

Sri Lanka
State of the Economy Report 2011

Chapter 4
Imperative of Inclusive Growth

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4. Imperatives of Inclusive Growth

4.1 Introduction

Following the ending of Sri Lanka's long drawn separatist conflict in May 2009, the growth prospects for the country in the medium term look promising. However, sustaining growth and ensuring peace will largely depend on reducing disparities and improving opportunities for participation in development. There is general agreement that growth is a necessary condition for poverty reduction. Most countries that have experienced high levels of growth have experienced reductions in the number of people in poverty, at least in absolute terms.¹ But, there is an increasing realization that poverty alleviation depends not only on growth, but also on the distribution of incomes. For example, at Brazil's level of inequality, 1 per cent growth is estimated to reduce poverty by less than 1 per cent, while in India and China - countries with greater equality - 1 per cent growth is estimated to reduce poverty by more than 3 per cent.² Expressed in another way, with a 3 per cent growth rate and at the present levels of inequality, Brazil will take 30 years to halve its current levels of poverty, but if the same rate of growth is accompanied by a 5 per cent reduction in inequality, poverty can be halved in only ten years.³

Recent debates on development have focused on the need for 'inclusive growth' to achieve sustained growth outcomes. The inclusiveness approach is concerned with addressing disparities in population groups across a variety of dimensions including, gender, geographic location, sector, ethnicity, etc. According to recent literature, the need for inclusiveness across these different dimensions comes from several sources. First and foremost, inclusiveness is desired from an ethical standpoint. In addition, inclusiveness is needed for sustaining economic growth, as exclusion leads to

Continued disparities across regions could increase vulnerability of the country to future conflicts ... it is essential to understand the causes of inequality and redress them

¹ Rodrik, D., 2000, "Growth Versus Poverty Reduction: A Hollow Debate", *Finance and Development*, Vol. 37, No. 4, International Monetary Fund.

² Thomas, V., 2007, "The Difference Inclusive Growth Makes", *Latin America Emerging Markets Forum* 2007.

³ *Ibid.*

Box 4.1**Differing Views on Growth, Poverty Reduction and Human Development**

In a recent lecture to the Indian Parliament on “Reforms Yesterday and Today”, Prof. Jagdish Bhagwati argued for further strengthening India’s ‘conventional reforms’ (which he calls Stage 1 reforms) – that include liberalization and diversification of trade, liberalizing retail trade, and labour market reforms.⁴ He points out that these reforms have produced the growth that India is experiencing now, which in turn has improved the lives of all segments of society including those of the poor. He argues that policy makers should focus on growth because growth actively helps to reduce poverty, and not only through the trickle-down effect as sometimes argued. According to him, social sector reforms (which he calls Stage 2 reforms) must follow Stage 1 reforms aimed at growth. He refutes arguments made for replacing Stage 1 reforms with Stage 2 reforms, as without revenue generated through growth, it is not possible to undertake social expenditure.

Prof. Amartya Sen also agrees that growth is necessary for poverty alleviation, but does not believe that growth is synonymous with development. According to him, growth is important but only as an instrument for achieving human development, and not as an ultimate goal. He also points out that although growth can provide greater access to economic and social opportunities for many, some may need special assistance to come out of poverty.⁵

underemployment of productive resources that could restrict growth. Exclusion could also lead to social tensions and conflict, which could undermine the growth process. Inclusiveness is, therefore, especially important in a post-conflict setting. Inclusive growth strategies have become increasingly popular among developing Asian economies which have faced rapid growth and rising inequalities in the recent past; indeed, it has been identified as the first key development agenda in the Asian Development Bank's (ADB) 'Strategy 2020'.

The term 'inclusive growth' is sometimes confused with 'pro-poor growth'. But the two terms have related, but different meanings under most definitions. In this discussion, growth that accompanies reductions in absolute levels of poverty is termed 'pro-poor', while growth that is accompanied by a

decrease in inequality is termed 'inclusive'. Growth that is pro-poor may not necessarily be inclusive. This is because growth can increase the average income of a population while also increasing inequality. If the growth effect of income is more than the inequality effect, poverty can reduce, making growth pro-poor but not necessarily inclusive. On the other hand, if growth is inclusive (i.e., cuts across all segments of population), poverty will also fall. Hence, inclusive growth is also pro-poor.

4.1.1 Inclusive Growth: A Framework for Analysis

Inclusive growth starts with the assumption that sustained growth over a long period is a necessary condition for rapid and long term poverty reduction. For growth to be sustainable in the long run, 'it should be broad-based across sectors and inclusive of the large

⁴ Bhagwati, J., 2011, “Indian Reforms Yesterday and Today”, prepared statement on the Prof. Hiren Mukherjee Memorial Annual Parliament Lecture, <http://www.cfr.org/india/indian-reforms-yesterday-today/p23607> [accessed June 7th, 2011].

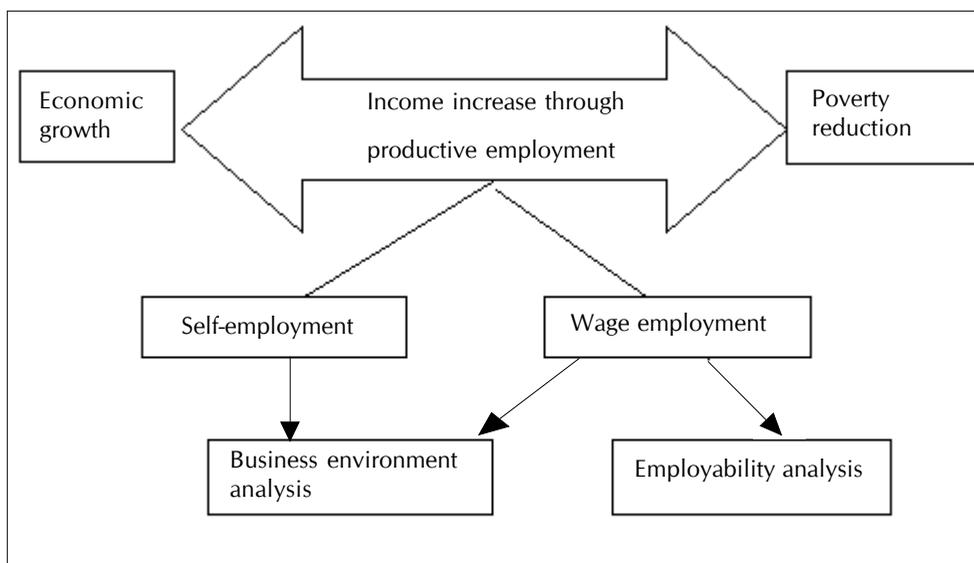
⁵ Sen, A., 2011, “Growth and Other Concerns”, *The Hindu*, New Delhi, India [February 14, 2011].

part of the country's labour force'.⁶ Whilst there are different frameworks for analyzing inclusiveness of growth, many are concerned with improving the utilization of productive resources and identifying constraints to growth.

The Hausmann, Rodrik and Velasco (HRV) framework looks at inclusive growth from the perspective of the individual.⁷ It assumes that access to productive employment provides the main means of inclusive growth and poverty reduction. To achieve this, first, there should be employment growth - whether self-employment or wage employment. Second, there should be productivity growth so that wages increase and there are higher returns from self-employment.

According to the described framework, an inclusive growth analytics should start with a background analysis which provides an overview of the country's growth patterns and poverty trends. This should be followed by an examination of the involvement of different economic population groups in the growth process. Lastly, the analytics should evaluate the constraints to inclusive growth. This step involves examining growth potential for different sectors of the economy, the ability of individuals to participate in these sectors in the short term, generating employment and improving productivity. In some instances, when some sectors are lagging, it could also involve re-orienting training and other aspects of human resource development for restructuring the economy.

Figure 4.1
Framework for Inclusive Growth Analysis



Source: Hausmann, Rodrik and Velasco (2005) as shown in Ianchovichina and Lundstrom (2009) "Inclusive Growth Analytics – Framework and Application", Policy Research Working Paper 4851, The World Bank.

⁶ Ianchovichina, E. and S. Lundstrom, 2009, "Inclusive Growth Analytics – Framework and Application", Policy Research Working Paper 4851, World Bank, Washington, D.C., pp. 2.

⁷ *Ibid.*

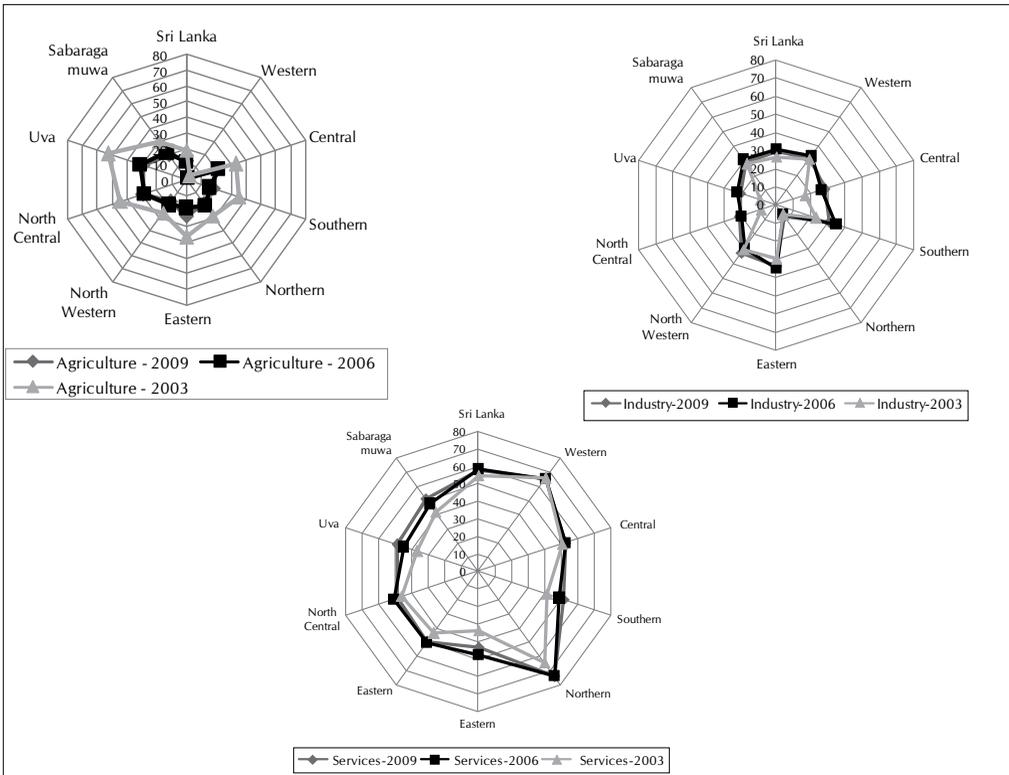
Whilst it is beyond the scope of this discussion to conduct a full scale inclusive growth analysis, taking a cue from the policy stance of the government in balancing provincial growth and making use of regional growth trends, this Chapter focuses on the following. Section 4.2 sets the stage by discussing patterns of growth experienced in Sri Lanka across various population groups, and examines whether past experience with growth has been inclusive. Section 4.3 briefly discusses the employability and access to infrastructure. Section 4.4 describes key areas of policy focus essential to foster an inclusive growth strategy. The discussion looks at the importance of raising productivity in the primary sector,⁸ given the large numbers of poor who

are economically engaged in this sector. The discussion also takes stock of opportunities and strategies for Sri Lanka in a changing world economy, as well as the implications of efforts currently under way to improve connectivity within the country as well as with the outside world. Section 4.5 examines the institutional environment for inclusive growth that can better encourage effective use of underutilized resources and investments. Section 4.6 concludes.

4.2 Patterns of Growth and their Inclusiveness⁹

On average, the Sri Lankan economy maintained a growth rate of 5.9 per cent during

Figure 4.2
Contribution to GDP by Industrial Sector and Province



Source: Compiled using data from CBSL, *Annual Report*, various issues.

⁸ The primary sector is defined as consisting of industries – such as agriculture, fisheries, mining and quarrying – that produce goods using natural resources.

⁹ All poverty statistics in this section are officially published statistics by the DCS, available at <http://www.statistics.gov.lk/poverty> [accessed 30th April, 2011].

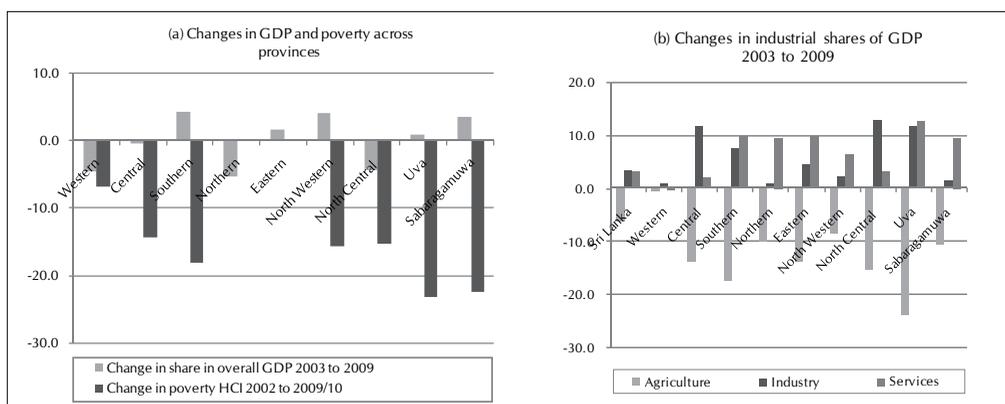
2003-09.^{10,11} The contribution to overall growth was mixed across provinces. Economic activities remained highly concentrated in the Western Province, which contributed a little over 45 per cent of GDP in 2009, a slightly lower share compared to its 50 per cent contribution in 2003. The provincial shares of GDP also declined in the Central, Northern, and North Central Provinces, indicating lower than average growth in these provinces (Figure 4.2). This decline was sharper in the Northern and North Central Provinces and marginal in the Central Province. The contribution to overall GDP improved in all other provinces, with the Southern, North Western and Sabaragamuwa Provinces showing the largest improvements.

The number of people living under the official poverty line declined from 4.3 million in 2002 to 1.8 million in 2009/10 (a reduction of close to 58 per cent), and per capita GDP at current market prices (US\$) increased by more than 141 per cent over the period 2003-10 to reach US\$ 2,368,

indicating a general improvement in living standards.¹² The proportion of population living below the official poverty line - referred to as the poverty headcount ratio (PHCR) - dropped from 22.7 per cent to 8.9 per cent over the 2002 to 2009/10 period. For provinces for which data is available, this decline was more than the national average, except in the Western Province.

In the overall economy, growth was driven mainly by the industry and services sectors. The agriculture sector also grew at above 4 per cent during 2003-09, although its growth was lower than the overall growth levels in the country. The contribution of the agricultural sector to the overall economy declined by 6.3 percentage points to 12.7 per cent over 2003-09, while the contributions of industry and services sectors increased over the same period by 3.3 and 3.1 percentage points to reach 29.7 per cent and 57.6 per cent, respectively. In all provinces, except the Western Province, the shares of industry and services sectors gained, while the share of agricultural sector declined (Figure 4.3).

Figure 4.3
Changes in GDP, Poverty and Sectoral Shares of GDP across Provinces



Source: Compiled using data from CBSL, *Annual Report*, various issues.

¹⁰ From 2003 to 2010, the average growth rate was 6.2 per cent. As province-wise disaggregated GDP estimates are not available for 2010, the rest of the analysis uses 2009 estimates.

¹¹ The DCS took over the function of calculating GDP estimates from 2003. As data prior to that use a different methodology for estimating GDP, the Chapter conducts comparisons from 2003 to ensure consistency in the series.

¹² CBSL, *Annual Report*, various issues.

Table 4.1
Labour Productivity by Major Economic Sector

	2002	2003	2004	2005	2006	2007	2008 ^b	2009 ^b	2010 ^{b,c}
Labour productivity by major economic sector (Rs. '000 per person) ^a									
Total	132.0	132.6	134.0	286.0	294.2	317.0	309.3	322.2	343.3
Agriculture	73.6	74.0	70.8	117.5	112.4	120.7	114.8	119.2	125.3
Industry	168.0	161.2	161.3	305.5	312.3	339.0	335.6	367.1	407.2
Services	161.0	163.7	169.1	392.3	424.6	449.0	446.1	451.8	472.8
Index of labour productivity (2002 = 100)									
Total	100.0	100.8	101.9	217.5	223.7	241.1	235.2	245.0	261.1
Agriculture	100.0	100.5	96.2	159.6	152.7	164.0	156.0	162.0	170.2
Industry	100.0	95.7	95.8	181.4	185.5	201.3	199.3	218.0	241.8
Services	100.0	101.8	105.2	244.0	264.1	279.2	277.4	281.0	294.0

Note: a: Employment data excludes Northern and Eastern Provinces, unless otherwise specified;

b: Employment data excludes Northern Province; c: Provisional.

Source: CBSL, *Annual Report*, various issues.

In the Western Province, the shares of both the agriculture and services sectors declined, albeit marginally. However, the patterns of change in sectoral shares were not uniform across provinces. The decline in agriculture share of GDP was more pronounced (more than 15 per cent over 2003-09) in the Southern, North Central and Uva Provinces. In the Southern, Northern, Eastern, Uva and Sabaragamuwa Provinces, the share of the services sector increased markedly (by 10 or more percentage points), while there was a moderate increase in the services sector in the North Western Province. In the Central, North Central and Uva Provinces, the share of the industrial sector increased markedly (by more than 10 percentage points), while it increased moderately in the Southern Province.

These differences in the patterns of growth may have had a role in contributing to poverty reduction. A cursory glance at available statistics implies that the productivity improvements in the services sector, rather than improvements in employment levels, played a key role in alleviating poverty (Table

4.1). Improvements in employment levels in the industrial sector, which also experienced a moderate increase in productivity, may have also helped. Productivity in the total economy was mainly driven by productivity improvements in the services sector.

During 2002-09, total employment in the economy grew at 1.4 per cent on average per annum. This increase in employment is mainly explained by employment generation in the industrial sector, which grew at 3.6 per cent on average over the period. The comparative growth in employment in the agriculture and services sectors (at 0.5 and 0.9 per cent, respectively) was marginal.¹³ Across provinces, the contribution of the services sector to total employment remained largely constant, except for an improvement in the Uva Province and a reduction in the North Western and the Sabaragamuwa Provinces (Table 4.2). The contribution of the industrial sector to total employment increased in the Southern, Eastern and the Sabarabamuwa Provinces. The reductions in poverty levels were greatest in the provinces that experienced high growth (more than 5

¹³ Calculated based on DCS, *Labour Force Survey*.

Table 4.2
Contribution to Total Employment by Industrial Sector and Province

	Agriculture			Industry			Services		
	2004	2007	2009	2004	2007	2009	2004	2007	2009
Western	8.3	7.9	9.0	34.2	34.5	33.5	57.5	57.6	57.5
Central	45.4	42.4	43.2	16.9	20.8	18.1	37.7	36.8	38.7
Southern	40.0	36.2	36.9	22.9	27.2	26.6	37.1	36.6	36.5
Northern ^a	37.7	n.a	n.a	17.8	n.a	n.a	44.5	n.a	n.a
Eastern	37.5	n.a	34.0	16.8	n.a	18.9	45.7	n.a	47.1
North Western	29.7	31.2	34.4	28.8	29.1	27.9	41.5	39.7	37.7
North Central	54.9	56.9	55.8	14.0	13.0	13.2	31.1	30.1	31.0
Uva	67.7	62.7	62.8	11.3	11.8	10.9	21.0	25.5	26.3
Sabaragamuwa	40.7	38.2	40.1	23.2	27.3	26.5	36.1	34.5	33.4

Note: a: 2004 data excludes Killinochchi and Mullaitivu districts.

Source: CBSL, *Annual Report*, various issues.

Table 4.3
HCI by Major Industrial Group of Head of the Household and by Sector: 2006/07

	Sri Lanka	Urban	Rural	Estate
Agriculture	21.6	8.3	20.8	29.4
Industry	15.1	8.3	16.0	29.2
Services	11.3	6.5	12.1	26.4
Total	15.4	7.1	16.0	28.8

Note: Poverty data are not yet available by sector for 2009/10.

Source: DCS, *Poverty in Sri Lanka*.

per cent) in the services sector (see Figure 4.3). The poverty data also indicate that the poverty levels are higher in the agriculture sector, when measured by the sector of employment of the head of the household (see Table 4.3).

The above analysis indicates that generally economic growth has been beneficial across provinces, with less deprived provinces (i.e., those outside the Western Province) showing greater reductions in poverty and improvements in growth, perhaps with the exception of the Central and North Central Provinces. Due to lack of data, the analysis did not fully examine the growth patterns in the N&E, but available data looks promising. They indicate that the contribution to GDP is shifting from agriculture to the services sector in

the Northern Province, and to the services and industry sectors in the Eastern Province.

Growth was less inclusive across sectors, where the decline in the proportion of the population below the poverty line was sharper in the rural sector, marginal in the urban sector, and increased in the estate sector. Limited available data on poverty rates for 2009/10 indicate that the poverty levels have come down sharply in the estate sector since 2006/07.

An analysis of the distribution of occupations across provinces from 2002 to 2009 indicate that there has been a marginal increase in the share of white collar occupations nationally and across provinces (not shown), and a larger decline in the shares of

skilled agriculture and fishery workers, as well as in the share of elementary occupations (Table 4.4). There has also been a relatively higher increase in the shares of plant and machine operators and craft and related workers. Without more in-depth analysis, it is not possible to conclude whether growth has benefitted individuals with different skill levels. But, available data suggests a general movement away from elementary and skilled agriculture and fishery workers and a movement towards craft and related workers, and plant and machine operators and assemblers. In addition, in the Southern and North Western Provinces there is a large increase in professionals, sales and service workers.

Examining unemployment rates by education levels indicate that although unemployment levels have declined steadily over the last decade, unemployment rates are still high for more educated workers outside the Western Province. In 2009, the unemployment rate in the country was 5.8 per cent overall, but it was twice that (11.2 per cent) for those who have passed A-Levels. However, the unemployment rate for those with A-Levels in the Western Province (at 5.9 per cent) was

closer to the general unemployment rate. In contrast, in all other provinces, the unemployment rate was more than 10 per cent for individuals with A-Level qualifications. These rates were also much higher for females with A-Levels, than for males. An examination of unemployment rates alone cannot determine whether the high unemployment rates are caused by lack of jobs for more skilled workers or by the lack of relevant skills amongst the more educated workers. Available literature indicates that there is a need for both creating better jobs as well as for improving skills.

4.3 Improving Employability

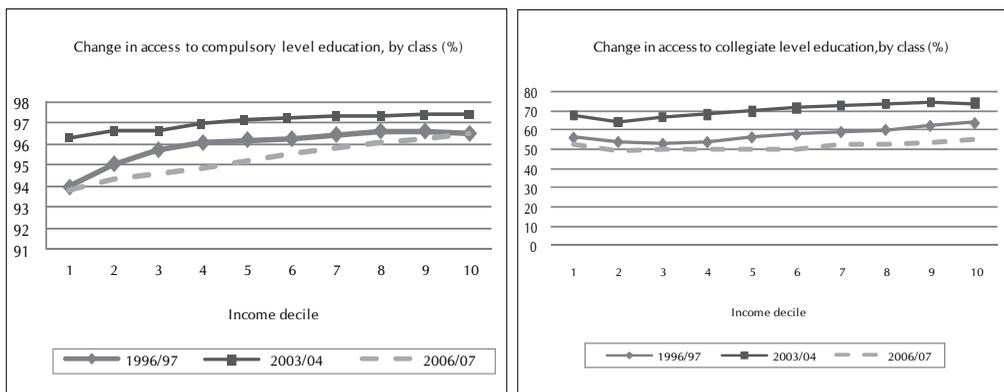
The usual measures of human development have a role in explaining poverty. The PHCR is found to be higher when the head of the household has low levels of education. Further, the more educated have a better chance of making use of opportunities opening in the more productive services sector. To reap better returns from education and to gain better access, other dimensions of human development such as health, housing, access to clean water and sanitation, roads, financial services, etc., are important.

Table 4.4
Percentage Distribution of Employed Population by Occupation, Selected Years

	2009	2002	Annual Average Change (2002-09) Sri Lanka
Senior officials and managers	1.6	1.3	0.3
Professionals	6.0	5.4	0.6
Technical and associate professionals	5.2	4.9	0.3
Clerks	4.1	4.4	-0.3
Proprietors and managers of enterprises	6.7	6.2	0.5
Sale and service workers	8.0	7.8	0.2
Skilled agricultural and fishery workers	22.4	24.2	-1.8
Craft and related workers	15.5	14.3	1.2
Plant and machine operators and assemblers	7.0	5.7	1.3
Elementary occupations	22.6	24.7	-2.1

Source: Compiled using data from DCS, *Labour Force Survey*.

Figure 4.4
Change in Access to Education, by Class (Selected Indicators)



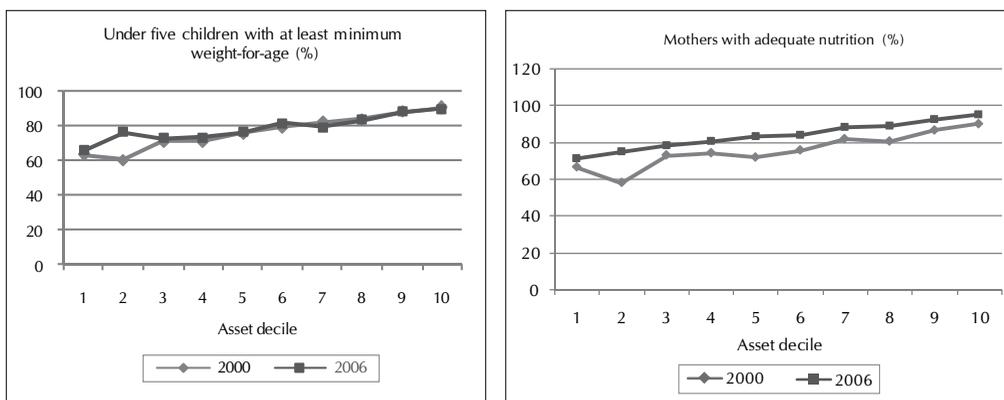
Note: Data for 1996/97 and 2003/04 are from *Consumer Finance Survey* of CBSL. Data for 2006/07 are from *Household Income and Expenditure Survey* of DCS. Given that the data for 2006/07 is from a different source, the data from this year are not comparable to those in the previous two years.

Source: Arunatilake, N., and P. Jayawardena, 2010, "Equitability in Education and Health Services in Sri Lanka", Asian Development Bank, Manila.

Overall, Sri Lanka's indicators of human development have shown progress over time. The percentage of underweight children declined from 29.4 to 26.9 between 2000 and 2006/07, and enrolment in primary school increased (from 95.7 per cent to 97.4 per cent between 1996 and 2006/07).¹⁴

Comparison of some of these improvements over time across different income groups indicates that the improvements are not always inclusive across different dimensions. For example, improvements in access to compulsory education were inclusive, with the poor benefitting more than the rich; but,

Figure 4.5
Change in Access to Health, by Class (Selected Indicators)



Note: Compiled based on data from DCS, *Demographic and Health Survey* (2000 and 2006). Nutritional levels are based on recommendations by the World Health Organization.

Source: Arunatilake, N., and P. Jayawardena, 2010, "Equitability in Education and Health Services in Sri Lanka", Asian Development Bank, Manila.

¹⁴ IPS/UNDP, 2010, *Millennium Development Goals Country Report – 2008/09*.

Table 4.5
Access to Infrastructure by Sector and Province: 2006/07 (%)

	Access to Safe Drinking Water		Access to Electricity for Lighting		Telephone (Mobile or Fixed)	
	Poor	Non-poor	Poor	Non-poor	Poor	Non-poor
Sri Lanka	70.3	86.9	55.1	83.6	9.2	51.9
Sector						
Urban	90.9	98.1	74.1	96.0	16.7	69.6
Rural	72.7	86.9	54.1	82.2	8.9	50.3
Estate	40.9	48.1	53.1	65.5	7.9	20.6
Province						
Western	85.5	95.0	71.2	94.3	12.4	66.5
Central	51.5	74.9	62.6	81.7	9.1	47.6
Southern	74.9	85.6	66.3	86.6	6.1	51.5
Eastern			26.4	72.1	7.9	35.0
North Western	86.3	91.1	46.2	74.1	12.2	48.0
North Central	81.9	87.0	40.2	73	9.6	44.2
Uva	76.7	82.9	46.7	76.2	6.1	36.3
Sabaragamuwa	51.6	71.2	48.8	76.9	8.7	38.9

Source: DCS, *Poverty in Sri Lanka*.

the inclusiveness of improvements to adequate levels of nutrition is not clear (Figures 4.4 and 4.5).

Access to infrastructure plays a key role in improving returns to self-employment activities by reducing transaction costs. Available information on access to infrastructure suggests that there are wide disparities across sectors and provinces. Some examples of these are given in Table 4.5. Making improvements in access to infrastructure will be imperative in opening up opportunities to participate more meaningfully in economic activities across different segments of the population.¹⁵

4.4 An inclusive Growth Strategy for Sri Lanka

Despite improvements in the services and the industry sectors, about a third of the employed rely on the primary sector for employment. Further, the household heads

who are employed in this sector, particularly in agriculture, are more likely to be poor. Given this, it is important to improve the productivity in the primary sector while exploring avenues for expanding and improving the industry and services sectors.

4.4.1 Improving Productivity and Sustainability in the Primary Sector

The proportion of those engaged in agriculture varies widely across provinces, but can be quite large. For example, in the Central, North Central, Uva and Sabaragamuwa Provinces more than 40 per cent of employed are engaged in agricultural activities. It is not possible to vastly increase the employment levels in the more productive industrial and services sectors in the short term. Also, available newer employment opportunities in the services sector require better skilled workers. Given this, in the short to medium term, it is imperative to improve the productivity levels of the primary sector and provide those

¹⁵ See discussion on "Driving Infrastructure Developments for Inclusive Growth" elsewhere in this report.

in this sector means of coping with different vulnerabilities through effective social protection mechanisms.¹⁶

Opportunities to access productive assets, develop capabilities and resources, including natural resources, are key ingredients in inclusive growth. Among natural resources of the categories of mineral, petroleum, hydropower, and other resources of commercial importance, minerals play a major role in Sri Lanka. The country is endowed with industrial mineral resources, including limestone, graphite, mineral sands, gems, phosphates, clay, etc. However, the share of natural resources in Sri Lanka's exports is very limited compared to other countries in the region. Exports are dominated by garments, tea, rubber, etc. From natural resources, only gems, graphite and mineral sands have any significant share.

On top of the contribution to the economy through exports, there is a range of other non-exportable natural resources which are nationally important and contribute to the economy through activities related to tourism, fisheries, and other livelihood related activities. Hydropower is a major natural resource endowment. The natural ecosystem is another such, but most of them are confined spatially to specific geographic areas. Sri Lanka is considered as one of the world's biodiversity hotspots and has the highest biodiversity per unit area of land among Asian countries in terms of vertebrate groups, except birds. The biodiversity rich ecosystems like the rainforests and coastal habitats are on the top of the list. The coastline which is about 1770 km. long hosts a number of interrelated coastal ecosystems, with habitat of mangroves and coastal reefs.

Centred to the industries related to natural resources, inequities exist across different types of actors. For example, a recent study finds that small scale fishers are poor and extremely vulnerable compared to the large scale/export oriented fishers.¹⁷ The relatively isolated small scale fisher communities that locate their work places on the beach front are predisposed to natural disasters. Entitlement constraints that such small scale fishers face can also raise their vulnerability. The majority of coastal communities are functionally or absolutely landless. There are inequities depending on asset ownership. For instance, there is evidence to suggest that growth in fish trade was significant for multi-day boat owners and exporters who are anyway better-off.¹⁸ By contrast, non-skilled workers in the supply chain were found not to have benefitted much from trade opportunities. Even amongst workers, the highest family income was earned by a multi-day crew and the lowest was reported by crew members of traditional craft.¹⁹

If an economy is backed by the presence of natural resources, a major challenge would be to ensure equal distribution of access to the natural resource wealth across different dimensions: whether it is shared fairly by spatially, by income groups, by gender, by ethnic groups, etc.

4.4.2 Improving Connectivity and Making Use of Emerging Opportunities

Improving access to better quality jobs is an essential component of an inclusive growth strategy. As such, while improving productivity of the sectors where the poor are engaged in the short term, there is a need to open avenues for creating better employment

¹⁶ This will be addressed in more detail in the discussion in Chapter 5 on "Social Protection as an Indispensable Instrument".

¹⁷ IPS, 2010, "Trade Poverty Nexus in the Sri Lankan Fisheries Sector", a report prepared for the United Nations Industrial Development Organization (UNIDO).

¹⁸ *Ibid.*

¹⁹ See discussion in Chapter 8 on "Inclusive Growth and the Fishery Sector".

opportunities in all sectors over the long term. In this regard, it is important to improve the physical connectivity of the country both within and with the outside world. The government has initiated several programmes to improve opportunities for creating jobs in the country.

External connectivity - Sri Lanka's historical legacy and post-conflict resurgence: For centuries, Sri Lanka enjoyed a strong position in international commerce owing to its strategic location in the Indian Ocean, at the crossroads of East and West. The country's ports were once a critical link in the ocean 'Silk Route' from China to the Middle East and West. During its time as a colony, particularly under the British, Sri Lanka continued to enjoy strong external economic relations, particularly as a key Asian trading outpost of the British Empire. The Colombo port, the only external access point at that time, was the hub for the country's exports of commodities like tea, rubber, coconut, and spices to the West. However, in the post-colonization era, Sri Lanka was unable to leverage on this 'first-mover' advantage that it gained, and transition into a modern regional and/or international hub. This was due to, among other reasons, the political instability that resulted from the rise of an armed separatist conflict.²⁰

Since the end of the conflict, Sri Lanka has been making renewed efforts to become a hub by improving infrastructure of its points of external connectivity. A five-hub concept is envisioned for the country, with two of these hubs being for external connectivity - aviation and maritime. A key component of this policy thrust has been to rapidly develop the existing external connectivity infrastructure in the country, by improving existing access points, as well as building new ones.

External connectivity - improving airports and seaports: Sri Lanka's sole international airport - the Bandaranaike International Airport (BIA) - is being expanded to cater to 12 million passengers per annum by 2016 from the current 6 million, along with a new domestic terminal, elevated access roads and monorail connectivity, and widened runway or a parallel runway to ease congestion as well as to accommodate new generation 'wide-bodied' aircraft. Additionally, several domestic airports are being 'de-militarized' to cater to increased tourism as well as business travel. The Ratmalana airport is to be developed into a 'city airport' by 2011, to cater to both leisure travellers as well as corporate jet traffic. The Koggala airport (which has immense tourism value), the Ampara airport and the Jaffna airport are also slated for development. Sri Lanka is also constructing a new international airport in Mattala, Hambantota, touted as an important complement to the new Hambantota seaport in advancing the region as a new hub for commercial and manufacturing activity.

Sri Lanka is already an embryonic aviation hub for the southern Indian continental region and the Maldives, but has been overtaken by other regional locations like Singapore, Dubai, and recently South India (Hyderabad and Bangalore) in establishing a true aviation hub. Moreover, it is contended that although the country is strategically located for marine transport, it is much less so for aviation as Sri Lanka is well away from established air routes connecting Asia, the Middle East, Far East and the West. New seaports are being developed in five areas, including the largest in Hambantota and the addition to the existing Colombo port by way of the Colombo South Port.

²⁰ In fact, the only external air connectivity point, the international airport at Katunayake, was a direct target in 2001, that in turn raised the war-risk insurance premiums on both airport and seaport services, impacting on the international competitiveness of the country's exports.

External connectivity - bridging regional disparities: It is clear that the dominance of the Western Province in the country's economic activity is attributable to the monopoly that it enjoys over external connectivity, being host to the country's only international airport and seaport. Enterprises have concentrated their operations around the Colombo metropolitan area, taking advantage of proximity to these international gateways, resulting in the clear emergence of the region as the country's only veritable industrial and commercial agglomeration. Colombo and its surrounding districts in the Western Province account for 70 per cent of industrial value added, and is home to 37,000 industrial production units, employing 540,000 people.²¹ It employs over 60 per cent of the country's estimated 350,000 textiles and garment workers.

With the new Hambantota seaport, a new industrial and commercial agglomeration is likely to emerge in the district. With better road connectivity from neighbouring districts into these facilities, poverty-stricken, lagging areas like those in the Uva Province would gain better access to, and be 'included' in, the new economic opportunities generated by this.

The development of the new ports and airports throughout the country not only facilitates greater access for non-Sri Lankans into Sri Lanka, but also directly improves the connectivity of Sri Lankans to the world, particularly to global markets. Better spatially-spread external connectivity points can catapult a producer or service-provider from the confines of his/her town, district or province, to lucrative regional and global value chains. This is particularly true of perishable goods exports. The time between 'catch' to 'table' or 'farm gate' to 'consumer

plate' determines the value of perishable cargo. Considering that agriculture and fisheries still form an important part of livelihoods in lagging regions, and the ongoing policy push is towards greater value addition in these, better external connectivity (particularly via air cargo across the country) has the potential to be truly transformational. A co-operative of yellow-fin tuna fishermen from Trincomalee could plug-in directly to a supply chain exporting to Japan, via the Jaffna airport, which has connecting flights to Colombo. A processed food manufacturer in Moneragala would be able to export goods more cost-effectively directly from Hambantota instead of having to bring it all the way to Colombo.²²

4.5 Improving the Institutional Environment

4.5.1 Institutional Effectiveness and Inclusiveness

The inclusiveness in the future growth strategies for Sri Lanka for a large part will be determined by the legal, political and institutional environment which govern the economic activities in the country. In order to facilitate growth and improve inclusiveness, it is essential to critically examine the existing policy environment to identify sources of exclusion and to improve inclusiveness so as to free resources and improve efficiency in the economy.

Security was a main constraint that held back investments and restricted economic activities, not only in the N&E of the country, but also in other parts. It is clear that the security situation in the country at present is very different from that which existed during the conflict. Businesses are now thriving in towns where fighting and bombing once prevented commerce from flourishing. Fishing activity

²¹ World Bank, 2009, *Sri Lanka: Reshaping Economic Geography*, World Bank, Washington, D.C.

²² Recently, a local joint-venture firm has begun advertising a small 'Cessna' cargo aircraft which could operate flights with fish catch from Dondra, Point Pedro, or Batticaloa to BIA, and remarks that this would transform the prosperity of fishermen by enabling better access to markets and getting them higher prices for their catch.

has increased in the Northern Province following the lifting of restrictions imposed during the conflict years. Agricultural output in the N&E of the country has grown following the restoration of peace in regions severely affected by fighting. The return of security in many areas across the country has helped thousands return to a normal life and facilitate investments.

However, existing constraints in the system are holding back progress on several fronts. For example, despite good access, adequate credit is still not available easily across the country (Box 4.2). The legal environment with regard to gender equality is another area which needs to be examined. There still exist clear disparities in national legislation on gender. These disparities in part may have also influenced the low participation of females in the labour force. The labour force participation of prime age (25 years or older)

females at just below 40 per cent is half that of prime age males. A recent UNDP report highlighted these differences.²³ Notable examples include the absence of laws entitling maternal leave for women in a comprehensive range of industries (particularly for those in the informal sector), a lack of equal rights for women when administering property. Although Sri Lanka has fared well in gender equality compared to other comparative countries, there is still room for improvement.

The observed disparities and inefficiencies in institutions stem from a variety of factors, including archaic and obsolete laws, lack of awareness among policy makers on the need to improve inclusiveness and issues in introducing changes. To improve inclusiveness, more attention needs to be paid to identify the specific causes of disparities and inefficiencies and to recommend remedies.

Box 4.2 **Improving Access to Credit**

Easy and affordable access to credit is important for developing livelihoods. The following discussion looks at inclusiveness in the financial infrastructure in the country.

Expanding financial infrastructure - post-conflict 'bank branch boom': Following the end of the conflict, and the overall take-off in the Sri Lankan economy since then, nearly all of the country's commercial banks have rapidly expanded their operations. In just the second half of 2009, 49 new bank branches opened island-wide, and in 2010, a total of 121 new bank branches and related service centres opened up in the N&E alone, according to the CBSL. While in newly liberated areas in the N&E much of the initial activity was dominated by deposit-taking and pawn-broking, the overall picture is one of faster credit growth than deposit growth.

Discussions with regional entrepreneurs, particularly in the North, North-Central, Eastern, and Uva Provinces note that bank branches in their regions appear to be extremely risk averse, often despite borrowers being able to provide the requisite collateral. Many entrepreneurs noted that even when loans are approved, they are often as low as Rs. 100,000 - grossly insufficient for local businesses wishing to expand or undertake new ventures; even, for instance, a small-scale rice farmer looking to invest in agro-machinery like combine harvesters and mechanized threshing equipment.

Expanding access to finance - improving financial literacy: Aside from supply-side issues, there are demand-side issues as well, particularly stemming from weak financial literacy of small business owners. It is observed that they are often unable to wade through the complicated formulas and calculations for loan products, find it difficult to understand

²³ Cheema, Hasna, 2010, *Benchmarking National Legislation for Gender Equality: Findings from Five Asian Countries*, UNDP Human Development Report Unit, UNDP.

Table 4.2 contd.../

the nuanced 'small print', and are not sufficiently 'bank-savvy' in order to get a good deal. Many record their frustration at the 'lack of transparency' of the banks' lending practices, insisting that more awareness needs to be created, and rules need to be simplified.

The financial literacy issue extends also to the limited capacity of business owners to produce book-keeping records and accounting requirements of a standard acceptable to managers of local bank branches. Additionally, many businesses looking to venture into new projects or expand existing ones find it challenging to produce business plans to convince bank managers of their borrowing needs. Solving this problem can be addressed in several ways: 1) improving the capacity of local business owners to produce credible and attractive business plans; 2) expanding the provision of business development services (BDS) to assist local entrepreneurs in this exercise; and 3) educating local branch managers on evaluating SME business plans in conflict-affected areas with a different mindset to regular loan applications.

Microfinance in financial inclusion: Despite the extensive financial infrastructure, a vast section of society still remains financially excluded and continue to remain outside the formal system. This limits their access to savings, credit and insurance. Microfinance has the capacity to further the agenda of financial inclusion as it seeks to reach out to the financially excluded category of the population.

The poor should be able to take advantage of the opportunities presented by higher growth in the economy. Microfinance can be a critical step towards that. The basic concept of microfinance is to provide financial services for the poor who are left behind by the formal banking systems. Fundamentally, microfinance products and services are designed with flexible features to meet the financial needs of the poor. Flexible credit is essential in initiating, rebuilding or expanding businesses, while deposits are often important for the poor to cope with shocks. Particularly its role in social and political development within conflict affected environments is indispensable. The asset base of most conflict-affected households has been partially or fully destroyed. Many such households will not qualify for credit under standard conditions. Flexible credit can provide the necessary capital to kick-start economic activities.

Access to microfinance services in Sri Lanka is quite high. Provision of microfinance in the N&E of Sri Lanka is a challenging task for the microfinance institutions (MFIs). The infrastructure and human resource limitations in the N&E are high. Sending resources from other regions increases operational costs. Many conflict affected households are restarting their livelihoods, rebuilding their asset bases and building social networks. In such a setting, obtaining collateral or pay back guarantees are difficult - increasing the risks of credit.

Lesser formalities to access microfinance and the non-requirement of collateral favour the poor. The poor would compensate the cost aspect of borrowing with the convenience of borrowing, which they would not have enjoyed with formal banking systems. However, loan amounts are still perceived to be too small, while product characteristics are considered to be more supply driven and therefore limited. MFIs are quite sluggish in providing for non-productive credit needs such as emergencies, life-cycle services, etc. In addition to credit and savings, MFIs have to build on improving non-financial services to the poor such as vocational training, marketing assistance and other business development services to achieve sustained poverty reduction. MFIs should facilitate graduation of entrepreneurial businesses, by linking them with different kinds of service providers. At the same time, strengthening the microfinance regulatory environment will enable the MFIs to mobilize savings, which matters in institutional sustainability and sustainable service provision.

4.6 Conclusion

There is general agreement among policy makers across Asia about the need for inclusive growth, to improve the rate of poverty alleviation and to sustain growth over the long term. The growth dynamics of the Sri Lankan economy since 2003 indicate that growth has generally been inclusive across provinces, with the exception of perhaps the Central, Northern and North Central Provinces. Economic activities have moved away from the Western Province to the regions, and the shares of services and industrial sectors have increased relative to the agriculture sector across provinces, outside the Western Province. There has also been a marginal improvement in the share of more skilled occupation categories across provinces, and a reduction in elementary and skilled agriculture and fishery related occupations. However, unemployment rates amongst the more educated individuals remain high in the country, and these rates are higher for those outside the Western Province, especially females. These developments indicate that although there is progress in the right direction, the change needs to accelerate and employment generation in better skilled occupation categories needs to increase.

Education and health indicators for the country have generally improved over time. But, the improvements have not always been inclusive. The disparities in access to clean water, sanitation and other infrastructure are still large. To improve living conditions to all and give them a better chance at engaging in the economic process more effectively and efficiently, it is necessary to improve access to services across the country.

Despite recent developments in the industry and services sectors, a large proportion of the poor are dependent on the primary sector

for their livelihoods. Given this, along with developing new growth areas, it is important to improve the productivity of the primary sector and provide those engaged in this sector with the necessary safeguards to enable them to be independent and to improve the sustainability of their livelihoods. The present policy stance focuses on improving the connectivity of regions across the country, and the connectivity of the country to the rest of the world. The developments are taking place across provinces, and as such, they are likely to benefit individuals across the country as well. However, the exact impacts of these developments on individuals from different socio-economic backgrounds are difficult to estimate at present. It is important to examine the inclusive nature of these developments to ensure sustained growth and more effective poverty alleviation.

Sri Lanka has emerged from a thirty year long separatist conflict which has improved the security situation and boosted the investment climate of the country. However, evidence shows that the engagement of different institutions can be made more inclusive to free unutilized and underutilized resources to maximize growth, while reducing disparities. Countries that emerge from violent conflicts remain vulnerable to recurrence of violence, unless underlying causes of violence are examined and eliminated. There is general agreement that continued disparities across regions could increase vulnerability of the country to future conflicts. Given this, it is essential to understand the causes of inequality and redress them. The analysis in this discussion shows that patterns of growth are becoming more balanced across provinces, but more needs to be done to improve inclusion of different types of actors in the Sri Lankan economy.