Sri Lanka
State of the Economy Report 2010

Chapter 1
Policy Perspectives

by
Dushni Weerakoon

1. Policy Perspectives

Sri Lanka made significant progress towards long term peace and stability in 2009 with the successful end to a 30 year armed separatist conflict in the country. The economic dividends, however, were slow to materialize, held down not only by a severe global economic downturn but also by the distractions of Presidential and Parliamentary elections. In the midst of such developments, Sri Lanka's relatively low GDP growth of 3.5 per cent for 2009 went almost unnoticed. The reasons were primarily two fold. First, the adverse knock-on effects of the global economic crisis on the Sri Lankan economy were anticipated well in advance. And secondly, any residual concerns about the downturn were eclipsed by optimism of new opportunities for growth that a 'post-conflict' economy could generate in the medium term.

Usage of the term 'post-conflict' implies many things, including the many political nuances it contains in relation to issues of conflict resolution. At its simplest, however, it can be taken to imply a phase of reconciliation and reconstruction, with intended political and development objectives. In so far as post-conflict development relates to the economic sphere, the primary objective is to reduce the major risk factors of conflict recurrence by formulating economic policies that are sensitive to issues of inequities among groups. While there can be many commonalities in the policies adopted by conflict-affected countries towards this end, there is no recommended "one-size-fits-all" approach. Sri Lanka, like other conflict-affected states, must fashion an approach that is context-appropriate to its own circumstances. Above all, it must be owned, formulated and driven by national actors.

In this, the government had already taken the lead in enunciating its development objectives for the Northern and Eastern Provinces under the 'Uthuru Wasanthaya' (Northern Spring) and 'Nagenahira Navodaya' (Eastern Re-awakening) programmes, respectively. In turn, these were included in its broader national programme of activities spelt out in the 'Mahinda Chinthana: Idiri Dekma' (Vision for the Future) that served a dual purpose as the government's election manifesto. The intention is clearly to deliver rapid economic development to the war ravaged North and East (N&E), while focusing on bridging the rural-urban divide in the rest of the country. That the government's message resonated with a vast majority of the voting public in Sri Lanka was apparent from the overwhelming mandate received at both the Presidential and Parliamentary elections held in January and April 2010, respectively. Whilst it cannot be discounted that support for the government stemmed in part from its military successes in 2009, its economic message - rapid infrastructure improvements to rural Sri Lanka - has also become a decisive factor to an important constituency of voters.

Thus, the electoral successes of the ruling government in 2010 have guaranteed Sri Lanka a degree of political and policy stability that comes with a strengthened Executive, assured of a healthy majority in Parliament. Indeed, the elections have delivered the country an opportunity to overcome what has been a recurring constraint on successive governments to carry out a sustained development drive - i.e., fragile coalitions that have often failed to hold together for the full life time of an elected Parliament. At the same time, however, the electoral successes have also raised the stakes for the government in the coming years. With the ending of the military efforts, the attention of the electorate will be focused almost exclusively on reaping the economic benefits of peace. As a consequence, the pressures on the government to meet high and rising expectations of economic progress and durable peace in the country are that much greater.

And expectations have been on the rise since the defeat of the Liberation Tigers of Tamil Eelam (LTTE) by government forces in May 2009. The groundswell of optimism in relation to Sri Lanka's medium term economic prospects was immediate. The country was quick to capture global attention, not only as a prime destination for tourism, but also as an emerging economy tipped to record a sharp rebound in performance from 2010. In this, Sri Lanka appears well placed to achieve a targeted growth rate of around 6.5-7.0 per cent in 2010, supported by a recovery in almost all key sectors of the economy. While it is understood that growth alone does not define an economic recovery, broad based growth is an initial critical component. It holds out the possibility of generating employment opportunities and improving the lives of the people in the near term.

Early, robust economic growth that has an immediate widespread impact will go some way towards meeting the aspirations of a conflict weary population. From a socio-political perspective, it is critical that such a recovery process should begin to immediately redress imbalances in the conflict-affected regions vis-à-vis the rest of the country. Revival of agriculture and tourism in these regions will help. But, more will need to be done to position the N&E to grow rapidly in the next few years. Indeed, reactivating economic growth in a region that is emerging from a prolonged conflict may call for different approaches. For instance, where conflict prevention is a priority - needing a speedy response - it may be that the benefits of some public expenditure cannot always be subject to standard investment appraisal techniques. In the immediate short term, actions to develop both physical infrastructure and regenerate social capital - a rapid rebuilding of destroyed homes, hospitals, schools, roads, etc. - can make a timely contribution to achieving Sri Lanka's long term socio-political objectives.

Many of these elements have already been captured in the policy documents put forward by the government. Indeed, many more activities are in the process of being implemented as evident by the sharp increase in spending allocated to the N&E. But beyond the immediate recovery efforts must lie clear medium term policy goals that anticipate the transition to long term post-conflict economic development. In the absence of a sound medium term macroeconomic framework that underpins a strategy of growth with stability, the 'phoenix' effect - whereby countries rebuild and grow faster in the immediate post-conflict years - may prove to be unsustainable in the longer run.

The need for a credible macroeconomic policy framework is very real as Sri Lanka grappled with an expansion of its projected budget deficit of 7 per cent of GDP for 2009 to a realized figure of 9.8 per cent of GDP by year end. While it can be explained in part by falling tax revenues in the midst of an economic downturn, expenditure needs - partly related to rehabilitation and resettlement of internally displaced persons (IDPs), etc. - were on the rise. Nonetheless, such fiscal constraints are a reminder that the challenges for macroeconomic management over the next few years will be highly complex. Macroeconomic policy will be called on to support high growth - as almost a precondition to minimizing conflict risk - while ensuring that stability is not compromised in the process. Clearly, this will entail some trade-offs between growth and stability. Indeed, it may even mean tolerating moderate inflation and budget deficits to support Sri Lanka's post-conflict economic recovery process. What is important is the recognition that such a path will hold fewer risks if a medium term macroeconomic framework is underpinned by a clear and transformative process of economic policy reforms.

The priority for fiscal policy is to release financing for infrastructure investment and reconstruction spending. This entails that a mix of far reaching economic, institutional and policy reforms accompany a re-orientation of public finances. In the absence of such reforms, Sri Lanka will falter in putting its public finances in order - that is, cutting back on recurrent spending to support capital investment. Without such flexibility, a heavy infrastructure-led development drive will inevitably rely on borrowed funds. This will not only lead to an accumulation of the country's stock of public debt, and associated risks for macroeconomic stability, but will also mean that Sri Lanka's development priorities do not have the financing that is needed on a predictable basis.

The absence of a broader programme of economic reforms will have another downside effect. Undoubtedly, investing in a critical mass of infrastructure projects will facilitate a growth take-off. Infrastructure spending creates not only public assets but pushes money into the economy with all its multiplier effects. However, for such a growth process to be sustainable beyond the medium term, overall productivity in the economy has to improve. Lower costs that come with improved infrastructure - in transport, energy, communication - can help firms to be more competitive. But, raising the overall productivity in the economy also calls for improvements in the allocation of factors of production. In the absence of such improvements via economic reforms, Sri Lanka's growth will be sub-optimal, and will be subject to increasing volatility as the economy comes up against supply-side rigidities. The concern is that in the absence of a broader reform effort, improved infrastructure delivery will only take the country so far and no further.

The strong political mandate received by the government suggests that Sri Lanka has a very real opportunity for pushing through some of these reforms. Restructuring of state-owned enterprises to ease the financial burden on the Treasury, labour market regulatory reforms to create an attractive environment for employment generation, and education sector reforms to improve the quality, relevance and delivery of education to meet the needs of a modernizing economy are some areas that need attention. There are also more difficult and politically complex areas for reform that touch on improving the efficiency and productivity of Sri Lanka's rural agrarian economy. The government will weigh its options and decide what is feasible. That should not, however, negate adopting a sequential approach to reforms, picking on what is more easily doable and building on the reform process in the medium term.

What Sri Lanka should avoid is to be lulled into a sense of complacency. A post-conflict economic recovery phase driven by accelerated infrastructure spending can see the country achieving an annual average growth rate in excess of 7 per cent in the next few years. Already, the country has rebounded to post a GDP growth rate of 7.1 per cent in the first quarter of 2010. Such promising news on the growth front can also drown out calls for reforms. But, if the country is to truly lay the most viable platform on which to base long term growth, complementing an infrastructure development thrust with a broad reform effort will provide the most sustainable outcome.

A prudent fiscal policy framework will go a long way towards ensuring that a growth rebound is accompanied by macroeconomic stability. Without major attempts to rationalize recurrent spending, some degree of fiscal stability can be achieved by focusing on the revenue side. Indeed, as the Sri Lankan economy recovers from its current downturn, revenue generation can be expected to be positive. In addition, the government has already taken steps by appointing a Presidential Taxation Commission to rationalize the taxation structure and improve tax administration with a view to raising revenue by two per cent of GDP by 2011 from current levels. It is important that an appropriate mix of taxation measures is adopted. Raising taxes can harm growth. Those that are least likely to harm growth are taxes on consumption or on immobile assets such as property. However, there are limits to how much consumption taxes can be raised in view of their immediate and regressive impact on the cost of living.

While improved revenue generation may help to bridge fiscal deficits, it will only be partial given the above factors. The government can still make the case for a development strategy that relies on raising public capital investment in the economy primarily through sovereign debt. There is little doubt that a public investment-led infrastructure drive - based on economic needs - can make a significant contribution towards a growth take-off for Sri Lanka. Arguably, such a strategy can also be justified on the grounds that higher growth reduces the burden of public debt, and may make it easier to rationalize public finances by bringing in more tax revenue. In principle, governments that borrow and spend prudently can reap these benefits. But it is also the case that in practice, management of public debt has been at the centre of macroeconomic instability and crises for many developing countries.

There are other downside risks. A coherent post-conflict economic recovery strategy will solicit the return of private investment. This means government borrowing cannot be allowed to crowd out private investment, which could also lower future growth. To mitigate the crowding out effect, countries can resort to sourcing a larger chunk of financing needs through foreign borrowing. The dangers of greater sovereign foreign debt exposure are well known. Foreign debt brings with it additional exchange rate risk and vulnerability to downside shocks of external economic conditions.

The greater the dependence on short term foreign capital, the greater the risks of macroeconomic volatility. In 2009, Sri Lanka depended heavily on foreign investment in Treasury bills and bonds to bridge its fiscal financing gap. The potential for such capital to take 'flight' at the first signs of investor risk are well known. As the country's ratio of foreign debt service to exports grows - doubling from 7.1 per cent to 14.6 per cent between 2006 and 2009 - the safest course is to ensure that earnings from exports keep pace, to enable external debt service obligations to be held at comfortable levels. This again requires reforms that raise productivity and efficiency of Sri Lanka's export sectors. A supporting macroeconomic environment for export expansion is also critical. The inflows of foreign savings are exerting upward pressure on the country's exchange rate. In turn, intervention in the foreign exchange market to mop up excess capital inflows adds to the domestic monetary base, requiring a prudent monetary policy response that will ensure price stability in the medium to longer term.

As Sri Lanka learned from the withdrawal of GSP-plus concessions by the European Union (EU) that came tied with conditions of marginal relevance to trade relations, reliance on the goodwill of developed countries to provide preferential market access does not come without a heavy cost. Whilst such a "carrot-and-stick" approach may also go against the dictum that in post-conflict recovery, donor countries fuel positive economic recovery and do no harm by promoting actions that heighten the risk of conflict recurrence in any form, the onus is on Sri Lanka to lay the foundation for the export sector to compete in any market. This not only encompasses improved infrastructure, flexible labour markets, improved labour force skills and a competitive exchange rate regime, but it also means strengthening the institutional infrastructure for better governance. Transparency and accountability - be it in relation to investors and/or tax payers - will strengthen the state's credibility and prevent its authority being undermined in myriad ways.

Thus, the ingredients to guide a successful post-conflict development effort are many. This year's 'State of the Economy' report devotes itself to an initial exploration of many of the above policy issues that Sri Lanka faces in meeting the challenges of a post-conflict economic development effort. Primary among them is the need to bridge socio-economic inequities across the country, taking a cross-sectoral assessment of policy concerns.

The lack of reliable information in the previously conflict-affected regions of the N&E - be it on demographic trends, production, asset base, or socio-economic conditions - stymies efforts to arrive at a robust analysis of the regions' developmental needs and prospects for recovery. Nonetheless, it is clear that the N&E face problems peculiar to a region that has been the theatre of conflict for nearly three decades, despite the fact that similar deprivations and disparities exist even within the 'conflict unaffected' areas of the country.

The scattered information available suggests that the decades of marginalization have left the N&E as two of the poorest provinces of Sri Lanka. The need of the moment is not only to build up the socio-economic environment in the N&E - comparable to the rest of the country - but to do it rapidly. This means taking a multi-pronged approach to development, which takes into account rebuilding and modernizing destroyed infrastructure, alleviating poverty through promoting economic independence, and providing the necessary social safety nets for managing vulnerability to shocks.

In this, a key element is rebuilding - rebuilding of destroyed physical and social infrastructure such as roads, schools, telecommunications, electricity services, and health facilities, etc. Such measures on the one hand provide an environment for human resource development, as well as encouraging investments through reduced transaction costs and improved returns to private investments.

The traditional livelihood practices and the know-how that took advantage of the natural resources in the N&E were discontinued due to decades of conflict, while most productive resources in the area were oriented towards military efforts. For sustained development, it is essential that the people in the N&E are able to take advantage of their natural endowments and be economically independent. To achieve this, they must be assisted in reviving their traditional livelihoods, including tourism, fisheries, agriculture and other industries. Assistance is needed in a variety of ways including, skills training, managing local assets, and improving access to credit.

The long duration of the conflict has also damaged the social infrastructure and the trust of the people in the area. Efforts must be put in place to encourage community-led approaches to developing the production base in the N&E and help rebuild the damaged social fabric in these war torn areas.

Going beyond livelihoods, human resources in the N&E regions should be developed such that people are productive and are able to make use of new opportunities. In this regard, filling existing gaps in service delivery - such as improving immunization coverage and providing second chances to school drop-outs - is important. At the same time, education and health services need to be modernized so that people are able to take advantage of new developments in health care, and be able to gain modern skills that are in demand in the labour market.

The rest of this report will discuss these inter-linked issues through a series of chapters and policy briefs.