

**ECONOMIC
REVIEW**

Feb. / Mar. 2013

Regional Development in Sri Lanka



A People's Bank Publication

DIARY OF EVENTS

February, 2013

07th In an interview with the 'Voice of Russia' radio, Russian Foreign Ministry spokesman Alexander Lukashevich criticized the United States for imposing sanctions on Iran over its nuclear energy programme, saying such measures only hamper efforts to resolve the West's dispute with Iran over the programme.

10th Commonwealth Secretary General Kamalesh Sharma visited Sri Lanka to oversee Sri Lanka's preparations for the 2013 Commonwealth Heads of Government Meeting (CHOGM), scheduled to be hosted by Sri Lanka in November, 2013.

15th According to the Disaster Management Centre (DMC) floods were reported in Matale, Ampara, Batticaloa, Kilinochchi, Mulaithivu and Vavuniya districts while a flash flood was experienced in the Kandy district. Landslides were reported in Badulla and Matale districts. 134,693 people belonging to 45,918 families were affected due to the inclement weather during the day.

26th Israel President, Shimon Peres congratulated Sri Lanka on her achievement in eradicating terrorism, adding Israel stands firmly committed to support the development of the country's economy in the prevailing environment of peace and stability, when External Affairs Minister of Sri Lanka, Prof G. L. Peiris called on him at the President's Office in Jerusalem.

28th Speaking at the committee hearing on "The Rebalance to Asia: Why South Asia Matters", a ranking member of US Foreign Affairs Sub-Committee, Eni F.H. Faleomavaega called for the withdrawal of the US sponsored resolution against Sri Lanka for focusing only on the last few months of the war and failing to acknowledge almost 30 years of conflict.

According to a survey by a China-based wealth magazine report, Asia has more billionaires than any other continent, followed by North America and Europe. There were 1,453 people around the world with a personal wealth of \$1 billion or more as of January, 2013. Asia had 608 billionaires, North America 440 and Europe 324.

A motion presented by the opposition Social Democratic Party (SDP) group in the German Parliament on Sri Lanka titled "Use the UN Human Rights Council and Demand Observance of Laws, Human Rights and Reconciliation Process in Sri Lanka" was rejected with the votes of the governing coalition in the German Bundestag (German Parliament).

March, 2013

05th Venezuela's President Hugo Chavez died of cancer.

07th Sri Lanka received the title "Most Popular Tourist Destination" at the 'Buyers Night and Award Ceremony' held in Guangzhou, China on the sidelines of the Guangzhou International Travel Fair 2013.

12th President Mahinda Rajapaksa arrived in Japan on a four-day official visit.

13th Japan's Minister of Foreign Affairs, Fumio Kishida called on President Mahinda Rajapaksa at Hotel Imperial in Tokyo. He stated "Japan welcomes the efforts made by

Sri Lanka in the areas of reconstruction, reconciliation and human rights after the conflict".

14th President Mahinda Rajapaksa met with members of the Japan-Sri Lanka Parliamentary League in Tokyo and told them "We greatly appreciate Japan's contributions to many different sectors in Sri Lanka".

President Rajapaksa held discussions with Prime Minister of Japan, Shinzo Abe at the Prime Minister's Office. Japanese Prime Minister assured Japan's continued support for Sri Lanka's sustainable growth while the two leaders agreed that national reconciliation must take precedence.

After a meeting between President Rajapaksa and Prime Minister Abe a joint statement was issued by expressing their satisfaction at the outcome of the official visit by President Rajapaksa which had provided further testimony to continuing excellent relations between the two countries and the Government of Japan agreed to provide development assistance totaling 43.8 billion Yen to Sri Lanka to be used in areas including infrastructure development and disaster prevention. (Out of this, 41.1 billion Yen will be loans while 2.7 billion Yen is grant aid). Further, Sri Lanka and Japan agreed to work towards expanding maritime cooperation between the two countries, especially with Sri Lanka's potential to become a maritime hub in the region using its unique location on the Indian Ocean sea lanes.

15th President Mahinda Rajapaksa met leaders of Japan's corporate and industry sectors and inaugurated the Sri Lanka Business Forum. During the meeting with Japanese business leaders, Sri Lanka External Affairs Minister and Governor of the Central Bank of Sri Lanka spoke to the delegation about the economic climate in the country as well as areas of opportunities for potential investors.

17th Indian media reported, Bharatiya Janata Party (BJP) does not endorse the DMK's demand that the Sri Lankan President should be declared a war criminal. It further reported the party also refrained from categorically supporting Tamil parties' demand that India should take a stringent stand against Sri Lanka at the United Nations Human Rights Commission in Geneva.

18th Sri Lanka's second international air gateway - Mattala Rajapaksa International Airport (MRIA) was opened by President Mahinda Rajapaksa.

21st Chinese media reported at least 24 people died and scores were injured after a tornado carrying huge hailstones lashed southern China, causing widespread devastation.

22nd A powerful tornado ripped through more than a dozen rural villages in eastern Bangladesh, killing at least 20 people and injuring more than 100.

27th The leaders of the BRICS nations (namely Brazil, Russia, India, China and South Africa) wrapped up their latest round of summit in the South African city of Durban to promote their partnership for development, integration and industrialization.

29th The External Affairs Minister of India, Salman Khurshid rejected the resolution passed by Tamil Nadu assembly that called for enforcing sanctions against Sri Lanka and holding a referendum to create a separate Tamil Eelam in Sri Lanka.

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Special Report**Regional Development in Sri Lanka**

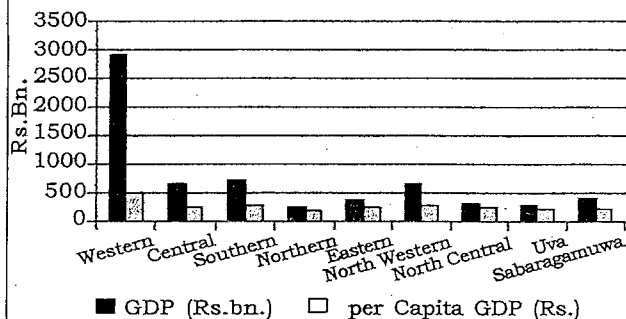
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Economic Review wishes to acknowledge with gratitude the unstinted support extended by Dr. Wilbert Gooneratne in organizing this special issue on Regional Development in Sri Lanka.

Cover - "Impressive Economic Mountains around Colombo" depicted in World Development Report 2009: Reshaping Economic Geography

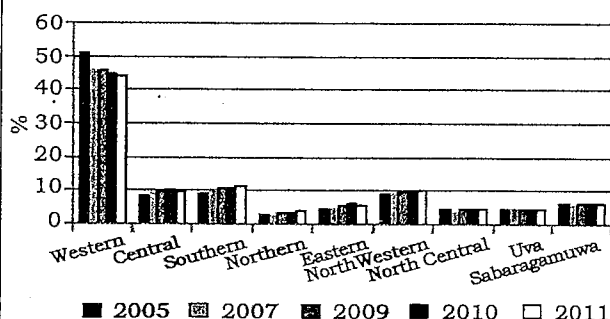
SOME HIGHLIGHTS ON REGIONAL DEVELOPMENT - SRI LANKA

Provincial GDP and per Capita GDP - 2011



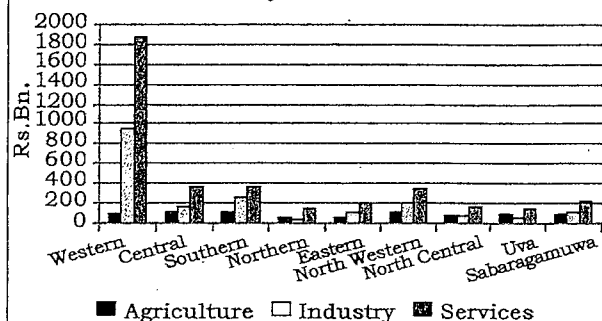
Source: Central Bank of Sri Lanka

Provincial Share of GDP



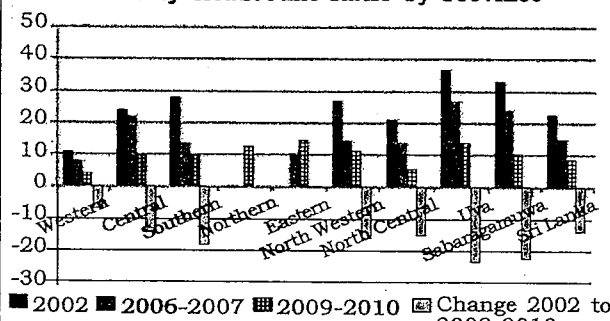
Source: Central Bank of Sri Lanka

Provincial GDP by Economic Sectors - 2011



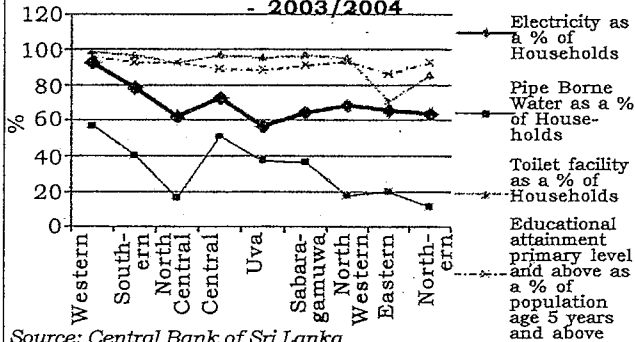
Source: Central Bank of Sri Lanka

Poverty Headcount Ratio by Province



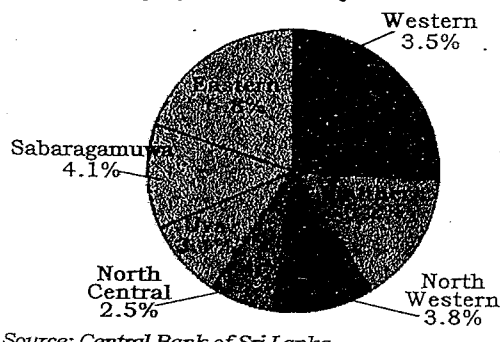
Source: Sri Lanka Human Development Report, 2012

Selected Key Socio Economic Indicators by Province - 2003/2004



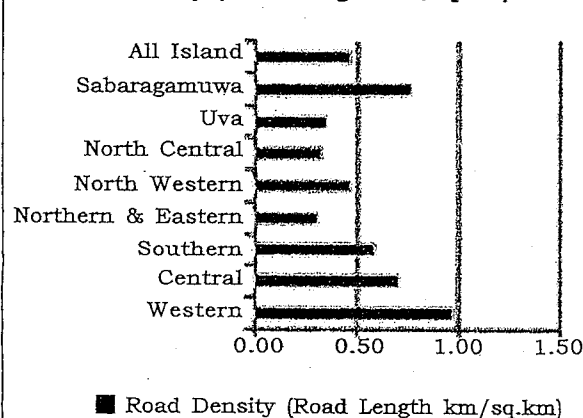
Source: Central Bank of Sri Lanka

Unemployment Rate by Province - 2011



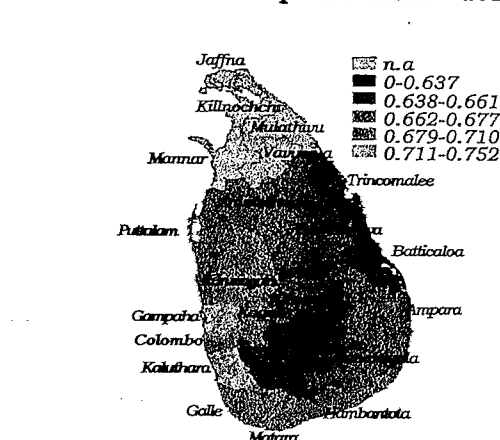
Source: Central Bank of Sri Lanka

Road Density (Road Length km/sq.km) - 2011



Source: Sri Lanka Human Development Report, 2012

Human Development Index - 2011



Source: Sri Lanka Human Development Report, 2012

Regional Development in Sri Lanka: The Need for a Paradigm Shift*

1. Introduction

The issue of persistent regional disparities continues to be a stubborn development challenge and a politically sensitive factor in Sri Lanka. While the Western Province (Colombo Metropolitan Region-CMR), as the core region, has continued to experience high rates of economic growth, job creation and poverty reduction, rural and peripheral regions continue to lag behind due to an array of stubborn development problems. Over four decades of largely rural focused development policies and interventions have not been successful in closing the gap between the fast growing CMR and the periphery. Sri Lanka, however, has been able to achieve a high degree of leveling in access to most of the critical services such as education, health as well as access to electricity, water, sanitation etc. despite the lower quality of such services and facilities in the lagging regions.

Today, Sri Lanka is on a steady growth path. One of the major challenges is to sustain and accelerate this trend by maximizing the diverse potentials of the country. While the leading region, the CMR, needs to continue to grow, the lagging regions also need to grow in parallel, without falling too far behind (IPS 2012). Trickle down effects take a long time to benefit lagging regions. Hence the need for growth promotion as the best way to address regional inequalities by harnessing the potentials of lagging/peripheral regions and improving their economic dynamism. This can greatly contribute to national economic development by improving competitiveness and resilience of national and regional economies.

Today, globalisation of trade and economic activity increasingly tests the ability of regional economies to adapt, exploit or maintain their

competitive edge. Globalization also increases the tendency for inequalities to widen between and within regions. Yet, rapid technological change, the extension of markets and the greater use of knowledge offer new opportunities for local and regional development. Most countries recognize the need to reconsider their strategies and policies to improve the competitiveness of regions by focused investment to improve their business environment, diversification and improvement of production and upgrading of skills and innovation, all of which are key elements of competitiveness.

This paper underlines the need for a paradigm shift in the approach to regional development in Sri Lanka. It stresses the need for a rationally delineated system of development regions for the country that is better suited to generate economic and social development of the peripheral/lagging regions, and support overall national development in the context of a fast changing and integrating global economy. The paper stresses the need for regional economies to be not only competitive but also resilient.

2. Regional Disparity: Trends and implications

The spatial pattern of growth that has emerged in Sri Lanka is one of sharp regional disparities where a core/periphery phenomenon is clearly evident. We are witnessing high concentration of growth in the core region (CMR), which is also the capital city region, leaving the large rural periphery lagging far behind it. The rural periphery consists of two fairly clear large regional groupings. The four provinces closest to the CMR is the inner periphery while the four provinces located farthest from the core region constitute the outer periphery. The latter is the more depressed, distant and more lagging of the two.

Dr. Wilbert Gooneratne**

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CMR with only 6% of the land area and 25% of the country's population occupies a pre-eminent position among Provinces in its contribution to GDP (+45%), share of industry (+60%), construction (+65%) and financial and production services (+80%). The GDP growth rate of the CMR has been nearly 3 times higher than in other Provinces.

The CMR accounted for over 50 percent of GDP in 2005. However, it has declined to 45 percent by 2010. The provinces in the inner periphery (North Western, Central and Southern) occupy an intermediate position contributing around 10 percent each to GDP. Sabaragamuwa with a lower GDP contribution is included in the inner periphery due to its proximity to the CMR. All the other provinces (outer periphery) lag far behind contributing 5% or less each. Also, the annual per capita GDP of the CMR was 1.6 times the national average. All other provinces had GDPs below national level (Central Bank 2012). In 2010, CMR's share of GDP has come down to 45.1% due mainly to the gains by the Southern, Central and NW Provinces. The outer periphery as a whole has remained stagnant.

The CMR is also facing diseconomies like congestion, pollution, escalating land prizes, rents etc. Despite this, it is piling up growth. Jobs, wealth, superior infrastructure, services and amenities and, administrative and political power are all concentrated here. The much expected growth spread to the periphery from the CMR

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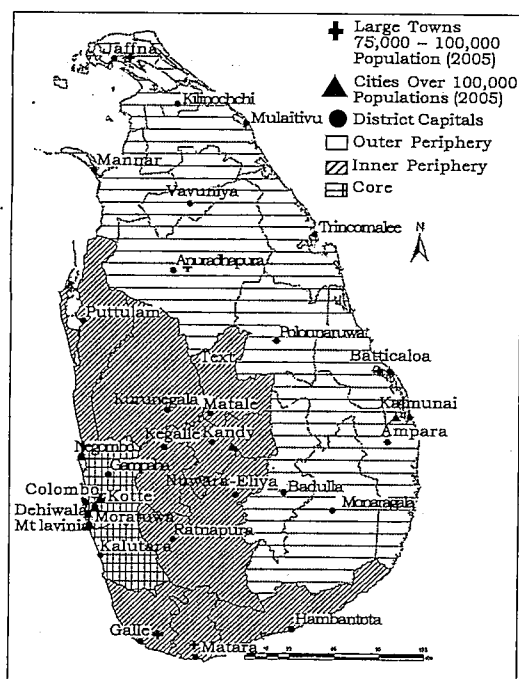


Figure 1 Core and the Periphery - Regional Disparity in Sri Lanka

is not taking place. Even the adjoining provinces in the inner periphery, like the Sabaragamuwa, the obvious candidates for such spread effects, have benefited little from the rapid growth of the CMR.

CMR is also depleting the periphery of its valuable resources including capital, the educated, the skilled and the young and more dynamic people further weakening their economies. Note that moving away from the core to the periphery also means moving from developed to lagging, advantaged to disadvantaged and largely urban and industrial to mainly rural and agricultural regions.

The poor growth and slow diversification of the peripheral region economies has been due to a combination of factors such as their predominantly rural and agricultural character with low economic diversification, poorly developed (and linked) urban centres and inadequate and poor infrastructure limiting connectivity within and outside the region. Finally, rural peripheral regions remain grossly deficient in high quality services and amenities linked to dynamic cities and towns in these regions.

3. Past Initiatives in Addressing Regional Disparity

Successive governments, since Independence, have taken noteworthy

steps to address issues of poverty, inequality and neglect. Besides numerous subsidies and social welfare policies, others included investments in physical and social infrastructure, resource development involving irrigation and land settlement in the Dry Zone, and programmes to assist specific groups like plantation workers and the Kandyan peasantry in up country areas. Population redistribution from the overcrowded Wet Zone areas to the Dry Zone was an important objective of the early land settlement schemes. Other measures were the decentralization of governmental functions to the lower administrative unit, the district and the initiatives taken to achieve better coordination of development activities at the Sub-national/District level (District Coordinating Committees [DCC] of 1953, District Political Authority of 1973, Decentralized Capital Budget [DCB] of 1974 and District Development Councils [DDC] of 1980).

Regional development thrusts under the liberalized economic regime of 1978 included 'lead projects' like the Greater Colombo Urban Development Project, Free Trade Zones Project, the Mahaweli Project and the Integrated Rural Development Projects (IRDPs) to assist rural areas not covered by lead projects. There were also efforts to decentralize industries to the outer regions by establishing industrial estates and garment factories in rural locations.

Introduction of the elected Provincial Councils in 1987 devolved considerable authority and responsibility to the sub-national level; the provinces (see below).

The above noted programmes and initiatives

have contributed in many different ways to improve the socio-economic conditions

of many rural and backward areas of the country and helped to attain several national level development objectives of employment generation, food production, power generation, population redistribution etc.

The above were clearly insufficient to promote sustained growth at the regional levels, in particular, in the lagging periphery. They were not able to achieve a spatially balanced settlement system and create dynamic and resilient regional economies. Further, most policies were not geared to address the long standing disadvantages of the lagging regions and did not provide the required tools to generate growth. The policies lacked a strong link between welfare and growth.

Rural/peripheral regions in Sri Lanka are clearly not declining, although they are lagging behind the more prosperous CMR. What has been lacking is the absence of sustained innovative policies to valorize their underutilized resources and potentials. The persistence of regional disparities actually demonstrates the unused potential for growth.

4. Emerging Realities of Regional Development

There are several dynamic processes that are at work at different levels which exert a profound impact on regional development today. Globalization has fundamentally restructured the economic and political geography of countries by creating a new architecture of regional space. Some mega cities and city regions are emerging as world centres of investment, economic growth and wealth creation. This is happening at the expense of rural areas, secondary cities and small urban centres pushing other sub-national regions to a position of disadvantage.

Table 1 GDP share of Provinces-%

Year	WP	SP	CP	NWP	SBP	UVP	EP	NCP	NP	Total
2005	50.8	8.9	8.5	8.9	6.4	4.5	4.7	4.3	3.0	100
2010	45.1	10.7	10.0	9.4	6.3	4.5	5.9	4.8	3.4	100

Source: Central Bank (2005 and 2010).

These developments have altered the background against which future regional development policy will have to be based. They require effective shifts in policy as well as repositioning of strategies to (a) tap the opportunities that globalization opens up in numerous areas such as employment, trade and investment, (b) prevent rural/peripheral regions from further weakening and (c) face the likely damaging shocks of a volatile global economy by strengthening the resilience of the regional economies. This is possible by *complementing competitiveness with a desirable level of economic completeness* in the regional economies by maximizing on their potentials and comparative advantages (Douglass 2001, Storper 1997).

Today, the unprecedented advances in science and technology and the revolution in transport and communications are eliminating the traditional disadvantages of regions. They help to shift the comparative advantages of regions and alter the industrial location dynamics. They have helped regional centres and small towns to become attractive locations for investment in many countries.

A Regional Development strategy can also provide the framework for meeting the growing demand by local and regional entities for a greater role and say in participating more inclusively in their own development.

5. Need for a Paradigm Shift

Today, there is a growing body of evidence from many countries where regional development has shifted to policies that focus on growth and competitiveness of regions with emphasis on the exploitation of comparative advantages, science and technology, and endogenous effort through stakeholder partnerships at regional and local levels. In other words, there has been a major paradigm shift in regional development concept and strategies.

The need for a paradigm shift in Regional Development in Sri Lanka has also been enhanced by several recent developments, both internal and external. Among the internal factors, the more significant ones are the following:

- The restoration of peace, security and political stability in the country following the end of the prolonged 30-year conflict. It has created a wide window of opportunity for achieving rapid and sustained growth and development as well as improvement in connectivity of places and people for realizing greater integration and unity. It has also created greater awareness on the need to address regional issues with special reference to the war-affected areas of the Northern and Eastern provinces as well as the adjacent affected districts, all in the outer periphery,
- Notable expansion and revival of economic activity in all key areas (such as agriculture & fishing, industry/manufacturing, construction, tourism & other services) and opening up prospects for further growth and expansion. A major economic transformation of the country is under way as seen from the growth of industrial exports from 5-6% of national exports in the 1970s to over 60% in more recent years,
- Widespread, extensive & accelerated investments in key infrastructure-roads, ports, airports, power, irrigation etc. which will create a favourable environment for accelerated investment & growth in different parts of the country,
- High levels of social development in the country, particularly in education and health. Among the lower middle income countries, Sri Lanka is unique in achieving many of the MDGs. These are assets that can help drive growth and transformation.

Among the external factors, besides the opportunities and challenges posed by globalization in general that we noted above, Sri Lanka needs to position itself to reap the benefits from the expected growth in the Asian region (India, China, SE Asia), Middle East, Africa as well as the expected recovery of the economies in the EU and the US. A system of dynamic, competitive regions can assist in reaping the benefits of these developments. As stressed by the

Chairman of the National Chamber of Commerce of Sri Lanka recently (The Island 27/1/2013), a greater state of readiness is necessary as Sri Lanka is poised to move forward.

A Paradigm Shift in regional development involves the following essential parameters:

- New objectives with focus on growth and competition,
- New geographical scale with development oriented territorial units,
- New policy instruments with focus on endogenous development, science & technology and innovation as well as focus on key regional growth drivers,
- New governance and institutional arrangements.

The discussion in the following sections will address some of the essential features of the above noted parameters:

6. Case for a Development Responsive Territorial Framework for Regional Development

Sri Lanka needs a territorial/regional framework to promote sustainable growth across national space and to revitalize the lagging rural/peripheral regions. The promotion of regional growth is a more realistic way to deal with the problem of regional disparities. A well-conceived regional development policy will also enable Sri Lanka to benefit from the country's great diversity (natural, economic and cultural), manage the environment and the natural resource base more efficiently and deal with the expected urban growth (projected to increase to nearly 60% of the population by 2030) especially to bring about a more balanced spatial development in the country.

Sri Lanka also needs to improve competitiveness of key economic sectors at the national level to gain a competitive edge. This is likely to be greatly facilitated by enhancing the competitiveness of different regions with different and untapped potentials and comparative advantages. We need regional economies that are fit for the 21st century.

Today, there is a growing trend in many countries towards strengthening the regional level. This is because economic activities and processes are taking place across traditional administrative structures and boundaries. The prevailing fragmented systems do not permit addressing such economic growth factors or enable existing institutions to develop critical measures to address them.. This is why an increasing number of countries have introduced more relevant regional scales and mechanisms for strategy formulation, policy initiatives, resource allocation etc. (see section 10 below). IPS (2012) has recognized the need to focus on regional development the need for the lagging regions also to grow by utilizing their growth potentials and achieve a high degree of resilience and economic dynamism and thereby contribute to national development. The need for Sri Lanka to move towards strategic and integrated national, regional and urban planning has also been highlighted by the World Bank recently (World Bank 2009).

7. The Need for a Larger Territorial Unit

Since the 1990s, the need for a larger territorial unit to promote regional development in the country has been recognized from time to time as indicated by several initiatives.

The creation of the now defunct Southern Development Authority (SDA) in 1995. It adopted a development-oriented regional unit going beyond the Province (included the Southern Province, Moneragala District and two Southern Divisions of Ratnapura District).

The more recent initiatives to create Regional Development Ministries by previous governments (2001 & 2004) again demonstrated the recognition of the need to move beyond the present administrative unit to promote regional development. Some Regional Development Ministries adopted a larger unit than a single Province. These were, however, largely *ad hoc* initiatives, with unclear objectives and not guided by sound concepts.

The Regional Development Division (RDD) after nearly two decades of implementing district IRDPs, introduced the concept of a Regional

Economic Advancement Programme (REAP) going beyond the district (RDD 2000). The case for a system of larger development regions based on geo-economic criteria has also been made by others (Gooneratne (2001 and 2005). More recently, the leader of the main Tamil political party has recognized the need to have a smaller number of larger territorial units (4 or 5) "to avoid the waste of resources".

Today, the need for larger territorial units to promote growth and transformation at regional level is slowly emerging. The special focus on the CMR and the Northern region as well as the increasing references to the need for a larger RUHUNA (covering Southern Province and Ratnapura, Moneragala, Ampara and Batticaloa districts) to create a geographically larger hinterland to benefit from the mega infrastructure and other concentrated investments in Hambantota are some examples. A recent TV advertisement of Mattala airport announces that the new facility caters to people from the above districts. A multi sectoral and integrated regional development strategy covering the entire South East region would improve the scale and scope of multiplier effects of the investments in Hambantota- present and future.

8. Unsuitability of the Present Territorial Units for Regional Development

The suitability of the Provinces, as a rational territorial framework for regional development has been questioned by numerous commentators. The Provinces were not created by the colonial administration to promote development. It has been recognized that Provinces such as the Southern and the land-locked Uva and Sabaragamuwa and the Eastern Province are not meaningful territorial units from the point of view of economic development (see Economic Review, 1990).

The suitability of the Provincial system has also been questioned on other grounds such as its failure to significantly contribute to Provincial economic development, its over dependence on the centre for resources and as an expensive and wasteful exercise. Many

commentators also reject the Provincial system on socio-political considerations. The most important criticism is that it was imposed on Sri Lanka against its will (Hewavitharana 1997).

The district, on the other hand, though well established, is too small as an effective territorial unit for meaningful regional development as the IRDPs have demonstrated. This was why, in the year 2000, REAP proposed larger territorial units going beyond the district.

Several alternatives to the present Provinces have also been advanced by a number of academics, researchers and others (Economic Review, 1990) and Madduma Bandara (1991). These proposals are mostly based on agro-hydrological, historical and other considerations and were advanced mainly as a solution to the ethnic problem and as an alternative to the PCs. The proposed regions are not development regions. In addition, many of these proposals also came up with too many units that lacked scale advantage. Note that the *Mahinda Chintana Idiridekma* regional development vision is anchored on the existing 9 Provincial units.

9. Development Regions: Key Attributes

The Concept of *REGION* continues to be an elusive one and the quest to establish an overarching definition has remained futile. Regions become definable only in relation to specific purposes and criteria. They can be defined for different purposes ranging from economic, social to political and even security. Regions can be demarcated by one or several criteria such as natural (rivers or mountains) or administrative boundaries. Regions are not to be discovered; they are our constructions. Development regions are defined by taking several inter-related socio-economic, geographic and resource management aspects.

Considering the major challenges confronting Sri Lanka, any system of development regions that the country may adopt must have some of the following attributes: (i) they have to be large enough to permit the emergence of dynamic and

Table 2 Development Regions and Regional Development Institutions in Selected OECD Countries

Country	Number & Type of Region	Year Introduced	Planning Institution
Denmark	5 regions	2007	RED* Council
Hungary	18 regions	1996	RED Council
Japan	8 planning Regions	2006	Reg. planning Council
Korea	5 economic regions	2008	RED Committ-ee

*RED-Regional Development

Source: OECD (2010)

Table 3 New Regions in Selected S & S. E Asian Countries

Country	New Regions	Year Introduced
Malaysia*	5 economic regions (corridors)	2006 (under 9 th Plan)
Vietnam**	8 geographic & socio-economic regions 3 key economic zones	2004
Nepal***	8 regions	2007 (proposed by NPC/ADB)

Source: * www.dpu.gov.my/home

** Vietnam Briefing, May 2012

*** NPC/ADB 2007

competitive regional economies by enlarging scale and scope of each region, (ii) they possess certain common characteristics in terms of development potentials and problems, and combine strong/weak, high potential/low potential and rural and urban areas to strengthen complementarities and (iii) they should not be altogether artificial or arbitrary units that are unfamiliar or unconnected to the local populations. They should make some territorial sense to the people of the region.

There are several advantages that a larger territorial unit can offer in supporting regional development. It helps (i) enlarge the overall resource

base; both physical and human; (ii) increase the multiplier effects of capital injections in to the local economy, (iii) enhance complementarities and growth linkages between rich/poor and high and low potential areas, (iv) enlarge the scope for building strategic partnerships among key stakeholders, (v) create conditions for a science and technology-led regional development: A larger territorial unit will be able to bring together the minimum bundle of institutions that are vital to launch and later expand science and technology support for the region. The impact of globalization is too strong to be adequately dealt by small regional units.

Flexibility has to be a key distinguishing characteristic of regions delineated for development purposes in a rapidly evolving global environment. They have to be flexible in at least three important respects. First, they need not have rigid geographical boundaries. Flexibility allows regions to make adjustments when required, in relation to the changing economic and political realities. Second, under a system of devolved/decentralized governance at sub-national and local levels (Provincial/other and Urban and Local Authorities), development regions need not have administrative and political powers. They would only require political and/or constitutional recognition. The politico-administrative powers and planning/implementation responsibilities could remain in the hands of the devolved/decentralized entities of governance, an arrangement widely adopted in many countries. Third, development regions require only a competent, representative, committed organizational mechanism with a major role for the key stakeholders of the region (see below) to road-map and guide long-term regional growth. There are several examples of institutional forms/arrangements that have been adopted in different countries (see Tables 2 & 3).

Thus, the central role of development regions would be the elaboration of a long-term development vision or comprehensive basic framework of

development (development road map) for each region. This is the elaboration of a bold agenda of strategic initiatives to expand *development potentials and capabilities* of the region

Development region institutions also have the important role of lobbying with the central government for support for the envisioned long-term development strategy, publicising and promoting it among the stakeholders and the larger regional community, assisting in the coordination of policies, programmes and projects of devolved/decentralized units and guiding and supporting the sub-national and local governments and other relevant agencies to translate the regional development framework in to policies, plans, programmes and projects for implementation. Thus, the role of the development regions will be largely regional development strategy formulation, promotion and advocacy and monitoring development rather than actual planning and implementation.

10. International Experience

The need for larger geographical scales to enable regions to harness comparative advantage and strengthen regional (and national) competitiveness has been recognized by many countries. Recently, some countries in the European Union have recognized the need to redefine their regions to better meet the emerging challenges of European integration and global competition. Similarly, several Asian countries have also adopted the concept of larger development regions in different forms, positing them above the existing devolved/decentralized units. Such examples in East Asia include China, Japan and Korea and in South East Asia, Malaysia and Vietnam and Nepal in South Asia.

11. Proposed Development Regions for Sri Lanka and their Characteristics

On the basis of the criteria and concerns outlined in the previous sections, six development regions for the country are proposed on a rule of thumb basis. These are shown in Map 2. A brief description of the main characteristics of each of the regions is given in Appendix 1. We stress the

New Development Regions Two Asian Cases

KOREA

Close to half century of economic growth has resulted in over concentration of growth in the Capital region and stagnation in peripheral areas. The government now gives priority to policies to balance regional inequality with a new administrative capital in the centre and several innovation and enterprise cities outside. This has been strengthened by the adoption of 5 economic regions in 2008 (RDD 2008).

MALAYSIA

To avoid further growth concentration around the capital and achieve a more balanced development, Malaysia adopted 5 economic corridors in 2006. Described as 'gateway to prosperity', these corridors are said to be 'paving the path of continuous domestic regional growth'. Each of these corridors has its own vision, focus and own authority to oversee development. (www.dpu.gov.my/home and Borneo Post-24/6/2012).

need for flexibility in delineating development regions. They need not have rigid and permanent geographical boundaries. However, in the case of the regions that we have proposed, it is possible to demarcate the boundaries to coincide with the established administrative boundaries of a mix of provinces, districts or divisions. The actual delineation of the development regions must be done only after a careful analysis of the data/information pertaining to regional characteristics and long term development potentials. The Colombo Metropolitan region need to stand as a separate unit due to the special role it plays in the national (and global) economy.

There is clearly no conflict between the adoption of a system of larger development regions and the devolved/decentralized governance system. The former provides a more rational and effective territorial unit to organize the national territory for improving regional growth and competitiveness. As we noted above, a well-functioning devolved/decentralized system of governance is indispensable to enable subnational and local areas to participate meaningfully in their own development and face global challenges. They are an integral component of a regional development strategy for serving as planning and implementation organs of the larger development regions. The development regions create a more effective framework for dealing with development challenges arising from the processes and economic activities

taking place across traditional administrative structures and boundaries. The prevailing devolved/decentralized system by itself is too fragmented to permit addressing such economic growth factors.

12. The Development Region Drivers

To be dynamic and competitive in today's global economy, regions must be driven by two powerful forces.

First and foremost, regional development must be propelled by endogenous effort. A region's ability to grow and prosper and sustain its prosperity is clearly a function of what the region can do. State and other external participation and investments, interventions can become effective and sustainable only when they are rooted in and internalized by the local/regional economy. This can happen only when strong partnerships are built among the

key regional level stakeholders, consisting of local governments, private sector, educational institutions and the civil society and the State. But it is the "committed stakeholders" who need to play a pivotal role. These are the stakeholders with a long-term commitment to the region who want to shape and reshape the future of their region. The stakeholder partnerships improve the capacity for local self organization and create internal ability and capacity for transformation than centre and externally driven development. It is only committed stakeholders who can create faith and hope in the regions and their capacities and potentials. In the context of the prevailing public policy environment, the private sector has to be a key partner in development and the engine of regional growth.

Second, today's regional development must be science and technology-led and eventually knowledge-based. This is because the creation of competitive regional economies rests on sustained increases in production, productivity and value addition through innovation. Regions that have

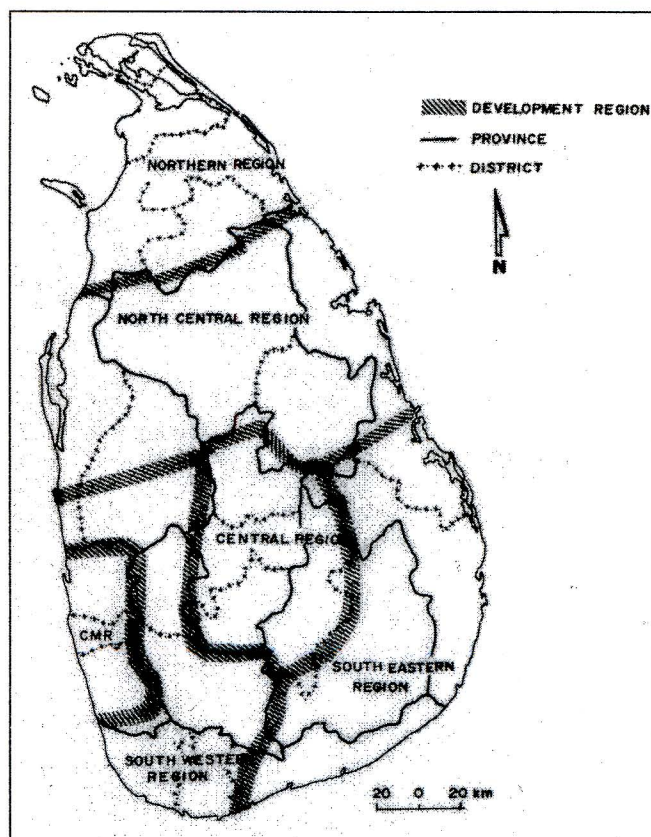


Figure 2 Proposed Development Regions for Sri Lanka

World Bank (2009) on the National Physical Plan: NPP

The NPP projects that Sri Lanka will see rapid urbanization in the coming 20 years. It is projected that 70% of Sri Lankans will live in urban areas by 2030, of which 80 percent will live in the five metro cities and smaller district capitals. Some urban areas are projected to experience explosive population growth. For example, the population in the city of Hambantota is expected to reach 1 million by 2030. (2001 population was 21,000). Conversely, the NPP projects that the population of Kandy, one of the few areas with concentration of economic activity outside the Western Province, will shrink between now and 2030.

The NPP also does not assess the drivers of demographic and economic transformation. For example it is not clear whether and why the Trincomalee- Anaradhapura-Dambulla (TAD) triangle will eventually have the same density as Colombo. The TAD triangle is expected to have 4 million people by 2030 compared to Colombo's projected 5 million people. And the NPP does not identify the economic factors driving this rapid concentration. This may limit the extent to which the NPP can be used as a guide for prioritizing infrastructure investments.the policymakers should leave it to firms and households to decide where to locate production and live, while focusing public policies on facilitating the pace with which transformations take place".

Although the concept of metro regions resembles regional economic concentration, the Plan does not specify how and why such metro regions should emerge specifically in the designated places.

World Bank also notes that the NPP proposals need to mainstream economic considerations in the national, regional and urban plans... the need for strategic plans for MRs to be anchored on national and **regional level** visions (including the Provincial)...and the need to assess key regional growth drivers.

acquired the capacity to innovate and create new and better things are known as "innovative regions" and in their mature stage 'learning regions'. These latter are regions that have created for themselves a sustainable economic advantage based on several things such as, knowledge creation, local technology development, building a regional business culture, upgrading local labour skills and strengthening production networks (Edington 2001). *Learning Region* forms part of the wider concept of the Knowledge Economy. Sri Lanka urgently needs to radically improve all sectors of the economy through extensive knowledge inputs. These include management of the resource base; (irrigation systems, forests, land, water sources and bodies etc.), diversification and modernization of agriculture, expansion of agro-processing and value addition to local produce; environmental management, energy and so on. Shift to high value added jobs is needed in all sectors and regions. Productivity of industry and quality of products and exports need improvement to enhance competitiveness through extensive knowledge inputs and innovation.

Since innovation is a key driver of growth and competitiveness, many countries have placed it at the centre of their development strategy. Some countries have ministries dedicated to science, technology and *Innovation*. (OECD 2010, IPS, 2012). Note that in both the global competitive rankings and knowledge economy index, Sri Lanka is placed at 52 and 82 among 142 and 125 countries respectively. Sri Lanka's science and technology policies have been based largely, if not entirely, on the centralized model and the lagging/peripheral regions lack even the minimum of clustered infrastructure needed for strengthening regional technology capacity.

13. Pillars of Regional Growth

Regional growth is a function of several inter-related and interdependent factors. We discuss below several key pillars of regional growth and transformation particularly in the lagging regions. These are indispensable for any region to generate and sustain growth and move to the next stage of development.

13.1 An efficient settlement system

The development trajectory that Sri Lanka is currently following envisages an increase of the present urban population of 30% to 50% by 2016 and close to 70% by 2030. This is a challenge of unprecedented proportions for Sri Lanka, whose management would be greatly facilitated by a well conceived regional approach. Growth, prosperity and resilience of regions are greatly influenced by the nature of the settlement system. A desirable settlement system would be one with well distributed dynamic urban centres and rural settlements served by efficient transport systems.

Available data for 2005 (DCS) shows that in the outer periphery there were only 4 large towns with population above 75,000 and only Kalmunai claimed a population of 108,696. Other 8 cities/towns with populations above 75,000 were in the core and inner periphery. Five of the large towns with over 100,000 population were in the CMR.

National Physical Planning Policy (NPPP) proposal for the development of 5 Metro Regions is an urban strategy with focus on land management. It is not a strategy for regional development. Whether it can bring about a spatially balanced settlement system is not very clear. Compared to many Asian countries, Sri Lanka has managed to avoid the growth of too many unmanageable cities/city regions. Sri Lanka has also, thanks to its long standing rural policies, managed to sustain a diverse and pleasant rural landscape despite problems of poverty and access to services.

Regional cities: A spatially balanced system of regional cities can serve regional growth and balanced spatial development in several ways such as by serving as production, distribution and financial centres, as incubators of industry and innovation and promoters of forward and backward linkages in the regional economy; helping to slow down excessive migration especially of young, skilled and talented people to the capital city region, and as attractive places for investment and living. Without regional cities, peripheral regions are likely to remain as hostages to a weak rural

economy. (see also Uduporuwa this Volume). A strong central city is the key to regional prosperity. It is the psychological and symbolic centre of the region's economy. Investment in regional city growth is an investment in the economic vitality of the entire region. Eventually, regional cities need to become centres that attract businessmen, scientists and academics and artists. Increasingly, the locational advantage of a place for sustained growth depends on its attractiveness for residence than only for investment and business.

Urban networks: In Sri Lanka, urban and rural areas have been generally taken as separate entities, independent of each other. This has been true in IRDPs, settlement schemes in the Dry Zone including the Mahaweli Project. The latter developed only dispersed service centres to cater to the needs of the agricultural communities. IRDPs excluded urban development altogether. These policies failed to promote strong rural urban linkages and integration in the rural regions. The expected future urban growth and the need for greater rural-urban integration could be better managed by adopting the concept of "urban networks" (Douglass 1998). These consist of well connected and interactive clusters of urban centres linked through good transport and communication systems. These can integrate rural and urban areas more efficiently and improve market access in intermediate areas. The network concept emphasizes greater horizontal diffusion of impulses.

A good example of this approach is the Greater Dambulla Development Plan (2005). It envisages five growth centres networked with Dambulla as the administrative and Business Centre (other centres are Habarana, Sigiriya, Galewela, Madatugama and Naula/Nalanda). Urban networks can also provide an alternative strategy to deal with cities/towns confronted with overcrowding and environmental concerns (Kandy, Nuwara Eliya etc).

13.2 Integrated/concentrated infrastructure

The development of regional cities and urban networks and rural urban connectivity have clear implications

for infrastructure development. Sri Lanka needs extensive infrastructure development, particularly in the lagging/peripheral regions to make transport of goods and people more efficient, fast and economical. Improved infrastructure increases rural/urban connectivity, intraregional exchanges between high potential areas and growing urban centres as well as peripheral and core-region connectivity.

It is now clear that one of the major obstacles to regional industrial development and attracting investment to lagging regions has not been the mere inadequacy of infrastructure but concentrated, connected and efficient infrastructure. The largely dispersed, low profile and unconnected small scale infrastructure development, such as under the IRDPs and other programmes were insufficient to enhance the generative power of the regional economy. High quality, concentrated infrastructure helps improve the investment climate in general, increases the capital productivity of private investment and competitiveness of the key economic sectors and the regional economies. The ongoing and planned infrastructure expansion and improvement (network of expressways, improvement of Provincial and other roads, railway rehabilitation, especially in the North and construction of domestic airports) will improve intra and inter-regional connectivity dramatically and support regional growth.

13.3 Industrial and business clusters

Today, cluster-based economic development has emerged as a key to regional competitiveness. Clusters are defined as a system of market and non-market links between geographically concentrated firms and institutions. They represent critical masses in one place of linked industries and institutions. The geographical proximity that clusters provide reduces search and transaction costs; create marketing externalities across industries and enable cost sharing of public goods such as training and R & D. Once a critical mass of cluster activity develops, the attractiveness of locating in the cluster increases rapidly,

which accelerates the cluster growth (see Narayanan and Musharraf, this volume).

Many Countries are increasingly adopting cluster development as a strategy for industrial development in lagging regions. Sri Lanka however, has been slow to recognize the potential role of this emerging approach in promoting industrial and business development, particularly in the rural/peripheral areas. Although there are many emerging and old clusters of small industries including numerous cottage industrial and tourism clusters in different regions of the country, there are few well coordinated support programmes to assist them.

Sri Lanka's experience in industrial development in the rural/peripheral regions and industrial relocation have had a poor record. The vast majority of industrial enterprises in the rural/periphery are micro and small and medium enterprises. They are widely dispersed in rural areas. This has made them out of reach to even available technology, information, training and skills and markets. (Gooneratne & Hirashima 2006). Location of many State-sponsored industrial ventures including some industrial estates have mostly ignored the benefits of agglomeration. More recently, the National Enterprise Development Board (NEDA) has been supporting a few selected small industrial clusters to improve their competitiveness. These are furniture (Moratuwa), Cane products (Wewaldeniya), Cashew (Mannar), Handloom (Batticaloa) and Light Engineering (Webada and Bandanagala), (NEDA Annual Report 2010).

This is an area where detailed analytical studies and information are necessary to initiate appropriate action to support a cluster-based strategy. The adoption of such an approach could help diversification of lagging region economies, revive traditional cottage and craft industries and expand job opportunities for the young, the educated and the skilled in such regions. Note that *Mahinda Chintana Idiridekma* has correctly recognized the need to promote geographical industrial clusters.

14. Knowledge Infrastructure for Regional Development

Regional growth and transformation are not possible without an educated, adaptable and skilled human resource base. This is the key to enhancing competitiveness and staying competitive, and attracting investment. Emerging and expanding sectors of the economy require highly skilled manpower. This has to be met by high quality tertiary level education. Today, regions lacking high quality educational infrastructure (including research) are placed at a distinct disadvantage. Higher educational institutions (universities, research and training institutions) can support regional development in expanding the stock of human capital and skills, providing technology, advisory and leadership support as well as research support for regional analysis.

Universities located in the regions have a keyrole to play here. The potential role of the regional universities would be strengthened when they cooperate and network with local research and other training institutions such as technical colleges. Such cooperation can promote greater coordination of limited resources and provide coordinated responses to regional demands. Further, regional universities form the ideal locations to establish science and technology centres and parks that are increasingly becoming key players in regional development (see Ekanayake this Volume).

All universities in Sri Lanka are national universities but there is at least one university in each of the provinces, but university involvement in the regions has been extremely limited. As Senaratne (2012) recently pointed out, Sri Lanka's universities need to be active partners in the knowledge-led competitive economy by championing regional growth and revival. A more rational approach to regional development can provide the required spatial framework for this to materialize.

15. Role of the State

Regional potentials can rarely be maximized by relying on market forces alone for well-known reasons. Public

policy has a central role to play in releasing such potentials.

Regional development and national development are not two separate things. They complement each other and are interconnected. As all regions form a part of the national space, it is necessary to have a national framework that provides the broad guidelines for regional development based on the needs and potential of the different regions in the context of overall national development goals and strategies.

Sri Lanka still does not have an established institutional mechanism responsible for regionalization itself, for elaborating national regional development priorities, identifying the investment needs, providing technical support for regional development and monitoring regional performance. Today, different aspects of regional development are handled by an array of different ministries and agencies dealing with different subject areas. It is a well known fact that, in the absence of a national regional development policy, regions can fall into the trap of unnecessary duplication of effort and unhealthy and costly competition.

A system of development regions can make a qualitative change in the role of the central State as a mediator of regional development in the context of a more liberal market economy where private sector plays the dominant role. There is evidence from many countries of the positive role market forces and conscious policy direction in speeding up development.

A regional strategy enables the allocation of scarce resources more efficient in several ways, such as in addressing the issues of inter-regional (provincial) balance and equity, channelling focussed and sustained interventions in the lagging regions to gradually overcome their entrenched structural problems and activating the under-utilized potentials of less developed regions.

16. Conclusion

The adoption of a regional development strategy using development regions would make a qualitative change in the roles of

central State, sub-national/local institutions and the relations between the two. The need for a strong regional Planning Agency at the centre has been heightened by the growing demand for strengthening the devolved/decentralized system of governance.

There is still considerable uncertainty on the type of devolved/decentralized form of governance that Sri Lanka is likely to adopt. The parallel system we have today with the devolved system represented by the centre, PCs and Local Governments on one hand and the central ministries, districts and Divisional Secretariats on the other, create numerous problems due to irrational overlapping of public agency jurisdictions and poor coordination. Whatever sub-national unit Sri Lanka will eventually adopt, it would have to avoid the wasteful parallel systems we have today.

Excessive number of ministries, irrational truncation of common subjects, and the large number of State and Local Government officials at local and regional level further increase the need for a more coherent coordination at local/regional level, in particular by strengthening the local government system, as many countries have done.

If the sub-national and local governments are to play a more dynamic role in regional development they must be provided with real decision-making powers, adequate financial resources and skills for planning and implementation. Hence, the need for a genuine commitment to strengthen the sub-national and local governance system in the country (see Coorey this Volume).

National level policy decisions and regional needs and priorities need to coalesce to achieve national development objectives and targets. In a multi-level governance system, different levels are mutually dependent. A complete separation of responsibilities is not possible. Greater efficiency demands close coordination. The vertical distribution of power between the different tiers of government and the decentralisation of resources and competencies need to be reassessed in order to better respond to the diverse opportunities and demands of

different regions, challenges of global competition and the need to improve policy efficiency and coherence.

***This paper is partly based on the following previous studies by the author: Gooneratne (2000, 2001 and 2005).**

APPENDIX 1

Distinguishing Characteristics of the Proposed Development Regions

South Western Region:

This is a region of high concentration of population, economic and social infrastructure. The national capital, the major airport and sea port as well as most of the largest towns in the country are located here. This is also the most industrialized region. Growth, however, is largely concentrated in the CMR and the coastal belt, while the interior areas, especially the present Sabaragamuwa province, remain less connected and lagging in many respects. The region has considerable areas under tea, rubber and coconuts as well as the best gem-bearing areas. With Colombo as the national capital and the commercial hub and home to five major universities and most national institutes, as well as the best schools and hospitals of the country, it has the potential to grow further as a dynamic region.

CMR Special Region:

This is the capital city region and the dominant region in every respect, accounting for close to half the country's GDP, and demonstrating a high potential for further growth. With better management, it can emerge as an important city region in the global and regional economies, due to its strategic location. With improved connectivity to the rest of the western region (such as Southern Expressway), the CMR can spread its growth dynamism and growing prosperity to the rest of the western region that has remained as lagging neighbours (Sabaragamuwa Province, for example). Given the need to manage this region in the most efficient manner as possible, and to make it a dynamic city region, it is important to take it as a special region within the larger SW region.

South Eastern Region:

Climatically, this is a dry region and contains some of the poorest districts of the country. It is largely rural and

agricultural and lacks good infrastructure and any dynamic urban centers. The region's high potential for agriculture, fisheries and tourism development is yet to be fully exploited. The mega infrastructure projects at Hambantota and Oluvil harbour in the South East would spearhead growth in this region. Further, the development of key urban centres like Batticaloa, Ampara and Hambantota as well as other emerging centres would accelerate growth in this region. A well-coordinated higher education and research system for the region is a prerequisite for supporting rapid regional growth and transformation.

Central Region:

This region serves as the source of most of the rivers of the country and is an environmentally fragile region due to its topography and agricultural and settlement expansion during the last two hundred years. Here, resource conservation and environmental management have to be the key development concerns. Future expansion of settlements, economic activities and urban development have to be guided by these concerns in managing development in this region (NPPP 2006). The region has a large potential for promoting conservation based eco-tourism exploiting its special climatic and unique natural attractions as well for other forms of resource conserving agriculture. It is also the tea country of Sri Lanka, with an untapped potential for conservation based productivity growth and value addition. The well established Peradeniya university, the new Uva Wellassa university, Gannoruwa research station and the Tea research Institute are major assets in the region.

North Central Region:

This is the region of best developed irrigation facilities and offers vast potential for further development of agriculture, livestock and inland fisheries. The potential for agro-based industrial development is yet to be exploited. The region's two coastal fronts offer vast marine resources and tourism possibilities. However, it is the rich historical sites and the living hydraulic civilization that offer major opportunities for

tourism development. Trincomalee harbour is a major asset. In addition to the cities included in the NPPP metro region (Trincomalee, Anuradhapura, Dambulla and Polonnaruwa) there are several other urban centres with clear growth potential located in the growing and diversifying agricultural areas. The Rajarata University (with other research centres like Mahailuppallama) can support higher educational and R & D needs of the region.

Northern Region:

This region boasts of fisheries and valuable mineral resources such as mineral sands, limestone, salt etc. and underground water for intensive agriculture and livestock development. The rich human resources, in particular the educated (especially youth) population, are a major asset for industrial and higher order services development. The large expatriate Tamil population living and working in the developed countries would be a major asset for this region to tap resources, expertise and investment. The well established Jaffna university with its Vavuniya campus can provide the needed educational and research support for this region's development. Jaffna is the historical centre of the North and will continue to be so, but other towns like Mannar, Vavuniya, Kilinochchi and Mullativu can emerge as dynamic-area (and region) serving urban centres.

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Financing Regional Development: Concentrating the Dispersed

1. Introduction

Growth has never been even across geographical space in any country. But it is not a valid justification for Sri Lanka to let growth concentrate only in the Colombo metropolitan area in the Western Province. Nearly 29 percent of people in Sri Lanka live in the Western Province occupying less than 6 percent of the country's land area, but contributing to half of total GDP. Consequently, as portrayed in the World Bank's (2010) country report titled *Sri Lanka: Reshaping Economic Geography – Connecting People to Prosperity*,¹ there are high-rise economic mountains (defined as GDP/km²) in and around Colombo. Although Colombo economic mountains still have a long way to rise further, many have looked at them from a negative perspective as an evil outcome of trade liberalization and globalization.

There are valid economic reasons for people to concentrate in some places rather than to spread everywhere, in order to invest, work, and live. Economic activities get concentrated in some locations because investors find these places offering better investment opportunities than others. People get concentrated in such places as they also find better opportunities to participate in (work) and to derive benefits from (live) growth. The issue is, therefore, not the 'high rise' economic mountains in the Western Province, but the 'too low' plains below them stretching over the rest of the country. What is important is to acknowledge that provided the necessary 'conditions', economic activities would concentrate in a few specific regions according to their 'local comparative advantages' and that people would also concentrate in such areas enjoying the benefit of growth. Economic regions of a country would differ from each other according to the differences in local comparative advantage, which could be the source of enhancing regional economic identity.

The purpose of this paper is to address the financing issue of economic concentration in specific regions in Sri Lanka. There are primarily two parties to finance regional growth – the private sector which invests in economic activities, and the public sector which plays a facilitating role operating at both Central and Local levels. While analyzing the key constraints related to financial aspect of regional growth, the paper presents guidelines that are vital in formulating an effective regional growth strategy in Sri Lanka.

The rest of the paper is organized as follows: Section 2 presents growth statistics highlighting spatial disparities and polarization. This is followed by a discussion in Section 3 on the distribution of private capital as a source of spatial growth disparities. Section 4 presents the problem of decentralization and public finance enabling the public sector to play its facilitating role at regional levels. Finally, in Section 5, conclusions and inferences of the study are presented in guiding policy planning.

2. Regional Growth Unevenness

Generally manufacturing activities end up concentrated in one or a few regions of a country due to economies of scale and transportation costs, leaving much of the geographical space for agriculture, as Krugman (1991) argued. However, the spatial differences in production structure may not necessarily be between manufacturing and agriculture, because specialization could exist among and within narrowly defined production sectors including the service sectors, depending on the differences in local comparative advantages. Economies of scale arising out of externalities improve global competitiveness of an economic activity by reducing production cost and enhancing product development. Falling transport cost adds up to cost advantage, when the location of

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production gets closer to and connected smoothly with the input and output markets through a decline in physical distance as well as information gaps and institutional constraints. The availability of natural resources would be an advantage for spatial differences in growth, but not necessarily limit the comparative advantage of a region. There are some countries in the world which did not have natural resources but achieved growth and development. At the same time there are some countries in the world which continued to remain poor in spite of abundant natural resources.

Sri Lanka has long-standing historical experience with policies, programmes and projects that were aimed at spatial economic disparities. Nevertheless, the issue received much attention during the past decade at both policy and political spheres. One of the main reasons was the compilation and publication of regional national accounts highlighting the acute growth disparities across the regions (CBSL 2003, Mutaliph et. al. 2002).² The issue that was put forward as a priority area of concern at Parliamentary and Presidential elections (Rajapaksha 2005 and 2010), and entered subsequently into the government's main policy documents (MFP 2005 and 2010). The end of the separatist war in 2009 has also raised the need and expectations for greater concerns over regional issues with special reference to the war-stricken areas of Northern and Eastern provinces.

Provincial Economic Indicators

Throughout its development process of Sri Lanka, economic output got concentrated and economic structure got transformed more in the Western Province than in the other provinces. Along with that people also got concentrated as they could find better opportunities in the Western Province than in the rest of the country to work and live. Apparently, the post-1977 trade liberalization process has speeded up the divergence between the Western Province and the rest of the country. This is because market forces are neutral, and by nature they create competition and rewards efficiency. Liberalization policies in Sri Lanka opened up the market horizon for production activities to benefit from global competition and economies of scale. Thus the market has rewarded the Western Province more than the other provinces of the country, providing lessons to be learnt on the issue of regional growth.

According to the provincial national accounts, Western Province accounted for over 50 percent of GDP in 2005, which declined to 45 percent by 2010 (Figure 1). While North Western, Southern, and Central provinces occupy an intermediate position in terms of their contribution to GDP around 10 percent each, other provinces appear to be lagging far behind. Annual per capita GDP of the Western Province, amounting to Rs 430,000 is 1.6 times the national average, whereas that of all other provinces remains below the national level (Table 1).

The changes in the structural composition in output also explain at least partially the growth disparities across the provinces. The Western Province with its share of agriculture as tiny as 3 percent of the provincial GDP resembles the output composition of an advanced economy where production structures dominated by industrial and service sectors. Sectoral composition of GDP needs to be compared across the provinces with caution, as the figures do not reflect the important attributes of production activities that transform with growth over time, but do reflect specific provincial growth patterns in 2010.³ Spatial differences development disparities in the country closely follow the spatial

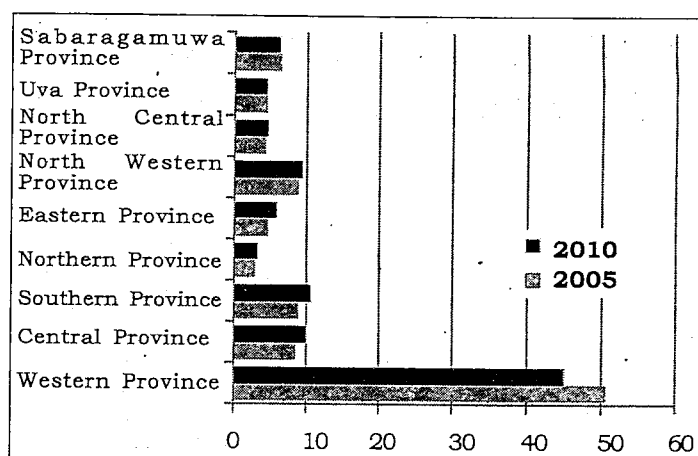


Figure 1 Provincial Contribution to GDP, 2005 and 2010

Source: Central Bank of Sri Lanka (2012)

differences in growth unevenness, resulting in higher living standards of people living in the Western Province than those living in the rest of the country (Dangalle 2005, World Bank 2010).

It is worthwhile noting the reduction in the provincial share of GDP in the Western Province and the corresponding increase in that in other provinces during the second half of the decade. Plausibly, this appears to be largely a result of the government's interventionist policies and the post-war economic recovery, both factors that have influenced alterations in provincial growth patterns.

Economic backwardness in the Northern and Eastern provinces presents a special case due to the prolonged political conflict, and the resulting separatist war erupted in 1983. Consequently, the two provinces did not have an adequate time span to benefit from the post-1977 trade liberalization, but did experience its immediate negative impact on the regional economy (Abeyratne 2004). Subsequently during the course of the war, the region also lost much of its development prerequisites – the local investor class, human resources, physical infrastructure and institutions. Given these specific circumstances, at the conclusion of the war in 2009 the economy of the Northern and Eastern provinces appears to be lagging few decades behind the rest of the country.

Provincial Economies and Economic Concentration

We often make use of political and administrative units such as the provinces or districts of Sri Lanka to identify economic disparities across space for different purposes. Nevertheless,

there is no valid economic reason for them to be alike in terms of output magnitudes and sectoral composition. It is absurd to think of "economic regions" in terms of spatial boundaries based on political or administrative units, or historical factors (such as ancient kingdoms), or cultural divisions (such as ethnicity or language), or geographical attributes (such as mountains, rivers). Even the policies based on such an imagination would bring about more harm than benefit as they tend to violate economic principles of efficiency, impeding overall economic growth. Rather the uneven growth concentration would provide an opportunity for such units to compete as well as integrate.

It is thus necessary to acknowledge the reality of the spatial transformation of the Sri Lankan economy, giving up two extremist notions. One is the idealistic notion of growth evenness across all provinces or districts. Implicitly, this assumption appears to have dominated some of the development programmes and projects undertaken by the government as well as donor agencies throughout the post independent development history of the country. Sometimes, such interventions appeared to have extended to their extreme ends even to push economic activities away from Colombo damaging their cost-competitiveness in a market environment.

Other extremist notion is the possibility of getting connected to

Colombo prosperity. In spite of the interventionist strategies to equalize growth across geographical space (as mentioned above), this has been the most dynamic natural outcome of economic transformation of the country. As a result, economic and population density of Colombo in particular, and the Western Province in general, has increased well above the rest of the country.

Although the concept of metro regions resembles regional economic concentration, the Plan does not specify how and why such metro regions should emerge in specifically in the designated places. In contrast, depending on the economic potentials based on local comparative advantages as well as socioeconomic and environmental needs of the country, Gooneratne (2005) reveals

countries like Sri Lanka has demonstrated overwhelming progress of its service sector (Wijewardena 2006). It is also noteworthy that the agriculture sector itself would undergo structural changes with changes in the scale of operation, commercialization and mechanization. Therefore, structural change which is still an important attribute of growth may not necessarily be in line with an 'old fashioned' industrialization process.

Table 1 Provincial per Capita Income and Output Structure, 2010

Province	Per Capita GDP		Composition of GDP (%)		
	Rs. (1000s)	Provincial to National Ratio	Agriculture	Industry	Services
Western Province	430	1.6	3.0	31.9	65.1
Central Province	208	0.8	18.2	28.8	53.0
Southern Province	241	0.9	16.7	34.8	48.5
Northern Province	161	0.6	16.0	14.2	69.8
Eastern Province	212	0.8	22.3	29.3	48.4
North Western Province	225	0.8	18.3	30.9	50.8
North Central Province	215	0.8	29.8	20.2	50.0
Uva Province	190	0.7	32.6	19.1	48.3
Sabaragamuwa Province	181	0.7	21.8	24.4	53.8
Island	271	1.0	12.8	29.4	57.8

Source: Central Bank of Sri Lanka (2012)

In the same way that economic concentration progressed in the Western Province, given the 'right environment' there would be economic and demographic concentration in a few key areas of the island. Even the World Bank's 3D approach (higher Density, shorter Distance, and fewer Divisions) to "inclusive development from uneven growth" is not specific about the potential for the emergence of few high-rise economic mountains around the country. People would also migrate and gather around such places, leaving other areas of the country sparsely populated. Remote rural areas would also be depopulated leaving the space for forest expansion, as the benefit of providing infrastructure, and establishing services and facilities in such areas needed for better living would be falling short of its economic cost.

The National Physical Plan 2010-2030 highlights emerging "metro regions" in Sri Lanka within the next two decades to accommodate 42 percent of population (NPPD 2007).

development regions of the country for the planning purpose.

3. Spatial Distribution of Private Investment

While long-term growth is primarily associated with capital formation, to a large extent spatial differences in growth unevenness can be identified through spatial distribution of capital stock and investment. Spatial unevenness in growth has been accompanied by changes in production structure in different regions. Traditionally the change in production structure is assumed to be a shift away from agriculture to industry, as depicted in Kuznets (1955) analysis of growth and inequality, producing an inverted U curve. However, the progress of service-based small economies in the recent past has reflected alternative possibilities for countries to grow with the service sector by flattening the inverted U curve. While advanced countries were also shifting into service sector-based economies in their post-industrial era, small

Although there is no reason to argue for even distribution of the share of manufacturing industries across the provinces, it is the Western Province that has attracted much of manufacturing investment in Sri Lanka. This has resulted in an overwhelming contribution to national economy through manufacturing output and employment. For instance in 2009, Colombo and Gampaha districts in the Western Province account for the largest share of the total number of manufacturing units (with five or more persons engaged), employment, value addition, and additions to fixed capital. Kandy in the Central Province, and Kurunegala and Puttalam in the North Western Province occupy an intermediate position in terms of the distribution of manufacturing units. While a number of districts in all other provinces appear to have recorded dismal performance, Uva, Northern and Eastern provinces were lagging far behind.

In spite of the government's continuous intervention to establish industrial zones and to provide special incentive packages for investment outside the Western Province, it was the Western Province that dominated in investment under the Board of Investment (BOI) in Sri Lanka (World Bank 2010: 53). This confirms that government intervention and special incentives do not constitute the 'right' environment to attract 'right' form of investment. Perhaps, it may not be limited to foreign investment facilitated by the BOI. Although data in this area is not readily available, it is possible that the formal banking system is operating throughout the country to mobilize household savings and to finance investment in leading areas such as the Western Province.

Table 2 Spatial Distribution of Manufacturing Sector (units with 5 or more persons engaged) 2009

Province / District.		As % of totals			
		Number	Employees	Value added	Addition to fixed assets
WP	Colombo	19.6	25.0	28.1	26.9
	Gampaha	17.6	27.4	32.5	31.9
	Kalutara	5.6	6.9	4.4	4.6
CP	Kandy	8.2	5.4	2.7	5.6
	Matale	1.9	1.2	0.9	1.2
	Nuwara-Eliya	1.8	2.7	2.4	2.5
SP	Galle	5.4	5.6	10.0	3.2
	Matara	3.2	2.3	2.1	1.4
	Hambantota	1.2	1.4	0.4	0.1
NP*	Jaffna	1.3	0.3	0.1	0.3
	Mannar	0.2	0.1	0.0	0.2
	Vavuniya	0.2	0.0	0.1	1.2
EP	Batticaloa	0.9	0.2	0.1	5.2
	Ampara	2.4	0.7	0.3	3.4
	Trincomalee	0.4	0.1	0.1	0.4
NWP	Kurunegala	11.2	8.2	5.4	1.4
	Puttalam	8.0	3.0	1.8	1.6
NCP	Anuradhapura	2.2	1.3	1.2	0.8
	Polonnaruwa	1.6	1.0	0.8	0.3
UP	Badulla	1.5	1.4	1.1	1.6
	Moneragala	0.5	0.3	0.9	0.7
SBP	Ratnapura	2.6	3.6	3.6	3.3
	Kegalle	2.5	2.0	0.9	2.4
Total		100.0	100.0	100.0	100.0

* Data not reported for Mulativu and Kilinochchi districts, which are lagging behind the other three districts in the Northern Province.

Source: Department of Census and Statistics (2010)

While economic activities that are integrated with the global markets were getting concentrated in the Western Province, population in general and human resources in particular also got concentrated in the same area. According to *Census of Population and Housing 2012* (DCS 2012), out of 3.7 million migrant population in Sri Lanka the majority of nearly 37 percent live in the Western Province. The top most important reason for migration to the Western Province has been 'employment', compared to 'marriage' for the all island. Out of 711,400 people migrated for employment purpose, 60.6 percent have migrated to the Western Province. In consistent with their low economic density Northern, Eastern, Uva, and Sabaragamuwa provinces appear to be

those found in the Western Province.

4. Fiscal Decentralization and Public Finance

Public finance is an essential part of the role played by the government in facilitating regional growth. As the government operates at both central and sub-national levels, public finance is linked to the degree of decentralization of decision-making. An appropriate combination of central control and local autonomy that satisfies regime requirements and popular demands is a persistent dilemma for governments all around the world (Turner 1999). However, the global trend for decentralization has been strengthened in the past due to technical efficiency of decentralized governance systems in

the least attractive provinces for employment. In general, Sri Lanka has often been cited as one of the best countries in the developing region for 'inclusive development' due to its commitment to universal welfare policy, although there are issues related to the improvement in quality standards (World Bank 2010). The statistical evidence on internal migration suggests that even if human resources are built up in lagging areas flow towards Colombo, because lagging areas do not have the capacity to provide better work and living conditions as competitive as

managing regional economies as well as democratization processes and the regime requirements.

Decentralization process in Sri Lanka which has been neither progressive nor regressive continued to remain as an 'unfinished agenda'. While the sub-national governance consists of many layers at provincial, district, divisional, local government and grassroots levels, and of many vertical lines connecting them to the central government. By implication, power-sharing between central and sub-national levels, demarcation of roles and responsibilities, coordination among different institutions continue to remain a source of confusions and questions. More importantly, their relevance in setting up an "environment" conducive to competitive regional growth remains an issue overlooked considerably at policy levels.

Among all the lines and layers of sub-national bodies in Sri Lanka, it was the Provincial Council system which ought to play an important role directly connected to regional growth and development. After reviewing over 20 years of experience with the Provincial Council system in Sri Lanka, one may wonder asking a valid question: What prevents a Provincial Council's competitive quest to set up a good school or hospital, to attract investment flows to the province, and to retain high-skilled human resources within the province?. Although there are sporadic cases of attempts as such in the Provincial Council systems, much of the capacity and responsibility in relation to above areas continued to remain with the central government.

The Provincial Council system which was set up in 1987 in response to the country's ethnic conflict and the pressure from India did not appear to be a purposive sub-national political system created for regional growth and development, and neither has it performed with that objective (Amarasinghe et al. 2010). Decentralization of public finance reveals the financial constraint of the Provincial Councils as well as their financial dependence on the Centre which was a source of academic and policy discussions since the time of the establishment of the Provincial Council system (Leitan 1990).

Table 3 Migration for Employment 2012

Province	Total migrant population		Migration for employment	
	No. (1000s)	%	No. (1000s)	%
Western Province	1352.5	36.9	431.3	60.6
Central Province	358.6	9.8	52.2	7.3
Southern Province	276.9	7.6	35.4	5.0
Northern Province	455.4	12.4	23.0	3.2
Eastern Province	186.1	5.1	26.2	3.7
North Western Province	343.5	9.4	45.3	6.4
North Central Province	295.5	8.1	36.8	5.2
Uva Province	177.8	4.9	31.8	4.5
Sabaragamuwa Province	215.1	5.9	29.3	4.1
All Island	3661.4	100	711.4	100

Source: Department of Census and Statistics (2012)

The Provincial Councils share only 4.3 percent of the consolidated revenue, and 4.1 of the consolidated tax revenue of Sri Lanka (Table 4), in reflecting the revenue constraint of the system. However, the Provincial Councils spend 11 percent of the consolidated public expenditure, after receiving the central government transfers amounting to 8.1 percent of consolidated expenditure. There are also substantial disparities between the Western Province and other provinces in terms of provincial public finance, which has been to a great extent neutralized by central government transfers. The fiscal operations at Provincial level reflect a heavy *vertical* and *horizontal* fiscal imbalance. There is vertical fiscal imbalance as the Provincial Councils are made to rely heavily on central government transfers for expenditure. There is horizontal fiscal imbalance, because the Provincial Council tax revenue is much lower than the central government tax revenue; during 2008-2011 Provincial Council tax revenue is only about 0.5 – 0.6 percent of GDP, compared to central government's tax revenue, amounting to 12 – 13 percent of GDP (MFP 2011: 148).

Provincial Councils are a system superimposed on the existing institutional arrangement for centralized exercise of state powers and de-concentrated delivery of services (Gunawardena 2010). By Constitution the central government also retains its power to engage in the areas devolved to the Provincial Council, limiting the Provincial

little space for the Provincial Councils to play a facilitating role in regional economic growth. Rather they are confined to engage in either duplicating or supplementing the central government's operations at sub-national levels, which are also often perceived as 'inferior' to those carried out by the central government.

The role of the government at both central and sub-national levels is important in shaping the conditions for regional growth. At the central level, the public sector plays its role in formulating the country's overall development strategies and policies, in setting up the common institutions (defined as 'rules of the game'), and in providing social and economic infrastructure at national levels. At sub-national level, the public sector attempts to set parameters of an environment conducive to invest, work, and live within its local boundaries. However, the Sri Lankan experience suggests that the public sector capacity at sub-national level is significantly weak in performing this task efficiently.

5. Conclusion

Particular areas of a country grow faster than others because people choose to invest in those areas by reaping the benefit of local comparative advantages, and choose to work and live there by reaping

Council's capacity for decision-making. The expenditure patterns at provincial levels show that much of the responsibilities vested upon the Provincial Councils are related to the service delivery on behalf of the central government. The Constitutional arrangements alone with financial constraint provide

the benefit of growth. Thus, the overwhelming concentration of economic activities in and around Colombo is *not* the issue in question. The question is how to create such an environment in the rest of the country facilitating fast growth and allowing economic and population concentration. The Colombo episode, in fact, reveals why people choose it to invest, work, and live, and how state supported it, providing valuable lessons for embarking upon regional growth in Sri Lanka.

In respect of regional development disparities in Sri Lanka, an idealistic misconception that has to be avoided is that all nine provinces and 25 districts of the country would grow evenly and reap its benefits evenly. It is neither that all of provinces or districts should be connected to Colombo prosperity nor that economic activities located in Colombo should be pushed away into other regions of the country. Given the right environment, there would be few regions where productive resources get concentrated resulting in higher growth. The provinces and districts of the country do not have any valid economic reason to grow in isolation, although some of the regional development policies and programmes were based on such conceptualizations. They would compete with each other and get integrated into emerging economic regions deriving the benefits of economic concentration.

There are two major players in regional growth and development; the private sector which divert their investment finance and, the public sector which play its facilitating role at both central and sub-national levels. In both cases, the deficiency in financing regional growth appears to be a major bottleneck that hinders the formation of economic regions

Table 4 Provincial Council Budget 2010

	Rs. billion	National share (%)*
Provincial Council revenue	36.8	4.3
(of which) tax revenue	31.0	4.1
Central government transfers	107.0	8.1
Provincial Council expenditure	145.5	11.0

* As % of respective items in the consolidated budget

Source: Central Bank of Sri Lanka (2011)

outside the Western Province. Investment capital seeks better location due to economies of scale and smooth connectivity. People get concentrated in places as such, as economic concentration offers them an opportunity to participate in growth (work) and to reap the benefits of growth (live). The government operating at central level should engage in creating the national policy, regulatory, and physical environment ensuring higher growth without spatial discrimination. The government operating at sub-national levels should have the required capacity to act efficiently and independently within the national policy framework in order to offer a competitive local environment for people to invest, work, and live.

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Footnotes

¹ The Sri Lanka Country Report of the World Bank (2010) records the publication year as 2004 (sic). As the Report acknowledged, it has been prepared in the context of the analytical framework of the *World Development Report 2009* on Reshaping Economic Geography (World Bank 2009).

² Perhaps, for the first time the Ministry of Finance and Planning attempted to compile provincial GDP accounts for 1990s. However, it was the publication of an analysis on provincial GDP data by Mutaliph et. al. (2002), followed by the Central Bank's Annual Report (CBSL 2003) that attracted much attention on the issue.

³ For instance, the share of industrial sector in the Southern Province (almost 35 percent), and that of service sector in the Northern Province (almost 70 percent) both are greater than the respective shares in the Western Province (Table 1). The figures do not necessarily mean that the technological standards and the scale of units of the economic activities are similar to those in the Western Province. In addition, the figures reflect the specific pattern of government intervention during this period resulting in skewed growth in both Southern and Northern provinces.

SMEs in Regional Development: The Case of Punjab Province of Pakistan

1. BACKGROUND: Role of SMEs in the Economy of Pakistan

The significance of the small scale industry to the economy of Pakistan can be judged from the fact that it contributes greatly to value added in the manufacturing sector (35%), to GDP (40%) and to total exports (30%). It also provides employment to 80% non-agricultural labour force of Pakistan. (Pakistan Economic Survey 2011-12)

Pakistan faces a major challenge of unemployment as its labour supply continues to grow rapidly. According to the Economic Survey 2011-12, the population of Pakistan is estimated at 180.71 million with an estimated population growth rate of 2.03%. According to the Labour Force Survey (LFS) 2010-11, Pakistan has a labour force of 57.24 million people which is 0.91 million more than the previous year. The total number of people employed during 2010-11 was 53.84 million, 0.63 million more than the preceding year. The overall participation rate in Pakistan is only 29.79% of the total population. Out of the total labour force, 67.55 million live in the urban areas while 113.16 million in the rural areas. The volume of labour force shrinks a bit in Punjab and Baluchistan while it expands in NWFP and Sindh in the same order. The change in the provincial profile is more of rural than urban origin. Therefore, the millions of unemployed workers justify the urgent need for promoting small scale labour intensive economic activities.

Looking ahead, the two largest sectors of the economy, namely the agriculture and large scale manufacturing sector, do not seem to be capable of absorbing the annual growth in the labour force. There is an overall decline in the labour absorptive capacity in the economy. There is the issue of declining employment in the public sector and negative employment elasticity in the manufacturing sector. All indicators point towards a further decline in these two sectors of employment.

SMEs are the only option to revitalize the stagnant economy of Pakistan by their capacity for income generation and employment potential.

The role of SME in Pakistan's development is three fold; to enhance employment absorption leading to poverty reduction, to promote balanced regional development and to strengthen the areas where SME has comparative advantage over large scale enterprises (LSE). The public support to SME can be justified because of the above. However, in Pakistan, the SME sector has not been a leading actor as the engine of growth or a conduit for desirable employment generation. Pakistan clearly falls into the category of countries where the potential of SMEs has not been fully exploited. However, the small-scale and informal sector is much "more dynamic and productive" than figures tend to show. (Zaidi, 2005)

2. Small and Medium Enterprises in Pakistan

In Pakistan, there are approximately 400,000 small scale manufacturing units, 600,000 service sector units and one million retailers in the country adding up to a total of approximately 2 million units. The Economic Census of Pakistan-2005 lists 3.2 million business enterprises nation-wide and SMEs constitute over 99 percent of all. Notwithstanding the infrequent surveys of the SME sector in Pakistan, the number of such units, especially small, is probably much larger than is officially reported.

According to the most recent economic census report, 84% of enterprises have sales below Rs. 0.5 million rupees and 93% report sales below Rs. 1 million. More than 97% of the SME's are owned and managed by an individual as a sole proprietary concern, supported by family workers. The hired workers are few and found mostly in growing firms. Professional and technically qualified workers in the sector are as low as 5 in 76% of the SMEs. The remaining workforce is either semi-skilled or unskilled.

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Slightly more than 2% of the firms are partnerships and there are hardly any corporate entities in the SME sector. 58% of the SMEs have been established after 1990, while 18% were set up before 1980. Generally, SMEs in the manufacturing sector are 15 to 20 years old. Almost 54% of the SME's sell their products in the local markets.

These characteristics of SME sector suggest that most of the businesses are in a low growth trap, dealing in traditional products and unable to climb up the technology ladder. They often become vulnerable to various shocks and disappear from the scene. This view gets credence from the fact that 19 percent SMEs are less than 5 years old and only 4 percent are able to survive beyond 25 years. The encouraging sign however, is their mushroom growth which makes it imperative that there should be a mechanism through which they could get support in terms of resources such as capital, finance, trained human resource or services like advice on technology up-gradation, marketing or quality management etc. (Khawaja 2009)

2.1 SME: Types, Sub-Sectors, Distribution and Size

2.1.1 Defining SMEs

There is no universal definition of small and medium enterprises. Each country has adopted different criteria for defining SME. In Pakistan, there is no single definition of SMEs in use. In fact, the Census of Manufacturing Industries data include all manufacturing units with 10 or more workers in the category of large scale manufacturing units.

Generally, SMEs in Pakistan are categorized into the following (but still

there are differences of category among various ministries in Pakistan):

Micro

- Less than 10 people employed
- Productive Assets limit of Rs. 2 million

Small

- Between 10-35 people employed
- Productive Assets limit of Rs. 20 million

Medium

- Between 36-99 people employed
- Productive Assets limit of Rs. 40 million

2.1.2 Major SME Sectors

In the formal manufacturing sector in urban areas, the largest number of employed workers is in textiles, as they are in the small-scale and household sector. Fabricated metals account for a substantial share in the small-scale urban manufacturing sector and is ranked second, while food and tobacco are the next largest sector in the formal sector. Formal sector dominates in the heavier, capital-intensive large-scale industry, while the informal sector dominates in wood and furniture products and jewellery (Zaidi 2005).

According to the Economic Census of Pakistan (2005), there were 2.96 million units in the country, of which 2.8 million (93.9%) were Establishments and 0.18 million (6.1%) were Household Units (including all activities of producing goods and services for sale or barter in the market). Area wise analysis indicates that, of the total establishments, 44.3 percent were in the rural areas and 55.7 percent in urban areas. Further, Punjab had the largest share of 65.26% in the total establishments in 2005, followed by Sindh (17.82%), NWFP (14.21%) and Baluchistan (2.09%).

Of the total 2.96 million establishments about 53 percent were in the Major Industry group of Wholesale Retail Trade & Hotels and Restaurants, followed by Community Social and Personal Services group (22.3 percent). Manufacturing is the third largest group sharing 19.72 percent of the total establishments. Among the Household units, the highest share

is that of the Manufacturing sector (66.5%), followed by Community, Social and Personal Services (20.5%), Agriculture, Poultry Farming, Fishing etc. (8.7%), and Wholesale and Retail trade, etc. (about 4%).

The Manufacturing firm's data show that out of 583, 329 units in the census, 466,153 (80%) in the category of establishments and 117,176 were Household units (20%). The majority of the total manufacturing establishments (43.2%) were in Textile, Apparel and Leather industries, followed by Food, Beverages and Tobacco (20.9%). Wood and Wood Products (10.8%), Fabricated Metal Products, Machinery and Equipment (10%), Other Manufacturing Industries and Handicrafts (8.9%) and the remaining sectors had 8.2% share. It is also interesting to note that in the large industries group of Textile, Apparel and Leather, 68.5% were Establishments and 31.5% were Households. The other important group of activities within the Household sector was Non-metallic Mineral Products (28%).

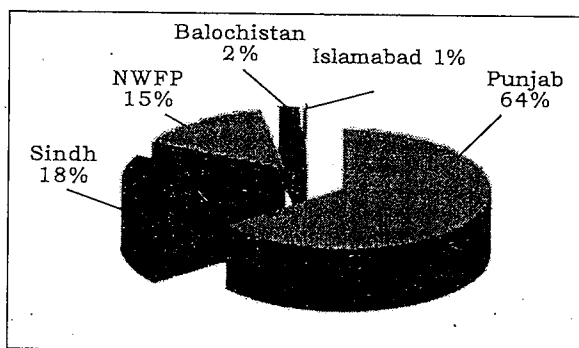


Figure 1 Distribution of Establishment by Province

Source: Economic Census of Pakistan, 2005, FBS, Statistics Division, Islamabad

An analysis of the distribution of establishments by major industry division and province indicates that, of the total 583,329 manufacturing industries 68.4 percent were in Punjab, 15.9 percent in NWFP, 13.9 percent in Sindh, 1.4 percent in Balochistan and 0.4 percent in Islamabad. (Economic Census of Pakistan, 2005)

3. SME Centres and Clusters in Pakistan: Specialization, Distribution & Location

Clusters of similar industries have developed in cities like Sialkot

(surgical and sports goods industry), Gujrat and Wazirabad (light consumer engineering), Sargodha (agribusiness and light electric), and Faisalabad (textiles). However, this clustering has not led to any real development of ancillary activities that will facilitate business growth (Haque Nadeem 2007).

Promoting clusters can strengthen SME competitiveness and thus promote economic prosperity in the area. In Pakistan, there are a number of cities where similar kinds of SMEs are geographically agglomerated, with advantages of easy availability of raw material, labour and technology or information spill over. The following Table shows these sectors and their details.

The industrial clusters lack both breadth and depth, making it difficult to develop new industries. This eventually weakens the competitive position of the base industries. The development of related and supporting industries is one way that sources of expertise can ripple through the economy and move forward. However, the absence of such industries in Pakistan means that so far this avenue for further growth and prosperity has not played a major role.

4. Punjab Province of Pakistan

During the last decades, the Pakistani economy has experienced dramatic ups and downs with the Punjab historically playing a key role in the country's development.

In analyzing its longer-term growth prospects three aspects have to be emphasised: First, history matters. This draws the attention to factors such as the region's ancient role as hub between Central Asia and the Ganges valley, the influences of Islam and the colonial inheritance. Second, institutions matter as they set the frame for private economic activity. A third aspect is the regional dimension of growth.

Punjab is the most populous province of Pakistan. According to 1998

Table 1 Manufacturing Firms by Industry and type

Major Industry Division	Total		Establishments		Household Units	
	No.	%	No.	%	No.	%
TOTAL	295,8310	100	2,782,051	100	176,270	100
Agriculture, Forestry, Hunting Fishing	46,378	1.57	30,995	1.11	15,383	8.73
Mining & Quarrying	713	0.02	713	0.03	0	0
Manufacturing	583,329	19.72	466,153	16.76	117,176	66.48
Electricity, Gas & Water	124	0	124	0	0	0
Construction	1,410	0.05	1,410	0.05	0	0
Wholesale & Retail Trade and Restaurants & Hotels	1,566,720	52.96	1,559,266	56.05	7,456	4.23
Transport, Storage & Communication	51,564	1.74	51,564	1.85	0	0
Financing, Insurance, Real-Estate & Business Service	48,440	1.64	48,366	1.74	74	0.04
Community, Social & Personal Services	659,641	22.3	623,460	22.4	36,181	20.53

Source: Economic Census of Pakistan, 2005, FBS, Statistics Division, Islamabad

census, the population of the Province is 72,585,000. The population density is 353 persons per square kilo meter as compared to the national figure of 164. At the beginning of this century, about 56 per cent of the entire urban population of Pakistan was living in the Punjab (Zaidi 2005).

Punjabis themselves are a heterogeneous group comprising different tribes, clans and communities. In Pakistani Punjab these tribes have more to do with traditional occupations such as blacksmiths or artisans as opposed to rigid social stratifications. According to Khalid Aftab and Eric Rahim 1986), the indigenous labour force in the western Punjab was augmented at the time of the partition of the subcontinent by an influx from the eastern districts of workers with metal working experience. A majority of the united Punjab's black smiths were Muslims. A majority of the labour force in general metal work were also Muslims. Thus, with the 1947 cross-migration of Hindus and Sikhs and Muslims, the Pakistan Punjab inherited more than its share of the black smith population and metal working labour of the united Punjab. The newcomers together with their indigenous counterparts formed a large reservoir of labour with a metal-working tradition going back many

generations. Concentrated in a small number of towns they engaged in diverse metal working activities either as labourers or as small workshop owners. These resources formed a modest, but not negligible, base upon which future metal working in the Punjab was to be founded. After partition of the subcontinent, the industry did not develop till 1950.

Traditionally, agriculture makes the Punjab the "breadbasket of Pakistan". The economy of Pakistan Punjab is one that is largely based on agriculture and industry. Its

share of Pakistan's GDP was 54.7% in 2000 and 59% in 2010. Punjab is the most industrialized province of Pakistan; its manufacturing industries produce textiles, sport goods, heavy machinery, electrical appliances, surgical instruments, vehicles, auto parts, information technology metals, sugar, cement, agriculture machinery, bicycles and rickshaws, floor coverings, and processed foods. Besides manufacturing important sectors are wholesale and retail trade, housing and construction, and transport, storage and communication. Punjab has more than 68,000 industrial units. There are 39,033 small and cottage industrial units.

The number of textile units is 14,820. The ginning industries account for 6,778 units. There are 7,355 units for processing of agricultural raw materials including food and feed industries.

Punjab contains several major cities of the country: namely Lahore, Faisalabad, Rawalpindi, Multan, Sialkot and Gujranwala. Lahore and Gujranwala Divisions have the largest concentration of small light engineering units. There is cotton ginning in Multan. District of Faisalabad is famous for Textile products. District of Jhang has the

Table 2 Main Industrial Clusters in Pakistan

City	Industry	No. of Units	Employment
Sialkot	Surgical goods	2,500	60,000
	Sports goods	1,000-1,500	300,000
Karachi	Leather	170	5,000
	Gems & Jewellery	8,000	250,000
Gujrat	Electric fan	400	50,000
Wazirabad	Cutlery	300	25,000
Faisalabad	Textile	7,700	100,000
Chiniot	Wooden furniture	3,000-4,000	25,000

Source: Towards Vision 2030: Direction of Industrial Development in Pakistan, November 2006, Japan International Co-operation Agency, International Development Centre of Japan.

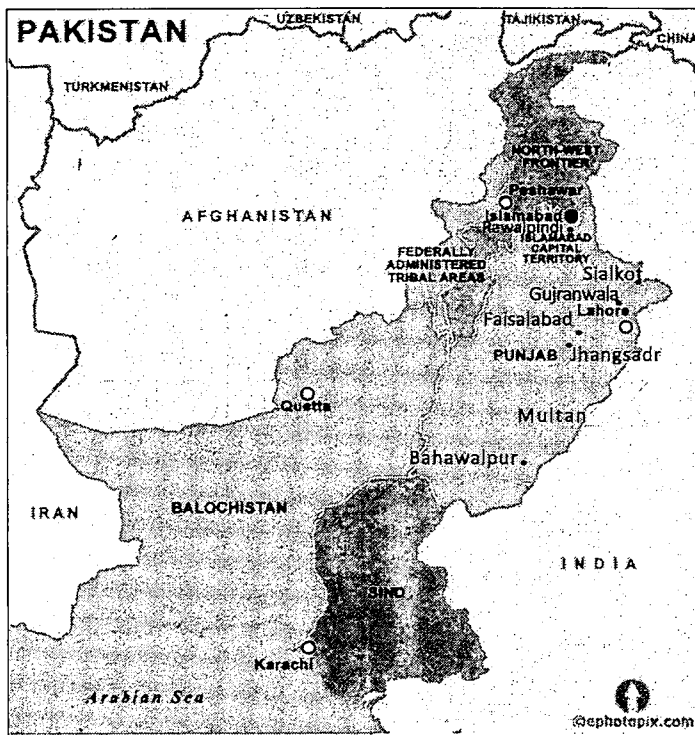


Figure 2 Punjab Province of Pakistan

largest Wheat & Sugar cane production share with the maximum number of flour and sugar producing industries. The district of Chiniot is famous for more specialised furniture industry. The district of Sialkot excels in sports goods, surgical instruments and cutlery goods.

5. Sialkot: Centre of SME Development in Pakistan

The population of District Sialkot is more than three million. Around 300,000 people are working directly or indirectly in industrial sector of Sialkot. Sialkot epitomizes the industrial bourgeoisie of Pakistan, a class that has created "pockets of efficiency" in the economy. The district of Sialkot is the third most economically active zone in the province of Punjab.

The city is dotted with thousands of Small and Medium Sized Enterprises engaged in production of the following main commodities: Sports Goods, Surgical Instruments, Leather Garments & Products, Sports wear, Military Uniform Badges & Accessories, Musical Instruments, Gloves, Cutlery & Kitchenware, Hosiery & Knitwear, Saddlery equipment, Martial Arts Equipment and Uniforms. Currently, the firms registered with the Sialkot Chamber of Commerce & Industry in key

typical of industrial clusters in other parts of the world. Sialkot is very much a city at work, energetic and chaotic. It has a high degree of exposure to the international economy with entrepreneurs participating in numerous trade fairs abroad, thereby establishing dynamic and reliable linkages in the international market.

Sialkot is earning more than US\$ 1 billion per annum and its share reaches to 6% of the total exports of Pakistan. Sialkot is placed at No. 2 in the rank of exporting cities of Pakistan. Almost 60% of total exports of Sialkot are done via Sialkot Dry Port Trust and 40% is exported from other ports like Lahore, Islamabad, Karachi, etc.

5.1 Nature of Sialkot SME Clusters

Sialkot has a strong export and entrepreneurial culture combined with widespread availability of subcontracting arrangements which has resulted in low barriers to entry and a proliferation of small and medium scale enterprises. The vast majority of firms in this city are family owned and managed, which produce customized products and focus on niche markets. There are few professional firms which are staffed

industries are approximately 7000 Sialkot Chamber of Commerce and Industry-SCCI]. Almost all the industries mentioned contribute towards the exports of Pakistan. The success story of Sialkot based industries can be attributed to unmatched skill of local workers and their craftsmanship.

Sialkot's industries are in many ways

by craftsmen, who learnt their trade by serving as apprentices to other craftsmen. These entrepreneurs lack formal business training and marketing skills. These enterprises are financed mostly through family savings. They compete by remaining lean, with low and shared overheads. They thrive through a network of subcontracting relations which allows each company to specialize in only part of the overall value chain. These enterprises have limited distribution channels, both in the domestic and international markets, which are concentrated in few geographic markets. The "trickle down" effects in terms of information, skills, and wealth are many; in sharp contrast to the relatively insular circuits of power and wealth promoted by the vertically-integrated organizations which have developed elsewhere in the country.

The craftsmen entrepreneurs of Sialkot, with their middle-class backgrounds, emerged to fill the vacuum created by the departure of the primarily non-Muslim trading and industrial class to India at the time of partition in 1947. These craftsmen entrepreneurs are quite distinct from another small but powerful industrial elite class, which also emerged at this time. This latter class consisting mostly of traders turned-industrialists, who received strong support from government policies, mostly invested in capital intensive and highly protected large-scale manufacturing industries.

In the successful export-oriented industries like textile and apparel, leather and leather product, sports goods and steel basic industries like surgical instruments and cutlery the productivity is low. This is because of the fact that all these three industries are labour intensive and depend on traditional methods of production. Most of the processes are done manually because of the lack of machines and modern techniques. Moreover, these production techniques are flexible with quick turnaround times. In Pakistan especially in the case of leather garments and manufactures, surgical instruments and sports goods, firms operate without "real" production techniques and with little concern to improve productivity. They apply the rule of "one-piece-one man"-instead

of assembly line method. If the unit needs to double its production it doubles the number of its employees without wanting to improve its productivity. This is particularly true in the case of Sialkot where the number of workers in the factories varies with the number of orders received. This system tends to be harmful over the long term, to the profitability of the firm, the quality of its products and to the social role the companies play in their respective regions. As a result Pakistani products are placed on the 'average' scale in the international market. It is mainly because of these reasons why Pakistan exhibits competitive advantage in fragmented industries or segments of industries.

Firms typically prefer to subcontract rather than to make the investments in equipment and manpower, which would be necessary for manufacturing in-house. Even among the workers working within the firm, many are piece-rate craftsmen rather than salaried employees. Firms subcontract anywhere from 20% to 80% of their manufacturing to vendors. The preference for subcontracting and piece-rate workers rather than on vertical integration and the development of a loyal workforce is a natural outcome of the fierce entrepreneurial spirit, which is characteristic of the citizens of this city. Widespread subcontracting, strong socio-economic networks of support, and the entrepreneurial spirit in the city result every year in the birth of hundreds of companies. This fierce individualism also leads to localized rivalries and price wars, and the lack of collective long term vision among the various industry segments. A "radius of trust", which is limited to the extended family, prevents medium-sized companies from growing further. No firm in Sialkot has yet gone public and few hire professional managers, thus considerably diminishing the chances of growing into truly world-class companies.

5.2 Analysis of Industrial Performance in Sialkot

5.2.1 Sports Goods Industry

More than 200,000 people are directly employed in the sports goods sector exporting sports goods worth US\$ 450 million annually from around 2,500 companies of various sizes. They

include around 20 large manufacturers-cum-exporters, 500 Medium manufacturers - cum - exporters, 500 Small manufacturers - cum - exporters, 1000 Commercial exporters and 500 vendors.

Pakistan exports sports goods to about 130 countries, up from 50 countries in 1991, its exports were US\$ 307 million in the world market of about US\$ 25 billion. Pakistan's share of the world export sale of sports goods was 0.1%. Pakistan is, however, is leading only in few sports items like footballs, gloves and hockey sticks.

Sialkot continues to compete in the global market without a fully mechanized industry, relying mostly on old and traditional production techniques. The sports good sector can increase its share in world exports through improvement in quality of existing range of products as well introduction of new products. Greater emphasis, however, should be laid on diversification of sports goods, where chances of increase in the share of world exports are comparatively higher. There is a need for Pakistani investors to come forward and open sports goods and sportswear retail outlets in international markets. Branded retail chains, rather than marketing through OEM¹ will not merely boost the foreign exchange in international market but will also develop the brand image of Pakistani sports goods (Ghani 1998).

5.2.2 Surgical Instruments Industry

The success in surgical instruments sector lies due to the technical expertise and skills of the people of Sialkot in mechanical engineering. About 1900 small and medium surgical units, with labour force ranging from 10-500 employees, are producing surgical instruments through the workforce of about 100,000 (SCCI). The industry manufactures about 100 million instruments annually (Saleem K 2007). The surgical instruments sector, as a sub-sector of the light engineering sector, contributes about 70% to the exports of this sector. The surgical instruments industry is labour intensive. Majority of the manufacturing units in the sector continue to operate manually through a skilled and semi-skilled workforce. Due to this, desired growth in value addition has not been achieved.

(Expert advisory cell: Surgical Instruments Sector Profile, September 2000)

Also, as a result of wide spread vendorization in the industry, most of the surgical instruments can be manufactured by outsourcing. There are about 800-1,000 traders in Sialkot, some of them involved in trading of multiple products such as sports goods, leather products, etc. (I&A research publications report # 038 surgical industry).

Despite its successes, the surgical goods industry remained vulnerable to local rivalries, price wars, lack of professional workforce, short term orientation of businessmen and compromise on quality standards. The decline in the exports can be attributed to mainly internal price wars amongst the manufacturers/exporters selling products in the US market. The other factors are the sanctions imposed especially by the USA in the areas of child labour, non-compliance with the FDA standards, requirements of Good Manufacturing Practices (GMP) and ISO-9000 quality standards. To cope with the challenges in the area of quality standard, the sector is gradually attaining ISO-900 certification. (Expert advisory cell: Surgical Instruments Sector Profile, September 2000.)

Effective quality management practices are required to boost the exports of Pakistan's surgical instruments and to raise the share of this over a century old industry from the current less than 1 % of world exports (www.exportadvisorycell.org, 2005). The average unit export price of Pakistan surgical instruments is US\$1.24 compared to German instrument at US\$ 18 per unit (www.exportadvisorycell.org, 2005). Despite the low unit price of Pakistan's surgical instruments, the penetration in the world markets is as low as less than 1 % of the world exports. Pakistan's surgical instruments industry therefore needs to build competitive edge to revive its lost historical glory and to be able to penetrate the existing export markets deeper as well as develop new ones.

5.2.3 Leather and Leather Manufacturing Industries

Leather and leather products carry a significant importance in the

Pakistani economy. The sector contributes approximately 5 % to the manufacturing GDP and 7 % to the total exports in the country, it employs 250, 000 people and has a share of less than 1% in the total national employment. With almost a quarter of the GDP still contributed by agriculture, Pakistan's natural advantage in livestock population can be exploited to enhance output in the leather sector. There are over 723 tanneries, 461 leather garments manufacturing units, 348 Gloves manufacturing units and over 524 Footwear manufacturing units in the country. (Expert advisory cell: Leather Sector Profile. September 2000)

The leather and leather products industry is concentrated in Karachi, Kasur, Gujranwala, Sialkot, Faisalabad, Multan and Peshawar with the majority located at Karachi, Kasur and Sialkot. (I & A research report # 061 April 01-15, 2007) As per the survey conducted by LIDO in 1997 there were a total of 355 units in the country out of which 186 are in Sialkot. In Sialkot approximately 12,000 people are directly employed by the sector. The leather garments entrepreneurs of Sialkot enjoy a distinctive edge over their counterparts in Karachi mainly due to expertise and skills they assimilated from the export culture of the city. This sector is exporting goods worth US \$ 217 million annually from Sialkot.

Although Pakistan is a leading producer and exporter of leather and leather products of various types and has progressed during the last 20 years, it still is an unorganized industry and lacks skilled and efficient labour, high losses of hides and skins value and under-developed accessories industry. Due to non-availability of export quality leather for high value-added leather garments and leather products, leather garments in Pakistan are made from low and medium grade leather. These goods face a stiff competition from Chinese and Indian products. Both Pakistan and India are facing tough competition from China which has captured about 90 % of the lower end of the market of leather garments. The survival of Pakistani leather goods and leather products industries lies in improving quality of its products and moving towards the high-end market.

6. Crucial Issues for Scrutiny: A Comparative Perspective of Developed & Developing Economies

In Pakistan SMEs have not been paid serious attention for a long time. As a result it is understandable that no serious effort was made in data generation and academic analysis. The access to the institutional finance has been regarded as the most important bottleneck for SME growth. However, we should pay more attention to three aspects for further development of SME in Pakistan. First, is the development of R & D. Second, is the importance of human resource development. Third, is the establishment of useful linkages between SME and LSE for improving the level of division of labour. We will discuss these aspects by referring to the empirical evidence from experience of developed economies, such as that of Japan.

6.1 R & D in SME Development

The obvious disadvantage of developing countries is that they have to import the necessary technology from developed countries, either by technology transfer through licensing or through FDI (Foreign Direct Investment). However, experience suggests that the imported technology has to be internalized and adapted to suit the local conditions. In the context of sustainable development of the receiving countries, successful internalization depends on two things; to develop and improve the absorptive capacity of human resources, and to make effort to increase their own domestic R & D capacity.

6.2 Human Resource Development

As we have indicated earlier, unless receiving countries are able to enhance absorptive capacity at home, the transferred advanced technologies would cease to be the technologies in an enclave, notably in the export processing zones. In the case of manufacturing industries, technical education and vocational training have to be strengthened. However, more importantly mathematics and science education from the lower level of school system have to be strengthened deliberately. The son of traditional blacksmith can only be a useful person in iron & steel industry

only after systematic and scientific education.

From the experience of developed countries we can suggest two things. First, industrial development requires continuous input of advanced technology, which is the outcome of the persistent efforts of R&D by both public and private sector investment. Secondly, since developing countries are handicapped with R&D, the most efficient way to accelerate technology transfer from developed countries requires serious and well thought out human resource programs. Success in this process would enable developing countries to generate appropriate technology for sustainable development.

6.3 SME-LSE Linkage

In the Japanese manufacturing industrial structure, the sub-contracting arrangement between SME and LSE is regarded as normal, while it is not so in the case of Pakistan. Every firm, however small it may be, is conceived as an independent entity in the market place to compete with larger firms, and always tries to grow to LSE. However, as discussed, SMEs are handicapped compared with LSE in certain crucial areas in doing business.

Because of the smallness in size, SMEs face difficulty in access to institutional credit and capital. SMEs are handicapped in the access to professionally skilled manpower and are less capable of acquiring advanced technologies, thereby less capable of innovating. SME in Pakistan is further handicapped by the simplified industrial structure. In other words, the opportunity to capture forward as well as backward linkage effects is limited.

If the ongoing globalization is accelerated further, the SMEs depending on the local market would face serious challenges by the influx of less expensive goods with high quality from developed countries and neighbouring countries, such as China and India. Implications of this challenge for employment, poverty and regional development will be enormous.

One of the means to overcome this situation is to promote SME-LSE linkage in the form of sub-contracting

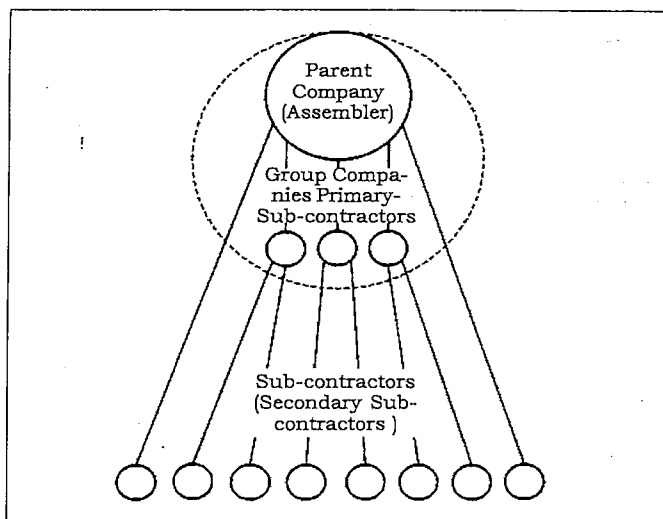


Figure 3 SMI-LSI Sub-Contracting Model

Source: Masahiro Shimoya "Japanese Enterprise Group - Affiliated Companies" Youhikahu, 1993

system. Admitting that the sub-contracting arrangement is not the best option available, since it is not an equal partnership between the two in real terms, given so many constraints SME in developing countries face, this is the second or third best option.

In the case of sub-contracting system in Japan, it is noteworthy to emphasize three points. First, the sub-contracting system today is not the one prevalent during the pre-war period, which was exploitative in nature, but the one observed among exporting firms in post-war era (i.e. after 1945). Here the relationship between the two is not completely horizontal as the quality of goods to be exported by LSI is influenced by the quality of components produced by SMI. Second, although SMI and LSI are not equal partners in sub-contracting arrangement, it has a variety of advantages for both parties. SMI seeks assistance from LSI in the fields of finance, procurement of inputs, advanced technology, staff training, managerial skill and assured market. Third, LSI can control inventory, procurement of specialized components, smaller overhead capital and business cycle adjustment.

However, this SMI-LSI relationship should be regarded as a transitional mode of arrangement in which it gives an opportunity for SMIs to become independent and innovative through the learning process with LSI.

sufficiently innovative yet. In other words, the effort to internalize the foreign technology in the form of increasing R&D expenditure over sales value in the firm so far have not been realized. Thus they have remained as international sub-contractors without being able to generate their own unique technology.

The relationship between Pakistan's firms and foreign firms in Sialkot is to some extent analogous to the Japanese sub-contracting arrangement between SMI and LSI. The basic difference is that the mutual relationship between the two in the case of Japan cannot be observed in the former case. In this context, the case of Sialkot may be similar to the FDI arrangements. In either case the firms in Sialkot do not have strong incentive to develop their own technology: they may earn sufficiently well with same arrangements; they are not yet growing as innovative entrepreneurs; they do not have sufficient number of graduate engineers and skilled manpower; and not much effort to spend their profit for future development in the form of R&D.

The Sialkot's experience seems to reinforce our proposition that without being supported from R&D and technical & vocational training, internalization of foreign technology is not possible. Furthermore, it is clear that technology transfer from LSI

7. Lessons and Challenges of Globalization

Considering the clusters of Pakistan, Sialkot is the only evidence to call 'industrial cluster'. The private firms in Sialkot have made isolated efforts to grow as a centre of export. However, it cannot be called industrial cluster in the real terms, because the firms in the cluster are not

to SMI is not possible, if LSI is not guided by the innovative spirit.

SMEs in general are handicapped in many aspects compared with its counterpart, large and medium enterprises (LME) (Gooneratne and Hirashima, 2006). However, the crucial issues faced by most SMEs face are: first, the access to land, water and credit, second, access to technology, including management and marketing and, third, qualified manpower. However, the area of technology and human resource development needs to be given serious attention in the long-run perspective.

Although, Pakistan seems to maintain that SME and LSE should be treated the same in the market place partly, due to the legacy of western business culture, i.e., the support to SME being regarded as distorting the market. Support of the government, however, should be justified on the ground that SMEs are small and poor.

By the same token, the advantages of sub-contracting arrangements with LSEs are not readily accepted. However, most of the SMEs will be wiped out if we allow globalization with liberalization to invade Pakistan, unless we promote SME-LSE linkage.

Finally, in discussing SME issues, one tends to focus on financial aspect and government R&D support. Here again, we would like to set forth a strong argument that R&D and human resource development are the most crucial factors to be strengthened vigorously. Otherwise, 'internalization of imported foreign technology' is not possible and there is no chance for SME to establish as equal partner in the market place by specializing the areas where LSE does not have advantage.

The following are some of the suggestions for further inquiry and action:

First, the need for systematic data and statistics enabling us to discuss the issues in a more comprehensive manner; second, among short-term measures for SME development, innovative approach towards effective credit supply is crucial. Investment environment; including the regulatory framework and law & order situation, must be drastically improved.

Third, longer term development requires human resource development with special emphasis on technical education and vocational training, R&D development, and promotion of linkage effects between SME and LSE; fourth, the role to be played by the public sector should not be neglected. The experience of Sialkot demonstrates that it has progressed without enough public sector support. The development process can be accelerated with the appropriate role of public sector as a facilitator and finally, recognize that LSE holds a key position in promoting industrial linkage with SME during its formative stage. In this context, the role of the public sector to promote SME-LSE linkage is significant.

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Footnote

¹ OEM stands for original equipment manufacturers.

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The Role of Dynamic Emerging Urban Centers in Regional Development

Introduction

Today urbanization has become one of the most powerful, irreversible forces and an essential part of most nations' development. There are evidences especially from developed countries that they have achieved stronger and more stable economies with the advantages of urbanization. Cities often hold a great potential for growth creating jobs and innovation and play an important role in their local economies. Many countries have understood the role and potential advantage of cities as centres of market, service, commercial, transport, distribution, communication, manufacturing, innovation diffusion, social development and integrating rural economies. Therefore, development of cities as a regional development strategy has been used largely to promote the development of lagging regions by concentrating investment so as to reap agglomeration economies and diffuse development to surrounding areas.

Economic growth and urbanization are often positively linked. Cities are the driving forces of economic growth of a region. They are more productive than rural areas due to the economies of agglomeration effect. Cities are equipped with infrastructure, services, communications and skilled labour. They can achieve economies of scale, agglomeration and urbanization. Agglomeration economies have positive benefits of economic activities when firms are located in close proximity with those engaged in similar businesses. Cities generate positive externalities of agglomeration, scale, diversity and specialization. Sustained economic growth cannot be achieved without the growth of cities. Dynamic cities play a vital role in generating economic growth and development in a region.

Economic Role of Urban Centers

Cities serve as market centers in providing various needs of people in

the rural hinterland. They usually offer a wide variety of consumer goods, and commercial and personal services through small-scale enterprises and through the informal sector activities. They are the centers of distribution, transfer, storage, brokerage, credit and financial services through their regularly scheduled and institutionalized markets or through periodic markets and bazaars. They provide convenient locations for decentralizing public services through field offices of National Ministries or agencies, or regional or provincial government offices, thereby creating greater access for both urban and rural residents to public services and facilities. They act as local or regional centers for the provision of variety of services and facilities such as health, education, welfare, recreation etc.

Cities help rural producers in many ways. They act as market centers for rural produce. Many cities act as agro-processing and agricultural supply centres for their regions and their hinterlands. They create conditions that are conducive to the commercialization of agriculture and to increasing agricultural productivity and income in their immediate hinterlands. They provide conditions that are conducive to the growth of small and medium scale manufacturing and cottage industries that can serve local markets and satisfy internal demand for low-cost manufactured goods.

Cities are magnets for non-farm employment and supplementary income opportunities for rural people through remittances of migrants. At the same time, they serve as centres of transportation and commercialization, linking their residents and those of rural villages and towns in their hinterlands to larger cities and other regions in the country. Regional cities can absorb the rural migrants that might otherwise more directly to the largest city or national capital.

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Cities provide more opportunities for learning and sharing. They are the centers of knowledge, innovation and specialization of production and services. High concentration of people in cities generate more opportunities for interaction and communication, promotes creative thinking, creates knowledge spillovers and develops new ideas and technologies.

They accommodate social heterogeneity and encourage the integration of people from diverse social, ethnic, and religious groups, provide organizations that help socialize and assimilate rural people into city life, and infuse new attitudes, behaviour and lifestyles that are more conducive to urban living; and give new opportunities for social and economic mobility.

The other side of the significance of cities is that cities are proven to be better poverty fighters than their rural counterparts. Today the importance of cities in poverty reduction has become increasingly prominent. For example, average incomes of urban residents are four times higher than those of rural ones in countries such as China and Thailand (United Nations Human Settlements Programme, (2011). China, with its program of urbanization millions of people have escaped from poverty in less than 25 years. With economic growth highly correlated with poverty reduction, the high growth of cities bodes well for poverty reduction.

In the above context, the central role of cities in regional development is more obvious. According to Rondinelli and Ruddle (1978) urban growth is

essential to development and according to Freidman (1966), economic growth which is the fundamental factor of development of a society tends to occur more in urban regions. A well developed system of cities of a region creates economies of scale and benefits for surrounding areas. Opportunities that cities offer for investment lead to higher levels of growth and help achieve spatially balanced growth in a country. Today with the increasing globalisation process, regional cities have to play a crucial role in development. They should be more dynamic and productive in building competitive regions to meet the challenges of the global economy. Hence, the pursuit of competitiveness in cities has become a major local and national policy objective of many countries.

Urbanization in Sri Lanka: Issues of Data and Definition

It should be noted that accurate and up-to-date information in urban growth and its trends in Sri Lanka are not available. First and foremost Sri Lanka does not have a clear definition or method in identifying urban areas. "Urban areas" in Sri Lanka are not based on any definite criterion and urban status is conferred on an area by the Minister in charge of Local Government purely for local administrative purposes. There are no definite criteria to guide the ministerial discretion and it seems to be based on "the nature of the development of the locality or its amenities and urban characters. Accordingly, decisions of upgrading of towns' or downgrading of towns is based only on political considerations and no attempt is made to consider morphological, demographic, sociological or economic factors which are prerequisites in the process of urbanization. Current definition of urban status in the country is based on the administrative status and there is no consistency of applying this definition due to the changes made in the administrative status from time to time by the government. The present official definition of urban centres in Sri Lanka considers only Municipal Councils and Urban Councils as urban. Even though, many settlements in the country have

attracted more population as well as urban type characteristics they are not shown by statistics. This has led to underestimate the country's level of urbanization. Today this has become a major issue in planning and measuring in urban development in the country.

Available data on urbanization in Sri Lanka shows the country has a rather low level and slow tempo of urbanization for a long period. As shown in Table 1 the urban population in Sri Lanka has slowly increased from 10.6 percent in 1891 up to 22.4 percent in 1971. It has increased only by tenfold in eight decades. In 1981 this gradual increase declined to 21.5 percent due to downgrading of urban status of an urban settlement and further, it had dropped to 14.6 percent at the Census in 2001. This decline was due to the downgrading of urban status of 89 urban settlements. After the 13th amendment to the constitution in 1987, Town Councils were incorporated into rural local government bodies termed "Pradeshiya Sabhas". Accordingly, 89 urban settlements lost their urban status and were classified as rural settlements after 1987. The annual growth rate of urban population also does not show a gradual increase but fluctuating trends with considerably high increase only in some years. The natural increase of population was the

Table 1 The Level of Urbanization in Sri Lanka, 1891-2001

Census years	Level of urbanization (%)	Average annual growth rate of urban population (%)
1891	10.6	1.4
1901	11.6	2.9
1911	13.1	3.1
1921	14.2	1.7
1931	15.0	3.4
1946	15.4	1.9
1953	15.3	2.1
1963	19.1	6.2
1971	22.4	4.1
1981	21.5	1.2
2001	14.6	1.9

Source: Mendis, 1982
Department of Census and Statistics, 2005

chief factor for the urban population growth up to 1953 and the increase of migration however was particularly significant in the towns in the Western Province and colonization projects in the Dry Zone in 1963. In addition, the creation of 56 towns and the extension of town limits in some municipalities have also increased the urban population in 1963. Decline in average annual growth after 1963 was mainly due to the change of number of towns. These figures show that the share of the urban population in the total population in Sri Lanka has always remained below 25 percent from the period of 1891 to 2001. Current level of urbanization has not been reported since the census data in 2011 is still not available. However, in terms of emerging trends in the urban environment urban population of the country may have reached 23-40 percent by 2001 and according to the development trajectory that Sri Lanka is currently following it can be envisaged an increase of the current urban population to 50 percent by 2016 and to 70 percent by 2030 (Climate Change Secretariat, Ministry of Environment, Sri Lanka, 2010).

Spatial Distribution of Urban Centres

Considering the spatial distribution pattern of urban centres in the country, considerable significant differences exist in the number, size, growth rates, and the level of urbanization among provinces. Most urban centres are located in the Wet Zone which corresponds to the South-Western quadrant of the country comprising about ¾ of the total urban population. A large concentration of towns can be found in the Western Province. According to the census in 2001 there are 17 officially identified towns in the Western Province and 7 larger cities having more than 100,000 population located in the Colombo district. Western Province with the domination of Colombo city has become the highly developed core region in the country and rest of the eight provinces act as the periphery with relatively low level of urban development (Table 02). During European rule especially in the British period Colombo city was selected as the main centre for all

socio-economic, administrative and political activities. Other urban centers which are located within raw material supply routes were linked to the Colombo city. As a result today domination of Colombo city both demographically and functionally has become a most striking feature in the urban system in the country. It includes both the commercial capital of Colombo and the administrative capital of Sri Jayewardenepura with numerous suburbs and urbanized rural areas. It is the financial, commercial, industrial and administrative centre as well as the hub of the rail and transport system in the country. This concentration of all activities reinforced economies of scale, agglomeration, and migration and created multiplier effects, which generated competitive advantages over all other centres. Competitive advantage made it a magnet for all types of activities. Polarization of Colombo metropolitan region has already become a major issue in the context of development of the country creating a problem of regional imbalance in development.

Outside the Western Province rest of the Wet Zone consists of a number of administrative district capitals and small and medium scale towns which have significant potentials for development. Though, urban centres located adjoining provinces of Western Province were stagnating for a long time period today there is a potential for rapid growth with the influence of overspill of Colombo Metropolitan Region. Kaluthara, Galle, Ambalangoda and Matara in Southern Province and Kegalle and Rathnapura in Sabaragamuwa Province are several such centers directly connected to CMR experiencing strong employment growth in manufacturing especially in agro processing activities and tourism related activities. These towns being located in the most dynamic export segment in the country should be well linked by improving connectivity through building up of expressway network in the interior of the country. Newly established southern expressway would allow cities in these provinces to be well connected.

Among other secondary cities in the country, a number of towns are located in the Dry Zone. Urban

growth in the North Central Province is a production of colonization schemes and agricultural development in the Dry Zone areas. After Independence, due to the intensification of colonization programs and Mahawali Development Program, North-Central Province attracted a large volumes of migrants. During 1971-1981, the highest recorded in migration had occurred in the Ampara, Anuradhapura and Polonnaruwa Districts. 32 percent of the total urban population increased in the country between 1971 and 1981 which had been absorbed by the Dry Zone (Deheragoda et al, 1992). Dry Zone has a great potential of diversification and commercialization of the economy through expansion of a number of sectors such as agriculture, fisheries, cottage industries and tourism. It will increase rural job opportunities and income levels and will results urban growth and expansion.

In the North, Jaffna as the major city of the Northern Province can play a big role as a blooming commercial port. Jaffna has strong potential to revive as a major trade, agro processing, fishery, and tourist center. Before 1983, it had a vibrant small-and medium-enterprise sector and a dynamic industrial base including salt-processing plants, cement and

chemical factories, and weaving mills. With the end of the conflict, Jaffna started rebuilding its economy. At the same time, historically important sites of religious attract thousands of people to the peninsula. Trincomalee, a town of 52,000 inhabitants (2010) on the coastal belt, is the capital of the Eastern Province. Fisheries and agriculture are the main growth drivers in the Eastern Province, and tourism is emerging as a high-growth sector. Agro processing activities have strong potential for development in Trincomalee due to their linkages with the region's vast agricultural production. Tourism also has strong potential to emerge as a growth sector for Trincomalee, as the city boast s miles of pristine white-sand beaches, one of largest and finest natural deepwater harbours in the world, and the largest Dutch fort in Sri Lanka. Now tourism is expected to revitalize by the government.

There are several urban centers in the central hill country which are directly linked to the plantation economy. In the nineteenth century after opening up of hill country areas for the plantation crops a number of factors contributed to urban growth in these areas. The immigration of British planters and South Indian plantation workers and the development of railway were initial

Table 2 The Level of Urbanization in Sri Lanka by Provinces, 1963-2001

Province	1963		1971		1981		2001	
	Level of urbanization (%)	No. of towns	Level of urbanization (%)	No. of towns	Level of urbanization (%)	No. of towns	Level of urbanization (%)	No. of towns
Western	40.5	38	47.9	38	46.56	38	30.5	17
Central	10.2	16	10.6	15	11.1	15	9.8	9
Southern	14.8	19	15.4	19	14.9	19	8.6	6
Northern	23.1	10	42	10	28	10	*	-
Eastern	20.6	16	24	16	22	16	*	2
North Central	9.6	4	9.9	4	7.3	4	5.1	1
North Western	5.9	12	6.7	12	6.2	12	4.6	4
Uva	6.8	8	6.9	8	6.2	8	4.5	3
Sabaragamuwa	3.8	12	7.1	12	7.6	12	4.2	3
Sri Lanka	19.1	135	22.4	134	21.5	134	14.6	45

* No data available

Source: Mendis, 1982
Department of Census and Statistics, 2005

Table 3 Growth of Large Towns in Sri Lanka

Town	Population in 1981 (000)	Population in 2001 (000)	Population in 2009 (000)
Colombo	585,776	642,163	686,779
Dehiwala- Mt.Lavinia	174,385	209,787	224,661
Moratuwa	135,610	177,190	189,750
Kotte	101,563	115,826	124,039
Jaffna	118,215	-	76,080
Kandy	101,281	110,049	123,952
Galle	77,183	90,934	97,101
Negombo	61,376	121,933	153,670
Battaramulla	56,535	-	-
Kolonnawa	-	55,341	-
Katunayake	-	73,025	-
Anuradhapura	-	56,632	83,312
Kalmunai	-	94,457	108,696
Trincomalee	-	-	51,624
Batticaloa	-	-	83,470
Rathnapura	-	-	49,477
Matara	-	-	75,930
Gampola	-	-	61,052

Source: Department of Census and Statistics, 2005

http://en.wikipedia.org/wiki/List_of_cities_in_Sri_Lanka

stimuli to urban growth in these areas. The central hill country of Sri Lanka, a roughly triangular mountainous area located at the south-central part of the Island is the most important geographical sub-region in the Island. In addition, Urban centers such as Nuwara-eliya, Badulla, Bandarawela, Haputale, Walimada are main urban centers with potential in tea plantation, vegetable growing areas, and eco tourism related activities. These urban centers are significant as main contributors in the export sector, tourism and serve as market place to its hinterland. However, excessive growth of urban centers is not suitable in this area due to its environmental sensitiveness and need to be carefully managed as environmentally friendly but dynamic centers focusing on its natural beauty (eco-tourism). Due to its topographical nature most towns of this area are under threat of natural disasters. Towns such as Gampola, Kadugannawa, Kothmale, Rathnapura, Haputhale have been suggested to relocated by the national physical planning policy and plan in Sri Lanka for 2010-2030 for environmental sustainability.

Emerging Trends

Despite the lack of available information, it is able to witness the emergence of an increasing number of urban centres playing a dynamic role of the local and regional economy. Even though many towns in the country were experiencing stagnation in terms of growth in the past it is noticeable that new trends after 2001 are emerging in the county's urban environment. As Table 3 shows most district capitals which are categorized as medium size towns with the population from 10,000 to 49,000 have become large towns exceeding 50,000 population. This

is much appreciable trends because they can be stimuli in the development of their regions with the increasing demand and supply of the goods and services and with the provision of infrastructure. Concentration of population leads concentration of all other commercial and service activities. Towns such as Anuradhapura, Kalmunai, Trincomalee, Jaffna, Batticaloa, Rathnapura located in the periphery are emerging as dynamic centers performing a higher functional diversity.

These towns provide the local population with a wide selection of retail goods, personal and professional services. These towns are basically administrative centers with different development potential in other fields. The public institutions include secondary schools, hospitals, banks, state's offices and cinemas etc. Small towns are the majority of towns in the urban system in Sri Lanka. Sri Lanka being an agricultural country still contain over 75 percent of rural population and small towns as lower order service centres cater to the

requirements of the agricultural hinterland. These towns are very significant as centres that serve the hinterland and as market towns for the rural producers. A large number of small towns are widely distributed at route junctions as low-order-service centres catering to the basic needs of their residential population and those in their hinterlands. Recently these towns have attracted more goods and services such as cinemas, bus-stop facilities, clinics and low-order administrative activities enhancing their functional significance. In addition, these towns, have also played a very significant role in avoiding the large-scale rural migration to the large towns.

As pointed out recently by Wanasinghe and Karunanayake (2003) the other new trend in the urban environment at present in Sri Lanka is emergence of small metropolitan regions in the periphery and the formation of agglomerations through the combination of previously separated towns. Sub-urbanization around Kandy and Galle have already started and transformed their land use pattern, functions of settlements and the employment structure. In addition, the other recent phenomenon is the amalgamation of expanding towns through ribbon development. Tangalle-Beliatta, Tissamaharama-Weerawila-Pannegamuwa and Middeniya-Katuwana in Southern Province and Rathnapura-Kuruwita, Kegalle-Mawanella are such agglomerations in the Sabaragamuwa Province and Kadugannawa-Pilimathala-Peradeniya-Kandy also are connecting due to ribbon development.

One of the other new trends in the urban environment in the country is blooming of some small and medium towns with new growth potentials. Dambulla located in Central Province is one of newly emerging towns as dynamic centre with a great potential due to its location at a major junction, it is the centre of vegetable distribution in the country serve a vast agricultural hinterland. It has a great potential to be developed as a commercial hub and transit centre for agro-cargo and other products and as a tourism and leisure hub because of



Figure 1 Urban Centres in Sri Lanka

Source: The World Bank Colombo Office, 2012

the major tourist attraction of the cave temples at Dambulla. Hambantota in the Southern Province is now receiving much attention due to the selection as a new growth pole in promoting the development in the Southern Province by the government. With these development efforts it will become a catalyst for major economic, transportation, industrial, and commercial centre not only in the southern part of the country but also in the South-Eastern part of the country. Trincomalee is another town thriving presently due to the favourable conditions after the end of the civil war in the Eastern Province. The civil conflict over the past three decades has denied the development in the Northern and Eastern Provinces and adjoining districts. Eastern Province is one of lowest developed provinces in the country due to the war in spite of having the city of Trincomalee with divers potentials. It can play a major role in regional development as a social-economic hub, industrial and tourism zone of the eastern part of the country. It offers vast potential for port related activities.

Dambulla, Polonnaruwa and Trincomalee metro cities, Eastern metro region with Ampara and Batticaloa metro cities, Hambantota metro region with Hambantota metro city and Jaffna metro region with Jaffna metro city will be major metro regions covering entire country in recent future (Map 01).

In addition, towns such as Galle, Kandy, Horana, Kurunegala, Puttalam, Kegalle, Vavuniya, Badulla, Mahiyangana, Awissawella and Monaragala will be established as regional growth centers so as to allow them to be competitive centers in their regions. These towns are long being main urban centres in their regions performing a divers functions but without a proper plan for growth. Towns such as Hikkaduwa, Tangalle, Nawalapitiya, Kataragama, Potuvil, Maharagama, Panadura, Gampola, Beliatta and Eheliyagoda which are in middle and lower levels of urban system of the county will be developed as secondary town centers. Tourism, manufacturing, agriculture and cultural values are growth drivers of these towns.

Way Forward

With all these capacities, growing importance and weakness in the urban system of the country it is important to discuss what actions can be taken to create the environment that make these towns and cities located in the periphery more dynamic and productive centers and significant contributors to regional development. In this regards a comprehensive and a coordinated strategy is needed to make them better prepared to support development in these regions. None of potential advantages in cities can blossom automatically. They depend on concerted effort of the key stakeholders: State, local government, private sector and civil society groups.

Government intervention is one of the chief factors in making a supportive environment to promote urban growth in the country. Government has a big role to play in providing the enabling environment for cities to hit their full potential, while reinforcing the economic linkages and complementarities among the entire spectrum of urban areas. Since lagging periphery having divers potential for urban growth rebuilding of physical as well as human environment in especially conflict-affected areas for the better functioning of the civil society comes as major responsibility of the government. At the same time, recovery of key economic sectors such as agriculture; fisheries, manufacturing industry and tourism which were badly affected during the civil war is essential to improve the urban environment in these areas. Extensive infrastructure development and expansion which help strength connectivity between urban and rural areas and among towns and cities is the other key factor that is prerequisite in urban growth. Most of the peripheral towns and cities in the country have no sufficient physical as well as social infrastructure facilities. Infrastructure investment in the development of roads, communications, information technology, schools, and hospitals is important to both economic

development and quality of life within cities. Improvement in transport network is important in linking small, medium and large cities to function as an efficient city network. This will lead to improve business environment especially private sector and make them attractive places for investment, employment, living and leisure activities. Majority of urban centers in the country are service oriented centers rather than commercial and industrial centers. Therefore, investment in infrastructure development will attract more private sector involvement in commercial and manufacturing sector.

Improving local government capacity is another important factor in regional development. In this respect one critical issue that should be noted and addressed in the context of urban environment in the country is introducing a proper methodology to identify "urban centers". As mentioned at the beginning, absence of proper method is a problem for local authorities in their decision making. On one hand it affects the income of local authorities. New dwellers who are added due to the outgrowth of the towns do not pay taxes but enjoy all facilities provided for the city dwellers. Non-payment of taxes reduces the income of local authorities and cost of providing urban services increases. This affects the poor maintenance and inefficiencies of the urban system. Local authorities such as Pradeshiya Sabhas have very little capacity in financial, human and institutional resources. They are restricted by some of the by-laws in implementing fiscal and other policies supportive of economic growth and development. There are many urban centers including some district capitals such as Monaragala, Polonnaruwa and fast growing towns such as Mawanella and many satellite towns in Western province with appreciable levels of population and urban functions but without urban status. The absence of a proper definition and not expanding physical boundaries of towns also creates some problems for infrastructure facilities in towns. Physical expansion beyond the city

boundary makes more demand for urban infrastructure facilities due to addition of new users. Use of facilities and services designed for a small population constrains the proper functioning of existing services and facilities. Provision of infrastructure facilities for the expanded areas also is a problem. More investment is needed in supplying the facilities and services for the areas that have developed in an ad hoc manner. Organizing of a proper waste disposal and waste water management system also is impossible in sprawling areas. This situation prevent them from playing vital role in the development in their region. It does not help create an urban environment that is attractive for investment in Sri Lanka.

Absence of proper methods to demarcate the urban areas also imposes some constraints in the urban planning process. Urban Planning is the instrument which is used to achieve the orderly development of an urban area. In the absence of clear definition and demarcation of urban centers it is difficult to implement the powers of planning and development control by various institutions in order to guide the development achieving the better physical and economic utilization of land. Excessive use of lands including environmentally sensitive areas for residential and commercial purposes, emerging of sporadic land use patterns, presence of a lot of unauthorized activities, increase in environmental pollution due to the presence of polluting industrial activities are some of the issues that harmful for the development of better cities and towns.

In summing up the discussion on role of cities in regional development, it is understandable that how much town and cities are vital in generating growth and development. There are much potentials as well as some weakness in the urban system in regional development in Sri Lanka. Therefore, it is needed to implement a coordinated approach to make them more dynamic and supportive components in the growth and development in regions by lessening

the weaknesses and promoting their strengths.

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Industrial Clusters in Regional Development: Lessons from Karnataka, India

This paper analyze the role of industrial clusters in regional development of Karnataka State in India. The Analysis are focused on identifying the nature and composition, economic size and performance of clusters in the State as compared to national level. Results indicate that the nature of industrial clusters has high degree of homogeneity. Location of multiple clusters in a single place has the advantage of cost-effective provisioning and co-operative sharing of common facilities by enterprises. Clusters in the State are more capital efficient but less labour productive. These results have important lessons for designing of a holistic policy for promotion of clusters and improvements in databases.

1. Introduction

This paper analyze the role of industrial clusters in regional development of Karnataka State in India. The aspects of promotion and regulation of an industry is in the Concurrent List of the Indian Constitution, and the development of industrial clusters is jointly undertaken by the Central and State governments. Thus, economic analysis of the role of industrial clusters in regional development may need to be focused on a comparative framework between the State and national levels.

Industrial clusters are a large spatial concentration of industrial units which are horizontally and/or vertically linked together by inputs and outputs relationships between units. Industrial clusters are generally recognized with product-specificity (e.g. readymade garments, footwear) and location-specificity. This distinguishes the cluster development from other spatial approaches to industrial development in India.¹

Importance and advantages of clusters for industrial development is specially recognized for small and medium enterprises (SMEs) by policymakers and professional researchers in

India.² For instance, the Report of the Expert Committee on Small Enterprises [Government of India (1997)] had identified the following advantages: "The proximity of a web of businesses lowers the unit cost of infrastructure, leads to accretion of skills and is a source of informational economies. From an institutional point of view, the costs of monitoring and promotion are lowered since news spreads faster in a regional context." (p.137). Government of India (2003) emphasized that existence of strong linkages between units may (a) give rise to external economies, (b) lead to emergence of specialized technical, administrative and financial services and (c) create inter-firm and inter-institutional (e.g. between public and private) cooperation and specialization for local production, innovation and collective learning. Narayana (2004) showed that, in terms of size and capacity of production and employment generation and possibilities for exports promotion and technology upgradation, clusters eliminate the disadvantages of smallness of dispersed industrial units, such as, small scale enterprises. More recently, distributive objectives for promotion of clusters are emphasized in India. For instance, Hashim et al (2010) argue for cluster development for promotion of inclusive growth through employment generation with case studies from footwear clusters in Kolkata and Agra and a garment cluster in Tirupur and National Capital Region.

Industrial clusters are developed in the Karnataka State as a Government of India-assisted programme under its Micro and Small Enterprises Cluster Development Programme. The key objectives of the Programme are to enhance productivity and competitiveness through exploitation of economies of scale as well as capacity building of small enterprises in the country [Government of India (2006)]. Karnataka State Council for Technological Upgradation, under the Department of Industries and Commerce of the Government of

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Karnataka, is the implementing and monitoring agency of the programme within the State. To our knowledge, an economic analyses of the role of industrial clusters in regional development of Karnataka are not available. This paper is an attempt to fill in this policy research gap.

The main objective of this paper is to explain the role of industrial clusters in regional economic development of Karnataka State in Southern India. This explanation is based on available current databases. The methodology is descriptive and positive. Overall, the paper has important lessons to be shared with other States in India as well as sub-national industrial cluster analyses for regional development in developing countries of Asia.

The rest of the paper is organized as follows: Section 2 describes the current databases on industrial clusters in India including Karnataka State. Section 3 describes the nature and composition of industrial clusters in Karnataka. Section 4 distinguishes the economic performance of clusters between Karnataka and all India. Section 5 summarizes the major determinants of size-class of production of clusters in Karnataka. Section 6 includes major conclusions and lessons.

2. Current Databases

Government of India's (2003) database on 358 industrial clusters (including select artisan clusters) in 16 States provides with information on the clusters identified by the UNIDO Focal Point in India.³ The information distinguishes clusters by (a) natural or policy induced,⁴ (b) modern SSI/

traditional consumer goods/ traditional arts and craft, (c) large unit centered/vertical/horizontal/both,⁵ (d) high/medium/low heterogeneity, (e) high/medium/low technology upgradation, (g) high/medium/low export potential, (h) market based, resource based or infrastructure based,⁶ and (i) presence of competition with large units and (j) production size categories.

The Final Report of the IVth All India Census of Micro, Small and Medium Enterprises (MSMEs) 2006-07, is the latest database on industrial clusters on MSMEs [Government of India (2011)].⁷ At present, its availability is limited for the registered MSMEs.⁸ A district having 100 or more registered MSMEs units, and engaged in manufacturing the same product as per Annual Survey of Industry Commodity Classification 2000 (at 5 digit), is considered as a cluster for that product in that district. The cluster data is provided for 25 States by 6 indicators: (a) number of clusters, (b) number of working enterprises, (c) employment (number of employed persons), (d) original value of plant and machinery, (e) market value of fixed assets and (f) gross value of output.

Karnataka State Council for Technology Upgradation (KCTU) is the official agency for implementation of the industrial cluster programmes in the State. The cluster database with the KCTU provides cumulative progress of induced clusters in the State as on 31 March 2013. The database includes the list of 108 cluster development projects by their location, main activity and main product/s, and progress of projects under different implementation status. Surprisingly, only three projects are reported in the final stage of implementation and no performance data (e.g. production, exports, capital investment and employment) on these clusters are available.

The available databases noted above are not comparable due to differences in (a) definitions for clusters, (b) composition of units and (c) nature and number of indicators for spatial distribution and for economic performance of clusters. Lack of comparability signifies that each database should be used separately to capture its underlying unique information.

The Directorate of Economics and Statistics of the Government of Karnataka estimates the State Income of Karnataka, including the gross value added in manufacturing, by registered and unregistered sectors. These estimates are not distinguished between the clustered and non-clustered units.⁹ Consequently, growth effects of industrial clusters cannot be obtained from the available estimates of State Income by Industries in Karnataka State. Further, available national and State level databases on clusters do not provide the estimates of gross value added by clusters. In addition, the available databases lack data on personal income distribution of working population in the industrial clusters. These data limitations preclude the estimation of growth and distributive effects of the industrial clusters. Thus, we focus our analyses on nature, composition and performance of industrial clusters in the State and its comparison at the national level.

3. Nature and Composition of Clusters

Table 1 gives an overview of industrial clusters in Karnataka based on the CDP database. Total number of clusters in Karnataka is 25 or about 7 per cent of total clusters in India. All clusters are single product clusters with highest share of traditional consumer goods. Clusters with products manufactured by the modern SSIs constitute 48 per cent. Highest number of clusters (92%) is characterized by horizontal linkages and medium and low heterogeneity. Potential for technology upgradation (or exports) of the clusters is largely classified under medium and low (or high). Resource based rather than market based cluster are dominant. Surprisingly, no clusters in Karnataka are infrastructure based because they are being developed only in recent years. Clusters by size-class of production show considerable variations. Highest number of clusters belong to size-class of production between INR01 billion and INR1 billion. Number of clusters with highest size-class of production (INR10 billion) is about 4 per cent.

The distinguishing features of nature and composition of clusters in Karnataka are comparable at all India level except by the following: That is, unlike in Karnataka, higher share of clusters at all India is dominated by (a) modern SSIs, (b) medium and low potential for export technology

upgradation, (c) market based and (d) competition with large units.

The above descriptions have the following interesting implications:

First, nature of industrial clusters in Karnataka has high degree of homogeneity in terms of natural clusters and single product clusters. Homogeneity can also be extended to select elements of composition of clusters by the dominant share of horizontal linkages; medium and low potential for technology upgradation; high potential for exports; and value of size class of production between INR1 billion and INR10 billion. Composition of clusters show few remarkable heterogeneity in terms of types of products produced or sources clustering. Nevertheless, elements of homogeneity are more dominant than the elements of heterogeneity. This implies that a policy on development of each natural cluster can be designed given the framework of elements of homogeneity.

Second, industrial clusters in Karnataka are not completely distinct by products and location. This is evident in the note to Table 1, where natural industrial clusters are given by their products and geographical location. All products are not distinctly exclusive. For instance, food product clusters are located in Mysore and Mangalore; and silk clusters in Bangalore and Mysore. In the same way, not all locations are distinct. For instance, Bangalore has the location of seven clusters and Mysore has 5 clusters. These two locations account for about 48 per cent of total natural clusters in the State. Location of multiple clusters in a single place has the advantage of cost-effective provisioning of common facilities and its co-operative sharing by enterprises in different clusters.

4. Economic Performance of Clusters

Industrial clusters are contributory for regional capital formation, employment generation and output. Table 2 presents the current status and select performance indicators of industrial clusters from the IVth All India Census of MSMEs in 2006-07. Karnataka shares about 9 per cent of nation's total clusters, number of working enterprises in clusters and total employment. Share of the State in the gross value of output of clusters is about 6 percent. State's share in the capital formation of the total clusters is about 3 per cent by original value of plant and machinery and about 2 per cent by market value of

Table 1 Nature, Size and Performance of Clusters in Karnataka State, 2003

Indicators	Value of indicator	
	Karnataka	All India
1. Total number of clusters (SSEs and Artisan)	25	354
Per cent of total clusters		
2. Natural clusters	96	92
3. Single product clusters	100	100
4. Composition of clusters by nature of products (not mutually exclusive):		
4.1 Traditional art and craft products	48	36
4.2 Traditional consumer good	68	54
4.3 Modern SSI	48	75
5. Linkages		
5.1 Large unit centred	8	2
5.2 Vertical	0	8
5.3 Horizontal	92	73
5.4 Both vertical and horizontal	4	16
6. Heterogeneity		
6.1 High	8	7
6.2 Medium and low	92	93
7. Potential for technology upgradation:		
7.1 High	24	16
7.2 Medium and low	76	84
8. Potential for exports:		
8.1 High	68	47
8.2 Medium and low	16	53
9. Sources of clustering:		
9.1 Market based	40	57
9.2 Resource based	60	40
9.3 Infrastructure based	Nil	3
10. Competition with large units	44	57
11. Value of production:		
11.1 More than Rs.1000 crore	4	9
11.2 Between Rs.100 crore and Rs.1000 crore	32	25
11.3 Between Rs.10 crore and Rs.100 crore	52	51
11.4 Less than Rs.10 crore	12	15

Note: The product and location of 25 clusters in Karnataka are as follows. Leather and leather Chappals in Athni; Machine tools, Silk, Electronics, Ready-made Garments Leather Products, Agarbatti and Screen Printing in Bangalore; Food Products, Agarbatti, Leather Footwear, Rose Wood Inlay and Silk in Mysore; Leather products in Raichur; Coir and Coir Products in Arasikere; Powerlooms in Belgaum; Bidri Ware Craft in Bidar; Oil Mills in Bijapur; Carpets (Tibetan) in Bylakuppe; Lacquer Craft in Channapatna; Dal Mills in Gulbarga; Cotton Handlooms in Ilkal, Gadagh, Rabkavi and Barnhatti; Food Products in Mangalore; Sandle Wood Craft in Sagar; and Rice Milling in Shimoga.

Source: Compiled by the author using basic data in Government of India (2003).

fixed assets (include land and buildings).

Further, Table 2 presents select economic ratios per cluster and per working unit in Karnataka and all India. Employment per enterprise is 4 persons in Karnataka and 5 persons at all India level. This indicates the smallness of enterprises in the clusters. Smallness is further evident by original plant and machinery per cluster (INR50 million) and per

enterprise (INR0.17 million) in Karnataka. According to the definition of MSMEs, the size of original plant and machinery per cluster is equivalent to a manufacturing enterprise and that of per enterprise is less than for a micro enterprise. In general, except for number of working units per cluster, all other indicators of clusters are remarkably different between Karnataka and all India. In particular, the value of these performance indicators is lower for Karnataka.

In addition, the select performance indicators in Table 2 show a lower value for Karnataka than at all India level. This includes capital labour ratio, capital output ratio, and output labour ratio. A lower value for capital labour ratio and capital output ratio implies that the value of capital (measured by original value of plant and machinery or market value of fixed assets) required per labour unit and per unit value of output is less for Karnataka than at all India level. Thus, other things being equal, clusters in Karnataka are more efficient in using capital per labour unit employed and per unit of output produced. On the other hand, labour productivity, as measured by gross output per employment is less for Karnataka than at all India. In short, clusters in Karnataka are more capital efficient but less labour productive than at all India level. This implies that from the viewpoint of increasing the production and productivity of clusters in Karnataka, efforts should be directed to improve the labour productivity in the enterprises.

5. Determinants of Size-class of Production of Clusters

Production is an essential variable to capture the growth effects of industrial clusters. Knowledge of determinants of production in clusters is useful to introduce policies and measures for attainment of higher production and higher regional economic growth. Using the CDP data of 354 individual clusters, Narayana (2013) estimated the Binary Logit Model to estimate the determinants of size-class of production (in Table 2) by individual clusters at national level. The empirical results showed that clusters belonging to the highest size-class of production are higher if they (a) produce traditional and craft or modern SSI products, (b) are horizontally linked, (c) comprise high and medium heterogeneity, (d) include units with high potential for technology upgradation, (e) include units with high or high and medium export potential and (f) are market-based. The above results are obtained at all India level. Assuming that the estimated parameters at the national are similar at the State level, estimated probabilities across clusters are shown to be remarkably higher in the State than at the national level. Thus, the above determinants are considerable for improving the larger size-class of production of industrial clusters in Karnataka State

6. Conclusions and Lessons

Using the available current national and State level databases, this paper

Table 2 Nature, Size and Performance of Clusters in Karnataka State, 2006-2007

Indicators	Value of indicator	
	Karnataka (% of India total)	All India (Total)
Number of clusters	9.25	2443
Number of working enterprises	9.19	718000
Total employment (persons)	8.97	3245000
Original value of plant and machinery	2.98	INR379.37 billion
Market value of fixed assets	1.92	INR1510.96 billion
Gross value of output	5.83	INR1344.63 billion
Select ratios per cluster and working unit		
Number of working units per cluster	Karnataka 291	All India 294
Employment (persons)		
• Per cluster	1282	1328
• Per working unit	4	5
Original value of plant and machinery		
• Per cluster	INR50 million	INR160 million
• Per working unit	INR0.17 million	INR0.53 million
Market value of fixed assets		
• Per cluster	INR130 million	INR620 million
• Per working unit	INR0.44 million	INR2.10 million
Value of gross output		
• Per cluster	INR350 million	IN550 million
• Per working unit	INR1.19 million	INR1.87 million
Select performance ratios		
Original value of plant and machinery	Karnataka	All India
• Per employment	INR0.04 million	INR0.12 million
• Per output	INR0.14	INR0.28
Market value of fixed assets		
• Per employment	INR0.10 million	INR0.47 million
• Per output	INR0.37	INR1.12
Value of gross output		
• Per employment	INR0.27 million	INR0.41 million

Source: Computed by the author based on the basic data in Government of India (2011).

has focused on economic analyses of industrial clusters in Karnataka by identifying the nature and composition, economic size and performance of clusters in the State as compared to national level. Contributions of industrial clusters to regional economic development are measured by indicators of capital formation, employment generation and output. Main conclusions and lessons of this paper are as follows:

The nature of industrial clusters has a high degree of homogeneity in terms of natural clusters and single product clusters. Location of multiple clusters in a single place has the advantage of cost-effective provisioning of common facilities and its co-operative sharing by enterprises in different clusters. Clusters are more capital efficient but less labour productive. Further, available empirical results suggest that clusters belonging to the larger size-class of production are higher if they (a) produce traditional and craft or modern SSI products, (b) are horizontally linked, (c) comprise high and medium heterogeneity, (d) include units with high potential for technology upgradation, (e) include units with high and medium export potential and (f) are market-based. These conclusions offer a useful framework for designing of a promotional policy for industrial clusters in Karnataka with emphasis on attainment of higher regional economic development. In the meanwhile, available databases must be improved and updated for (b) direct estimation of the growth and distributive effects and for (b) monitoring the economic performance of industrial clusters at the State level.

Development of clusters needs a holistic policy approach with coordination between the public and private sectors but also between the policy departments at the Central and State level dealing with industries and commerce, trade and investment, science and technology, and banking and finance. In this regard, Government of India's efforts to formulation and implementation of Cluster Development Programmes in the Karnataka State are most welcome and deserve to be further strongly promoted and strengthened with the above coordination tasks.

Given the comparability of economic structures of industrial clusters, the methodology, results and implications of this paper have relevance and

applicability for assessing the role of industrial clusters in regional economic development in other Asian countries. Evidence from such international studies would be useful to generalize the conclusions based on the experiences of Karnataka as well as India in this paper.

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- Footnotes**
- ¹ These spatial approaches for industrial development include Industrial Estates, Industrial Growth Centres, Export Processing Zones, Industrial Parks, Integrated Infrastructure Development Centres and National Programme for Rural Industrialisation. An excellent description of these spatial approaches is given in Government of India (2001).
- ² International approaches to industrial clusters are available, for instance, in the excellent works of Nadvi and Schmitz (1998), Schmitz and Nadvi (1999) and Morosini (2004).
- ³ The methodological details of data collection of these clusters are available at (accessed on 10 March 2013): <http://www.dcmsme.gov.in/>
- [clusters/unido/methcludata.htm#basic](http://clusters.unido.org/methcludata.htm#basic)
- ⁴ Clusters developed without (or with) deliberate policy intervention by the Government are called natural (or induced) clusters.
- ⁵ Horizontal clusters comprise units, which process the raw materials, and produce and market the finished products by themselves with no scope for division of units. Clusters of units around a large unit or few large units are called large unit based clusters. Vertical clusters are linked with large units as suppliers or processors of raw materials or as subcontractors of large units.
- ⁶ Resources include raw materials and skilled labour. Infrastructure is largely in the form of public provisioning of economic infrastructure (e.g. industrial estates and technology parks).
- ⁷ According to the Micro, Small and Medium Enterprise Development Act 2006, the manufacturing enterprises are defined by upper limit on the original value of plant and machinery. For instance, the original value does not exceed INR2.5 million for a micro enterprise, not less than INR2.5 but does not exceed more than INR50 million for a small enterprise, and more than INR50 million but does not exceed INR100 million for a medium enterprise. Details of the Act are available (accessed on 26 February 2013) at: <http://www.dcmsme.gov.in/LegalFramework.htm>
- ⁸ The Census questionnaire includes questions which distinguish the clusters by two types: Natural Clusters and Artificial Clusters (i.e. developed through schemes/programmes of the Central and State governments). In other databases, these artificial clusters are called induced clusters. Data on types of clusters are yet to be released for public information and use.
- ⁹ Industrial performance in the State is also measured by the Index of Industrial Production (IIP). The Index has three components with differential weights: Mining (6.98%), Manufacturing (81.14%) and Electricity (11.88%). The Index does not distinguish production by industrial clusters. For details, see Chapter 8 in Government of Karnataka (2013).

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The Role of Higher Educational Institutions (HEI) in Regional Development

1. Introduction

One of the major development problems faced by Sri Lanka is the persistent regional disparities. We have developed a growing core region represented by the more industrialized and urbanized Colombo Metropolitan Region (CMR) on one hand and a periphery which is lagging behind and is largely rural and agricultural. The outer periphery is relatively more lagging than the inner periphery. Today, it is recognized that CMR need to continue to grow to generate wealth and prosperity to the country as a whole. However, it is also recognized that the lagging rural regions also need to grow and transform their economies to bring greater prosperity to these regions, as trickle down effects from CMR growth are not likely to filter down to these regions soon. Hence, the need for a coordinated policy of regional development for these regions. A second reason that underscores the need for a focused regional policy for the country is to maximize the diverse and untapped potentials of different regions of the country to support national growth which is already on a rapid path. Third, Sri Lanka needs to aggressively face the ever growing challenges of globalization and global competition. Finally, the Millennium Development Goals (MDGs) agenda of the UN have to be rigorously applied and addressed to bring about a more balanced development profile in the far and wide regions of the country (Gooneratne 2005).

Globalization is creating new opportunities as well as challenges for developing countries like Sri Lanka. Global competition is perhaps the most significant of the challenges and creating competitive regional economies (as part of national economy) has emerged as a key strategy for meeting this challenge. In this regard, HEIs consisting of

Universities, Technical Colleges, Research and Training Institutions form one of the key drivers towards a more competitive regional economy.

2. The Role of Human Resources (HR) and Skills in Regional Growth and Transformation

Regions can play a determining role in identifying opportunities for growth and transformation. Regions can also act as mobilisers for driving such growth and diversification and identification of new frontiers. This search for new regional advantage requires the active participation of the "triple helix", the government, business and the academic institutions. To become drivers of change, regions need to adopt more sophisticated policy approaches. It is in this regard that, among several critical steps, the role of HEIs take a central place. The emerging paradigm shift in regional development policies favours strategies based on the mobilisation of regional assets for growth and bringing knowledge and innovation to the core of the regional development agenda.

Today, the successful economy is a knowledge based economy. Knowledge (K) is key to improving practically everything essential for life (food, clothing and shelter, health & education, transport and communications, environment). K has to be the key to management, improvement and expansion of productive sectors/activities such as agriculture, industry, services etc. K and skills are, therefore central to regional growth and regional competitiveness.

Any growth agenda needs to consider how to drive and dynamise growth in the region, with respect to physical, human and geographical endowments. Investments in, and mobilization of human capital in

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developing knowledge-based and knowledge intensive production systems are vital for supporting endogenous growth based on regional potentials. It is here that knowledge creation, diffusion and exploitation, combining traditional instruments (such as support to human capital and skills), emerging instruments (such as new generations of Science & Technology centres/ parks, talent and creativity support) require greater regional focus. Note that innovation of all kinds from simple to complex ones, at the regional level may be more effective given the opportunity to exploit synergies between policies and instruments that are in the hands of sub national entities. Hence, in the modern economies orientation of primary and secondary education along the pillars of knowledge economy is necessary (Sedera MU 2010).

"Sustainable growth at the regional level is now, more than ever, predicated on the capacity to innovate," said Rolf Alter, director of the OECD's Public Governance and Territorial Development Directorate. "(2010). The competition amongst firms and business concerns have led to searching new knowledge for innovation and production. The States have also realised the importance of this leading edge and the need for development of quality human resources which would help them to increase employment and growth.

3. Critical Areas for University and Research and Training Institutions' (URT) Engagement

Universities & Research & Training institutions have always been at the forefront of the production and dissemination of knowledge and

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skills. Regions that are not supported by good universities and R & T institutions are clearly destined to lag behind those endowed with high quality HEI institutions. However, in Sri Lanka, though many URTs are scattered throughout the country, the regions are still handicapped by the absence of any tangible and active support by HEIs and/or research institutes.

There are several ways in which HEIs can support and assist regional development. They can play a central role in assisting regional economic development by improving Human Resources and skills to expand productive employment opportunities and raise incomes. When working in collaboration, they are able to drive and enhance the competitiveness of regions by supporting key sectors, activities or selected areas to improve their productivity and innovative capacity. HIE contribution can be most vital for the lagging regions to overcome their long standing problems of slow economic growth and transformation.

4. Universities in Local and Regional Development in Sri Lanka

In Sri Lanka there are 15 universities with an academic strength of around 4,500, including about 500 Professors and Associate Professors and over 1,750 Senior Lecturers with PhDs or equivalent qualifications. An appreciable number of these senior academics are promising scientists with international experience and make a significant contribution to the advancement and dissemination of knowledge in their respective fields. According to a study conducted by the National Science Foundation in 2004, the academics in the universities have accounted for more than 60 percent of the R&D personnel in the country.

As Senaratne (2012) noted, it is imperative for universities and higher education institutions to be actively involved with the society of which they are a part. Hence engagement should be considered as a 'core value' for the university. Universities need to build close, organic relationships with the economy and society in which they are located. They can no longer keep aloof from society and the

region. Universities need to get to the bottom of issues faced by society and community concerning livelihoods, diseases, poverty, illiteracy, agriculture, industry, productivity, education, environment etc. It should be a truly organic relationship.

Greatness of a university is measured by the contribution it makes to the locality, region, country and the world. This makes them obligatory to "contribute towards improving the economies and living conditions of rural/peripheral regions". "Therefore, it is incumbent upon the universities to develop an organic partnership with the community and the region and assist to harness the under-utilized and unutilized human and natural resources in rural areas". Building an organic relationship with communities requires re-positioning our universities, but also re-modelling the degree programmes so that they incorporate engagement with community as a core value and an integral part of university education and research. There are some staff members in the universities who are already constructively engaged with the community and are making a significant contribution to community development. But some still believe that universities should remain as elite institutions. Our universities still work mainly along disciplinary lines with hardly any team work across disciplinary boundaries. One has to understand however, though the Universities in Sri Lanka are located in the regions, they were not instituted to solve, regional problems. Hence, there is a need for policy change at the highest level.

It should be clear that outreach activities should be treated as an integral part of the university's responsibility to the community. Undergraduates should be provided with opportunities to work in relevant government and private institutions, community organizations etc. to gain first hand knowledge, hands-on experience and practical skills. "Graduates produced through such degree programmes can assist the regional economy later in numerous capacities with a good understanding of the regional problems". In this connection although some universities in Sri Lanka have extension programmes these are

rather ad hoc and do not have an integrated approach to development. Neither are their activities incorporated into a total development package, used as examples in the designs or at the minimum, lead to improving required skills in the development process of the region. Rather these are not continuous, and do not assist any specific development programmes of the state and therefore foot loose experimental projects and mostly serve as part of an academic exercise leading to course of study.

Engagement with the community can be further facilitated through the establishment of community service centres in the rural regions connected to the university. Students and teachers could live, study, teach, train, work and learn at these centres representing major faculties. The wealth of knowledge and experience gained through such engagement would enable the universities to offer useful courses related to rural/regional development.

"Thus the engagement with community would afford a new meaning, new direction and new momentum to higher education, making the universities in Sri Lanka true and effective partners and catalysts in regional and national development" (Senaratne 2012 1nd 2013).

Goddard (1997) emphasized the need to move from an 'elite' to a mass system of higher education and a new emphasis on lifelong learning'. The new knowledge in technology and information could be reached through a variety of institutions outside the traditional university.

5. University Contribution to Regional Development in other Countries

In many parts of the world, universities have now become powerful catalysts and agents of growth and wealth creators. They mobilize and channel their intellectual and infrastructure resources for industrial growth and regional and national development. Thus great cities naturally have great universities that contribute to the cities' intellectual, social and cultural

vibrancy as well as influence their development. In a knowledge-based global economy, there is even greater synergy between a city's development and the universities. Stanford University in California, Punjab University in Punjab, India, Fudan University in Shanghai, China, Chalmers University in Gothenberg, Sweden and NUS in Singapore are some telling examples in this regard. (Senaratne 2012). Universities located in the regions do play similar roles in many countries.

The UGC, India has categorically stated that the extension programmes of the universities should follow the aims and goals of the State and should imbibe the 'Extension Culture' of the State. Nepal is another country where the universities have to follow since 1974, Nepal National Development Service code, whereby a mandatory service of one year serving the community is imposed prior to sitting the degree. Sri Lanka too experimented with a similar idea earlier in the 1990s. All these activities do indicate the acceptance of serving the community helping the students to gain access to knowledge from realities as part of the learning programme to prepare them to serve the nation better once they commence work. It should be mentioned that the UN's International Conference on Adult Education (1997), with its exemplar materials from all over the world did present an array of projects developed for adult communities. Most of these were related to development of skills and knowledge in the peripheral areas.

6. Possible Areas for Concrete Action

The concept of a competitive (learning) region entails a greater role and engagement by the universities, technical colleges and research and training institutions at regional and local level. Regions become active learning regions when they adopt principles of knowledge creation and continuous learning. Universities, in particular, can support the regional economy, its firms and production systems to draw from their knowledge resources. In many ways, universities are located at the head of the supply chain that is devoted to the production of knowledge. Regions without high

quality educational infrastructure (including research) will clearly remain disadvantaged.

There are at least four major areas in which the contribution of universities can have a direct impact on the regional economy; these are technology, human resource development, advisory and leadership support and research.

Technology

Little do we realize that our universities have a large concentration of faculties of science, engineering, agriculture, IT etc. as well as most social sciences and a large number of staff members involved in teaching and research. This is an invaluable and unmatched source of expertise. These can be utilized to achieve several things. Most importantly, these can be utilized to acquire, develop and provide technologies to support and improve productivity of the regional economy in industrial, agricultural and other sectors. This is essentially the production and/or diffusion of technologies relevant for local and regional economic growth, employment expansion and resource management.

Expanding the stock of human capital

There are several possibilities in improving and expanding the human capital base of the regional economy. These include, (a) production of relevant skills for the regional economy to harness the untapped potentials; a competitive regional economy also requires trained and skilled people to manage local and regional development, (b) promotion of graduate retention schemes by linking with regional economic actors and other agencies., (c) catering to mature local students for undergraduate/ post graduate programmes as well as further training. Finally, regional universities need also to become the centres of teaching and training in local and regional development planning and management.

All these are essential to improve the production of high quality home grown talent for the regional economy. It is also important to remember that beyond technological leadership, in the context of today's

competitive economy, several production systems mainly add value by investing in non-technological innovations such as talent and creativity, the cornerstones of high quality human resources.

Advisory and leadership support

Today, the HEIs play an insignificant role in assisting and supporting local and regional institutions. These institutions, particularly in the lagging/peripheral regions suffer from a huge deficit in management and development capabilities. HEIs can offer advisory support and services to regional institutions such as local governments, 'industry/trade chambers, other local organizations like farmer organizations, fisheries cooperatives etc. They can also provide leadership support to local governments and other development agencies, for example by serving in their management/advisory boards.

Research

High quality data and information as well as analytical studies on key aspects essential for improving the performance of the local and regional economies are not readily available in Sri Lanka. What is available at different levels (LAs, Districts, Provinces etc.) is no more than basic data and information. HEIs can play a more proactive role in helping to fill this gap by contributing to assess regional potentials, possibilities and problems of (a) their own /local regional economies and (b) of other regions in competition. They can also help create and maintain a data/information base on the regional economy. These are essential for planning, implementation and monitoring of development activities at regional level. Today, there is also a need to revive time tested local knowledge (LK) systems in many different areas of the local economy and society—universities, in particular, can help in retrieving, validating and revitalizing these LK resources. These can be of invaluable relevance to the sustainable development of local/regional economies (Economic Review, April/May 2010).

All of the above would ultimately enhance the potential role of the regional universities when they cooperate and network with local research and other training

institutions such as technical colleges. Further, regional universities form the ideal locations to establish science and technology centres and/or parks. These are increasingly becoming key players in regional development, as mines and foundries of the new economy where innovation is induced by design, to create new industrial space, as seen in the East and South East Asian countries (Castells, M and Hall, P 1994).

Sri Lanka's experience

Today, there is growing recognition of the need for the university to ensure that the knowledge developed and available within the university is put to use, especially in its local region. 'This can take a variety of forms, including developing internal capabilities for technology transfer and commercialization of research to playing a collaborative role in establishing a strategy for knowledge based regional economic development and participation in initiatives to implement that strategy'. A university should be sensitive to the needs of the community and the region if it is to be entrepreneurial and innovative.

Sri Lanka universities & research & Training institutes are all national institutions and are engaged mainly in the delivery of teaching programmes. They are not expected to or are geared to play a local/regional development role. The engagement of these institutions with the region in the 4 areas identified above is minimum or insufficient to support the development of the regions.

Sri Lanka has the highest proportion of educational institutes run by the government, accounting for 95% and only 5% run by the private sector. Private sector participation in higher education, compared to many Asian countries, has been minimal. University engagement in industry and business has also not been strong either. Exceptions are that of Moratuwa University and Sri Jayawardenepura University Management Faculty which have a good track record of cooperating with business and industry and finding employment for their graduates.

Creditably, the recently established Sagara Vishva Vidyalaya, dedicated university for the fisheries sector and Uva-Wellassa university teaching/

training programmes covering plantation economy, management, IT etc, are forging ahead with new and challenging programmes directly geared to the country's needs of employment and production. Unfortunately, none of the other universities are still directly and actively engaged with the local/regional economy.

The Ministry of Science and Technology of Sri Lanka commenced a valuable grassroots level innovative practices based on indigenous knowledge and resources. These provide useful information and develop practical skills and help the community to market their products (Vitarana et al 2012). However, the quality of the products has remained a problem. Unfortunately these science and technology units known as 'Centres of Science and Technology' (Vidatha) have not been connected to any university or industry in the area indicating the gaps in exchange of knowledge and skills between institutions and the needs of the community.

On the basis of the available information, we can make the following observations on the role and contribution of HEIs in Sri Lanka:

(a) academic/research links/exchanges are not well developed among the HEI institutions. (b) joint/cooperative programmes are not widespread, not even widely spread amongst the university faculties, (c) region related/relevant R & D work has received insufficient attention, (d) teaching drawing on/from local/regional issues/situations is not integral parts of teaching programmes and (e) university engagement/contribution in several region specific areas of concern to regions has also not been significant.

7. Challenges

The expected rapid growth and transformation of the Sri Lanka's economy in the next stage would be greatly supported by enhancing the contribution of hitherto lagging/peripheral regions by creating favourable conditions that would enable them to improve the maximization of their potentials and comparative advantages.

Hence, the need for HEIs to become special/unique assets of the regions

is imperative. The regions have to feel and be proud that it is also their university (s), making a contribution to help attract investments and businesses and talent and skills to the region. They can help transform the regional economy, make it competitive in the global economy and make it economically and socially resilient.

"However, this enviable human resource base in the universities has so far remained untapped or heavily under-exploited. If it is properly mobilized and channelled for regional development, the universities can become the locomotives of regional growth and effective partners in transforming Sri Lanka" (Senaratne 2010).

Sri Lanka does not have a well articulated regional development policy. We do not have regions demarcated for development purposes (Gooneratne 2005). This has been one of the reasons that has prevented universities & R/T institutions from playing a meaningful development role in the regions.

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Empowering Local Government for Better Serving Regional Development in Sri Lanka: Sharing Japanese Experience

1. Introduction

The local government plays an important role, as it is the closest administrative unit to the people, in delivering the public services. It also serves as the most democratic, as local residents can participate in the decision making process and market friendly, as individual choice is given due consideration, a way of addressing the needs and concerns of the citizen. Classical and neo-classical liberal thinkers who believe in the market mechanism argue that enhancing social welfare of individuals should be the major objective of public policy. Therefore, empowering local governments to better serve regional development and also to better serve individuals is vital as socio-economic, political and cultural systems and values are rapidly transforming due to evolving information technologies and the globalisation process.

The global restructuring has generated strong and growing needs for regional development strategies for peripheral or lagging regions within nations than ever before. Therefore, empowering people at local level is vital. Local governments in Japan, value people and seek public interest in serving local citizens and making strategies for regional development. Their autonomy is constitutionally guaranteed. They also have fiscal health as they have their own revenue sources rather than been dependent on the centre to a large extent.

In Sri Lanka, however, empowering local administration or citizens is quite complicated and sensitive to political regimes as they are keen in empowering the centre rather than the local or periphery. Devolving power to regions as indicated in the 13th amendment to the constitution

and also as recommended by the "Lessons Learnt and Reconciliation Commission (LLRC)" needs comprehensive understanding, given the vision and mission of the current political leaders of the country. However, there is indeed, a strong need, particularly in the post-war conflict, to formulate policies for reconciliation, peace building and development at all levels-local, provincial and national. In short, the current local government in Sri Lanka can be identified as inconsistent, centralized, politicized and as a not so efficient system.

Considering those developmental and reconciliation needs and sensitivity of central-local relations into account, this paper aims: (a) to propose a viable, effective, and autonomous local level administrative unit for the country; (b) to identify the role and functions for the newly proposed administrative unit; and (c) to recommend some revenue sharing policies to finance the activities and functions of the public local administrative unit.

The paper is organised as follows: Following this introduction, Section 2 provides an overview of current public local government system in Sri Lanka. Section 3 attempts to identify a proper public local administrative unit for the country, while Section 4 discusses the functions and financial aspects of local governments in Japan and Sri Lanka. In the final section some policy inferences are drawn.

2. Public Local Administrative System in Sri Lanka: An Overview

The Sri Lankan administrative system consists of 9 provinces, 25 districts, 332 divisional secretariats and over 14,000 villages. Each province has a separately elected unicameral political body called Provincial Council (PC) with a Governor appointed by the

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country's President and Cabinet lead by a Chief Minister. There are 335 Local Government bodies in Sri Lanka which include 23 Municipal Councils (MC), 42 Urban Councils (UC), and 271 Pradeshiya Sabha (PS). The MCs, UCs and PSs function under the supervision of the Provincial Council. Divisional Secretariats are the closest administrative units to local level communities and coordinate village level government officers called Grama Niladari (Village Officers) and the functions of line ministries of the central government. There are also other separate governmental (or agencies with different territorial boundaries) institutions at the divisional level which function under their central or provincial organizations.

Several amendments have been made to the administrative system due to political, socio-economic and cultural reasons. Earlier changes were made due to economic and the political interests while recent changes were mainly introduced due to ethnic reasons. Despite many attempts since the 1950s, the country had no strong desire to introduce a decentralized system of administration until the 1970s (Robert, 1986, p. 163). Political insurrection in 1971 influenced reforms heavily. Divisional Development Councils (DDCs) were introduced immediately after the civil conflict in 1971 aiming to minimize regional unemployment by utilizing available local resources (Ramanie & Bennington, 2002, p. 91). DDCs failed to reach their objectives as they

suffered from many constraints such as weak service delivery, financial and management incapability (Ramanie & Bennington, 2002, p. 92). In 1973, then government introduced District Political Authority (DPA) system with the financial support of the Decentralized Budget (DCB). Under the DPA, a political leadership for local administration was introduced. The new initiative is considered as the first attempt to intrude political leadership to the divisional administration. However, the DPA system was abolished in 1977 and new District Minister (DM) system was introduced. District Minister who was an elected politician from the district as a member of parliament, is supposed to give leadership for the district development activities with the appointed GA and his staff. However, three years later, District Development Councils were established with the legal framework of the District Development Act in 1980.

In 1987, Sri Lankan government introduced 13th amendment to the constitution admitting Provincial Councils (PCs). Under the PC system financial decentralization was introduced expecting a more efficient service delivery at the sub national levels. Other than the provincial development activities, education, health, rural development, maintaining law and some other powers were given to the PCs. However, PS system has no proper co-ordination with the district level structures which function under the national ministries, but PCs were allowed to use Divisional Secretariats for local activities. The supervision of the local governments was also given to PC without degrading the powers given to local governments by the respective laws. Local political and administrative units remained unchanged under the PC system. For a short period of time local governments and divisional secretariats came under the supervision of provincial councils while divisional secretary was working as the secretary to the local government. However, due to various concerns, this system was terminated and divisional secretariats again came under the central government².

The PC system has been criticized due to many administrative failures. First, PCs were unable to co-ordinate different levels of government structures at the district and divisional level. Second, scarcity of financial resources constrained innovative development programmes and maintaining recurrent expenditure. Third, the high degree of centralization restricted the smooth functioning of the PC, as the centre simultaneously maintained central agencies at local level.

3. Towards an Appropriate Public Local Government Unit for Sri Lanka

Sri Lanka has a rather confusing and overlapping local administrative system. The Pradeshiya Sabha (as a local government political entity) functions with its own staff under an elected mayor or chairman while Divisional Secretariat (as an administrative unit) functions separately, implementing general administrative activities with appointed staff by central government. According to the surveys and interviews we undertook in Sri Lanka and Japan, both PS and DS perform social services such as elderly and child care, technical services, some development activities such as rural infrastructure development and maintenance. Some of these activities are overlapping and very often create conflict among local level politicians and administrative institutions. It is clear that an absence of clear demarcation of the responsibilities creates confusion, inefficiency, and coordination failure.

Local health department (MOH), agrarian services department (Govi Jana Sewa Madyasthanaya), police station, and education department (zonal or divisional education department) are functioning separately under the central or provincial governments. We propose, with some adjustments, to bring all those separate bodies into our proposed LAU. This is quite similar to what Japan has currently.

Table 2 shows various distances for basic service delivery of divisional government system in Sri Lanka. Access to the public services in the rural areas and estates is inconvenient when compared with urban areas. Since government offices are located in different places of the division, people need to spend longer time to reach particular government office and get a service done. Travelling to various places for obtaining services, given limited transportation facilities is more difficult for people who are already living in the rural and estate sectors. However, divisional secretariats and local governments (MC, UC, and PS) are located almost close to each other and people can reach to both offices without much difficulty.

It is obvious from the above discussion that there are different levels of local government structures currently functioning in Sri Lanka. Some of them have overlapping geographical boundaries. The number of local governments (PS, UC, and MC) has almost the same number as DSs. This means both organizations have more

or less same territorial boundaries even though they are independent from each other.

It was found that overlapping responsibilities and functions are the most significant characteristic of the service delivery process. The concurrent list of the 13th amendment creates a great opportunity to exercise

Table 1 Public Local Administrative and Other Functional Units in Sri Lanka

Organisation	Number of organisation	Average population per unit	Average land area (square km)
Local governments	335	60,489	195.85
Divisional Secretariats	332	61,035	197.62
Police Stations	401	50,533	163.62
MOH Division	332	61,035	197.62
Agrarian Services	610	33,219	107.56
Zonal Education Offices	67	302,444	979.25

Notes: 335 Local Governments include: 23 Municipal Councils, 42 Urban Councils, and 271 Pradeshiya Sabha. (2)

Source: Adopted from <http://www.statistics.gov.lk>

simultaneous powers to both central and provincial councils (Gunawardena & Lakshman, 2008, p. 123). Since there are no legal barriers for the divisional secretariats, they are implementing some services similar to the local governments. Local level overlapping service provisions are mostly related to welfare and development activities. It is common for both central and provincial governments to use divisional secretariats and local governments for the same activity. It should be noted that current local governments contribute non or little to regional economic development.

Japan has a two tier system-central and local government. The local governments are classified into two types: (a) ordinary local governments (includes 47 Prefectures and 1,788 Municipalities) and (2) special local governments (includes Special ward, Municipal cooperative, Property Ward and Local development corporation). Local administrative units are formed in Japan considering the geographical conditions, population size, degree of centralization of power, and content of the local administrative services. The autonomy of local administrative system is guaranteed by the constitution adopted in 1946, and it functions as a well-established democratic system. Japan's local governments do not simply signify administrative units of the central

government. They are incorporated as independent political and administrative entities within their respective jurisdictions having the responsibility of carrying out constitutionally guaranteed functions related to almost all day-to-day needs of the residents.

From the authors' experiences, field visits, and interviews conducted in Sri Lanka and Japan, and also from extensive literature surveys on other countries, it is possible to identify an appropriate administrative unit for Sri Lanka by combining PS and DS. The proposed Local Administrative Unit (LAU at divisional level) may comprise two branches; legislative branch and an executive branch. Legislative branch is responsible for preparing plans for local development and service delivery, budgeting, and introduction of local ordinance. Elected members (similar to PS system in Sri Lanka) of the local administrative unit fall into this category and they function as public representatives. The number of the councillors is set by the law and it depends on the population size of the area. The chief executive of the LAU, let's call him the Mayor, can be directly elected by the local citizens for a fixed term and should perform as the chief executive of the executive branch implementing policies formulated by the legislative branch. The prospective candidate for the

mayoral position may not submit nomination under any political party representation as it might be difficult for the person to be independent in office once it is supported by a political party.

The current Provincial Council in Sri Lanka has five ministries. In line with this, LAU may also consist five or similar divisions (for example education, health, development, election, information etc.) covering regional development and service delivery. The heads of those divisions are government officers and they perform independently. The current Zonal Director of Education can be the head of the Division (or board) of Education of LAU. The mayor ensures the overall consistency of the governmental operations and holding the power to convince legislature special meetings and sending bill proposals such as draft budgets. The mayor also manages the staff by appointing and dismissing. In order to prevent accumulation of power to a one particular agency or a person, power is devolved to separate committees (created for various functions) allowing each authority to exercise its duties independently. For an example, education committee is holding overall responsibility in handling its own affairs having its own standing. Those administrative committees have been established based on the pluralism and each

handling assigned duties within its jurisdiction. Members of these committees or boards are appointed by the chief executive with the consent of the legislature. Board of education is responsible for managing educational institutes of the division. In Japan, other than the education board, there are several boards for major public services such as public safety, elections, and health.

The link between provincial councils and proposed LAU are mutually independent entities without any hierarchical relationship in terms of administrative functions. Provinces are designated encompassing LAU which provide closest day-to-day needs of the people. However, province set guidelines and advice to

Table 2 Mean Distance to the Nearest Place of Facility by Poverty Status and by Sector - 2006/2007

Place of facility	Sri Lanka		Urban		Rural		Estate	
	Non poor	poor	Non poor	poor	Non poor	poor	Non poor	poor
Bus halt	0.5	0.7	0.1	0.3	0.5	0.7	0.9	1
Pre school	0.5	0.7	0.1	0.3	0.6	0.7	1	0.9
Primary school	1	1.2	0.5	0.8	1.1	1.2	1.2	1.4
M.V/M.M.V./N.S.	2.5	3.5	2.7	1	2.7	3.5	4.7	5
Hospital	6.6	7.7	7.1	3.6	7.1	7.9	9.4	8.8
Maternity Home	5	6.2	5.6	2	5.6	6.5	5.6	5.8
Government dispensary	3.9	5.1	4.3	1.9	4.3	5.2	5.3	5.7
Clinic(Maternity/Infancy)	2.5	3.3	2.6	1.5	2.6	3.3	4.4	4.2
M.O.H. office	6.7	8.9	2.1	2.1	7	8.4	16.5	16.5
M.C./U.C./P.S.	7.3	10.1	2.6	2.8	7.7	9.7	16.7	17.4
Divisional Secretariat	7.5	10.1	3	3.2	7.7	9.3	19.3	19.5
G.N. office	0.7	1	0.5	0.6	0.6	0.9	1.8	1.9
Post Office	1.6	2.2	0.6	0.7	1.6	2.2	3.7	3.6
Bank	3.5	5	1	1.1	3.8	5.2	6	5.7
Agrarian service centre	6.5	7.8	5.2	5.4	6.3	7.1	14.1	14.9

Source: <http://www.statistics.gov.lk/poverty/reportnew-Final.pdf>

municipalities from their perspectives on various issues in order to maintain uniformity within the province. Arrangement can also be made to provide clear division of responsibilities base on the concept that whatever possible should go to the closest institute (municipalities), and if it is not enough, to next the second layer (province) and the finally to the supreme layer (central government) according to the "principle of subsidiarity". However, in practice these institutes execute their responsibilities in a compound nature rather than in an isolated individualistic approach.

4. Functions and Finances of Public Local Government Administration: Lessons from Japan

Having discussed an appropriate local government unit for Sri Lanka in the previous section, an attempt is made in this section to discuss functions and financial aspects of the Japanese local government system with a view to obtain information for the proposed LAU. In Japan the local government system provides clear division of duties between national and local levels. The legal background had been setup by the law aiming to promote decentralization of governmental activities. This act guarantees clear division of responsibilities between national and local level preventing any possible overlaps. While handling the national interests by the central government, local governments are given almost all administrative functions related to their regions with exclusive power to exercise independently and comprehensively. Based on national interests, national policies are formulated by the central government. Moreover, local governments are given responsibilities as much as possible to deliver the services and administration that are much closer to day-to-day needs of the citizen. Main responsibility of local or regional development in Japan, more or less, falls under local administration.

Local governments handle two types of duties; "local autonomy functions" and "statutory entrusted functions". Statutory entrusted functions are referred to the functions that central government retains original

responsibility while local governments having implementation responsibility. Therefore, strong central government intervention can be observed for the statutory entrusted functions. Functions such as maintaining national roads fall under statutory entrusted function and others are fall into local autonomy functions. Responsibilities of municipalities are based on provision of basic public needs. Affaires relating to residents and family registration, town planning and street addresses, public safety and health, waste management, provision of water and welfare facilities such as health insurance schemes, maintaining public places such as parks, public roads, managing elementary and junior high schools are the major responsibilities of the municipalities.

As an independent authority, our proposed LAU can find its own funds to carry out the functions. In this regard, one may look for Japanese experience. Independent financial management is considered as a basic requirement of any organization. Despite close relationship with the central government, Japan's local governments maintain autonomy of fiscal operation within their jurisdiction. Tax autonomy of the local governments provides wider space to organize revenue sources. The concept of fiscal federalism is guaranteed in this system and it is considered as the major requirement for effective decentralization. Following figure shows that the revenue sources and their share of the different layers of governments. In 2006, the revenue of local governments consisted of local tax (39.9%), local allocation tax (17.5%), national treasury disbursements (11.5%), local government bonds (10.5%), and others (20.6%). These data suggest that local governments in Japan enjoy their own income sources and less dependent on central government funds. As national treasury disbursement depends on the financial situation of the local governments, they are given self-controlling discipline over their expenditures. Moreover, this system guarantees the independent operation of the local government activities. On the other hand, overall expenditure of the local governments includes education (18.5%), welfare (18.2%),

civil engineering works (15.5%), public debt payments (14.9%), hygiene (6.2%), industry and commerce (5.3%), agriculture forest and fisheries (4.2%), police (3.8%), fire fighting (2%), labour (.3), and others (1.4%). These figures show that how local governments are performing and their role at the local level (CLAIR, 2008, p. 21).

5. Concluding Remarks and Policy Implications

The paper discussed the local government systems in Sri Lanka and Japan with a view to find out a proper public local government unit for Sri Lanka for better regional development. Based on the discussion, it is obvious that current local governments (PS and DS) in Sri Lanka lack clarity and division of its functions. This paved the way for confusion, inefficiency and conflict situation among regional political leaders and government officials. Considering all the potentials and limitations of the current Sri Lankan and Japanese local government systems, this study proposes to merge PS and DS creating one local administrative unit close to the citizens. The merged unit may be still called Divisional Administrative Unit (DAU) (or any other suitable name), but the geographical area can be same as current DS area. The proposed DAU has executive and legislative branch. Public participation for the local administration and regional development as democratic representation is the base of proposed local administration system. Other than the voting right to elect their representatives, people should enjoy rights of direct participation in local administration and regional development safeguarding rule of law, governance, democratic values, ethnic harmony, and market elements.

Currently, central and provincial governments use existing divisional secretariats as their local agencies, and therefore, one can argue that amalgamation of PS and DS at divisional level seems more appropriate. And also this local focus may be a more viable form of decentralisation than concentrating on district and provincial units, as politicians have deep suspicion of

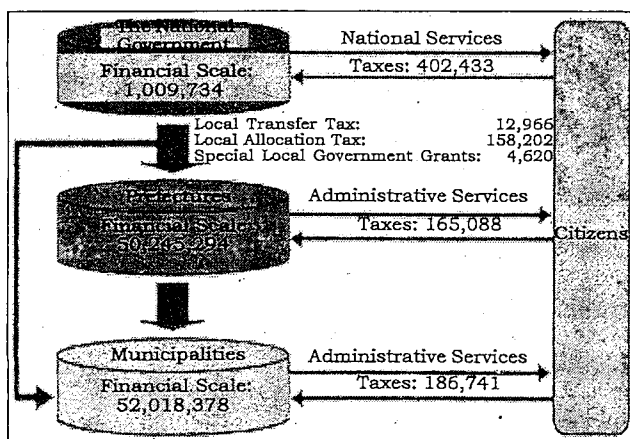


Figure 1 Structure of Local Finance in Japan (2009, Yen 100 Million)

Source: <http://www.metro.tokyo.jp/ENGLISH/PROFILE/overview09.htm>

devolving power to provinces. The current Government Agent, at district level, can be part of the provincial system by being district coordinator of PC. The present activities of the line departments of the central government at various levels may also be absorbed by the proposed LAU and PC.

National politicians and bureaucrats of the central government may think that they should get more resources and power while local level politicians and bureaucrats expect the other way around. The centre believes local administrations are inadequately equipped, less productive, and inefficient. It may also believe devolving autonomy to local levels to handle their own affairs might lead to more corruption at local level. There is also general misperception among some officials that the decentralization effort of provincial councils as a failed system. Proposed

public service should be improved and reforms are in urgent need as current system is too politicised.

Sri Lanka desperately needs regional development, peace and reconciliation with better governance at local, regional and central level. Local citizens have committed consideration and assessment of their needs, and can cater those needs if they are empowered. We believe that proposed local administrative unit plays vital role in empowering local citizen and achieving the above mentioned goals and improving the livelihood of the citizen. One can argue that Mahinda Chinthanaya may not work efficiently unless and until citizens are freed from undue politicisation. This is another approach to empower people at the local level. Considering experiences in Japan and also Sri Lanka, the members of local government council

LAU may face some other challenges also. Majority of bureaucrats who represent various governmental departments at the local level may not wish to work under elected politicians as the process might lead to further politicization of public administration. Instead of political leadership, bureaucrats want to work with capable government officers. Despite all unjustified negative mind-set, it is strongly felt that

may be elected by the people on non-political party basis. Bureaucrats and technocrats at local level are there to help citizens and not to decide on behalf of people.

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Footnotes

¹ Author would like to thank Wilbert Gooneratne and Sirimal Abeyratne for constructive comments given on earlier draft of the paper. However, remaining errors are entirely ours.

² Presiden R. Premadasa introduced this system and later changed as there was some resistance from bureaucrats.

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Entrepreneurship and Global Business Competitiveness in Sri Lanka: Is Sri Lanka Bad?

Abstract

Entrepreneurship facilitates economic development through income generation, innovation, employment, and welfare effects. There are considerable differences across countries in the orientation of entrepreneurial activities and entrepreneurial development. The nature and level of entrepreneurial activities varies depending on factors such as, the relative nature of competitiveness and opportunities for entrepreneurship. The purpose of the paper is to study the nature and the level of competitiveness of Sri Lanka.

In Sri Lankan economic development efforts, there has been no clear major step to promote entrepreneurship. A major constraint to development of entrepreneurship in Sri Lanka is the lack of an enabling environment, caused by many factors including, erratic industrial policies and priorities, market imperfections, weak infrastructure facilities, civil conflict and inappropriate technology. Policy and regulatory environment which facilitate and encourage entrepreneurship growth is of timely importance.

Introduction

Entrepreneurship is one of the most important factors for economic development through income generation, innovation, employment, and welfare effects (Acs and Audretsch 1988; Wennekers and Thurik 1999; Baumol 2002). There are considerable differences across countries in the orientation of entrepreneurial activities and entrepreneurial development (Autio 2007). The purpose of the paper is to study the nature and the level of competitiveness of Sri Lanka.

Sri Lanka has been undertaking as well as implementing liberalised policies to foster the growth of entrepreneurship since 1977, with mixed results. This article will study the comparative advantages of one over the other on various fronts of global competitiveness, alongside critical appraisals of the government's policy initiatives to spur entrepreneurship. As far as the competitiveness is concerned, Global Competitiveness Index (GCI) reports prepared by the World Economic Forum (WEF) are employed as the source of information.

Competitiveness of Environment

World Economic Forum (2010) defines competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country. Porter *et al.* (2002) define competitiveness according to a country's economic development, distinguishing three specific stages: (1) factor-driven stage, (2) efficiency-driven stage and (3) innovation-driven stage; and two transitions between these stages. According to WEF, countries have to step 12 pillars to reach the third stage, the innovation-driven stage. Figure 1 displays the 12 pillars. Determinants driving productivity and competitiveness include physical capital and infrastructure, education and training, technological progress, law and order, macroeconomic stability, good governance, firm sophistication, and market efficiency.

World Economic Forum while preparing its Global Competitiveness Report 2010-11 assumes that in the first stage (i.e. in the factor-driven stage), countries compete, based on their factor endowments- basically unskilled labour and natural resources. The factor-driven countries relay on low cost in the production of commodities or low value-added products.

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The first stage is marked with high rates of non-agricultural self-employment. Small manufacturing firms and service firms are dominant in this stage (Acs *et al.* 2008). Maintaining competitiveness at this stage of development depends primarily on first four pillars: well-functioning public and private institutions (pillar 1), well-developed infrastructure (pillar 2), a stable macroeconomic environment (pillar 3), and a healthy workforce that has received at least a primary education (pillar 4).

To move into the second stage which is the efficiency-driven stage, countries must step up 10 pillars (Figure 1). Countries must increase their production efficiency. In order to increase the production efficiency, countries must have a quality educated and trained labour force and a large market which allow business firms to make use of economies of scale. The efficiency-driven stage is marked by decreasing rates of self-employment (Acs *et al.* 2008) and small units.

There are several reasons for decreasing rates of self-employment and small units when countries reach development stage such as the efficiency-driven stage. Professional 'capital' is more important in advanced countries. As a result of

high professional skills, individuals have different endowments of managerial ability. Consequently, as an economy becomes wealthier, the average firm size should increase as a result of better skilled managers run

entrepreneurial activity predicting a U-shaped relationship between economic development and entrepreneurship. Studies have confirmed this result for most developed countries (Acs et al. 1994,

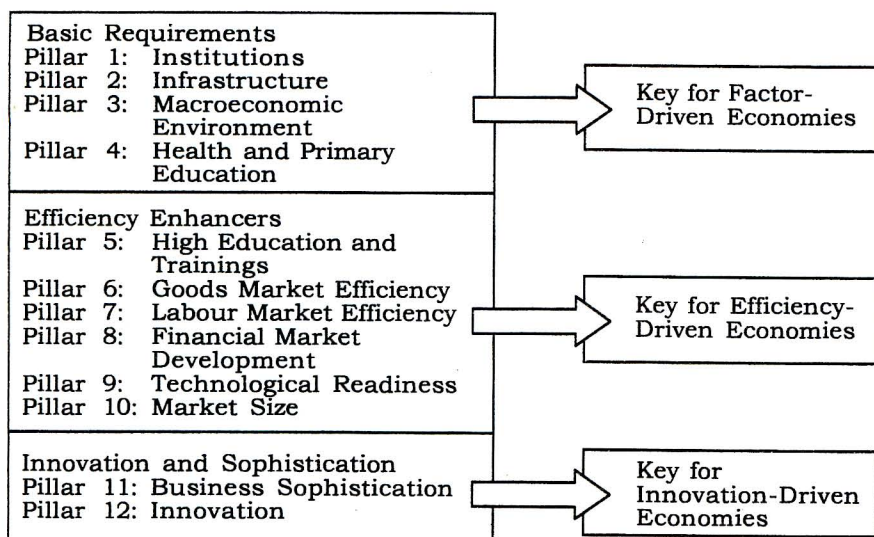


Figure 1 The 12 Pillars of Competitiveness

Source: World Economic Forum (2011), Global Competitiveness Report 2011-2012

the companies. According to this view of economic development, increases in the capital stock (through large scale firms such as private enterprises, direct foreign investment or government ownership) will increase returns to wage work relative to entrepreneurial activity. Accordingly, the relationship between entrepreneurial activity and economic development would be negative. Empirical studies support the view that economic growth in terms of increase the per-capita Gross National Product (GNP) is negatively related to the self-employment rates (Acs et al 1994, Fölster, 2002). The other argument is that improvements in the infrastructure in countries, such as transportation, telecommunications and credit markets, probably increase the advantages of larger firms over smaller firms (Tamvada 2009) through economies of scale. Therefore, the keys for efficiency-driven economies are high education and trainings for human capital development (pillar 5), good market efficiency (pillar 6), labour market efficiency (pillar 7), financial market development (pillar 8), technological readiness (pillar 9) and market size (pillar 10).

However, the innovation-driven stage is marked by an increase in

Evans and Leighton 1989). There are several reasons for this trend. Empirical studies conducted in developed industrialized countries show that the service sector has expanded relative to manufacturing. In general, service firms are smaller on average than manufacturing firms (Premaratne 2002); therefore, economy-wide average firm size may decline. Service firms provide more opportunities for entrepreneurship (Premaratne 2002). In addition, in an economy characterized by higher values of the aggregate elasticity of factor substitution (this is the case with advanced economies), one should expect a higher level of development, more entrepreneurs and smaller firms. In terms of competitiveness, this stage is characterized by innovative business networks ('Clusters') (pillar 11) and innovation (pillar 12).

Entrepreneurship in Sri Lanka: A Review of Government Policies

Since Independence, Sri Lanka has given emphasis to entrepreneurship in its policy stances. However, until the late 1950s, industrialization did not receive high priority due to the high demand for traditional exports

as a result of rubber boom, tea boom and the Korean War during that time. Until late 1950s, since Sri Lanka did not face major economic challenges, it did not identify the importance in implanting entrepreneurship for economic development. However, after this period Sri Lanka faced major economic problems such as unemployment which challenged the policy formulation on developing entrepreneurship. Thus, this led to a policy implementation related to industrialization, import substitution and emergence of large state owned enterprises. The import substitution was encouraged by stances such as high tariffs, and quota restrictions on imports.

In Sri Lanka, policy stances have been based on the government in power at a particular instance. Within this tendency, the government in 1965, introduced a new policy package through the 'White Paper of 1966 on Foreign Investment'. The objective was to attract foreign investment into the industrial sector which expected enhancement of managerial and technological capabilities of the sector. Moreover, a dual exchange rate system was implemented to reduce expenditure on importing inputs. This was to encourage entrepreneurship in the SME sector. Further, Industrial Development Board was established in 1969 for the same purpose.

Irrespective of the high nationalized policy stance in 1970s, in 1977 a radical policy stance was adopted with the opening of the economy. The tariff structure and exchange rate systems were revised in order to facilitate free market policies. The privatization was justified by the philosophy that private sector is the engine of growth.

In 2002, the government formulated a "white paper" to encourage the SME sector as SME sector was identified as to be having significant socio-economic implications. In a market-oriented policy framework, it was identified the need to make the SME sector more globally competitive through a business enabling environment. Thus emphasis was given to areas of finance, technology, access to information and markets, business development services,

linkage formation, infrastructure, legal and regulatory framework, industrial relations and labour, entrepreneurship skills and environment issues. To facilitate this, an SME Authority was established and a SME Bank (which was merged with Lankaputhra Bank in 2008) was set up. Neither the SME authority nor SME bank functions well. As an another attempt, however in 2012 the first branch of the SME Bank affiliated to the People's Bank, was opened at Anuradhapura. As proposed in the 2012 budget, the objective of the SME bank is to extend credit facilities to micro, small and medium scale entrepreneurs in the country at a minimum interest rate in order to develop local private sector. The SME Bank disburses funds on the basis of a simplified, flexible collateral policy and a low rate of interest on credit with a suitable grace period for the repayment.

However, with the change of government in 2005 it ended up only as policy document. The liberalized economic policy continued regardless of the changes in government. For instance, the current government's "Ten Year Horizon Development Framework 2006-2016" has emphasized more on domestic industrial development strategy. In the new policy framework, industrial policy place emphasis on assisting SME, micro enterprises, and self-employment ventures as a part of the shared growth strategy (Department of National Planning 2006). Government interventions focus on creating a sound incentive structure, including incentives for new investments, facilitating access to technology and credit, developing skills and entrepreneurship, maintaining standards and performing regulatory functions among others. Policy uncertainty, as implied, appears to be a major barrier to the entry of new investors.

However, several studies highlighted that economic liberalization did very little in developing the SMEs in Sri Lanka (Lakshman et al 1994, Osmani 1987). Though liberalization has brought about some expansionary motivations for many SMEs to operate competitively into international markets, the incentive structures favoured large enterprise against small

ones, foreign direct investment against local investment and metropolitan regions against rural and regional economies (Abeyratne 2006). Those policy incentives were unable to support local entrepreneurship development. In addition, the Task Force for SME Sector Development Programme (2002) highlighted that despite the liberalized economic policy experience there exists an overly bureaucratic system that often results in unnecessary delays in its deliberations and is excessive costs.

Amid the absence of a policy package directly targeting the SME sector in Sri Lanka, the establishing of industrial estates is one of the major initiatives. Industrial Estates are known by different names such as Export Processing and Promotion Zones. The strategies and initiatives under this consist of the encouragement of foreign private investment, increasing exports for the export oriented industrial development, the establishment of Export Processing Zones, export promotion villages, sub-contracting exchange and small and medium industry credit scheme etc.

'Mahinda Chintana'- Vision Towards a New Sri Lanka: A Ten Year Horizon Development Framework 2006-2016 integrates the positive attributes of market economic policies with the domestic aspirations by providing necessary support to domestic enterprises and foreign investment (Department of National Planning 2006). The Sri Lankan Government focuses on creating an investor friendly environment, limited in its bureaucracy in terms of good governance, and fast in the processing of licences and other requirements through e-Sri Lanka initiatives' (Department of National Budget 2006). Are we creating entrepreneurial friendly environment?

Global Competitiveness of Sri Lanka

In the results of 2007-2008 competitiveness ranking, Sri Lanka places 70th overall global competitiveness. In 2006-2007, Sri Lanka was 81st place. According to the latest GCI ranking (2011-2012), Sri Lanka secures the 52nd position out of 139 countries. The rank was 62 in 2010-2011.

Basic Requirements: Key for Factor-driven Economies

As one considers basic requirements (institutional, infrastructure, macro economy, and health and primary education) for global competitiveness, the Global Competitiveness Report (2007-2008) ranks Sri Lanka in 85th place in the year 2007-2008. Sri Lanka lifted to 73th position in 2010-2011 and secures 65th position in 2011-2012. In terms of institutional requirement under the basic requirements for global competitiveness, Sri Lanka is 68th in global ranking in 2006-2007 while 50th in 2011-2012. Sri Lanka, in terms of infrastructure, macro economy, and health and primary education, places 73rd, 125th and 51st respectively in 2006-2007. In 2011-2012, the picture has been slightly improved by reaching 60th in infrastructure, 116th in macroeconomic environment, and 45th in health and primary education. This reflects, however, a low quality business culture.

When comparing Sri Lanka's rank in GCI in 2008, there is a slight drop in 2009. In 2009, Sri Lanka's rank in GCI is 77th and the country's competitiveness is threatened by certain crucial factors. The competitiveness is threatened by the macroeconomic instability in the country. Moreover, the budget deficit in Sri Lanka is large to the extent that it is one of the countries in the world which has the largest budget deficit. The labour market efficiency and flexibility in the country is low due to high tax rates involved, high firing costs and low participation of females in its labour force. For example, according to GCI 2011-2012, Sri Lanka is in 126th place in the case of women in labour force, ratio to men.

As per 2008-2009 Global Competitiveness Report, Sri Lanka is listed as at its "factor-driven" stage in competitiveness. The three most problematic factors for doing business in Sri Lanka in order are inflation, corruption and tax rates.

In 2009 Sri Lanka ranks 79th in GCI which exhibits a further decline in its competitiveness compared to the previous year. This is owing to the country's reluctance to invest in basic determinants of competitiveness such

as in infrastructure, macroeconomic stability and basic/higher education. To worsen things, the threat of terrorism used to bear heavily on the business community in this period.

In this period, the three most problematic areas against competitiveness in order are, tax regulations, tax rates and access to financing. However, corruption still remains high. If these weaknesses can be rectified, then GCI of Sri Lanka will experience further improvements.

Efficiency Enhancers: Key for Efficiency-driven Economies

According to the graph, it can be observed that there is a considerable improvement in the GCI relative to the previous years. It is stated in Global Competitiveness Report (GCR) that the country is now in the transitioning period from "factor-driven stage" to "efficiency-driven stage" as can be seen in the large improvement in its GCI which can also be proven by its rising level of GDP. The shift to "transition stage" emphasizes on the need to invest more in its efficiency-driven factors. In this year, it is stated that the improvements in GCI is owing to its improvements in the institution pillar, increase in perceived security, efficiency in financial markets and benefits from innovation and business sophistication.

However, certain weaknesses which impede competitiveness still persist. These are namely, increasing levels of debt and deficit, declining savings rate, poor credit ratings in financial markets, labour market rigidities such as high redundancy costs and low level of ICT. These factors also have an impact on productivity which in turn affects the competitiveness of the country.

Technology and technological capabilities are key determinants of overall competitiveness. The access to latest technology is one of the major constraints in Sri Lanka. This results in poor quality of products and high cost of production result in lack of competitiveness in the international markets. Government intervention and the public and private sector partnership in developing technology

appears to be weak in Sri Lanka. Though there are a few institutions offered such services, their services are not 'need driven'.

With regard to macroeconomic environment (rank 116), government maintains a large budget deficit (rank 131). High levels of government debt (rank 126) and a wide interest rate spread (rank 34) indicate the heavy intermediation costs in the country's banking sector, which negatively affect private sector investment and contribute to lower economic growth. The overall dearth of progress in competition and the regulation of competition have also been attributed to the numerous issues faced by Sri Lanka as a developing nation in the midst of an ethnic conflict (Law and Society Trust, and Institute of Policy Studies 2002). However, as positive notes, the country show relatively higher performance on education and health sector (rank 45, health and primary education, and rank 66, higher education and training), though it is lacking in entrepreneurial education, the quality of higher education and research. Reform efforts, including greater private sector involvement in education and dealing with developing entrepreneurial skills, are under way, but the process is likely to be lengthy, interrupted and costly (Law and Society Trust, and Institute of Policy Studies 2002).

With regard to the policy and regulatory environment (rank 32: burden of government regulation),

despite various reforms introduced during the post liberalization period, the level of bureaucracy associated with business-government intervention appears to be high in Sri Lanka (Bernard 2006). According to the World Bank (2007), Doing Business 2008 Report, Sri Lanka is ranked 101 out of 178 economies in 2008 (Sri Lanka is ranked 89 in the 2007), in terms of ease of doing business. Her rank in 2011- 2012 is also the 89th. However, according to Doing Business 2013 Report, Sri Lanka is one of the ten economies in the world that are improving the most in the ease of doing business. In terms of starting a business, Sri Lanka is ranked 29 in 2008. The Starting a Business rank' has fallen down from 35th position in 2011 to 38th position in 2012. The worst scenario is in Dealing with Licences, of which the country is ranked 160 in 2008. In 2012 Sri Lanka is 111th position.

In terms of starting a business, when entrepreneurs draw up a business plan and try to get under way, the first hurdles they face are the procedures required to incorporate and register the new firm before they can legally operate. The process in this regard is largely ad hoc in nature (World Bank 2007).

However, the administrative structure in Sri Lanka is very complex, largely as the result of an incomplete decentralization process. At the local level, District Secretaries and their staff represent the Central Government, followed one level lower

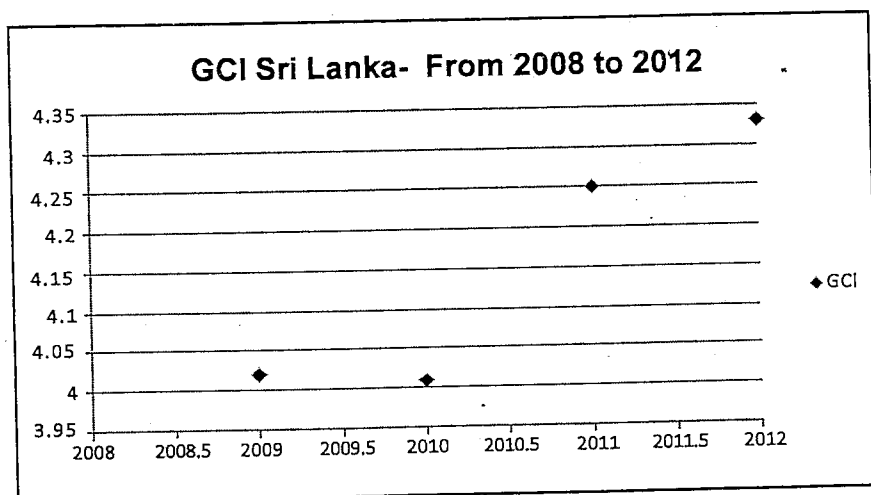


Figure 2 The changes in Global Competitive Index of Sri Lanka from 2008 to 2012

by Divisional Secretaries and further down by Grama Niladharis (the government representative at village level). Central Government agencies may or may not have representatives at the District level. The Provinces are made up of several Districts and are governed by an elected Provincial Council, with its own administration and decentralized budget but no say over the District administration. Elected Municipal councils and Pradesheeya Sabhas report to the Provincial Councils. There are thus two parallel and partly overlapping Government structures. Some "subjects" (such as local roads) are devolved, while others are not. Some are shared. This includes enterprise development generally and SME development in particular, with the result that a large number of agencies engage in enterprise promotion activities at local level, in addition to the national level agencies, in competition rather than coordination. On the side of the private sector, there are a number of Chambers and an Employers Federation at the national level, while most District Chambers of Commerce and Industry and local level business associations are still weak.

There is also no concerted and coordinate policy to enhance the regulatory and institutional environment for development of entrepreneurship (Bernard 2006, Premaratne 2002). Improving the environment for entrepreneurship development is generally not a part of development planning or day-to-day decision-making. The Officers who implement regulations are interested in control rather than facilitation. Those regulations and administrative procedures are outdated (see IDLO 2007). Law and order is another important area to be considered.

The unfavourable environment is partly due to the lack of dialogue among central, provincial and district authorities on the one hand and the private sector on the other. Officials are often ill informed about issues relating to the business environment and strategies to address them. Business Associations are weak and often function as welfare societies. Overall, there is little awareness that closer cooperation and better organisation would be beneficial to the local economy.

With regard to the labour policy, there are more than 48 laws that are related to labour relations in Sri Lanka, which at present are not been codified (LST and IPS 2002). The most stringent of the labour laws is the Termination of Employment Workmen Act of 1971. The origin and the rationale for the Act was the widespread retrenchment in 1971 due to the shortage of raw material for industries, and the problems faced by private industries. These problems essentially derived from the encouragement of state enterprises at the expense of private enterprises. This act removes the right of the employer to lay off and fire workers who have been employed for more than six months for any reason other than serious, well-documented disciplinary problems. This creates labour market rigidities in the market. However, this Act does not come into effect if a company employs fewer than 15 persons. Besides, firms with less than three employees are not liable for social security contributions. Overall, labour market policies in Sri Lanka do not facilitate mobility of labour. There is no encouragement for starting own businesses. Finally, the government has not yet grasped the need for labour market policy reform.

In addition, Sri Lanka has a large number of holidays when compared to other countries. The total number of public holidays per year is estimated at around 30 days (IFC-SEDF 2007). In addition, formal sector firms are required to allow workers 21 days' leave and around 21 days' sick leave a year. Labour unrest leads to the loss of an additional 2.5 days a year and absenteeism to another 3.5 days (World Bank and ADB 2005). These are some of the major contributing factors in reducing the competitiveness of the island internationally. The WEF evaluation highlights the labour market efficiency (7th Pillar). The rank (104th) does not display Sri Lanka's competitiveness in the Global context. Only three indicators are somewhat favourable for Sri Lanka. They are rigidity of employment (rank 48), pay and productivity (rank 40) and reliance on professional management (rank 31).

Enterprise culture at the local level may seem the most intractable aspect of the business environment. Norms,

values and attitudes as they relate to business, i.e. enterprise culture are not favourable for entrepreneurship in Sri Lanka. A range of studies have found a strong cultural bias in favour of public sector employment (Hettige, Mayer and Salih 2004, Ibarguen 2005). If this cannot be obtained, other white collar employment is preferred over own business, which is seen as an option of last resort. The enterprise culture is one of the underlying causes for lower rate of business start-up in Sri Lanka (ILO 2007). Women are generally discouraged from starting a business, or are expected to keep it small, especially in more rural areas. This is owing to factors such as lack of social capital and cultural values such (Reinprecht, and Weeratunga 2006).

Political stability is one of the positive factors in the business environment. Politically, Sri Lanka is now one of the world's most stable countries even though major issues in the Northeast and the South have not yet addressed properly. Nevertheless, policies in Sri Lanka have been changed when even a new minister is appointed. Policy and development decisions are making ad-hoc basis without proper analyses partly owing to changes in the government.

Weak infrastructure (poor roads, frequent power cuts, weak communications) and poor access to infrastructure (rank 61: quality of overall infrastructure) causes production stops and disturbances which has a negative effect on markets access, access to inputs and to information. Most of the businesses particularly SMEs suffer due to the weak infrastructure facilities (Bernard 2006, IFC-SEDF 2007, World Bank-ADB 2005). The availability of electricity for the smooth operation of industries and business enterprises was highly irregular (rank 62: quality of electricity supply). In addition, the unit cost of electricity is high as compared to competing countries. Transport is another bottleneck owing to the low quality of roads (Rank 49: quality of roads). Despite its higher rates, the telecommunications sector (rank 73: fixed telephone line, and rank 96: mobile telephone subscriptions) performs much better than electricity and transport (World Bank-ADB 2005).

Table 1 Twelve Pillars of Global Competitiveness Index: Ranks of Sri Lanka 2011-2012

Basic requirements (Sri Lanka rank 65)		Efficiency enhancer (Sri Lanka Rank 69)		Innovation and sophistication factors (Sri Lanka rank 34)	
1 st pillar	Institutions (rank: 50)	5 th pillar	Higher education and training (rank 66)	11 th pillar	Business sophistication (rank 32)
2 nd pillar	Infrastructure (rank 60)	6 th pillar	Goods market efficiency (rank 41)	12 th pillar	Innovation (rank 42)
3 rd pillar	Macroeconomic environment (rank 116)	7 th pillar	Labour market efficiency (rank 117)		
4 th pillar	Health & primary education (rank 45)	8 th pillar	Financial market development (rank 45)		
		9 th pillar	Technological readiness (rank 85)		
		10 th pillar	Market size (rank 67)		

(Ranks: 40 - quality of railroad infrastructure, 44 - quality of port infrastructure, 62 - quality of air transport infrastructure). All these factors increase the cost of doing business and thus impede competitiveness, which again greatly affect development of entrepreneurship.

Innovation and Sophistication factors: Key for Innovation-driven Economies

Is Sri Lanka an innovation-driven economy? Innovation-driven economies are led by innovation and sophistication factors, in which Sri Lanka is in a good position (rank 34). However, Sri Lanka has weak infrastructure for scientific research and innovation and still not an efficiency-driven economy. Companies and government spend very rarely on research and development. With regard to the innovation, Global Competitive Report in 2007-2008 ranks Sri Lanka in 47th place where as it was in the position of 40 in the year 2010-2011 while it was 42th position in 2011-2012. To identify the level of innovation on global competitiveness, WEF employs indicators such as capacity for innovation (50), quality of scientific research institutions (50), company spending on R&D (37), university-industry collaboration in R&D (73), government's procurement of advanced tech products (15), availability of scientists and engineers (34), and utility patents

granted/million population (77). The parentheses are given respective ranks in 2011-2012.

The fact is that it is very difficult to achieve a strong innovation capacity (pillar 12) without a healthy, well-educated and trained workforce (pillars 4 and 5) that is adept at absorbing new technologies (pillar 9), and without sufficient financing (pillar 8) for R&D or an efficient goods market that makes it possible to take new innovations to market (pillar 6). Therefore, Sri Lanka is still in the transition stage from the stage 1 (the factor-driven stage) to the stage 2 (the efficiency-driven stage). In 2008 Sri Lanka was in the factor-driven stage (Stage 1).

Conclusion

In Sri Lankan economic development efforts, there has been no clear major step to promote entrepreneurship. A major constraint to development of entrepreneurship in Sri Lanka is the lack of an enabling environment, caused mainly by erratic industrial policies and priorities, market imperfections, weak infrastructure facilities, and inappropriate technology.

In conclusion, Sri Lanka must properly plan industrial clusters with the supports from foreign enterprises through sub-contracting linkages, and provide with quality infrastructure facilities if the countries are eager to

develop entrepreneurship. Sri Lanka is also suffering from low level of inclusive growth. Further studies may focus on dynamic patterns of global competitiveness of entrepreneurship in Sri Lanka and how entrepreneurs react to the changes of the competitiveness.

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Poverty in Sri Lanka: Who are Poor and Where are They?

Abstract

Sri Lanka has made considerable progress in reducing poverty during last two to three decades and has already achieved the Millennium Development Goal (MDG) of halving the incidence of Income Poverty, well before the target year 2015, at national level. The achievement of the MDG on poverty is not only at national but also at regional level. However, still there are regional disparities in the incidence of poverty, which needs the attention of the relevant authorities.

It would be necessary to identify regions which are still lagging behind and also the people belonging to certain socio-economic groups, who are still destitute and therefore needs the attention of the State agencies involved in developing strategies to reduce poverty in Sri Lanka. If the poverty levels in Sri Lanka are to be reduced further, the people in all the regions in the country and belonging to different socio-economic groups, should be able to enjoy the benefits of growth.

This paper attempts to identify the poorest groups in Sri Lanka and to identify where majority of them live, which may help the planners and policymakers, when developing and implementing poverty reduction strategies, to help the poor to get out of poverty.

What is Poverty?

Being poor is generally viewed in terms of deprivation of some of the life's basic human needs, such as food, shelter, clothing, safe drinking water, sanitation facilities, basic education, primary health etc.

Different Measures of Poverty

Different Measures are being used to measure poverty. There are two broad classes of methodologies for

estimating poverty: Absolute Poverty and Relative Poverty.

Absolute Poverty: Absolute Poverty is a condition characterized by severe deprivation of basic human needs, including food, safe drinking water, hygienic sanitation facilities, shelter, education, health and information (United Nations, 1995).

Relative Poverty: Relative Poverty could be defined in terms of the position of the person or a household deemed poor, in relation to other individual or households in the community in which they live.

For the purpose of formulating policies for poverty reduction, a poverty line should preferably be "Absolute", especially when welfare measures are being considered (Ravallion, 1994). It is argued that such a poverty line guarantees that the poverty comparisons are consistent so that two individuals with the same level of welfare are treated the same way.

Absolute Poverty Line approach is used in measuring poverty in Sri Lanka, by the Department of Census and Statistics (DCS), as the changes in poverty over time or across regions can be compared easily, when this approach is used. In this approach, a consumption bundle, which includes food items needed to meet the minimum nutritional requirements and other basic needs, is kept fixed. The cost of this fixed basket, which is called the "Basket of Basic Needs", is considered as the "Poverty Line", which varies across time and across regions. In other words, the "Poverty Line" also varies, as the cost of food items and other essentials in the fixed basket varies over time and across regions. For example, the cost of the fixed basket is high in the highly urbanized areas like Colombo, than the total cost of the same basket in a district like Monaragala. As such, the poverty line has higher value in Colombo District than in Monaragala District. The DCS publishes the Poverty Lines at national level, as

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well as district level on a monthly basis, in its official website www.statistics.gov.lk.

The percentages of people below the poverty lines at national level, as well as district level are computed based on "Household Income and Expenditure Surveys (HIES)", conducted by the DCS, around once in five years. The percentage of people below poverty line is usually termed as "Headcount Index" or sometime as "Headcount Ratio", is the percentage of people in poverty. The series of HIES, based on which the incidence of poverty has been computed using the methodology developed in 2004, are HIES-1990/1991, HIES-1995/1996, HIES-2002, HIES-2006/2007 and HIES-2009/2010. The measurements of poverty based of these surveys are consistent as the food and non food items considered in the basic needs basket, explained earlier is kept fixed. It is essential to keep this basket fixed in order to compare the incidence of poverty, over time and across regions. The methodology adopted in measuring poverty is somewhat complex to be described in an article like this, which is meant for the general public. However, the details on the methodological aspects are found in Poverty in Sri Lanka-Issues and Options (Nanayakkara, 2006).

Although some criticise the poverty figures compiled by the DCS, which are based on the Household Income and Expenditure Surveys, the Headcount Index or the percentage of the poor, computed by the DCS is slightly higher than the percentage of poor, computed based on the poverty line used for international

Table 1 Population (%) Below International Income Poverty (US\$1.25 in Purchasing Power Parity Terms Per Day Per Person) and the National Poverty Lines, for Countries in the SAARC Region - 2009

Country in the SAARC Region	Rank of the country based on the Human Development Index (out of 187 countries)	Percentage of Population Below International Income Poverty Line (US\$1.25 per day per person, in purchasing power parity terms)	Population Below National Poverty (Income) Line
Sri Lanka	97	7.0 (2009)	8.9 (2009/10)
Maldives	109	1.5	
India	134	41.6	27.5
Bhutan	141	26.2	23.2
Pakistan	145	22.6	22.3
Bangladesh	146	49.6	40.0
Nepal	157	55.1	30.9
Afghanistan	172	-	36.0

Source: Human Development Report-2011 (UNDP)

comparisons: US\$1.25 per day per person. For example, the percentage of poor, based on the national poverty line was 8.9 in 2009/2010, while the corresponding figure based on the international poverty line (US\$1.25 per day per person) was 7.0.

Although US\$1.25 poverty line could be used to compare the incidence of poverty between the countries, it is not quite appropriate to compare the incidence of poverty between regions within a country. As such, most of the countries have developed their own national and regional poverty lines to compare the poverty situation between regions, within the countries. Most of the countries use Absolute Poverty and the Cost of Basic Needs approach to determine the poverty lines, like in Sri Lanka.

The Table 1 gives the population below international poverty line and the national poverty line, for the countries in the SAARC region. In Sri Lanka, the difference in percentage of population below international poverty line and the national poverty line is marginal. As such, it is reasonable to assume that the percentage of persons in Income Poverty, computed by the DCS, based on the Household Income and

Expenditure Surveys, is consistent with the corresponding figure computed using the international poverty line (US\$1.25 per day per person). Therefore, the poverty estimates of the DCS based on Household Income and Expenditure surveys, using the national and district poverty lines could be used with confidence, to compare the changing status of poverty over time and across regions.

Multidimensional Poverty

In addition to the above mentioned poverty measures, a new innovative index called "Multidimensional Poverty Index (MPI)" has been developed by the United Nations Development Fund (UNDP) and Oxford Poverty and Human Development Initiative. It is a measure of acute poverty, which reveals the combination of deprivations, that batter a household at the same time. The Multidimensional Poverty Index assesses the nature and intensity of poverty (i.e. how many deprivations, poor people experience at the same time) at individual level. The extent of their poverty is measured, based on the extent of their deprivations. It can be used to create a comprehensive picture of the people living in Poverty,

and permits comparisons, both across countries, regions within countries, as well as between various socio economic groups. The "Multidimensional Poverty Index" offers a valuable complement to traditional "Income Poverty". Multidimensional Poverty, is measured using three dimensions: **Health, Education and Standard of Living**. These are measured using ten (10) indicators. Each dimension is equally weighted and each indicator is weighted within each dimension (Human Development Report, 2011, UNDP). The Table 2 gives the three dimensions, the indicators considered under each dimension and the weights assigned to each indicator. If a household is deprived of any of the 10 indicators, given in Table, the corresponding weight is added for that particular household. If the sum of the weights exceeds 3, such households are considered to be in "Multidimensional Poverty". Then all the members in such households are considered to be "Multidimensionally Poor".

Income Poverty Trends since 1990/1991

Based on the Household Income and Expenditure Surveys (HIES) conducted by the Department of Census and Statistics (DCS), since 1990/1991, Sri Lanka has performed well, in terms of reducing poverty. The country has achieved the Millennium Development Goal (MDG) of halving the incidence of Income Poverty at national levels, around 5 years before target year 2015, which is an achievement for a country like Sri Lanka, which had affected by a 30 year long conflict. The incidence of Income Poverty declined from 26.1 percent in 1990/1991 to 8.9 percent in 2009/2010, while the target to be achieved in the year 2015 was 13 percent. Similar achievements are observed in both Urban and Rural sectors, as well. In the urban sector, poverty declined from 16.3 percent in 1990/1991, to 5.3 percent in 2009/2010, reaching the MDG target of halving poverty as early as 2002. In the rural sector, poverty declined from 29.4 to 9.4 percent during the same period. However, rural sector has the highest share of the poor in the country (84.7 percent of total number of poor persons in the country).

Table 2 Multidimensional Poverty - Dimensions, Indicators and Weights Used

Multidimensional Poverty Dimensions	Indicator Number	Multidimensional Poverty Indicators used	Weights Assigned to Each Indicator (equal weights are given to each dimension)	
1. Health	1	The Calorie consumption of the household is less than 80% of the requirement and the food expenditure is more than 60% of total household expenditure	10/3	5/3=1.67
	2	Head of the Household is Chronically ill or disabled		5/3=1.67
2. Education	3	No one in the household has completed five years of schooling	10/3	5/3=1.67
	4	At least one school-age child not enrolled in school		5/3=1.67
3. Living Conditions	5	Household has no electricity	10/3	5/9=0.56
	6	Household has no access to clean drinking water		5/9=0.56
	7	Household has no access to adequate sanitation		5/9=0.56
	8	Household has a dirty floor (mud/dung)		5/9=0.56
	9	Household living in a shanty/ line room		5/9=0.56
	10	Household has no car and does not own one of: radio, TV, telephone, bicycle, or motor bicycle		5/9=0.56

Source: Human Development Report-2011; Sri Lanka Human Development Report-2012

Although the estate sector is still lagging behind, with 11.4 percent in poverty, if the present declining trend continues, this sector will also be able to reach the target before 2015. The share of the poor in estate sector is 6.5 percent, out of the total number of poor in the country.

The number of poor people in Sri Lanka declined from 2.8 million in 2006/2007 to 1.8 million in 2009/2010, showing a reduction of around one million poor people, between 2006/2007 and 2009/2010. However, analysis of the data shows that a large proportion of them are just above the poverty line and therefore they are at risk of slipping back to poverty, due to economic or any other reason. If for example, the poverty line is increased by 10 percent, the percentage below the poverty line increases to 12.8, instead of the estimated 8.9 percent, which amounts to an increase of around 800,000 poor people. This indicates that they are within 10 percent above the poverty line. As such, suitable strategies need to be developed to prevent such near poor highly vulnerable people, from slipping back to poverty. If they are far above the poverty line, the risk of slipping back to poverty will be less.

Regional Disparities

Although Sri Lanka has made considerable overall progress at national level, still there are regional disparities, with some of the regions of the country are still lagging behind (Figure 2). In early 1990s, all the districts in the Southern, Uva and Sabaragamuwa Provinces, Kalutara District in the Western Province and Kandy District in the Central Province, around 30 percent were in poverty. However, all these districts showed a remarkable improvement by 2006/2007, except Nuwara Eliya, Monaragala, Badulla, Ratnapura and Kegalle Districts. In Nuwara Eliya, poverty has increased from 20 percent 1990/91, to 33.8 percent in 2006/2007. In 2006/2007 the worst districts were Nuwara Eliya and Monaragala, with more than 32 percent in poverty. However, by 2009/2010, the poverty situation changed completely, with all the districts except, those in the Northern and Eastern Provinces, achieving the MDG on poverty, around 5 years before the target year 2015. As the poverty estimates for the districts in the Northern and Eastern Provinces are not available for 1990/1991, it is not possible to compare

the estimates available for 2009/2010, with the base year for MDGs (1990/1991). As such, for these districts, it is only possible to monitor the progress from 2009/2010. The Household Income and Expenditure Survey which is being conducted by the Department of Census and Statistics, from July 2012 to June 2013, will be able to show the latest position on poverty, in all the regions. As the latest estimates on poverty are based on HIES-2009/2010, the analysis in this paper is mainly based on this survey.

The HIES-2009/2010 survey covered all three districts in the Eastern Province, and Jaffna and Vavuniya Districts from the Northern Province. The Batticaloa (20.3%) and Jaffna (16.1%) Districts recorded the highest incidence of poverty in 2009/2010. Although these two districts records a higher level of poverty, compared to rest of the country, in 2009/2010, the incidence of poverty in these two districts are much lower than the poverty levels of the two worst districts in 2006/2007: Monaragala (33.2%) and Nuwara Eliya (33.8%). If the present development activities taking place in Northern and Eastern Provinces

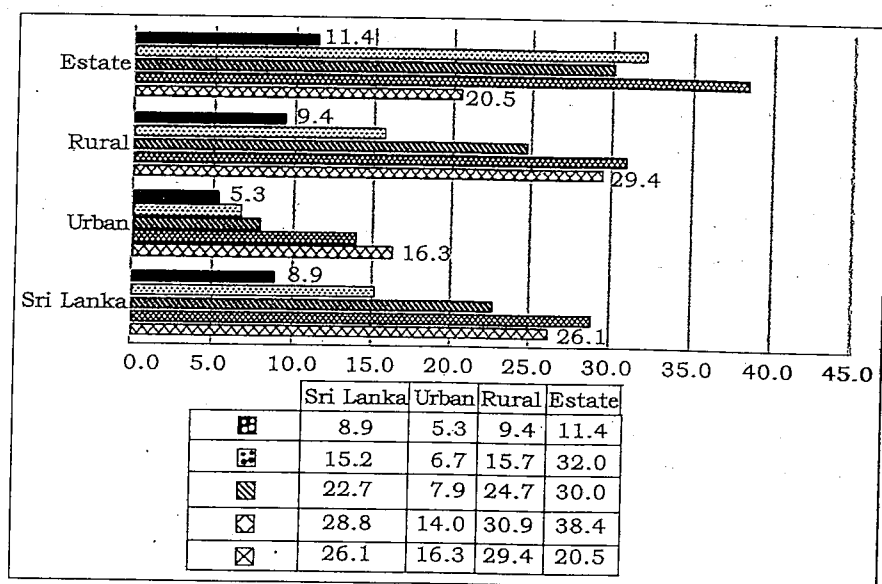


Figure 1 Trends in the Incidence of Income Poverty by Sectors, since 1990/1991

Source: HIES-1990/1991 to HIES-2009/2010, Department of Census and Statistics

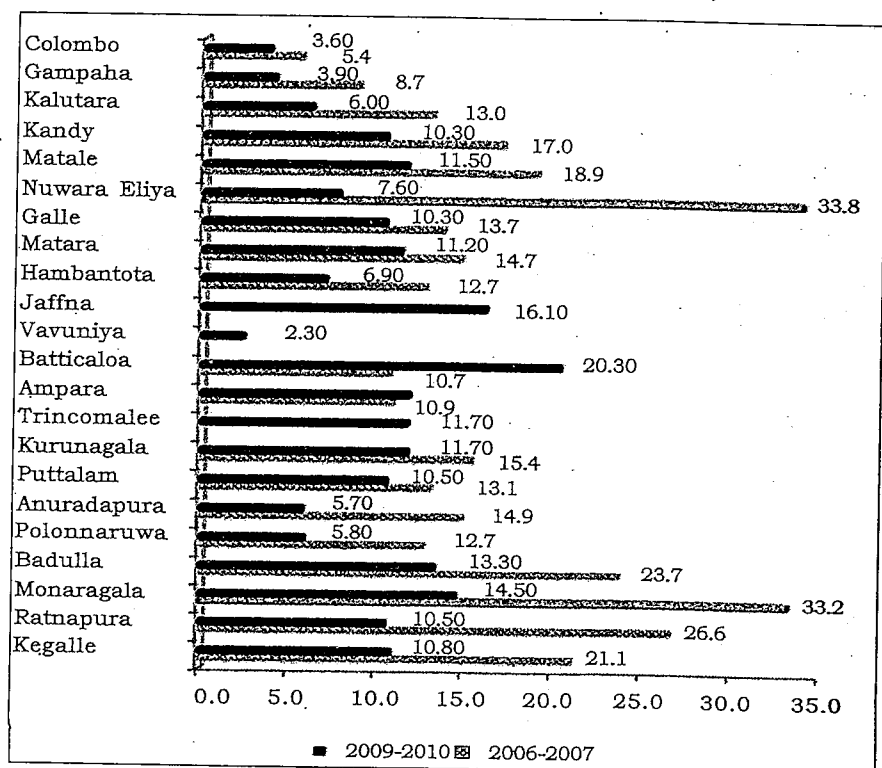


Figure 2 Comparison of Poverty between 2006/2007 and 2009/2010 by Districts

Source: Household Income and Expenditure Survey 2006/2007 and 2009/2010m DCS

continue without any interruption and the services to the people are improved further, poverty levels in the districts in these two Provinces, may also decline rapidly, like in the case of Monaragala and Nuwara Eliya Districts, which showed a rapid

reduction in poverty levels between 2006/2007 and 2009/2010.

Who are Poor in Sri Lanka

To identify the poorer groups in Sri Lankan society, the sample

households in the Household Income and Expenditure Survey- 2009/2010, were classified into 11 Socio-economic Groups, based on the main occupation category of the Head of the Household or his/her activity.

The households headed by 1. Administrators, Senior Officials & Professionals; 2. Technicians & Associated Professionals; 3. Clerical, Services, Sales & Similar Workers; 4. Skilled Agricultural, Forestry & Fishery Workers; 5. Craft & related trade workers, plant & machine operators, etc.; 6. Non Agricultural Labourers & similar workers; and 7. Agriculture, Forestry and Fishery Labourers), were considered, as the Socio-economic Groups with employed heads of household. The other Socio-economic Groups are those with the head of the household is either "an unemployed person", "a household worker", "a person who is not able to work or too old to work" or "a person whose occupation is not properly specified". Any member in a household belonging to the eleven Socio-economic Groups, as classified above, is considered to be in that particular Socio-economic Group. It is also possible to consider main income earner of the household, instead of the head of the household. However, the following analysis is based on the occupation or the activity of the head of household.

Based on the above classification, it is possible to identify the poorest socio-economic groups in the country. The Figure 3, shows that the Income Poverty is highest among the households headed by the "Non Agricultural Labourers and similar workers" (18.1%), followed by "Agricultural, Forestry and Fishery Labourers" (15.0%). The other Socio-economic groups with significantly high poverty levels, are the groups in which the head of the household is "unemployed" (10.5 %); "Skilled Agriculture, Forestry and Fishery Worker" (10.1 %); and those headed by persons who are "Unable or too old to work" (9.7 percent).

The Socio-economic Groups with high percentage of people in Multidimensional Poverty (or acute poverty), also show a similar pattern, with households headed by "Non Agricultural Labourers and Similar

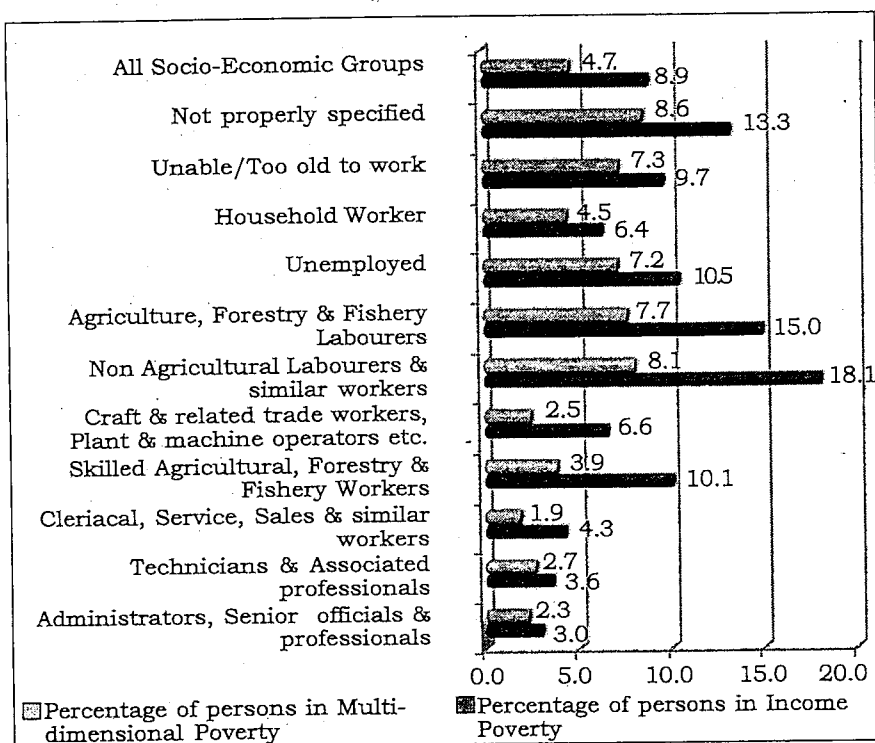


Figure 3 Comparison of Income Poverty and Multidimensional Poverty by Socio-economic Groups -2009/2010

Note: In the above chart: Socio-economic Groups are based on the Occupation or Activity of the Head of the Household and the percentages are the "Percentages of poor persons" (or the Poverty Headcount Index) within each Socio-economic Group

Workers" recording the highest percentage in acute poverty (8.1%). The other Socio-economic Groups with higher level of Multidimensional Poverty are those headed by persons who are **"Agricultural, Forestry & Fishery Labourers"** (7.7%), followed by households headed by persons **"Unable or too old to work"** (7.3%).

Nearly one fourth (23.6%) of the people in Income Poverty are living in households headed by **"Non Agricultural Labourers & Similar Workers"**. Around another one fifth (19.4%) of the "Income Poor" are in households headed by **"Skilled Agricultural, Forestry and Fishery Workers"**. Another nearly 18 percent, are headed by persons who are **"Unable to work or too old to work"**. As such, these three Socio-economic Groups accounts for more than 60 percent of the "Income Poor" in the country.

The share of the people in Multidimensional Poverty (or in acute poverty) also show a similar pattern, with the people in the same three

Socio-economic Groups having the highest percentage in multidimensional poverty: the households headed by people who are **"Unable to work or too old to work"**, leading with 25.4 percent of the total number of persons in Multidimensional Poverty. The people in household headed by **"Non agricultural Labourers and Similar Workers"**, accounts for 20 percent and those living in households headed by **"Skilled Agriculture, Forestry and Fishery Workers"** accounts for 14.1 percent of the people in Multidimensional Poverty in Sri Lanka. Like in the case of "Income Poverty", "Multidimensional Poverty" also has the highest contribution from these three Socio-economic Groups.

In Sri Lanka, the percentage of people in Multidimensional Poverty, is lower than the percentage in Income Poverty. In 2009/2010, there were 1,806,000 people (or 8.9 percent) in Income Poverty, while the estimated figure in Multidimensional Poverty, was 957,000 (or 4.7 percent). This shows that while 1.8 million people

were in income poverty, nearly one million were in acute poverty.

As already explained, Multidimensional Poverty is measured considering, Health, Education and Living Conditions, as the dimensions. The analysis based on Household Income and Expenditure Survey-2009/2010, shows that the contribution to deprivation due to **Health dimension**, experienced by the average Multidimensionally Poor persons, is as high as 53 percent, while the contribution from **Education dimension** is 12 percent and from the dimension of **Living Conditions** 35 percent (Sri Lanka Human Development Report-2012). The two indicators measuring the **Health Dimension** where, (i) **Nutrition:** The household not receiving at least 80 percent of the calorie requirement, although they spend more than 60 percent of the total expenditure, on food; (ii) **Head of the household is chronically ill or disabled.** In acutely poor households (or Multidimensionally poor households) the contribution to deprivation from the nutrition factor was 25 percent and due to disability or chronic illnesses of the head of the household was 28 percent. This clearly indicates that the **chronic illnesses or disability of the head of the household and inadequate nutrition**, are the two major contributory factors to acute poverty in Sri Lanka. When the head of the household is chronically ill or disabled, the entire family is affected. As such, acutely poor households headed by chronically ill or disabled persons, need attention.

Summary

- Sri Lanka has made considerable progress in reducing poverty, achieving the Millennium Development Goal (MDG) of halving the incidence of poverty (compared to the incidence of poverty in 1990) at national level, five years before the target year 2015. However, still there are regional disparities, which needs attention.
- Some argue that the poverty figures, based on the national and regional poverty lines computed by the Department of Census and

Contd. on page 66

National Defence and its impact on Economic Development: The case of Sri Lanka

1. Introduction

National defence is the main component of national security structure of a country. The main objective of national security is to protect national interest, sovereignty and the territorial integrity of the respective nation. National security includes military services, paramilitary services, police, private security mechanisms and other security related institutions. National defence and national security are two different terms. In many countries, military services that focus on external threats are identified as national defence and other security mechanisms are identified as homeland security which deals with domestic conflicts and other disputes and provides the security in the given specific area of national security (for example coastal guard service). In these countries the police is a separate civilian institution and plays a complementary role in providing the security to the nation. Example, USA. There are certain other countries where military service is combined with other security mechanisms depending on the requirement. All such defence structures are called national defence which holds the responsibility of dealing with both external and domestic threats. Example, Sri Lanka. In the case of Sri Lanka, national defence holds the responsibility of the security of the nation from both domestic and external threat.

In Sri Lanka, except in 2002 and 2003, in all the other years the military service (the armed forces), police and other paramilitary services have been under the Ministry of Defence. Further, in the case of Sri Lanka, depending on the importance, certain portfolios in the civilian sector are also assigned to the Ministry of Defence. For example Department of Registration of Persons, Department of Immigration and Emigration in the

1970s, Department of Civil Aviation, Department of Urban Development and the Department of Coast Conservation in the post 2009 years are such civilian sectors that have been brought under national defence. Yet, Military service is the major component of national defence. Unlike that of in many other countries, national defence in Sri Lanka needs to be considered differently from that of other countries. Firstly, it includes substantial civilian departments and secondly, all the departments and institutions under national defence are either directly or indirectly connected to national security of the country. This has transpired as such due to the specific socio-economic and political conditions that have historically developed in the society. Therefore, here in this study of national defence it addresses the armed forces, Sri Lanka Police, paramilitary services such as homeland security and coastal guard services that are responsible for national interest, sovereignty and territorial integrity of Sri Lanka. However, the analysis in this study is applicable for other countries as well because as far as the national security of those nations are concerned; the institutions coming under national defence of Sri Lanka hold a greater responsibility than others.

2. Gross Domestic Product (GDP) and National Defence as a Public Good

The original concern with respect to national defence as a public good can be traced by going back

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to the 'social contract' theory which explains the origin of the State/government (Hobbes 1651¹; Rousseau² 1762; Wolff 1998). The social contract theory says that people surrendered a certain part of their freedom to the government in reciprocation of what the government does for the protection of their individual freedom (Hobbes 1651). The government is strengthened by the surrendered freedom of the people that was referred in the social contract/agreement. It is believed that political structures and the legitimacy of the State are derived from an (explicit or implicit) agreement by individual human beings to surrender (some or all of) their individual rights in order to secure the protection and stability of an effective social organization or government. Distinct versions of social contract theory were proposed by Hobbes (1651), Locke (1690), Rousseau (1762), and Rawls (1971).³

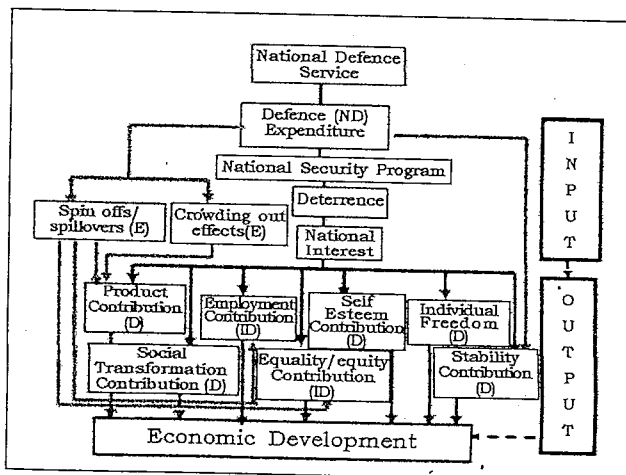


Figure 1 National Defence and Economic Development

Source: Jayawardena, 2011

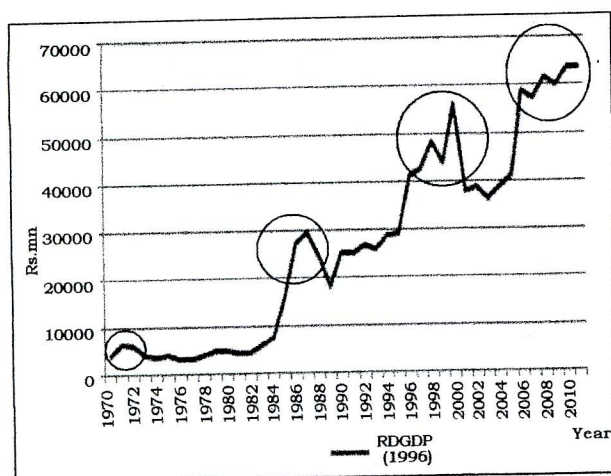


Figure 2 Real Defence GDP (RDGDP) and its Changes Over Time

Source: 1. Central Bank of Sri Lanka Annual Reports
2. General Treasury Annual Estimates

Note: Assumed that the contribution by national defence equals its expenditure

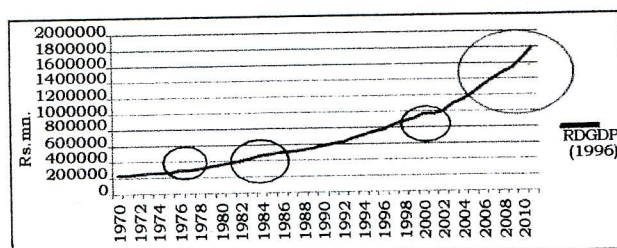


Figure 3 The Real GDP and its Changes Over Time.

Sources: Central Bank of Sri Lanka Annual Reports

In an economy the public sector is just like a private company, producing and supplying goods and services for the public. Here, the main difference is that the private sector supplies the goods and services at market price whereas the public sector supplies commodities either free of charge or at nominal prices. Under these circumstances, the value of public sector production cannot be measured at value added method or at the market price method. In this situation, the value of goods and services produced by the public sector is measured at cost prices and assumes that the value of public sector production is at least equal to its expenditure. That is why according to the theory of national income, the value of national production of an economy is explained as

$$Y = C + I + G + (X - M) \quad (Y =$$

National Income, C = Private Consumption, I = Private Investment, G = Government Expenditure, X = Exports, M = Imports). The value of national defence as a public good is included here as " G " that denotes government expenditure. According to this, the contribution by national defence to the economy is equal to its annual expenditure (Jayawardena, 2011).

3. National Defence and Economic Development of Sri Lanka

The surface picture of national defence and its relationship indicates either an alienation from national production or a negative relationship between the expansion of national defence and the economy. Yet, the theoretical analysis of national

defence as a public good and the underlying dimensions of national defence that can be witnessed from detailed analysis of such relationships indicate that it plays an important role in economic development of a country. In the context of Sri Lanka national defence as a public good absorbs significant amount of resources in the economy and therefore, national defence and economic development are closely associated with each other. The natures of national defence as a public good, its extent and prominence against the challenges and its role in Sri Lanka have evolved with the time. These changes are significantly related to the types of regimes in history. However, as national defence is theoretically linked with the government under the social contract the underlying theme that is the protection of

national interest, sovereignty and the territorial integrity of the nation remains unchanged (Jayawardena, 2011).

3.1 Role of National Defence as a Final Public Good in the Economy of Sri Lanka

National defence as a public good absorbs substantial amount of resources (see Figure 5) and therefore, it needs to deliver the returns for such expenditure back to the public and enhance the level of welfare of the people⁴. As identified in the conceptual framework (see Figure 1), the contributions of national defence plays a dual role as a public good (Jayawardena, 2011). Firstly, it plays the primary role as a final good and contributes through the deterrent programs and controls threats against the country's sovereignty and protects individual freedoms that contribute to enhancing self esteem while allowing the society a smooth transformation which is part and parcel of individual and collective development. This is the primary direct contribution of national defence. It is assumed to be equal to the expenditure on national defence (See section 2). However, in reality, it can be either less or more than its expenditure, because the deliveries of national defence towards GDP are dependent on the effectiveness and efficiency that is based on the current and forward defence policies. In the 1970s, the JVP insurgency was under control and peace was re-established to the country and therefore, the contribution made by national defence as a final good in this period was greater than its expenditure. However, as far as the long run is concerned national defences' contribution to the economy could not be maintained due to the failure in forward defence policies and therefore, as far as the long run is concerned, national security and sovereignty in the 1980s were under threat and therefore, there had been severe interruptions of for the individual freedoms, self esteem and social transformation of the society. Therefore, it can be argued that the primary direct contribution of national defence, until 2009 had been to a moderated level, despite its short run achievements in the 1970s, 1986, 1987 and 1996 to 1999⁵. In 1986 and

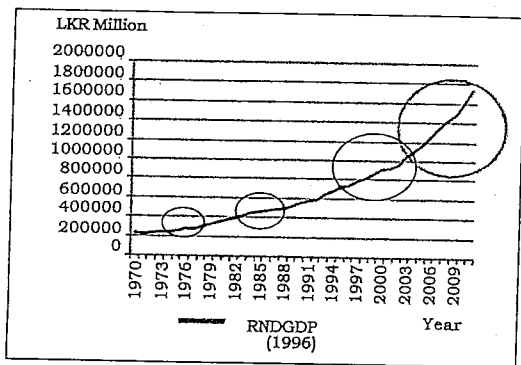


Figure 4 The Real Non-Defence GDP and Its Changes Over Time

Source: 1. Central Bank of Sri Lanka Annual Reports
2. General Treasury Annual Estimates

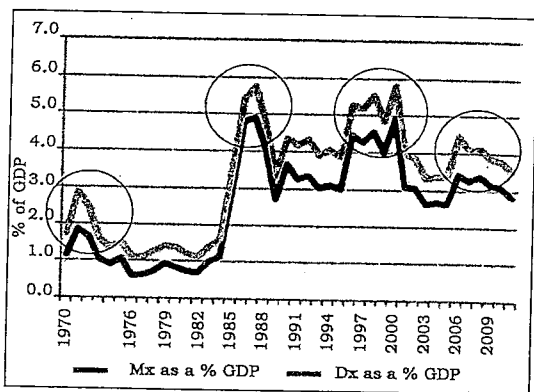


Figure 5 Defence and Military Expenditure as a Percentage of GDP

Note: MX - Military Expenditure
DX - Defence Expenditure

Sources: 1. Central Bank of Sri Lanka Annual Reports
2. General Treasury Annual Estimates

government. Therefore, according to the analysis, until 2009, the primary direct contribution of national defence has been effective and contributed only up to a moderated level (see Figure 2) to Real GDP and its changes over time. Further, we can argue that since 2006 onwards national defence has been effective as it has been able to defeat LTTE totally and maintains national security, national interest, sovereignty and the territorial integrity of the country (see Figure 2 and compare the GDP with less variation at moderately higher level). During the periods in which national defence has been effective in accomplishing its missions, the contribution by national defence has been greater than its expenditure that was accounted for in the GDP. Therefore, we can argue that the welfare level determined by per capita GDP, individual freedom, self esteem is more than what is depicted by GDP since 2009. However, we cannot take for granted on how long this increasing level of welfare can be sustained as it depends on the effectiveness and efficiency of national defence that is supported by forward national defence policies of the country. In this aspect research and development of national defence needs to be maintained dynamically.

3.2 Role of National Defence as an Intermediate Public Good in the Economy of Sri Lanka

Apart from the contribution of national defence as a final good, it also contributes as an intermediate good. According to the theory of determination of national income, intermediate goods are not accounted as such contributions are already included in the final goods and services. However, national defence as an intermediate good is important in creating necessary conditions to produce non defence goods and services in the economy. If there is

no political stability, the conditions for production are not conducive and as a consequence, the production function may place below the potential level. In other words, if there is no peace in the country factor mobility and other conducive atmosphere can be affected and thereby, factor productivity can be declined. The significant lower growth rate in 1971 and the negative growth rate (-1.5) in GDP in 2001 are clear example for such failure of national defence as an intermediate good. According to Figure 4 real non defence GDP except 1971 and 2001 has been increased, if we ignored the short term setbacks in certain periods. Among the factors that affected the increase in GDP, the expansion of national defence as a public good and its role as an intermediate good has been an important factor.

3.3 Indirect Effects of Increase in National Defence Expenditure on the Economy of Sri Lanka

In the context of Sri Lanka as a developing country the indirect effects that include both negative and positive effects also influence national production. As shown in the conceptual framework, the identified "crowding out effects"⁷ and trade off effects generate negative impact on GDP where as the "spin offs" and "spillovers", contribute to enhancing equity and improving the employment level of the economy (Benoit,1973; Benoit,1978). The expansion of national defence as shown in the Figure 2, defence expenditure as a share of GDP has been at a higher level and therefore, the crowding out effect, spillovers, spinoffs are also similarly increased.

3.3 - 1 Indirect Negative Effects of Increase in National Defence Expenditure

Here, the crowding out effect is one of the negative indirect effects of the expansion of national defence (see Figure 1). Increase in defence expenditure increases the budget deficit and affects on the interest rate in the lending market and affects on the investment of the respective country (Smith, 1980). According to the Figure 5 and Figure 6, there is a close association between the increase of defence expenditure and

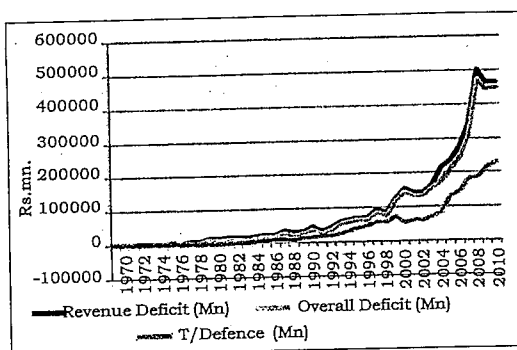


Figure 6 Defence Expenditure and Budget Deficits¹ (Values in Mn)

Source: 1. Central Bank of Sri Lanka Annual Reports
2. General Treasury Annual Estimates

the budget deficits. The increase in budget deficit pushes the government to increase its borrowings. The increase in borrowings lead to increase the interest rate in the money market and subsequently the investment will be declined. Figures 5, 6 and 7 indicate such relationships. Therefore, we can argue that the increase in defence expenditure has crowded out a certain level investment that lead to a negative effect on GDP. During the years of with high defence expenditure has led for higher interest rate in the lending market and reduction of investment in the respective years/consecutive years subsequently. See the changes marked in black thin line in Figure 8, with that of the circles of Figures 5, 6 and 7.

According to Figure 8 the ash lines indicate comparatively higher interest rate which may be an outcome of increasing government borrowing whereas the black line indicates lower interest rate which could be an outcome of a comparatively less burden or relief for the government as far as government expenditure is concerned. On the other hand in Figure 7 the circles indicate selected drops in investment that may be a result of high interest rate in the lending market. Accordingly, the interest rate in 1995 and 1996 was at a higher rate and as a consequence the investment reported low. Similar drop in investment can be observed at the end of the 1990s and in 2007 and 2008. The changes in the interest rate and the drop in investment could

have been associated with other factors other than the increase in defence expenditure. Yet, the drastic increase in defence expenditure is one of the main reasons for the drop in investment either in the respective years or in the immediately following years:

The increase in defence expenditure also has trade off effects on non defence activities in the economy and can affect GDP growth rate followed by economic growth and development unfavourably as these non-defence expenditures are more closely associated with economic growth and development than the defence services. Figure 9 indicates that in the years with an increase in defence expenditure there is a reduction in non defence services in the economy. The reduction in non defence services affect economic growth and development because these non defence services are closely associated with economic growth and development than the defence services.

Another negative impact of the expansion of national defence is inflation followed by monetary expansion and the increase of aggregate demand due to the acceleration of the size of national defence. Figure 10 shows that the increase in real defence expenditure would increase the inflation either in the particular year or in the following year/s. compare the small black thin circles with that of the black thick circles. Similar relationships can be observed with respect to the decline in real defence expenditure and the decline in inflation.

3.3 - 2 The Damage to Human Lives and Environment during Military Operations

In a situation where there is an increasing threat on national security, national interest sovereignty and the territorial integrity of a country, there is a need of

generate a substantial deterrent. In such conditions, increase in defence expenditure is unavoidable as the defence industry needs substantial increase of its man power military equipments, ammunitions and other inputs that are used in operations under security programs. In military operations economic factors are alienated as the effectiveness of military operations is a necessary condition in accomplishing the missions. The extensive operations especially offensive operations create conditions for more damage on human lives and resources. Under the increasing threat to national security, this particular damage is unavoidable. In the case of Sri Lanka, during the JVP insurgency in 1971, initially police and troops were massacred with a massive threat on national security. In the retaliations thousands of (over 12,000) rebel died (Bandarage 2008: 56-57). During the 2nd JVP insurgency that is connected to the North and East war, it is estimated that over 40,000 died (Bandarage, 2008). The total number of people who died due to North and East war is over 100,000 (UN Estimation). Unconfirmed sources reveal that the number of LTTE and the armed force members together died in the war was over 50,000. Apart from the homicide victims number people injured and disabled were also substantial. Further, among those who were killed by the militants, there are national leader as well as regional leader that cost the nation as well as the region. A similar loss of lives has been caused in the militants' side as well. In the analysis of nation's

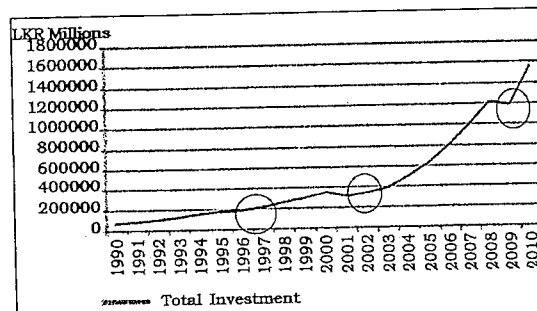


Figure 7 The Total Investment and its Change Over Time

Source: 1. Central Bank of Sri Lanka Annual Reports
2. General Treasury Annual Estimates

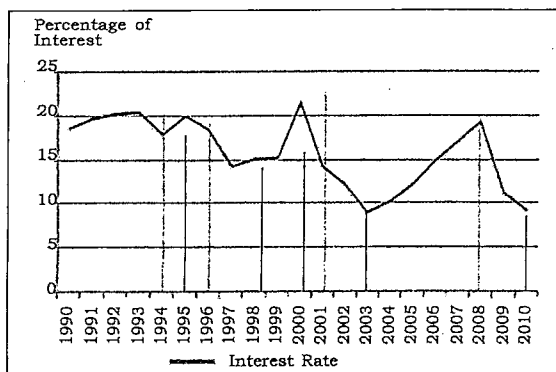


Figure 8 Lending Market Interest Rate

Source: 1. Central Bank of Sri Lanka Annual Reports
2. General Treasury Annual Estimates

defence and its impact on the economy we need to address such cost on human lives. However, in a scenario where the country's national security, national interest, sovereignty and the territorial integrity are under threat this cost is going to be inevitable and without these operations the country could have been vulnerable as a nation and could cost more than that which has been incurred at present. In the context of the Sri Lankan case some argue that if there had been no such role of national defence, Sri Lanka could have been another "Israel" and the region could have been another "Middle East" that interrupts the peace of individual countries, region and the world. Yet, if national defence had been effective in a consistent manner right from the initial stage, the number of homicide victims and the damage to the society could have been minimized and national defence as a public good could have been more productive.

3.3 - 3 Indirect Positive Effects of Increase in Defence Expenditure

In spite of these negative impacts of the above indirect effects of the expansion of national defence on economic growth and development, there are positive indirect effects on economic growth and development. Among them, Keynesian effect is important (Wijeweera and Webb, 2009). As a developing country, the expansion of defence generates a Keynesian effect and expands national income as the increase in government expenditure expands the

market size and enhances the supply side. This particular impact becomes significant mainly because in the context of Sri Lanka as country of labour intensive military industry, 40- 50 percent of the defence expenditure goes to the labour force as salaries and wages (Arunatilake, Jayasuriya, & Kelegama, 2000). These expenditures go back to the local market as consumption expenditure with an expansion of aggregate demand that induce the national production and finally benefit the economy. As a country with under employment, the benefits of Keynesian impact are significant. The increase in aggregate consumption during the war period as depicted in Figure 10 and 11, given below might have originated from the increase in defence expenditure (refer to the circled areas of the diagrams).

In the developing countries, the socio- economic disparity in society is greater, and therefore, the lower stratum of the population is ready to take more risks than the upper strata of the society. In the case of Sri Lanka, during the period of war, employment opportunities were more in the defence sector with a higher offer due to the life risk in the intensive operations, and therefore, the demand for employment in the defence industry was significant in the general labour market. On the contrary, the traditional labour

supply source in the population had been witnessing a reluctance to respond to this increasing demand in the defence industry due to the increasing life threat. In this environment, the lower strata of the population in the poverty ridden areas of the island received more jobs in the defence industry and received higher salaries compared to their normal job opportunities in the respective villages depending on their qualifications. Under these conditions, expansion of national defence has increased the level of employment and the consumption capabilities in the rural sector in Sri Lanka. These expansions also created more trickle down effects in the respective areas. Therefore, the Keynesian effects of the expansion of national defence have become more meaningful as it brings down the regional disparities while enhancing equity level of the society (Jayawardena, 2009). One can argue that the favourable changes in the Gini Co-efficient; during the last 20 years has been an outcome of the extensive employment opportunities in the defence forces for the rural sector as less income earning

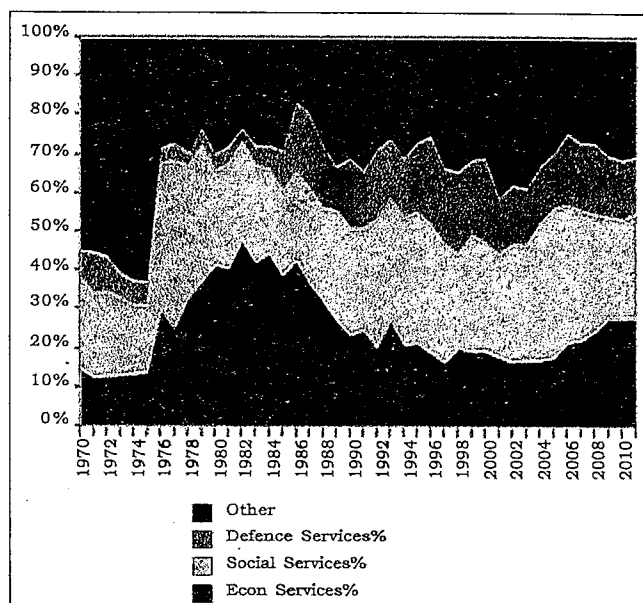


Figure 9 Comparison of Defence Expenditure with other Government Expenditures

Sources: 1. Economic Progress of Independent Sri Lanka, Economic and Social statistics of Sri Lanka 2006 and 2011, Central Bank of Sri Lanka
2. Annual Estimates, General Treasury of Sri Lanka

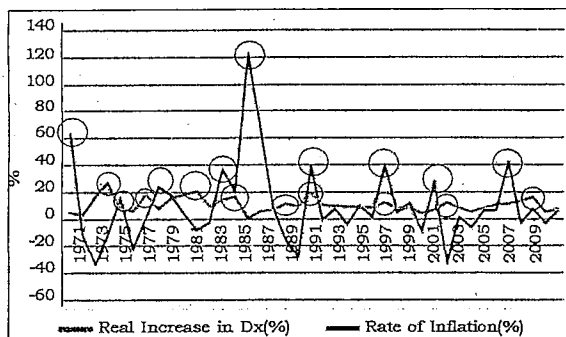


Figure 10 Rate of Inflation (Base year 1996) and the percentage of the increase of real Defence Expenditure

Source: 1. Central Bank of Sri Lanka Annual Reports
2. General Treasury Annual Estimates

population. For example in 1981/1982 Gini Co-efficient was 0.52 and it has declined up to 0.36 in 2009/2010 (Central Bank of Sri Lanka).

The employment opportunities in the defence sector have immensely contributed to the reduction of unemployment of a country (Dunne, Smith 1990; Dunne, Nikolaidoua, & Vougas, 2001). The expansion of Sri Lanka armed forces and Police during the last 30 years have created employment opportunities and therefore, the unemployment rate in Sri Lanka has reduced from over 15 percent to about less than 5 percent during the last 30 years (refer to area denoted by the circle in Figure 13). It is true that other factors also may have affected the decline of unemployment. Yet, as a source of employment during the last thirty years, the defence sector has played an important role (Jayawardena, 2010). The contribution by national defence had been crucial as the defence sector provides employment opportunities for unskilled labour that have less demand in the labour market. The unemployment of this category of population could have created problems due to the political sensitivity of such unemployment, and could have created other socio-economic and political tension that could cost the society, if they were not provided such employment. Therefore, national defence's contribution to employment of 25,000 - 40,000 in the armed forces to about more than 300,000 - 400,000 as

direct employment since the 1980s to 2009 has been a significant positive contribution to the economy.

The contribution may be further encouraging when one considers the numerous indirect employment opportunities in the non defence industries that linked with supply of needs of the defence industry. Further as far as the demobilization of the prematurely retired armed forces in the non defence sectors of both private and government sectors are concerned, labour force of the defence industry is an

economical source of employment for semi skill labour in the non defence sector of the economy. In the post war era also it has been identified that the labour force in the defence sector can be deployed in the production sectors where there are difficulties in maintaining the effectiveness and efficiency. Example: deployment of armed forces in the post war construction and reconstruction of economic infrastructure in the North and East. Thus the labour force in the defence industry contributed to the economy both directly and indirectly.

4. Summary and Conclusion

National security and national defence are closely associated with each other. National security is an umbrella term in which national defence is included. In the context of Sri Lanka, national defence includes the armed forces, Para military forces (e.g. civil security force, coastal guard service), Sri Lanka Police, as Sri Lanka is mainly focuses on internal threats that linked with regional factors and global factors. Prior to 1971

insurgency, national defence has been below 1 percent of GDP and less than 5 percent of government expenditure. This was increased marginally along with the 1971 insurgency and then it increased drastically with the Tamil separatist threat in 1980s. Thereafter, until the defeat of the LTTE the defence expenditure has been over 4 percent of GDP and about 15 percent of all government expenditure. The conceptual framework shown in Figure 1 has addressed all the linkages of national defence in an economy and has analysed each such relationship in the context of Sri Lanka. Here, the contributions of national defence is firstly, identified as direct, indirect and externalities, and secondly, it is identified as primary direct effects as a final good and then secondary direct effects as an intermediate good and then the indirect effects that include Keynesian effect, employment and the contributions of employment and equity. Thirdly, the externalities of national defence are identified as negative and positive externalities. Finally, the cost of damage to human lives and environment is also considered in evaluating the economic implications of national defence as a public good. Here the net outcome of national defence can be evaluated in comparison with a scenario based analysis as there is no actual situation to compare the condition without national defence. In the context of Sri Lanka, if national defence has not been there, at the prevailing level national interest, sovereignty and the territorial integrity could not have been

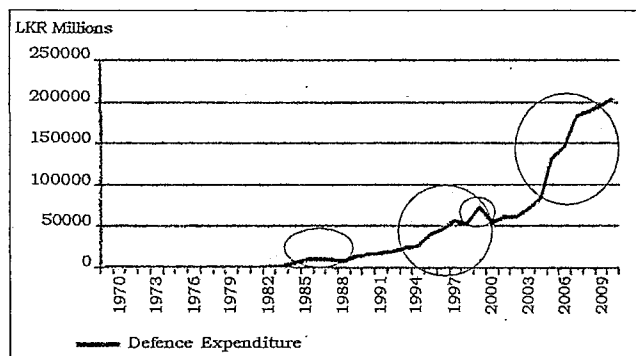


Figure 11 Defence Expenditure and its Increase Over Time

Source: 1. Central Bank of Sri Lanka Annual Reports
2. General Treasury Annual Estimates

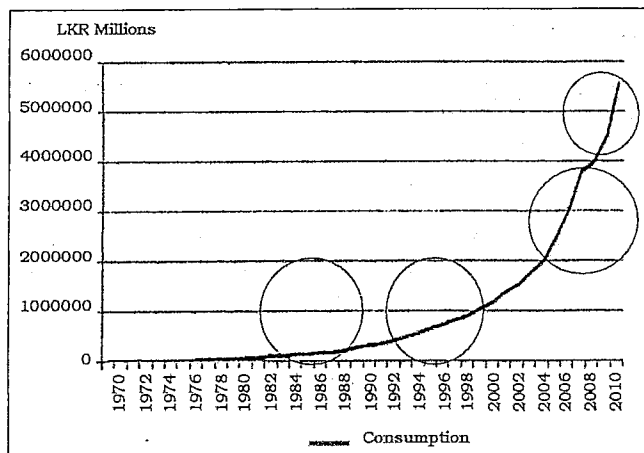


Figure 12 Consumption and its Increase Over Time

Source: 1. Central Bank of Sri Lanka Annual Reports

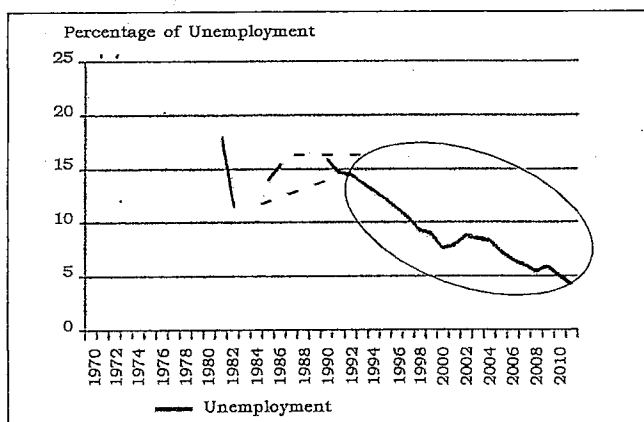


Figure 13 Unemployment Rate in Sri Lanka

Source: 1. Central Bank of Sri Lanka

protected as at present. When one looks at the complex Tamil issue, South Asia could have experienced the pandemonium of Middle East at country level as well as regional level. Within this background the contributions of national defence in Sri Lanka needs to be evaluated. In the overall analysis, the direct and indirect impact of national defence as a public good is considered in two scenarios. Firstly, the scenario in which national defence is involved in ceremonial functions, and along with the preventive measures against the national security threats and the second scenario in which national security is under threat and needs to function against such threats along with preventive measures. Under the first scenario, national defence is limited to basic functions and therefore there is no need for higher

time the threat on national security became an issue to the economy. During the post 1971 period, specifically up to 2009, the achievements of national defence as a public good both in the short run and long run needs to be addressed carefully as the defence expenditure as well as the threat on national defence had been increasing over the years. For example the JVP insurgencies in 1971 and 1987, Tamil ethnic clashes in 1978 and in 1983 and the Tamil militancy started from the mid 1970s and the increase of defence expenditure from 1% of GDP to over 4%. If national defence contributed to the economy, both in the short run and long run effectively, the size of national defence should have gradually declined to the saturated point that is compatible with the economy while maintaining

allocations. Under the second scenario, as national security is under threat national defence needs to be expanded depending on the intensity of the threat. In the context of Sri Lanka prior to 1971 and the period in between 1972 to 1980 can be viewed under the first scenario whereas, the periods of 1971-72 and 1980 - onwards can be viewed under the 2nd scenario. During the period under the first scenario, as far as the short run is concerned the objectives of the defence service as a public good have been achieved. However, as far as long run is concerned the performance of national defence has been

questionable because time to time the threat on national security became an issue to the economy. During the post 1971 period, specifically up to 2009, the achievements of national defence as a public good both in the short run and long run needs to be addressed carefully as the defence expenditure as well as the threat on national defence had been increasing over the years. For example the JVP insurgencies in 1971 and 1987, Tamil ethnic clashes in 1978 and in 1983 and the Tamil militancy started from the mid 1970s and the increase of defence expenditure from 1% of GDP to over 4%. If national defence contributed to the economy, both in the short run and long run effectively, the size of national defence should have gradually declined to the saturated point that is compatible with the economy while maintaining

sustainable peace in the country. Such conditions can be fulfilled only if national defence is effective both in the short run and long run. If national defence expenditure is increasing continuously, it is evidence of inefficiency and ineffectiveness of national defence. In order to accomplish such missions forward national defence policies that are strengthened with adequate research and development is important. In the context of Sri Lanka during the post 1972 period, the overall net contribution to GDP as a public good in the short run had been moderate except in the years of with negative growth rate. However, the contribution by national defence in the long run until 2006-2009 had not been substantial. In the post 2009 period the contribution to GDP as a public good has been substantial both in the short run and long run because of the effectiveness of national defence against national security threats. If national defence had been effective in the early period of the conflict with the support of its complementary mechanisms, such as diplomacy, public participation etc. and with conducive environment, the cost of war could have been reduced considerably and could have created necessary conditions for a smooth socio economic atmosphere with significant contribution to economic development of the country, without waiting for thirty long years.

Therefore, in the context of Sri Lanka, while maintaining the peace that was achieved with the cost of lives and opportunities for development especially during the period from the 1970s to 2009, a sustainable peace needs to be secured through the prevention of similar crises in the future. Here, the maintenance of the momentum in all segments of the society while addressing its retrospective and prospective aspects of performances against the challenges of national defence and the aspiration of development of the nation is important. Such momentum has to be aligned with the compatible philosophy that enables to guiding the nation with appropriate policy considerations.

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Footnotes

¹ Available at <http://www.iep.utm.edu/s/soc-cont.htm#SH2a-Interne> - Encyclopedia of Philosophy.

² Ibid

³ Available at www.philosophypages.com.

⁴ According to the social contract theory people have surrendered certain portion of their freedom to get protected from others in their life. In the context of Sri Lanka prior to 2006 there was no grantee of such protection but comparatively it was guaranteed gradually in the post 2006 period.

⁵ In 1986 and 87 national defence was able to trap the LTTE as the major militants against the security of the country and was able to prove the armed forces capability despite the failure to accomplish the mission due to India's intervention.

⁶ During the period from 1995 to 1999 also the armed forces were able to take over Jaffna under their control and proved its defence capability yet, as far as total control over LTTE was a failure

⁷ Here the crowding out effects referred to reduction in national production coming out from excessive borrowings due to the increasing budget deficit resulted from excessive government expenditure national defence.

⁸ Budget deficits here referred to the overall budget deficit (net cash deficit) and the deficit that equals to the difference between the revenue and expenditure.

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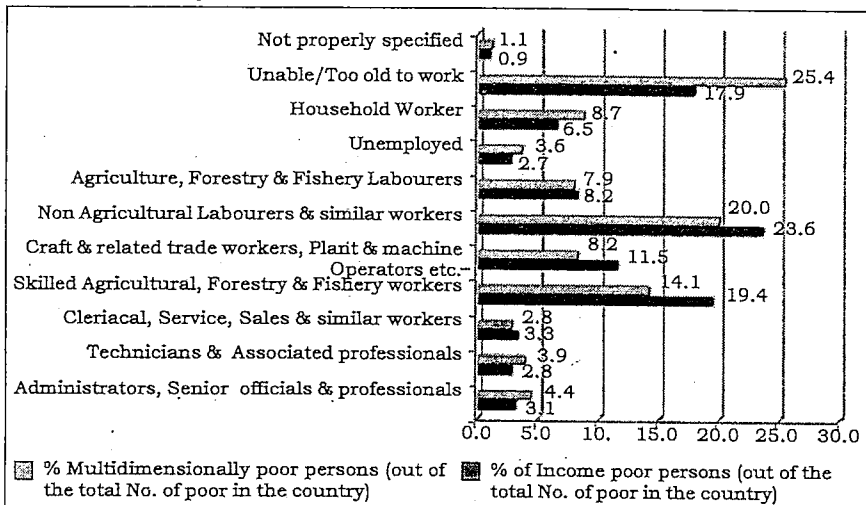


Figure 4 Percentage of people in Income Poverty and Multidimensional Poverty, out of the Total Number of People in Income Poverty and in Multidimensional Poverty, by Socio-economic Groups 2009/2010

Note:

In the above chart: Socio-economic Groups are based on Occupation or Activity of the Head of the Household and the percentages are the share of poor people in each Socio-economic Group, out of the total number of poor persons, under each poverty category (Income Poverty and Multidimensional Poverty)

Statistics, are under estimates. However, according to the poverty line used by international agencies to compare poverty between countries (US\$1.25 per person per day), percentage of poor in Sri Lanka, has been estimated as 7.0 percent, in 2009, which is lower than the poverty figure (8.9 percent) estimated by the Department of Census and Statistics.

Although Sri Lanka has managed to get, around one million people out of poverty, between 2006/2007 and 2009/2010, analysis shows that around 800,000, are just above the poverty line. As such, there is a risk of some of those people slipping back to poverty, due to economic shocks, due to whatever reasons. As such, strategies need to be developed to prevent such near poor people from slipping back to poverty.

The Income Poverty is highest among households headed by "Non agricultural labourers and similar workers" (18.1 percent), followed by those headed by "Agriculture, forestry, and fishery labourers" (15 percent).

The other Socio-economic Groups with significantly high poverty levels, are the groups in which the head of the household is "unemployed (10.5 percent)", "Skilled Agriculture, Forestry and Fishery Worker (10.1 percent)", and those headed by persons who are "Unable or too old to work (9.7 percent)".

The most deprived Socio-economic Groups in the country in 2009/2010, were those living in households headed by persons who are "Non Agricultural Labourer and Similar Workers", "Skilled Agricultural, Forestry and Fishery Workers", and those headed by persons who are "Unable / too old to work", with a total share of around 60 percent, out of those in Income Poverty, as well as in Multidimensional Poverty.

Chronic illnesses or disability of the head of the household and inadequate nutrition, are the two major contributory factors to acute poverty in Sri Lanka. The contribution from these two factors alone to Multidimensional Poverty or acute poverty, is 52 percent. As such, the poor households with chronically ill or disabled heads, may need urgent attention. Usually when the head of the household is ill or disabled, the entire family including children are affected. The members of such households are affected nutritionally as well, as they cannot afford to fulfil their nutritional requirements.

Fiscal Policy

Introduction

The major economic policies available to influence the demand side of markets are called fiscal and monetary policies. Fiscal policy is the use of government expenditures and taxes to promote particular macroeconomic goals such as full employment, stable prices, and economic growth. In other words, fiscal policy is the use of the government's budget to influence the total level of economic activity in the country by influencing the total demand for goods and services. Government expenditures consist of purchases of goods and services, such as the procurement of vehicles, furniture, aircraft, and transfer payments such as fertilizer subsidy, Samurdi grants, and flood relief. An increase in total demand can be achieved either by increasing total government expenditure or by reducing total taxes, or both. Reducing total demand requires reducing government expenditure, increasing taxes, or both.

An increase in government expenditure means that the government is demanding more of the goods and services to which it allocates its extra expenditure. This means that that the government is directly causing an increase in total demand. Reducing taxes has a similar, though indirect, effect on total demand. It leaves more money in the hands of the private sector and relies on that sector to increase total demand by spending some of this money. Fiscal policies thus, may be expansionary or contractionary. An expansionary fiscal policy increases real output, employment, and income. Such a policy can be used to move the economy out of recession. A contractionary fiscal policy decreases real output, employment, and income. It can be used to combat the problem of inflation.

Up until the 1930s, it was generally accepted that a prudent government should always balance its budget. The

argument was based on an analogy with what seems prudent behaviour for the household. It is a foolish household whose current expenditure consistently exceeds its current revenue so that it goes steadily further into debt. It was then argued that, if avoiding steadily rising debt is good for the individual, it must also be good for the nation. But the *paradox of thrift* suggests that the analogy between the nation and the household may be misleading. When government balances its budget annually, it must restrict its expenditure during a recession because its tax revenues will necessarily be falling. During a recovery, when its revenue is high and rising, it will increase its spending. In other words, it will roll with the economy, raising and lowering its expenditure in step with everyone else, thus helping to accentuate cyclical fluctuations in expenditure.

By the end of the 1930s largely because of the lead taken by John Maynard Keynes, many economists had concluded that the government could stabilize the economy by doing just the opposite of what everyone else was doing – by increasing its demand when private demand was falling and lowering its demand when private demand was rising. The classical economists were of the view that the economy automatically moves towards full employment in the long run. They ruled out the possibility of over production and hence unemployment in the long period. The role of the government in the economy, according to the classical economists, should be the minimal. Keynes in his famous book, *General Theory of Employment, Interest and Money*, disagreed with the views of the classical economists that the economy has the tendency to move towards full employment in the long run. He was of the strong view that the government must interfere in economic matters to achieve full employment, to prevent inflation and to promote rapid economic growth. In order to achieve

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the macro economic goals, he stressed that the government must step in and use government expenditure and taxes for changing the size of national income and the tempo of aggregate economic activity in the country. The use of deliberate changes in government expenditure and or taxes to achieve certain national economic goals is called fiscal policy.

Today many people feel that governments have abused the respectability that Keynesian economics gave to budget deficits. Instead of using deficits as an anti-cyclical tool, they have often spent in excess of revenues in good times as well as bad times. As a result, there are strong pressures in many countries to force a balanced budget policy on their governments. This may or may not be an effective way to restrain those governments who would run deficits at all times. If balanced budgets are enforced, however, they will contribute to cyclical instability by forcing governments once again to roll with the rest of the economy rather than, as Keynes advocated rolling against it.

How does Fiscal Policy Work?

Fiscal policy affects aggregate demand, the distribution of wealth, and the economy's capacity to produce goods and services. In the short run, changes in spending or taxing can alter both the magnitude and the pattern of demand for goods and services. With time, this aggregate demand affects the allocation of resources and the productive capacity of an economy through its influence on the returns to factors of production, the development of human capital, the allocation of capital spending, and investment in

technological innovations. Tax rates, through their effects on the net returns to labour, saving, and investment, also influence both the magnitude and the allocation of productive capacity.

Discretionary fiscal policy is the deliberate use of changes in government expenditures and taxation to affect aggregate demand and influence the economy's performance in the short run. Governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the degree and form of borrowing. Governments directly and indirectly influence the way resources are used in the economy. A basic equation of national income accounting that measures the output of an economy - or Gross Domestic Product (GDP) - according to expenditures helps show how this happens:

$$GDP = C + I + G + NX.$$

On the left side is GDP - the value of all final goods and services produced in the economy. On the right side are the sources of aggregate spending or demand—private consumption (C), private investment (I), purchases of goods and services by the government (G), and exports minus imports (net exports, NX). This equation makes it evident that governments affect economic activity (GDP), controlling G directly and influencing C, I, and NX indirectly, through changes in taxes, transfers, and spending. Fiscal policy that increases aggregate demand directly through an increase in government spending is typically called expansionary or "loose." By contrast, fiscal policy is often considered contractionary or "tight" if it reduces demand via lower spending.

The most immediate effect of fiscal policy is to change the aggregate demand for goods and services. An expansionary fiscal policy, for example, raises aggregate demand through one of two channels. First, if the government increases its purchases but keeps taxes constant, it increases demand directly. Second, if the government cuts taxes or increases transfer payments, households' disposable income rises, and they will spend more on

consumption. This rise in consumption will in turn raise aggregate demand.

Fiscal policy can play a major role in lifting the economy out of depression and closing the deflationary gap. When the economy is in depression, it is faced with rising unemployment, falling income, severe declining investment and shrinking of economic activities. To increase economic growth or reduce unemployment, the government can increase aggregate demand by increasing expenditure on goods and services. Alternatively, it can increase aggregate demand by increasing disposable income to increase consumption expenditure through decreasing direct taxes or increasing transfer payments. In addition to increasing consumption expenditure, a decrease in corporate income tax will also lead to higher after-tax returns on planned investments resulting in an increase in investment expenditure and hence aggregate demand. Expansionary fiscal policy helps moving an economy closer to full employment.

When the economy is faced with an inflationary gap, then the contractionary or restrictive fiscal policy should be adopted to bring down the prices and for closing the inflationary gap. To reduce inflation, the government can decrease aggregate demand by decreasing expenditure on goods and services. Alternatively, it can decrease aggregate demand by decreasing disposable income to decrease consumption expenditure through increasing direct taxes or decreasing transfer payments. In addition to decreasing consumption expenditure, an increase in corporate income tax will also lead to lower after-tax returns on planned investments resulting in a decrease in investment expenditure and hence aggregate demand. In reality, contractionary demand-side policies are more commonly used to reduce the growth of aggregate demand.

This ability of fiscal policy to affect output by affecting aggregate demand makes it a potential tool for economic stabilization. In a recession, the government can run an expansionary fiscal policy, thus helping to restore output to its normal level and to put

unemployed workers back to work. During a boom, when inflation is perceived to be a greater problem than unemployment, the government can run a budget surplus, helping to slow down the economy.

Problems of Fiscal Policy

Although Keynesians usually view fiscal policy as effective in combating recession and inflation, others are concerned about the shortcomings of fiscal policy. Let us examine some of these concerns. In theory, when there is an instability in the economy, the government should enact timely and effective fiscal policies to remove the instability. In practice, however, it takes months and often years for fiscal policies to be enacted and to have an impact on the economy. In particular, three timing lags constrain the operation of fiscal policy: (a) recognition lag, (b) administrative lag and (c) operational lag.

The recognition lag refers to the time between the beginning of inflation or recession and the recognition that it is actually occurring. For example, if the economy goes into a slump in January, the decline may not be apparent for three or four months. Once policymakers become aware of the problem in the economy, they rarely enact policies immediately. Instead, they want to be sure that the problem is more than a short-term disturbance.

After an economic problem is recognized, a solution must be formulated; thus there will be an administrative lag between the recognition of a problem and the implementation of policy to solve it. For fiscal policy, the administrative time lag is particularly long as much debate occurs before fiscal policy can change.

Finally, there is the operational time lag: After fiscal policy is enacted, it takes time for the policy to affect the economy. Although changes in tax rates can be implemented quickly, increased spending for public-works programmes will require construction firms to submit bids for the work, negotiate contracts, and so on.

Because of these lags, some economists contend that discretionary fiscal policy is too slow to have a

timely effect on the economy. By the time the full effect of the fiscal policy is felt by the economy, the economic situation may have changed considerably. A policy designed to combat a recession might not produce results until the economy is already out of that recession and perhaps experiencing inflation, in which case the fiscal policy would worsen the situation. Or a fiscal policy designed to eliminate inflation might not produce effects until the economy is in a recession; in that case, too, fiscal policy makes the economic problem worse rather than better.

Another concern about fiscal policy is the natural bias for Parliament to favour expansionary policies over contractionary policies. Because we elect politicians to office, they are generally apprehensive about voting for unpopular policies. Indeed, politicians may be voted out of office if we are not pleased with their performance. It is generally easier to get members of Parliament to vote for more government spending or tax reductions than the reverse. As a result, there is a natural tendency for Parliament to favour expansionary fiscal policies over contractionary policies this leads to an expansionary and inflationary bias in fiscal policy.

Crowding-out Effect

Not all economists believe that an expansionary fiscal policy can stimulate the economy the way we have described. Their concern coming under the heading of the **crowding-out effect**. With crowding-out, private spending (consumption spending and or investment) falls as a result of increased government expenditures and the subsequent budget deficits. According to the crowding-out effect, a decrease in private spending will occur because of higher interest rates generated by budget deficits that are financed by increased government borrowing. When the government enacts an expansionary fiscal policy, say, an increase in defence spending, the policy must be financed either by increased taxes or through the borrowing of funds to finance the enlarged budget deficit. If the government borrows funds to finance the deficit, the total demand for funds will increase as the government competes with the private sector to borrow the available supply of funds.

The additional government borrowing thus increases the demand for funds and pushes up interest rates.

What effect will higher interest rates have on private spending? Businesses will delay or cancel purchases of machinery and equipment. Residential housing construction will also be postponed. Consumers will refrain from buying interest-sensitive goods, such as major appliances and automobiles. Therefore, the higher interest rates caused by government borrowing squeeze out private sector borrowing. This decrease in private spending will at least partially offset the additional government spending. Therefore, the crowding-out effect suggests that the effect of a budget deficit on aggregate demand, output, and employment may not be very potent. Because of crowding-out, an expansionary fiscal policy may not be very effective in combating recession.

Fiscal Policy and Aggregate Supply

Fiscal policy is referred to as a demand-side policy because it is used to influence aggregate demand. However, it may also have an effect on aggregate supply in the long run. For instance, an increase in government expenditure on education and training will increase the productivity of the labour force. An increase in government expenditure on research and development will increase the productivity of the capital stock. An increase in government expenditure on infrastructure will increase investment expenditure and hence the size of the capital stock. An increase in government expenditure on capital goods will increase the size of the capital stock. A decrease in corporate income tax will increase expected after-tax returns on planned investments and hence investment expenditure resulting in an increase in the size of the capital stock. A decrease in personal income tax will increase the incentive to work and hence the size of the labour force. However, when economists talk about fiscal policy, they are normally referring to the use of it to influence aggregate demand.

From a supply-side perspective, the *marginal tax rate* is of crucial importance. The marginal tax rate is the fraction of additional income paid

in taxes. A decrease in marginal tax rates increases the reward stemming from extra work, saving, and investment. According to advocates of supply-side economics, a policy that reduces marginal tax rates will cause productivity to increase because individuals work harder and longer, save more, and invest more. As the total supplies of labour and capital in the economy expand, the aggregate supply curve shifts rightward, which will lead to higher real output. Lower tax rates encourage risk takers. Entrepreneurs and businesses will be more willing to risk their energies and financial capital on new production methods and new products when lower tax rates promise a larger potential after-tax reward. Besides cutting marginal tax rates for individuals, the government can promote increases in aggregate supply by enacting tax breaks that subsidize investment and by eliminating burdensome regulations on business.

Summary and Conclusion

Fiscal policy is an outgrowth of Keynesian economics. The goal of modern fiscal policy is to achieve economic efficiency and stability. According to fiscal policy theory, government spending and tax policies can be used to alter aggregate demand in order to close inflationary or deflationary gaps. Fiscal policy may be nondiscretionary or discretionary. Nondiscretionary fiscal policy is 'passive'. It relies on automatic or built-in stabilizers to keep the economy on course. Discretionary fiscal policy is 'active'. It involves purposeful changes in government spending and taxation to create expansionary or contractionary effects. Although Keynesians usually view fiscal policy as effective in combating recession and inflation, others are concerned about its shortcomings. Among the problems of discretionary fiscal policy are timing lags, inflationary bias and the crowding-out effect.

Besides having potential effects on aggregate demand, fiscal policy can also influence the level of economic activity through its effect on aggregate supply. According to supply-side fiscal policy, a reduction in marginal tax rates will cause productivity to increase resulting a rightward shift of aggregate supply curve leading to high real output.

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