

# **ECONOMIC CONSEQUENCES OF SRI LANKA'S ETHNIC CONFLICT**

**Shreekant Gupta**

**[ecsgs@nus.edu.sg](mailto:ecsgs@nus.edu.sg)**

**Visiting Senior Research Fellow**

**Institute of South Asian Studies**

**SRI LANKA'S ETHNIC CONFLICT:  
THE POLITICAL & ECONOMIC IMPLICATIONS**

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# OUTLINE

- Society and demography
- Economy
- Evolution of economic policy
- Economic performance
- Economic impact of ethnic conflict
- Sri Lanka's economic future

# Society

- Multicultural society
- Predominantly (Buddhist) Sinhalese (80%)
- Jaffna-based Tamils in north & east (7%)
- Up-country Indian Tamils on plantations (5-6%)
- Tamil Muslims (mainly traders) in east (7%)
- Two separate streams of education based on language and ethnicity

# Demography

- A rural, ageing and densely populated country.
- Low level (and rate) of urbanisation, virtually constant at 15% since 1950.
- Biggest city (Colombo) only 0.65 million.
- Reached an advanced stage of demographic transition at a relatively low income level.
- Fertility below replacement levels (pop growth 0.9%).
- Increased life expectancy (men - 72, women - 77).
- 3rd highest proportion of old people in Asia by 2050.

## Regional Imbalance → discontent?

- Relatively densely populated, 317 persons/km<sup>2</sup>.
- Population and economy concentrated in south-west and centre.
- 3 of 9 provinces (Western, Central and Southern) -- 70% of national income, 55% of population, but 23% of total area.
- *Western province* alone accounts for half of national income (and 60% of industrial output), 30% of population, but less than 6% of total area. Has the port and airport.
- Implications for demand for ‘federalisation’.





# The Sri Lankan Economy

- Plantation economy at the time of independence in 1948 (tea, rubber, cinnamon and coconut).
- Share of **agriculture** in national income dropped from 50% (1950) to 35% (1970) to less than 20% at present. But employs a third of the workforce.
- Currently **industry** accounts for 25-26% of national income (no significant change since 1970s).
- **Services** account for about 55% of national income at present (trade, transport, finance, communications and tourism).



# Evolution of Economic Policy

- Until late 1970s, extensive **state control** of economy (plantations, industry, etc.).
- Though Sri Lanka an ‘early liberalizer’, **uneven implementation** of economic reforms since then.
- Lack of **political consensus** on reforms (UNF-UNP more pro-reform than UPFA-PA-SLFP).
- At present economic reforms are **stalled** and several have been **reversed** by the UPFA government (fertilizer subsidy reintroduced, petroleum and electricity prices re-regulated, privatization halted, removal of hiring freeze and 20% pay hike to civil servants).

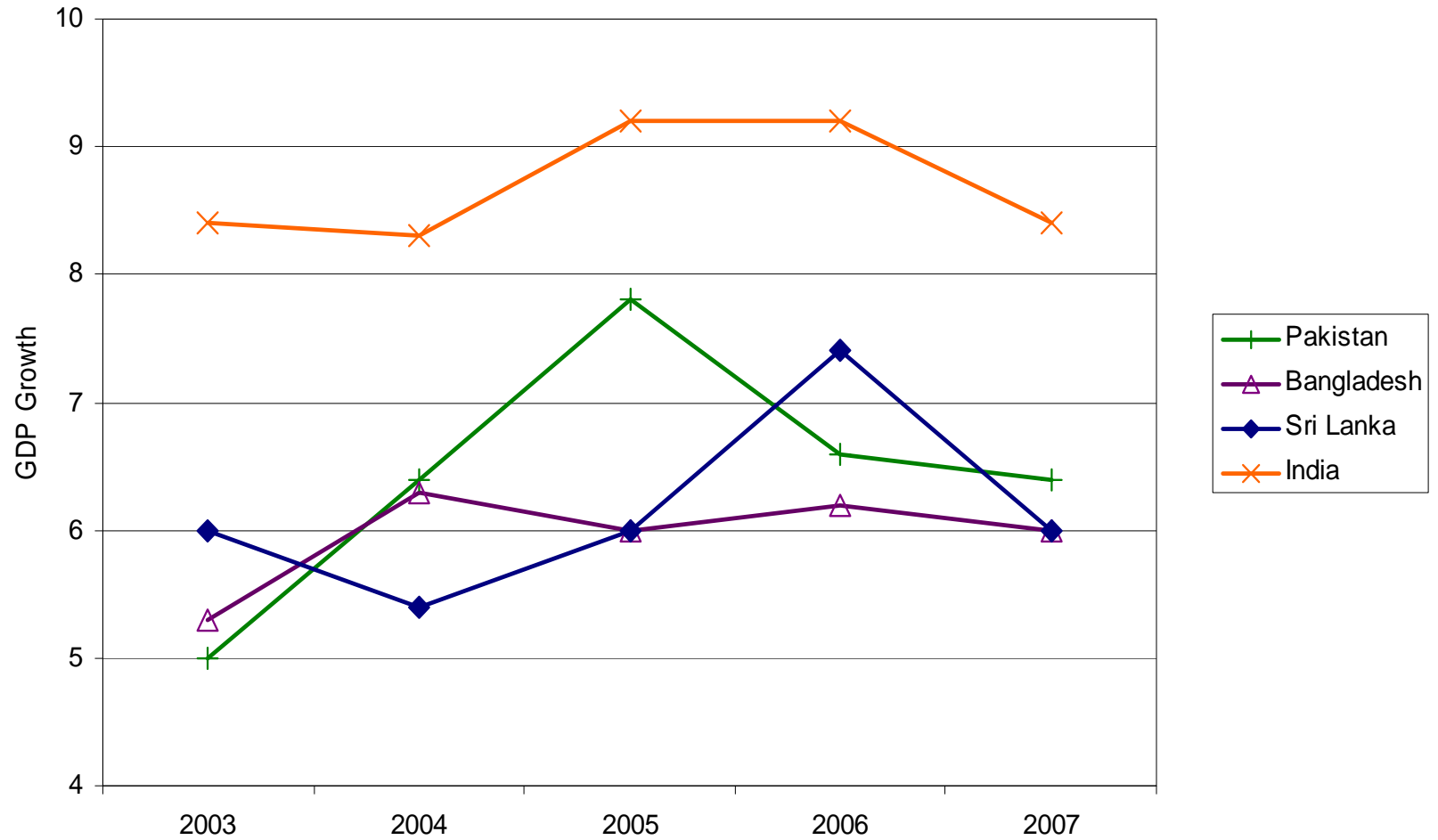
# Economic Performance

- Despite ethnic conflict and political instability, the economy has consistently shown **resilience**.
- Real GDP growth averaged almost 6% in 2002-06.
- Real GDP grew by 7.4% in 2006—highest since 1978 when liberalization began.
- Vibrant **private sector** remains the main driver of economic growth.
- But growth performance **below potential** due to:
  - Ethnic conflict
  - Political uncertainty
  - Unpredictable pace of economic reform

## The major economies of South Asia 2006

|            | Population (million)  | GDP (US\$ billion; market exchange rate) | GDP (US\$ billion; PPP) | GDP per capita (US\$; market exchange rate) | GDP per capita (US\$; PPP) | HDI value (rank) | Real GDP annual growth, EIU forecast (2008-12) |
|------------|-----------------------|--|-------------------------|---|----------------------------|------------------|--|
| Bangladesh | 156.0<br><b>(1.9)</b> | 62<br><b>(5.7)</b>                       | 290                     | 397   | 1,861                      | 0.347<br>(140)   | <b>6.2</b>                                     |
| India      | 1,095<br><b>(1.5)</b> | 923<br><b>(7.8)</b>                      | 2,743                   | 842   | 2,504                      | 0.619<br>(128)   | <b>7.5</b>                                     |
| Pakistan   | 160.9<br><b>(1.8)</b> | 127<br><b>(6.0)</b>                      | 415                     | 788   | 2,587                      | 0.367<br>(136)   | <b>5.8</b>                                     |
| Sri Lanka  | 19.2<br><b>(0.4)</b>  | 27<br><b>(5.8)</b>                       | 85                      | 1,404                                       | 4,411                      | 0.743<br>(99)    | <b>5.7</b>                                     |

# Growth rate of major South Asian economies



# Ethnic conflict only drag on the economy?

- Huge and inefficient **public sector**--state dominates financial sector and utilities. 1 million govt employees (one of the highest ratios of public employees to population in Asia), wage bill over a third of govt. current expdt (7.4% of GDP in 2006)
- Unsustainable **fiscal deficits**—averaged 8.4% of GDP in 2002-06.
  - low revenue—tax evasion, multiple tax exemptions, concessions, import duty waivers
  - high expenditure—reluctance to trim bureaucracy, rationalise welfare payments and subsidies, populist handouts, defence spending.

## Other structural economic problems

- Inefficiencies in **financial sector**—two largest commercial banks state-owned. State is a large borrower, crowds out private debt market.
- State owns 90% of land.
- Low **agricultural productivity**—heavy state interference (restrictions on land use—major portion of agricultural land to be used for paddy cultivation)—post-harvest output loss 40% due to poor storage and transport facilities.
- Bad **infrastructure**—poor roads (fatalities since 1983 as high as those from the civil war), railways carry 5% of passenger and 2% of cargo transport.
- Chronic **power shortages**—inadequate generation, transmission losses and theft.

# Strengths of Sri Lankan economy

- **Skilled workforce.**
- **Remittances** (second biggest forex earner).
- **Exports and services (telecom, ports)** are dynamic sectors, services principal driver of economic growth since 2002.
- Dynamic **telecom** sector (share in GDP doubled from 3.7% in 2002 to 7.4% in 2006).
- Port services doing well, 11% growth in 2007.
- **Manufacturing** doing well—80% of manufacturing output generated by private, export-oriented units—but narrow base (40% of mfg is textiles & garments, 22% food, beverages and tobacco). **Garments** account for 50% of total exports.
- **Central bank** highly independent in monetary policy.

## Chronology of ethnic conflict

- Depressingly predictable cycle of ceasefire, negotiations, breakdown, fighting and ceasefire...
- Start of 'Eelam Wars' in 1983 (I, II, III, IV)
  - 1983 to 1987-88 (arrival and withdrawal of IPKF)
  - June 1990 to December 1994
  - mid-April 1995 to November 2001
  - mid 2006 to present



## Economics of ethnic conflict

- Increased public (defence) expenditure—crowding out effect
- Fiscal deficits
- Reduction in investment, ↓ of capital stock
- 45-50% of defence expdt on wages (bigger army), rest for military hardware and equipment
- Armed forces quadrupled in size 1986-96
- 200,000 in 1996 (Malaysia 114,500, Philippines 107,500 and Australia 57,800)

## Economic cost of ethnic conflict

- Direct and indirect costs (Arunatilake and Kelegama 2001)
- **Direct costs** – destruction of K and L stock, military expdt and refugee care
- **Indirect costs** – capital flight, loss of potential foreign capital (FDI and FIIs), tourist inflows, emigration of skilled labour, human capital formation (trauma, education)

## Some numbers...

- IPS (Institute of Policy Studies) estimate for 1984-96 using an econometric model: 168% of 1996 GDP.
  - Kelegama (1999): US\$16 billion by 1994 or 131% of 1995 GDP.
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- Richardson and Samarasinghe (1991): for 1983-88, US\$4.2 billion or 68% of 1988 GDP
  - Grobar and Gnanaselvam (1993): for 1983-88, US\$1.5 billion or 20% of 1988 GDP.
  - Marga (1998): 13% of 1998 GDP

## Peace → Growth or Growth → Peace?

- Peace dividend of resolution of conflict
- What if more rapid economic and job creation had occurred during the ‘lost decades’?
- Would ethnic tensions/grievances been mitigated to some extent?

## Sri Lanka's (Economic) Future?

- Imperative to resolve conflict
- Self-rule/autonomy?
- EIU medium term growth forecast (2008-12) is 5.7%
- Does not compare too badly with Pakistan (5.8%) and Bangladesh (6.2%)
- But Sri Lanka can (and will) do much better!
- Sound economic policies conflict notwithstanding are imperative