# SRI LANKA: DEVELOPMENT CHALLENGES AND WAY FORWARD

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## 1. Overview

Just about three weeks ago Sri Lanka celebrated sixty five years of regaining independence from British rule. It is a brief period of Sri Lanka's long history of more than 2500 years, yet these sixty five years have witnessed profound changes in the economy and society. The country context has changed dramatically in recent years. There have been achievements we can be proud of, as well as inadequacies, concerns and discontents. Sri Lanka made significant progress towards long term peace and stability in 2009 with the successful end to a thirty year armed separatist conflict in the country. Sri Lanka has become a middle-income country, and its credit worthiness has opened its access to global financial markets. Sri Lanka has consistently remained at the global middle of the Human Development Index, in which it is currently ranked $97^{th}$ of 187 countries. Sri Lanka is on track to achieving the targets in respect of most of the MDG indicators. UNDP has identified Sri Lanka as an early achiever on 10 of 21 indicators, including those related to the goals of universal primary education and gender equality. Such a steady pace of development in national statistics and indices however, should not mask the fact that country has structural problems and faces a number of development challenges. It is a time to reflect on these and resolve to find a way forward.

## 2. Development Challenges

### *2.1 Poverty and Regional Disparities*

Sri Lanka has been experiencing rapid economic growth thanks to the market-oriented policy introduced in the late-1970s. Over the past decade, there has been a sharp fall in absolute poverty. Higher growth rates have been accompanied by sharper declines in poverty across the more disadvantaged estate and rural agricultural sectors, relative to the better off urban areas of economic activity. Nonetheless, socio-economic disparities do persist across provinces and population groups in the country. While Sri Lanka has seen a reduction in inequality at the aggregate level over recent years, more than half of income is still received by the richest 20 percent of households.

Poverty has multiple and interlinked causes and dimensions: economic. human, political, socio-cultural and security. Pro-poor growth therefore, requires a concordance of efforts between macro policies and micro interventions such as community development, private sector development, and human resource development. Better coordination between national policies and programmes and non-governmental actions is also required.

The government places regional disparities high on its policy agenda and is taking measures to address these structural problems. As outlined earlier, this requires a sustained multidimensional effort. For example, improving the infrastructure and providing incentives for investment in under-developed regions may be necessary conditions for development, but will not be sufficient conditions as the human resources in those regions do not meet the demands of modern industries. Thanks to the drastic decline in the overall poverty incidence, the regional disparities have narrowed over the years, although not disappeared. Structural problems that created regional disparities still largely remain, such as the lack of efficient transportation system, underdeveloped infrastructure, low productivity in agriculture, and the high poverty incidence in sectors such as the estate sector.

### 2.2 *Reduction of Agrarian Poverty*

The agricultural sector has to make the largest contribution in poverty reduction as the majority of poor are living in rural and plantation sectors, where agriculture is the predominant economic activity. According to the available estimates, about 40 percent of those involved in agriculture and related fields were in poverty. About 31 percent of the total labour force of the country, and over 75 percent of the rural labour force is involved in agricultural and related activities. And agricultural households account for nearly 50 percent of the poorest households. Because of this clear linkage between agriculture and poverty incidence, poverty reduction has become the top priority in agricultural development. In fact, the higher level of poverty in rural areas makes it imperative for the development of a productive, efficient and diversified agriculture. One of the noteworthy post independence achievements is self-sufficiency in rice to meet the demand of a 20 million population. This is a significant achievement considering the fact that in 1950, Sri Lanka imported about the half the rice requirements for a 7 million population.

Despite these achievements, productivity of most crops is comparatively low. Average paddy yields at around 4.3 metric tonnes per hectare are less than half the achievable levels. An important challenge in the years ahead is to increase yields in crops to improve farmer incomes, increase food production, generate higher exportable surpluses and reduce food prices. To achieve these breakthroughs there must be increased expenditure on research and an effective extension service. Both these are weak links in the country's development strategy. In this connection, government and public institutions have to play the major role, as the private sector is unlikely to undertake agricultural research due to the difficulty in securing property rights. There is a need to reconsider the mode of agricultural production in the light of labour shortages, technology advances, and the value orientation of youth. Large scale farming by private enterprise appears to be the way forward. Adapting agricultural systems to climate change challenges is also becoming an important area, as the adverse impacts are already evident in some parts of the country by way of irregular rain fall patterns.

### 2.3 *Challenges in Human Resources Front*

Sri Lanka's development initiatives aim to transform the country into a knowledge-based strong middle income country. The government is particularly focused on developing the naval, aviation, commercial, energy, and knowledge sectors of the economy. With the ending of the conflict, prospects for growth look promising. However, sustaining the growth momentum, will critically depend, among other factors, on the availability of a skilled, productive and flexible workforce. The importance of a skilled workforce for staying competitive and attracting investment and business is now well recognized. The skills demanded by the global labour market are changing constantly. The critical task facing policy makers is to develop and manage the available human resources in the country to cater to this demand. However, the ability of the present education system to cater to these emerging demands is questionable.

At present the main provider of tertiary and vocational training in the country is the public sector. Lack of resources has limited the expansion of tertiary and vocational education sector and contained improvements to its relevance and quality. At the same time the scope of university education in the country is very limited. The options for improving resources in the higher education sector include, either increasing public investments in the sector or encouraging private participation in the sector. Given the current budget constraints facing the government, large increases in public investments to higher education are unlikely. Further, an increase in public investment alone will not make the universities dynamic centres of teaching and learning that react to changes in the market in a timely manner. To introduce such changes, the way universities are governed and financed will need to be changed. Although there is no legal barrier, the political economy context of the country discourages investment in private universities. Sri Lanka is one of a very few countries in the world that has discouraged private universities functioning in the country.

The demographic transitions are also reflected in the labour force. Increasing life expectancy and reducing fertility rates are changing the age structure of the population. Sri Lanka's working age population is shrinking, while the older population is growing. The labour force projections for the country indicate that the labour force has already stagnated, and it will start to decline around 2030. Unless labour force and employment rates increase, a very small number of employed persons will have to provide for a very large number of non-working people, straining the budgets of families and the government. However, the effects of these changes on economic growth can be minimized by improving productivity and increasing labour force participation. With the aging rural population, issues arising from the possible labour shortages in the labour-intensive agricultural sector need to be seriously addressed.

### 2.4 *Entrepreneurship and Innovation*

Entrepreneurship and innovations are increasingly recognized as important drivers for economic dynamism and growth. With the technological transformations continuing at a rapid pace, and the emergence of a globalized market place, all countries are under pressure to become more innovative. For Sri Lanka too, adopting existing technologies and best practices, while gradually developing new ones, is the quickest way for its products to move up the value chain and for its economy as a whole to move up the development ladder. If Sri Lanka is truly aspiring to be a knowledge-hub, it needs take the creation of an innovation culture and innovation system more seriously. Although technology has permeated many levels of the economy and society in the country, Sri Lanka has missed successive 'waves' of transformative technology, partly due to the distraction of its long conflict. The UK, Europe and US advanced on the basis of industrial revolution, 'Asian tiger' economies latched on to the ICT and electronics revolution. China, India, Cuba caught the bio-technology revolution.

Sri Lanka ranks poorly in the Global innovation Index, at 82nd out of 115 countries ranked in 2011, but does show promise on several sub-indicators analysed in the report. The challenge now is to see which elements of these technology revolutions can still be adapted in the country to drive higher value exports and greater domestic value addition of products. The overarching issue for all of this is the need to create a dynamic innovation culture in the country, and for this having a holistic innovation policy is essential.

Sri Lanka displays a very low level of national R&D investment as a proportion of GDP. The available figures suggest it is as low as 0.1 percent of GDP when compared with the globally recommended value foe developing countries of 1 percent. Despite stated policy intentions to raise this to 1.5 percent of GDP by 2016, more needs to be done to put in place a holistic innovation policy that will bring together entrepreneurs and different organisations within the so called 'innovation system', such as universities, public laboratories, business chambers, banks, informal sector communities. In partnership with the private sector, informal sector communities and academia , policies to support entrepreneurs and to nurture the entrepreneurial culture that encourages them, need to be further developed and enacted.

### 2.5 *Domestic Resource Mobilization and Foreign Direct Investment*

Domestic resource mobilization efforts stand high on the policy agenda for sustaining stable long term growth. Sri Lanka has fared poorly in these efforts. The country needs to invest around 35 to 40 percent of GDP to accelerate its growth rate to over 8 percent a year and sustain such a growth momentum. Sri Lanka's domestic saving ratio stood at 15.4 percent as compared with the rate of investment of 29.9 percent in 2011 indicating a saving – investment gap of around 15 percent of GDP. The country's macroeconomic environment has not helped promoting savings. A high inflationary environment has been a habitual feature of the economy, discouraging saving and rewarding borrowing. In addition, the country's current demographic transition – a rapid aging population with fewer earners and a large proportion of dependents – will, over time, work against Sri Lanka's long term growth aspirations. In the absence of savings, and inadequate social security, the elderly will deend on the younger generations for support. In such instances, ageing can reduce the ability of younger workers to save as they have to support older adults longer.

Given the inadequacy of domestic resources, the government has been compelled to rely on foreign borrowing and foreign investment to meet the investment – saving gap. Despite the fact that successive governments have attempted to provide various incentives to foreign investors, Sri Lankan record of foreign investment has been far below expected levels and low in comparison with many other Asian countries. FDI flows to Sri Lanka have over the years, been fairly volatile, owing both to domestic and external developments. With net inflows having peaked at US$ 691 million in 2008 – led by the rapid increase in telephone and telecommunication related FDI – there was a sharp drop following the global down turn. With the post-conflict recovery in the economy, FDI inflows in 2011 increased to US$ 896 million, led by FDI into the hotels and restaurants on the back of expected expansion of the country's tourism activities. Despite the biggest impediment for foreign investments having been removed, FDI has been below the expected level. Sri Lanka needs a much higher volume of foreign direct investment to sustain a high trajectory of economic growth. Peace and security are necessary conditions, but not sufficient conditions to attract foreign investment. There are many conditions that have to be put in place to attract FDI. It is important to ensure an attractive investment climate. Consistent macroeconomic policies, good governance, economic stability, guarantee of property rights, rule of law and absence of corruption are among the conditions required to attract FDI. Without these, economic incentives alone will not bring in an adequate quantum of foreign investment of the right type.

Sri Lanka needs to develop the physical and technological infrastructure, enhance its human capital and improve its labour market conditions and administrative capabilities o induce higher levels of foreign investment. There has been progress in the development of infrastructure. The road network has been improved though urban traffic congestion remains a problem. The power situation is much better though electricity tariffs are high. Skill development leaves much scope for development. Labour legislation is considered a serious disincentive. It is unlikely that the government would formulate the necessary labour reforms to allow for flexibility in the recruitment and discontinuance of workers.

### 2.6 *Foreign Borrowing*

The slow growth in foreign investment and the inadequate domestic private investment have compelled the government to raise the level of public investment resulting heavy pressure on the public finances. Much of Sri Lanka's growth momentum in recent years has been coming from increased volumes of public investment. Infrastructure development has been driven by an ambitious public investment programme that has seen the country's public investment to GDP ratio climb to an average of 6.0 -6.5 percent from the more typical range of 4.0 – 4.5 percent, seen over the last decade. This increase in public investment has to be financed by costlier sources of foreign funds. The share of non-concessional loans and commercial borrowing in Sri Lanka's outstanding foreign debt has increased sharply from 7.3 percent in 2006 to 42.9 percent in 2011. The dependence on such foreign borrowing to finance public expenditure necessarily imposes constraints on domestic policy options on the macroeconomic front.

In recent years, foreign sources have appeared as the dominant means of deficit financing. In 2010, foreign financing of the fiscal deficit amounted to 4.4 percent of GDP, of which 3.5 percent consisted of loans and another 0.9 percent of GDP consisted of foreign capital inflows into government Treasury bills and bonds. Foreign currency denominated debt carries well-known additional risks, especially in relation to the exchange rate variation. In the presence of a growing foreign currency denominated debt portfolio, a depreciating currency leads to a growing public debt-GDP ratio. The growing reliance on costlier sources of foreign finance has important implications for Sri Lanka's foreign debt servicing obligations. The country's overall foreign debt service ratio has been rising steadily in the recent years. The increased recourse to foreign financing of the fiscal deficit clearly has other spill-over effects on macroeconomic management.

### 2.7 *State Owned Business Enterprises*

Extensive public sector involvement in economic activities is a significant feature of Sri Lanka's policy milieu. The state owned business enterprises (SOBEs) play a dominant role in banking, insurance, power and energy, water, ports, aviation, commuter transport, media lottery, pharmaceutical and fertilizer. The essence of the problem afflicting SOBEs is broadly similar in developing countries that carry a legacy of state-led growth combined with governance structures that lack consistency and accountability. Performance of most of the SOBEs continues to reflect operational deficiencies such as (a) a limited capacity to adjust output prices to reflect market conditions and profitability (b) inadequate competencies in corporate management (c) lack of proper business models with a long term vision (d) inability to separate business focus from welfare objectives. A majority of these entities are burdened with issues of overstaffing, mismanagement, corruption, inefficient procurement systems, excessive government intervention, and politicisation.

Most SOBEs commonly rely on Treasury funding not only to meet their operational expenditure but also for investments, as their business operations have often failed to generate profits or adequate returns. This remains major a concern in public financial management and economic performance. The financial assistance extended by the Treasury to SOBEs remained around Rs. 102 billion in 2010 and 2011.

Decades of experimenting with economic reforms in Sri Lanka has seen successive governments coming up with various strategies for public enterprise reforms; and yet today, Sri Lanka stands at cross-roads with little evidence of progress in terms of SOBEs reforms.

## 3. Conclusion

While economic growth alone should not be the sole yardstick by which governments attempt to gain legitimacy, growth does matter. Rapid growth over a period of years allows countries such as Sri Lanka to grow from low-income levels to middle-income status. The trickier part is to ensure that the growth process is sustainable and inclusive. This is particularly so for a country emerging from prolonged and divisive conflict. For Sri Lanka, the transition to a post-conflict era raises legitimate economic, political, and social aspirations that call for a steady and politically harmonious growth process. The Institute of Policy Studies in its review of the Sri Lankan economy noted that "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 percent in the next few years.... 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." ((IPS, 2010, p. 3-4).

## Reference

Institute of Policy Studies of Sri Lanka, 2010. State of the Economy 2010. IPS, Colombo