

Despite improvements to urban road infrastructure, the rapid increase in the number of motor vehicles on Sri Lanka's roads in the immediate post-conflict years —particularly in the more urbanized Western Province—meant more, rather than less, congestion. As seen in Table 2, the total stock of registered vehicles increased by a staggering 57% between 2009 and 2014 Ministry of Transport and Civil Aviation (2018). Much of the demand was vehicles most often used for private purposes, whereas passenger transportation-oriented vehicles showed more modest growth.

The disproportionate increase in personal transportation owed to two factors; pent up import demand for motor vehicles and rising purchasing power in an emerging "middle class" of consumers in Sri Lanka. With Sri Lanka's coincidental transition to a low middle-income economy immediately after the end of the conflict, helping to meet middle-class aspirations—doubling per capita GDP to USD 4,000 by 2016—became a key focus of government policy. In this context, ownership of motor vehicles was viewed as an aspiration of emerging middle-income Sri Lanka; as a result, prohibitive excise duties on imports of motor vehicles in excess of 300% were slashed in 2010 (Ministry of Finance (MOF) 2010). The enhanced purchasing power of vehicles was fuelled by availability of credit facilities for vehicle purchases, such as high Loan to Value (LTV) ratios in the range of 87–90% adopted by financial institutions immediately after the conflict (CBSL 2011). It is noted that the motor industry reached its peak as the economy improved after the war in 2011.

Thus, the immediate result was a domestic consumption boom and a rising trade deficit that put immense pressure on the Sri Lankan rupee. Corrective action included subsequent on-off revisions to motor car taxes. The more medium-term lasting result was an excessive growth in motor vehicle ownership in the country. This was particularly so in the more urbanized Western Province with over one-third of the vehicle registered in Sri Lanka within this single province (Ministry of Transport and Civil Aviation 2018). Owing to noticeable gaps between transportation plans and their implementation, both public transportation and expansion in road networks were unable to cater to the urban population.

4 "Militarization" in Urban Development

At the end of Sri Lanka's conflict, the country had a relatively large battle-hardened military strength to the tune of 300,000 (Wickremasinghe 2010). With little comparative experiences to draw on with regard to productively engaging such a large and well-trained resource in peace times, the government began to utilize the armed forces in its development programmes. Their most prominent presence was to be redirected to assist in the government's urban development projects, although the military was also present in other areas of economic activity.

This case of Sri Lanka's use of military can be explained to some extent in the context of urban development. Analogous to the voluntary reallocation of excess labour in a market economy, in post-conflict Sri Lanka, excess personnel in the armed military forces were in effect reallocated via a command economy towards urban development. For instance, the armed forces' civil engineering and architectural resources gradually became a key component of town planning and other activities. Initially, the sole reason for getting the services of the military is argued to be for cheap labour and a disciplined workforce (Kumarapperuma 2014). The use of the military for urban development was also considered as a crucial means of engaging a large armed forces presence constructively in peace times (Sirilal 2011).

Moreover, there was a severe shortage of services in the former conflict-affected areas that could be met by the deploying the armed forces. For instance, it was estimated that around 120,000–150,000 houses in the Northern Province alone were in need of rebuilding or repair, but that there was also a severe shortage of skilled labour that slowed down progress in reconstruction and rehabilitation efforts (Crisis Group 2012). As such, the availability of a well-disciplined and highly trainable and in some cases an-already skilled military personnel was an obvious choice to address some of this skill shortage for development activities in the North and East of the country. Hence, the military was tasked with providing assistance on renovation and construction of damaged houses as well as activities such as reconstruction of roads and bridges; cleaning of wells; renovation and reconstruction of irrigation systems; renovation and reconstruction of public utilities such as schools, religious places and medical centres; and clearance of agricultural lands that had not been used for years (Herath 2012). In addition to using the military personnel in the Northern and Eastern Provinces, they were also used in urban development efforts in other parts of Sri Lanka.

But the utilization of armed forces for urban development came at a cost to the government in non-economic terms. The military presence over urban development activities was often subject to criticism. The "militarization" of economic and development activities was viewed with suspicion with regard to any compromise of "democracy"; the military role at the forefront of urban development was also criticized for generating many negative implications for the well-being of the public (Farook 2013).

The political economy of urbanization during 2009–2014 is succinctly depicted as "underlying Colombo's urban transformation is the politics of urban land markets, the power of domestic, regional and international real estate finance and capital and the role and influence of bilateral and multilateral development lending mechanisms. The urban regeneration drive, the slogans of a "slum-free" (but not poverty-free) and "beautiful" (but not inclusive) Colombo, and the forced evictions are all inextricably tied into the political economy of land in the city" (Perera 2014, p. 6). These included ambitious mega projects such as the Colombo Port City project initiated in 2014. With Chinese FDI of USD 1.4 billion, it was the single largest FDI project in Sri Lanka aimed at reclaiming 233 hectares of land adjacent to the Colombo Port and Sri Lanka's financial district. As the developer, China was to be given 20 hectares of land under free hold right basis, with another 88 hectares under a 99-year lease. The project drew significant concerns regarding its environmental impacts, as well as the long-term geopolitical implications, and was the focus of contentious political debate.

Aside from large mega projects, much effort was put into a rapid beautification of the Colombo city with funding from agencies such as the World Bank. Alongside this, the UDA also embarked on beautification and housing efforts that called for the relocation of low-income settlements from state-owned land to make way for luxury apartments and other amenities. For instance, residents in Java Lane in Slave Island were evicted for collaborative redevelopment project by TATA Housing of India and the UDA, "as a major township rejuvenation initiative", which at the same time aimed to resettle shanty dwellers in the area in improved housing units (Lanka Information 2015). Similar evictions in Mews Street in Slave Island were to facilitate the expansion of the adjacent Defence Services School

(Farook 2013), while evictions from Mayura place in Wellawatte were to make way for plush Havelock City apartments. Within these evictions, some critics saw a degree of new forms of community disaffection. For instance, it has been argued that "behind the threats of eviction, for many, was the fear of what seemed to be an ambitious project of ethnic reorganization which would remake the city into the Sinhala Buddhist place it has never been before" Spencer (2016, p. 103).

The manner in which these relocations were handled bore the harshest criticism. Indeed, the placement of the UDA under the Ministry of Defence in 2010 was unprecedented. As noted by Spencer (2016), Sri Lanka's post-conflict urbanization efforts up to 2014 were characterized by a "mixture of military personnel and speculative capital" which contributed to urban development where "military muscle" was utilized to forge ahead with "endless legal entanglements of urban land tenure" (Spencer 2016, p. 103). Specifically, soldiers and police were utilized to crack down on street hawkers, evict families from shanties and demolish "illegal structures" (Wickremasinghe 2010). The excessive involvement of the Ministry of Defence over urbanization was further evident by taking Land Reclamation and Development Board, which supervises the sale of government land, under its purview, while the ministry also issued a directive "that property in Colombo city can only be sold with its prior permission" (Wickremasinghe 2010).

In addition to evictions, the military muscle of the UDA was also used for urban beautification efforts. For instance, the contribution of the armed forces under the direction of the professionals of the UDA to systematically refurbish the Colombo's dilapidated structures of historical value is well known. On the one hand, it was credit worthy to note "that the country's rebuilding initiative is most successful because of the manner and pace at which change is taking place. For a nation which has been slow to change in the past, this fast-tracked development is a dream come true" (Sunday Times 2014). Nevertheless, the use of the military forces for cleaning and maintenance of public spaces such as roads, gardens, walking trails, cycle paths and jogging tracks was also criticized as demeaning to military personnel.

4.1 2015 Elections: A Game Changer?

With an aim to create a well-developed social and economic infrastructure network to facilitate rapid economic development, the government's immediate post-conflict attention focused on large investments in almost all economic sub-sectors including highways, transport, power, energy, ports, aviation, railways, Irrigation, water, sanitation and urban township development (MOF 2012). Nevertheless, despite a significant contribution to urbanization and development, especially in terms of infrastructure development and city beautification, there was growing discontent towards the reigning government that ended the 30-year conflict. The proximate causes for the loss of public popularity were largely associated with allegations of corruption in the large investment and development projects under way. However, issues of erosion of democracy owing to the heavy involvement of the military in many spheres of development activities of the government were also of growing concern. For instance, perceptions of lack of transparency in the process of awarding development rights—many of which involve single bids or are non-competitive—were one such issue. These included projects such as "the multi-million dollar luxury mixed-use redevelopment of "Transworks House", one of the first high-profile projects handed to a private developer (the Krrish Group from India). The deal reportedly included land being leased to Krrish for 99 years for a mere LKR 5 billion, a 10-year income tax holiday, concessionary 6% tax for the next 15 years, tax-free shareholder dividends for 11 years, and exemptions from a range of other taxes, duties and levies" (Perera 2014, p. 14).

Similarly, there appears also to have been growing discontent among the rank and file of the government's bureaucratic machinery, including military personnel, the former possibly as a result of growing disenchantment with allegations of rising corruption and tilt to authoritarian governance, and the latter as a result of resentment to the use of use of military personnel for non-military and mundane tasks such as urban beautification. To a degree, the extent of this discontent can be deduced by the postal votes cast in the 2015 Presidential Election from the Northern and Eastern Provinces. Postal votes are cast mostly by public officers and military personnel posted to regionally. For instance, in Batticaloa district (Eastern Province) the incumbent president received only 19% of postal votes, while his main challenger, the common candidate, obtained 81% of the vote. Similarly, in Jaffna, the incumbent received only 29% of postal votes, while the common candidate led with 69% of votes (Lanka Business Online 2015). Due to these and many other issues, in January 2015, government that liberated the country from a 30-year separatist conflict and paved the path for rapid urbanization and economic development was defeated and a new government came into power.

5 Post-2015: Repackaged Urbanization?

At a broader level, the approach of the new government to development was to be more on a private investment-led model with public–private partnerships (PPPs). Learning from the mistakes of the previous government, the new government proposed to carve a new chapter in urbanization in Sri Lanka. One of the more central projects that drew attention was the Colombo Port City project; in opposition, various political parties had indicated intentions to cancel the projects on grounds of heavy environment damage. Similarly, election pledges of the new government among others aimed to delink the UDA from the Ministry of Defence and to provide relief to those who were illegally/forcibly evicted, and reassess and revalue their property to provide financial relief (New Democratic Front 2014). At the same time, the policy priorities in terms of urban development were cluster-based development with emphasis on mega projects.

Institutionally, a new ministry, named the Ministry of Megapolis and Western Development (MMWD),[4] was established in 2015 to spearhead urban development in Sri Lanka. The UDA was removed from the Ministry of Defence and placed under the purview of the MMWD. The continued emphasis placed on urban development was clear from the establishment of a new ministry and the rolling out of an ambitious megapolis development initiative.

However, there was no discernible shift in priorities given to urban development initiatives. As promised, the government halted work on the Colombo Port City project as one of its first acts in office. A cabinet-approved committee was established to review the project for its many alleged flaws including lack of transparency on the terms and environmental assessments. Based on a report of the Review Committee, the project was suspended in March 2015 until environmental, economic and security issues were examined and resolved. Nevertheless, this decision was backtracked on many instances owing to geopolitical contexts. For instance, Shepard (2016) notes that "in February, just before Sri Lanka's new foreign minister visited China, the government backtracked on their previous position and gave the go ahead to the port city project. Then a month later they flip flopped again. In March, just before Narendra Modi became the first Indian prime minister in 28 years to visit Sri Lanka, Colombo Port City was again postponed. Apparently, this was what Sri Lanka's ambition to re-balance relations with India, China, and the West looked like from the ground" (Shepard 2016). This policy U-turn of the new government on the project, and more broadly on China's involvement in financing development initiatives in Sri Lanka, was also influenced by the absence of anticipated financial support from the rest of the world such as USA, EU and India.

The Colombo Port City project was renamed the Colombo International Financial City (CIFC) and incorporated as part of the governments even more ambitious megapolis development plans.

The subsequent renaming and repacking was facilitated under a new tripartite agreement between the MMWD, the UDA and the China Harbour Engineering Company (CHEC). Construction activity on the project recommenced in August 2016. One important change in the terms of the project is the absence of a free hold land component to China, where only a 99-year lease is available for a 110-hectare portion of the reclaimed land area.

The leaning towards mega infrastructure investments for growth too continued with the launch of an ambitious USD 45 billion Western Region Megapolis Development Plan (WRMDP). The prime objective of the MMWD and the associated WRMDP is to bring systematic changes and development processes into the urban community in Sri Lanka to ensure that the inhabitants of urban areas become a part of socio-economic development of the country, while maintaining high levels

[4]The Western region, focused by this Ministry, includes Colombo, Gampaha and Kalutara districts, and the Marine Zone which encompasses the marine waters and the landmass associated with these districts (MMWD 2016).

in quality of life. Under the WRMDP, ten mega projects are identified. They are transport, energy and water; housing and relocation of administration; environment and waste management; the aero maritime trade hub; central business district; industrial and tourist cities; science and technology city; eco habitat and plantation city; smart city and spiritual development facilitation. The CIFC is included under the aeromaritime trade hub. The initiative was also not limited to the Western Province; it also includes developing strategic cities to ensure that the merits of urbanization are spread across the country to cities such as Galle (South), Kandy (Central), Jaffna (North), Anuradhapura (North-Central) and Trincomalee (East) (MOF 2016).

Another election pledge of the new government was to resolve issues related to evictions and related relocations of the past. However, it has been argued that the government that came to power in 2015 “has made very little headway in providing redress and/or improving the living conditions of those who have been forcibly relocated or those who are still awaiting housing or compensation after being made to leave their homes” (Perera 2017, p. 4). For instance, it is noted that “title-holders such as the residents of Mews Street have not been compensated for the value of the land they owned. Their 6 year court case ended with a settlement in September 2016 and they were not provided any relief or redress to correct the injustice caused by the military violently evicting them from their homes in May 2010, as well as their effective disenfranchisement” (Perera 2017, p. 4). Moreover, new eviction notices have been issued to urban dwellers, whereby ongoing research notes that the “main difference is that military officers now dressed in civilian clothes, continue to make decisions and liaise directly with the public” (Perera 2017, p. 6). As such, military involvement in many urban activities still continues, albeit to a lesser extent.

The reliance on the armed forces to step into clear-up and clean-up after urban disasters—be it owing to waste management, flooding—continues as before. For instance, in 2016, as the Western Province suffered from floods that killed over 100 people and affected more than half a million, rescue missions for this urban disaster were spearheaded by the military forces. In 2017, Sri Lanka witnessed deaths and destruction as a result of the collapse of a garbage mountain in the Western Province. It claimed 23 lives and displaced 180 families, with the military called on to carry out rescue and clean-up efforts; in the aftermath of a collapse of a high-rise building under construction that claimed two lives and injured 24 people, the armed forces were called in once again for rescue and clean-up efforts.

The latest examples of relying on armed forces for urban activities include identifying the Navy to operate a passenger boat service on canals in the capital Colombo, as a precursor to attracting private investment into the initiative (Economy Next 2018), and calling upon the military to assist the police in combating urban drug rings (Daily Mirror 2018). As such, the military involvement in urban activities is still persistent, albeit at a lesser and more nuanced degree.

Aside from the continued involvement of military personnel in urban management, these disasters also highlight the many gaps in weaknesses in Sri Lanka’s urban planning and policy implementation. The absence of a sustainable mechanism to dispose solid waste collected by local government authorities resulted in a small-scale garbage dump becoming a 20-m-high garbage mountain, spanning 17–20 acres in close proximity to over 5,000 urban dwellers. Similarly, lax urban development standards over the years have resulted in sub-standard and unauthorized urban development, which was symbolized by the collapse of a building under construction. Other examples of the perils of unauthorized urban development are the mushrooming of settlements on land reserved for river banks and unauthorized filling of marshy lands blocking the drainage of rainwater. Both these urban activities contribute to flooding in urban areas in the Western Province.

These urban issues such as unauthorized urban development and settlement, flooding and solid waste disposal are long-term issues to which both post-conflict governments have failed to provide sustainable solutions. Rather, the focus has remained on ambitious mega projects for urban regeneration. As a result, persistent and growing problems in areas such as urban transportation remain unaddressed; public transportation and congestion in Sri Lanka's urban areas still remains a critical issue. The growing urban population and the comparable increase in commuter populations during daytime add a significant stress on the already burdened transportation network in urban areas in Sri Lanka. Some administrative introduced in the post-conflict era such as a relocation of administrative offices away from the city of Colombo to the suburbs, and encouraging flexible working hours with the aim of lessening peak traffic times are ongoing, but concerted long-term plans are yet to be implemented. Ambitions under the WRMDP to address issues of urban transportation include restructuring and modernizing public bus services; electrification and modernization of railway, and an introducing multi-modal transport hub, a Rapid Transit System and a Water Way transit system (MMWD 2016). These require substantial funding, with the government looking to PPPs in view of Sri Lanka's already high and rising public debt burden.

6 Avoiding a Middle-Income Trap

With Sri Lanka's immediate target to become an upper middle-income country by 2025, and subsequently transition to a high-income country in a reasonable time period, it is important to adopt a long-term view on urban planning sans policy inconsistency. With such planning, the country stands a better chance of avoiding a middle-income trap, whereby countries may be unable to maintain growth momentum and move up to a high-income status within a reasonable time.

Despite rapid economic growth, the experiences of East Asian countries suggest that inadequate attention to livability of cities has resulted in most cities, except for Kuala Lumpur, being ranked above 100 in the Mercer 2015 City Rankings. Learning from the valuable experiences of East Asian countries on urban planning such that cities are livable is important for countries like Sri Lanka. Specifically, as discussed before, areas such as the Colombo Municipal Council (CMC) have a very high population density and will need extra attention to make livable cities, with appropriate infrastructure and amenities, such as public transportation in order to retain a critical mass of skilled labour to drive growth in the economy.

Another important facet of urbanization is structural transformation. As the engine of economic development and growth, structural transformation is one of the fundamental drivers for an economy to escape the middle-income trap (Aiyar et al. 2013). Nevertheless, when a structural transformation attracts the rural population to urban area as internal migrants, it has the potential to create rural–urban disparities. When urbanization is unplanned, such rural–urban disparities constitute the largest component of national inequality in lower middle-income countries.

For a country like Sri Lanka, avoidance of gaping socio-economic disparities—whether between population, geographical or ethnic groups—is even more important in view of its historical experiences of socio-economic and sociopolitical conflicts of the past. The root causes of these conflicts have pointed to social marginalization and exclusion from economic opportunities. As such, efforts to avoid rural–urban disparities must receive added attention in post-conflict Sri Lanka to ensure that such tensions do not serve as a breeding ground for fresh conflicts in the country. The probability of disparities emerging can be reduced through well-managed urbanization, which simultaneously helps promote innovation and productivity growth and can place an economy on a trajectory to transition to high-income status (Wang and Lan 2017).

As Kharas (2018) highlights “at its heart, the middle-income trap is a governance failure: an inability to take a long-term view of the best way forward for society as a whole”. Aspects of this governance failure can materialize through urbanization efforts as well. Reflecting on these concerns, Wang and Lan (2017) note that successful urbanization could be the single most important force that can prevent developing countries from falling into a middle-income trap. As such, planning ahead, Sri Lanka should ensure that the ongoing urbanization efforts would contribute to the economy to proposer as a middle-income country and avoid the middle-income trap.

7 Summary and Lessons

As evident in the foregone discussion, urbanization has been an important aspect of planning for post-conflict middle-income Sri Lanka. The urban development efforts immediately after the conflict focused on infrastructure development and urban beautification. Despite the many successes, the widespread perception is that these efforts were carried out with a heavy-handed approach, with the assistance of the military. It could be argued that this in part led to the subsequent disenchantment and ousting of the government that ended the 30-year conflict.

Nevertheless, in spite of promises of a new approach to urban development issues in Sri Lanka via a change of regime, it appears very much as if the same development programmes are being carried out under a new façade. As such, despite some improvements in institutional approaches, Sri Lanka is yet to reach its full potential in urban development. A clear focus and consistent policy framework on urban planning would contribute towards a more successful journey that can help the country to overcome a possible middle-income trap, and reach a high-income status as envisaged.

In hindsight, Sri Lanka's post-conflict experience in urban development provides some valuable lessons to other countries that are emerging from a conflict setting.

The first lesson is to acknowledge that there is pent up demand and unmet aspirations for better and higher standards of living due to the prolonged conflicts and lack of opportunities. In addressing these demands and ambitions, Sri Lanka should have been cautious in policy changes in a manner to ensure well targeted, sustainable and long-term policies, rather than resorting to quick fixes that please the masses. In hindsight, rapid urban development efforts could have been replaced with well-planned and inclusive urban development. Such planned and inclusive efforts can go hand in hand with appropriately developed institutional framework for urbanization.

Second, the end of a conflict such as that of Sri Lanka's invariably leaves a large and trained armed force with high morale. Given that active measures to downsize the military strength was not on the cards meant that the government was left with the hard choice of striking a balance between maintaining a large military force and keeping them occupied amidst a massive development effort. In this setting, resorting to an obvious choice of reallocating military resources to urban development initiatives among others is quite understandable. However, in hindsight it would appear a better strategy perhaps would have been to develop a comprehensive re-integration plan for the military personnel, to ensure that they adjust into a non-combatant military force that engages in performing civil duties.

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