

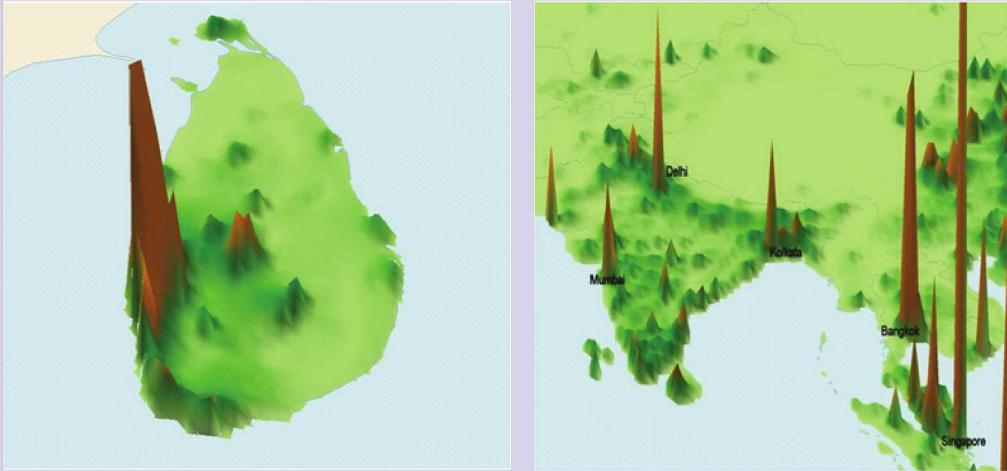
OVERVIEW: CONNECTING ALL SRI LANKANS TO PROSPERITY

Economic progress is accompanied by a fundamental spatial transformation where the economic landscapes of countries become increasingly uneven. The journey from low incomes to high incomes involves rising concentration of prosperity in a few places. Unbalanced growth is the norm, and has characterized the development experience of countries such as the United States and Japan, among the most prosperous in the world. And unbalanced growth is being repeated in China, India and other parts of the world that are prospering. At the same time, development can still be inclusive, as people who start their lives far from economic opportunity can benefit from the growing concentration of wealth in a few places. Connecting people to prosperity –is the principle behind economic integration policies that can help countries reap the benefits of both uneven growth and inclusive development. These are the main insights from the World Development Report 2009 “Reshaping Economic Geography (World Bank 2008).

These principles are important for Sri Lanka, which has laid the foundations for long term progress. Sri Lanka’s rise into middle income has been accompanied by a rapid transformation in how global markets view the country. Between 1975 and 2005, manufactures shot up from 6 percent of national exports to 60 percent. This reshaped the country’s economic geography—firms not farms now lead Sri Lanka’s connectivity with the rest of the world. And these firms benefit from concentrating production close to Colombo, whose port moved 3.7 million containers in 2008. As a consequence Colombo and its neighboring areas have prospered. Western Province now contributes more than 50 percent to national GDP and is home to 37,000 industrial production units that employ 540,000 people and generate Rs. 527 billion in value added.

By concentrating production, Western Province has productivity and wages twice those in other provinces. While the rise of economic mountains around Colombo has been impressive, Colombo still has a long way to grow (figure 1). The economic density of

Figure 1: Impressive economic mountains around Colombo look like a small hill from a distance



Note: World Bank Development Research Group's spatial analysis team based on sub-national GDP estimates.

Colombo is \$15 million per square kilometer. Compare this with \$73 million per square kilometer in Ho Chi Minh city, \$88 million per square kilometer in Bangkok, and \$269 million per square kilometer in Singapore—places that connect their countries to world markets.

Prosperity in Western Province has improved living standards for many Sri Lankans, including those who started their lives far from Colombo. More than 650,000 people who live in Colombo were born in other parts of the country. Many have moved from nearby Galle, Kalutara, and Kandy, and some from distant Jaffna. Others have been physically connected as national highways such as the A1 and A2 reduced transport costs and facilitated the flow of products across provinces.

While economic production has become concentrated, public policies have been remarkably successful in leveling social welfare. Poverty has come down in all provinces and education, basic healthcare, and basic infrastructure including water and sanitation are dispersed throughout the country. This has prepared Sri Lanka to take advantage of the next round of prosperity in the world and the region, and accelerate its journey through middle incomes. However, taking advantage of these opportunities requires that policies accelerate the pace of spatial transformations and connect more Sri Lankans with these opportunities. This report "Sri Lanka: Connecting People to Prosperity" provides insights for prioritizing these policies and associated investments, drawing on recently completed diagnostics and tailoring options to area specific challenges.

CONNECTING PEOPLE TO PROSPERITY

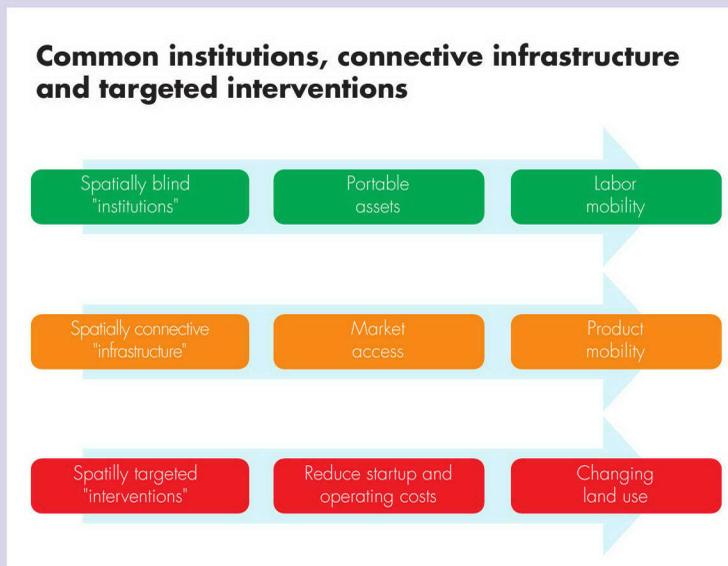
The World Development Report 2009: Reshaping Economic Geography provides a policy framework for territorial integration, highlighting that public policy should focus on increasing interactions between economically lagging areas and leading areas – and not be exclusively concerned with stimulating growth in places left behind by firms and workers. Reshaping Economic Geography highlights that enabling geographic mobility of labor and improving economic connectivity between lagging and leading areas are key ingredients for countries to gain from rapid economic progress and convergence in living standards across places. Which policies can help?

Policies that are “spatially blind” in design can have the spatially sharpest effects. These common institutions include progressive income tax policies, achieving national minimum standards in basic health and education indicators, and removal of barriers to labor mobility. In addition, “spatially connective” policies such as transport and communication improvements physically link lagging and leading areas. “Spatially targeted” interventions to stimulate economic development should be policy instruments of last resort, only to be used when factor mobility is weak due to internal divisions (figure 2). In these cases, interventions may be considered, but only after investing in information to identify sources of comparative advantage, and to amplify the benefits from spatially blind and connective policies. However in their current form, many policies in Sri Lanka have over-emphasized spatial targeting – what policies can jumpstart economies of the poorest areas?

Unfortunately these efforts have not generated the expected economic dividends. Consider the generous incentives offered by the Board of Investment to move economic activities outside Colombo. Analysis for this report shows that 80 percent of investments approved under Section 17 of the BOI Law and the 200 Garment Factory Programme took place in Western Province, not in lagging areas. And of the Rs. 44 billion worth of investments under “Nipayum Sri Lanka,” a flagship program to support rural employment creation in lagging areas, Rs. 21 billion is used at the doorstep of Western Province, the North Western Province. Firms benefit from being close to other businesses and the international gateway, so industrial relocation policies end up hurting productivity and profitability. Similarly, efforts to stimulate rural development in lagging areas through regulations on use and transfer of agrarian land have been counterproductive. Not only have land development ordinances limited diversification in rural areas—they have also slowed the pace of poverty reduction because wages are lower in both farm and nonfarm activities. What are sharper instruments for territorial integration?

First, ensure that basic services are available everywhere. A middle-income Sri Lanka can be ambitious in defining what basic services include. The current challenge is not one of ensuring geographically equitable access, but improving the quality of services.

Figure 2: Taxonomy of territorial development policies



Source: WDR 2009

Education quality needs to be improved further in a system where only 70 percent of grade 8 students pass their first language and in Mathematics, and only 50 percent pass in English. And performance is worst in the Northern and Eastern provinces. Improving the quality and relevance of education should be of high importance because it will give children in lagging areas the ability to enter labor markets in dynamic places.

Research for this report show that the payoff to education is higher in Western Province and that facilitating labor mobility from other provinces will contribute to further reductions in national poverty. One way to improve education quality is to consider consolidation in places where enrollments are low and to use the cost savings for much needed teaching-learning materials. But Sri Lanka invests little in education, by international standards, and public investment in education also needs to be raised over time. While there is no doubt that tertiary education is an important pillar for national transformation, the analysis here shows that higher education subsidies disproportionately benefit rich families in Western Province. For spatial efficiency and connecting people to prosperity, private involvement in the delivery of tertiary education should be among the options.

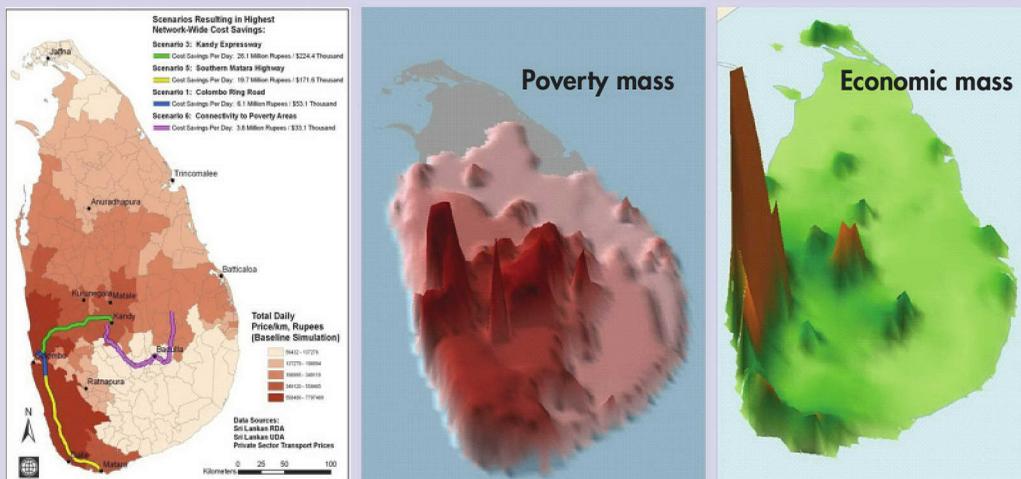
Now consider health services. Coverage is fairly uniform across provinces and by middle income country standards there is an excess of hospital beds. But services are underused in the network of hospitals run by provincial councils—people bypass lower level facilities to seek care at nationally run hospitals which are better resourced and provide a wider spectrum of services. This may be due to the non existence of a formal

referral system and the availability of free services throughout the system. Facilities in remote areas also find it difficult to attract specialist doctors, general medical officers and nurses as facilities in provincially managed hospitals are often inadequate. Furthermore, qualified personnel continue to be drawn to Western Province both due to availability of better resourced hospitals for health personnel and other non health related facilities, for example better opportunities for private sector income.

Second, improve infrastructure to connect lagging and leading areas. Transport costs within Sri Lanka are high by international standards. It costs \$2.90 per kilometer to move products, more than twice the \$1.25 in the United States. ‘Bumpy’ roads add to the cost of transport, and these costs are most pernicious along routes with high demand for transport services. From a national efficiency perspective, the challenge is to identify transport improvements that generate the highest aggregate reductions in transport costs. From a spatial equity perspective, the challenge is to improve connectivity in remote areas. How can transport policies manage these efficiency- equity tradeoffs?

The aggregate cost of ‘bumpy’ roads are felt the most along the national arteries such as the A1, A2, A3 and A4, where traffic volumes close to the boundary of Colombo city are as high as 60,000 to 80,000 vehicles per day. In contrast, typical traffic volumes on national roads in Uva Province are only between 1,500 and 2,500 vehicles per day. Improving transport quality along corridors with demonstrated potential is likely to improve the efficiency of the entire transport system and reduce island-wide

Figure 3: Strategic transport improvements can connect “mountains of poor people” to “peaks of prosperity”



Source: Felkner et al (background paper)
 HIES data, 2006
 World Bank DECRG based on sub-national GDP estimates

transport costs. Not only does the corridor linking Kandy (and the Central Province) to Colombo carry the highest traffic volumes, it also physically connects a large mass of poor people with prosperity. Simulations employing spatially detailed data on the distribution of road infrastructure, traffic demand and transport costs also emphasize that transport improvements between Kandy and Colombo can generate large cost savings—nationally as well as for lagging areas in Uva, Eastern Province, and Northern Province. Improvements along the Colombo-Kandy Highway and the Southern Highway generate high economic returns because these transport corridors connect large markets – effectively connecting “mountains of poverty” to “peaks of prosperity” (figure 3). These investments should be given priority among the national portfolio of transport improvements. What does this imply in terms of physical connectivity in isolated areas?

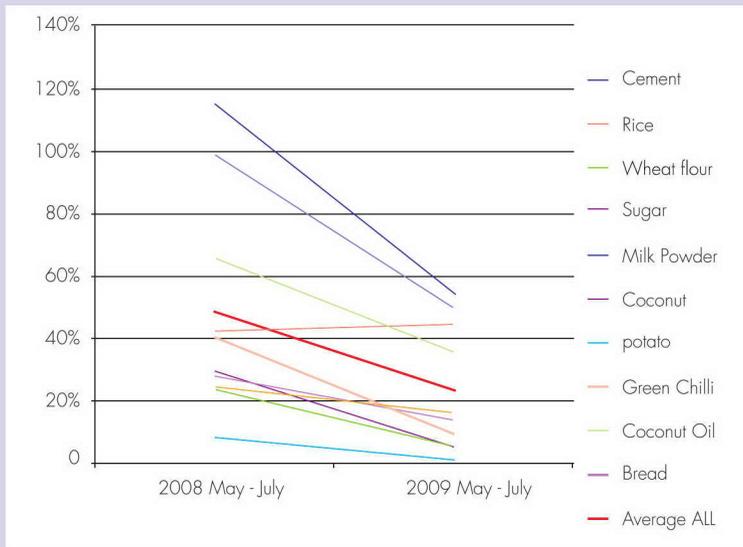
In addition to improving network efficiency, transport improvements may be needed for accessing basic services such as schools, health facilities, and local markets. While access to these services is important for people to improve welfare and make the most of local opportunities, the cost of providing, maintaining, and sustaining traditional transport services is higher in isolated areas. As low demand will discourage entry of formal transport providers whose services involve high fixed costs, the operational challenge will be to encourage Intermediate Modes of Transport (IMT) that can be operated and maintained by local residents. Vehicles such as bicycles, hand carts, motorcycles, power tillers and trailers, Ox carts, and tractors are commonly used to increase mobility in rural areas. Encouraging community involvement in providing and managing these services is a promising option that can enhance rural mobility.

Finally, target interventions in selected lagging areas: In some lagging areas, as in the North and the East, migration and interregional trade has been slow due to years of conflict and internal division. The dividends of peace already include faster movements of products and convergence of prices. Consider the Northern Province, in particular the Jaffna Peninsula, where an economic embargo was imposed in 1990 after the LTTE took military control of the area. The Government regained control of the Jaffna peninsula in 1995, but freight transport was only possibly by ships, usually from Trincomalee. While road connectivity between Jaffna and the rest of the country was temporarily reestablished when the A9 highway was re-opened after the ceasefire in 2002, the flow of goods was constrained by illegal taxation by the LTTE. And as armed conflict reemerged the A9 highway was once again closed in 2005.

Since the Government’s military victory in 2009, the emergence of common institutions has opened up the A9 highway for goods traffic. Convoys of trucks, subject to security clearance by the Sri Lankan army, are being allowed to bring goods to and from the Jaffna peninsula. The result? Rapid price convergence between the Jaffna peninsula and the rest of the country – at the peak of the conflict in late 2007 the price of a bag of cement

was more than 4 times higher in Jaffna than in other parts of the country. According to the monthly Price Monitor carried out by the Point Pedro Institute of Development, the average price premium in Jaffna compared to Colombo on ten selected items was 48%, in the 3-month period May-July 2008. During May-July 2009 the average price premium for the same ten products had declined to 24 percent (figure 4).

Figure 4: Reaping the peace dividend: Price convergence between Jaffna and Colombo on selected commodities



Source: Price Monitor, Point Pedro Institute, September 2009

As common institutions unify the country, there will be an increase in labor and product mobility in the medium term. But in the short term, these processes need to be complemented by strategic interventions to improve economic conditions in post conflict areas. However, rather than relocating existing industries from leading areas, making land more mobile—not across locations but across uses and users—is likely to accelerate structural transformation. Particularly important are institutional reforms that can improve the functioning of agrarian land markets. Land-development ordinances that regulate the use and transfer of land keep a larger proportion of people dependent on agriculture. They also keep people poorer because they earn less for their labor. Relaxing these ordinances is likely to raise agricultural incomes and accelerate poverty reduction and longer term transformation.

Targeted incentives to promote economic development work best when they are preceded by institutional reforms improving the fluidity of land markets. Most lagging areas are rich in natural endowments and private investors, such as Chemical Industries Colombo PLC (CIC) and Hayleys, are expanding activities in Eastern Province to make the most of the area's agronomic potential. Ongoing efforts to assist farmers in acquiring knowledge

about technical advances and skills for raising farm output and productivity, will improve market linkages, as will introducing farmers to higher yielding rice varieties, alternative crops, better irrigation techniques, and use of organic fertilizers.

TAILORING POLICIES TO AREA-SPECIFIC CHALLENGES

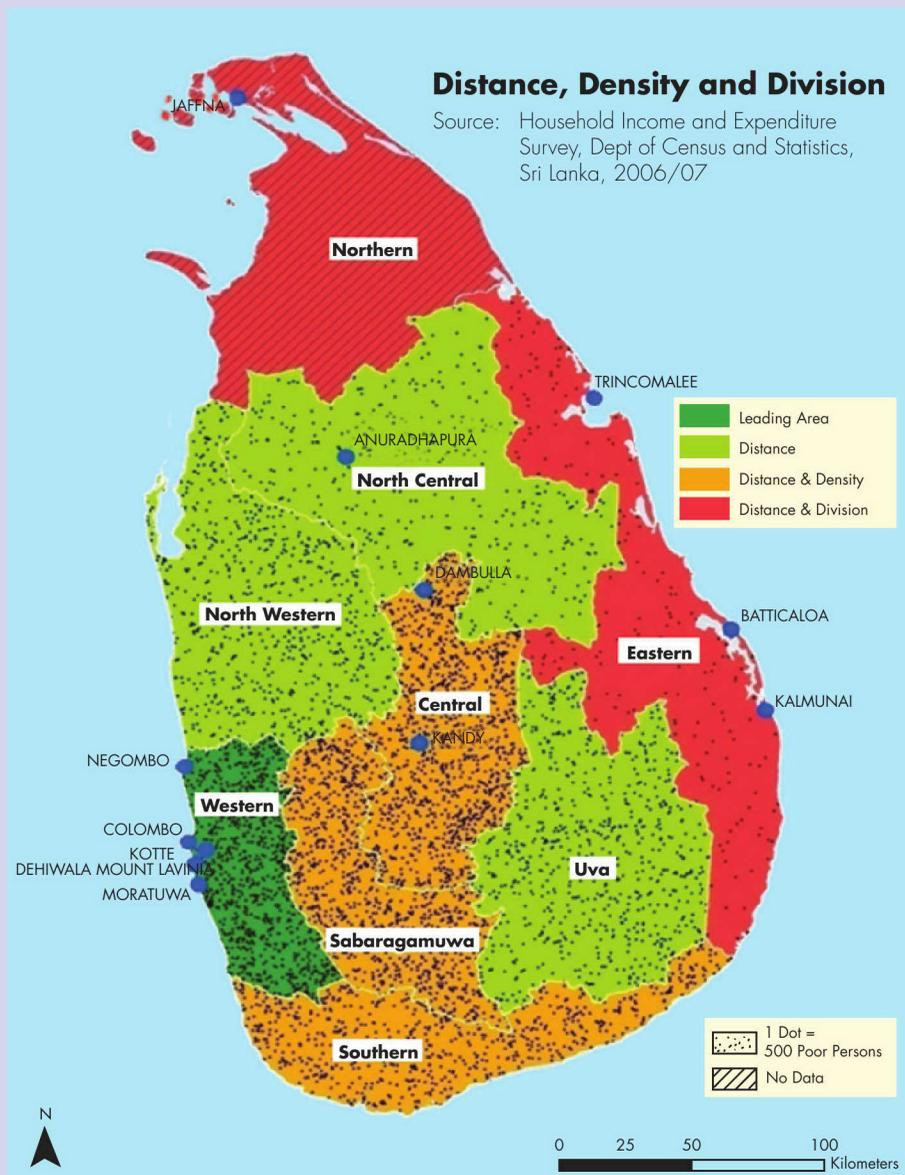
To be most effective in connecting people to prosperity, policies need to be tailored to specific challenges facing different areas. The analysis in the report shows that improving basic service delivery everywhere is the bedrock of successful policy initiatives. In addition, infrastructure that physically connects lagging areas that are home to a large number of poor people with prosperous areas can stimulate trade and commerce. And in a few places, targeted interventions are needed to stimulate economic production in places left behind by market forces. What are the principles for setting priorities?

World Development Report 2009 develops a framework to help calibrate policies to the severity of area specific challenges, best summarized with poverty maps that show which places are poor and where most of the poor live. Often, the two are not the same, because the poor have the most reason to move from poor places. Recall the “Poverty Mountains” in figure 3 showing that many poor people live close to prosperity— in Western Province. With per capita expenditures of Rs. 6935 and poverty incidence of 8.2 percent, Western Province is the most prosperous place in the country, but also home to 16.8 percent of Sri Lanka’s poor people. In contrast, Uva is the poorest province with per capita expenditures of Rs. 3879 and poverty incidence of 27 percent, but is home to 12.3 percent of Sri Lanka’s poor.

Figure 5 shows where poor people live and prioritizes how poor people can be connected to prospering places. In fact, the density of poor people is highest in Western Province, not in lagging areas. Analysis for this report and the policy framework of WDR 2009 highlight the following priorities for connecting people to prosperity:

- Uva, North Central, and North Western provinces have a small share of the country’s poor, relatively dispersed. Measures to enhance labor mobility should be the mainstay of connectivity policies. It does not make sense to place large-scale durable infrastructure in these places because investments would generate low economic returns. But by improving the quality of basic services, such as health and education, policies can facilitate migration and bring people closer to prosperity.
- Central, Sabaragamuwa, and Southern provinces are home to almost 50 percent of Sri Lanka’s poor people, but there are few impediments to their mobility. Improving the quality of services is important to promote labor mobility, but it will

Figure 5: Connecting people to prosperity: identifying area-specific challenges



Source: CPP Team

not be enough. Infrastructure improvements are needed to physically connect these places with markets in Western Province. Investments such as the Colombo-Kandy Expressway and Southern Matara Highway are likely to generate high economic returns by lowering transport costs, and are win-wins for rapid growth and inclusive development.

- Eastern and Northern provinces do not have a large share of the country's poor, but domestic divisions have limited the movement of labor and exchange of products. Prices for food products have been converging, showing that common institutions can help integration. In the short term however, bringing prosperity to these areas will be critical for enhancing the peace dividend. But exploiting the area's economic potential should not be based on policies that push economic activities out of Western Province. Instead, it should be grounded in improving the use and transfer of agrarian land, with complementary targeted efforts to help farmers develop market linkages. And these efforts should be preceded by improvements in delivery and quality of basic public services.

Table 1 summarizes the policy options for connecting people to prosperity using a calibrated combination of common institutions and service delivery standards, connective infrastructure, and targeted interventions. These policies can help Sri Lanka accelerate its journey through middle income while sharing the benefits of growth across its provinces. What policymakers will notice is that economic prosperity will become further concentrated in a few places—but more people will be connected to prosperity.

Table 1: An instrument per dimension – priorities for connecting people to prosperity

Provinces	North Central, North Western, Uva	Central, Sabaragamuwa, Southern	Eastern, Northern
Challenges	Sparsely populated lagging areas (economic distance)	Densely populated lagging areas (Economic distance and misplaced population densities)	Sparsely populated lagging areas with domestic divisions (Economic distance and internal divisions)
Policy priorities			
Spatially blind institutions	Improving health and education outcomes, safe water supply, and sanitation	Improving health and education outcomes, safe water supply, and sanitation	Improving health and education outcomes, safe water supply, and sanitation Improving the efficiency of land use and conversion
Spatially connective infrastructure		Interregional transport infrastructure - Improving connectivity with the Colombo metropolitan area	
Spatially targeted interventions			Incentives to agriculture and agro-based industry Amplify market linkages Don't force activities out of the Colombo metropolitan area