Poverty and Trade Issues in Sri Lanka

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Foreword

This series of Poverty Briefs (No. 1 to 10) was produced for OXFAM Great Britain (GB) by the Centre for Poverty Analysis to provide a macro overview of key thematic areas relating to poverty, of relevance to Oxfam GB's work in Sri Lanka. They are specifically designed to provide Oxfam GB programme staff with insights into the major issues, concerns, and debates within these themes and their linkages and effects on poverty in Sri Lanka. They also aim to highlight potential areas for policy advocacy by Oxfam GB. This input was used in staff preparation for Oxfam GB's Strategic Review in August 2004.

Oxfam GB's mission is, to work with others to overcome poverty and suffering. Its current programme focus is on: Livelihoods and poor people's access to markets; Gender equality, empowerment and ending violence against women; Public health promotion and access to quality water and sanitation facilities; Emergency preparedness and response; Relationship building between and within communities; and Empowerment of the poor through building of Community Based Organisations.

The views and opinions expressed in the Poverty Briefs are those of the authors and do not necessarily reflect those of Oxfam GB or the Centre for Poverty Analysis.

This series of Poverty Briefs was prepared in mid 2004, prior to the events of the Tsunami on 26th December 2004. The context and issues discussed in some of the Briefs could have changed since then.

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Abbreviations and Acronyms

AGOA	African Growth and Opportunity Act
ATC	Agreement on Textiles and Clothing
BIMST-EC	Bangladesh, India, Myanmar, Sri Lanka and Thailand Economic Cooperation
CEPA	Centre for Poverty Analysis
CEPA	Comprehensive Economic Partnership Agreement
EC	European Commission
EU	European Union
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GSP	Generalised System of Preferences
ILO	International Labour Organisation
IORARC	The Indian Ocean Rim Association for Regional Co-operation
ISLFTA	India-Sri Lanka Free Trade Agreement
LTTE	Liberation Tigers of Tamil Eelam
NAFTA	North American Free Trade Agreement
SAARC	South Asian Association for Regional Cooperation
SAPTA	SAARC Preferential Trading Arrangement
SMEs	Small and Medium Enterprises
UNF	United National Front
UNP	United National Party
US	United States
WTO	World Trade Organization

Poverty and Trade Issues in Sri Lanka

1. Introduction

Does closer global integration, in terms of increased trade flows and reduced trade barriers, help or harm the poor? What are the policies that can increase the access of the poor to the gains from trade and shield them from its negative effects? The trade-poverty relationship is a contentious one, and mainstream economists remain agnostic about the issue. This is mainly because the careful empirical evidence on the issue is in its infancy. Moreover, the work is plagued with limited data availability and methodological variations, which give conflicting results. The relationship also varies when looking at trade's short and medium term consequences on poverty versus a longer-term impact. This may also point to the fact that trade is neither the main problem, nor the main solution to poverty. In fact, many recent studies show that the impact of trade on poverty depends on accompanying complementary policies like labour market flexibility, human capital development and infrastructure development. Further, the trade-poverty relationship is sensitive to the market structure in product and factor markets as well as the political economy structure of government institutions.

Evaluating the impact of trade on poverty is further complicated by the fact that the poor are a heterogeneous group and are likely to be affected in a non-uniform way by trade. For instance, the trade impact may vary according to whether they are food consumers or producers, as well as whether they work in expanding export-oriented or contracting import-competing industries. It is no surprise then that the trade-poverty relationship does not lend itself to easy generalisations. Therefore, careful case studies of household survey data are the best approach to evaluate the issue. Systematic work on Sri Lanka is scarce. This policy brief identifies the channels through which trade and trade policy affect Sri Lanka's poor, highlights the importance of informed, precise policy making and the need to stimulate interest in pursuing rigorous research in the field.

2. Trade-Growth-Poverty Nexus: The Indirect Impact of Trade on the Poor

The longer-term impact of trade on poverty relies on a two-step argument: that trade stimulates overall economic growth and growth reduces poverty. Openness to trade allows a country to specialise in the production (and export) of goods and services that it can produce at lowest relative cost, while importing (and reducing domestic production of) the goods for which other countries have a comparative cost advantage. This reallocation of resources makes the country as a whole better off in terms of expanding consumption possibilities and higher economic growth, although there typically will be individual winners and losers of trade. It also allows the exploitation of scale economies (leading to lower average costs and prices) as producers cater to global markets and not small national markets, which is a key benefit of trade for a small country like Sri Lanka. Further, given the fragmentation of the production process, trade openness also facilitates offshore outsourcing, where firms headquartered in one country may base part of their production process in another country to exploit cost differences.

Although the empirical evidence of the trade and growth relationship varies significantly in quality, the overall findings tend to suggest that trade openness leads to more growth. Detractors however, point to inappropriate methodologies and the high sensitivity of the results to the model specification (see Winters et al, 2004; Rodriguez and Rodrik, 2000).

Less contentious is the cross-country work on growth and poverty, which finds that overall growth performance does indeed have a strong effect on reducing poverty. A 10 per cent growth in average income per capita has been associated with an 8-10 per cent growth in the incomes of the poor (e.g. Dollar and Kraay, 2004). Further studies have shown that as incomes rise, child labour also tends to fall. In fact, the strong growth in Asia and stagnancy in Africa accounts for the fact that in 1998, Asia was home to 15 per cent of the world's poor, whereas Africa to 60 per cent. The respective shares in the 1970s had been 76 and 11 per cent (Sala-i-Martin, 2002).

Underlying this positive Asian regional effect is the dramatic growth, employment generation and consequent poverty reduction in China and India following their trade integration into global markets, from the 1980s and 1990s respectively. While it is clear that their robust economic growth dampened poverty, the argument that trade led to this growth has less consensus. Some point to the importance of domestic reforms like land reform. Further, while trade is better than an autarkic, no-trade scenario, it is argued that the China and India success stories should not be used as evidence of the success of free trade policies because both these countries have maintained some trade protection in various sectors.

Lessons from the trade policies of China and India are less valid for Sri Lanka because both China and India are large economies, whereas Sri Lanka as a small open economy must look to world markets and open trade to exploit scale economies, market its products and attract much needed investment.

The record for Sri Lanka shows greater economic growth during a more liberal trade regime. The trade regime witnessed a dramatic change after the November 1977 election win of the United National Party (UNP). The previous 1970-77 regime was characterised by severe import controls and exchange restrictions, as reflected by an average openness indicator (exports plus imports as a share of GDP) of 30 per cent. In contrast, for the following seven years after trade liberalisation the openness measure was on average 75 per cent of GDP.[1] Economic growth doubled from an average of 3 per cent per annum during the protectionist 1970-77 period to 6 per cent during the 1978-85 period.[2]

Over these two periods, using the comparable Consumer Finance Surveys of the Central Bank,[3] the incidence of poverty (headcount index) declined from 27.6 per cent in 1973 (when annual growth averaged a low 2.4 per cent per year during 1971-73) to 22.3 per cent in 1983 (when growth more than doubled to 5.4 per cent annually during 1981-83).

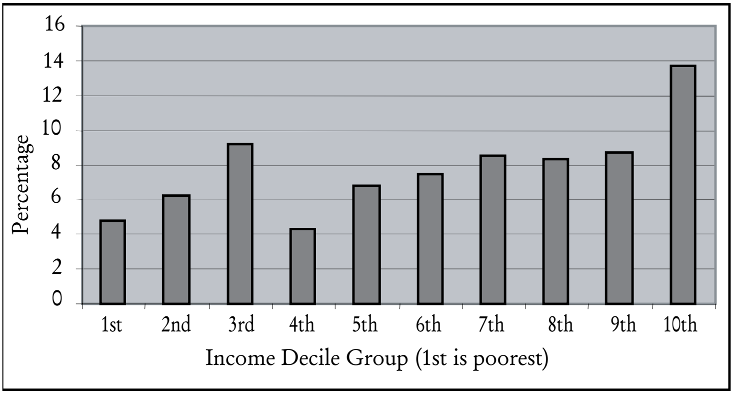
1 Comparing tariff rates does not illustrate the liberalisation episode because the liberalisation involved the tariffication of many items under quantity restrictions.

2 However, this does not prove a cause and effect, because we are not controlling for all the other determinants of growth.

3 The poverty line used for both surveys was per capita food expenditure of Rs. 70 per month at 1978/79 prices.

Data that are more recent also confirm that the poor gain from overall economic growth. Figure 1 however, suggests that while overall income growth does benefit the poor, it does so at a pace slower than the upper income group. The figure depicts the distribution of growth by deciles of income receivers, and shows that a 10 per cent average income growth was associated with a 5 per cent increase in the real income of a typical income receiver in the poorest decile group and a 14 per cent increase in the income of a typical member of the top income decile group.

Figure 1: Distribution of a 10 per cent increase in average real income per income receiver during 1996/7 – 2003/4, by deciles of income receivers



Source: Author's calculations using preliminary results from Consumer Finances and Socio-Economic Survey 2003/4 (excluding Northern and Eastern provinces), Central Bank of Sri Lanka.
Note: Interpret the figure as stating that a 10 per cent increase in average real income involves a 5 per cent increase in income for a typical income receiver in the 1st income decile and a 14 per cent rise for an income receiver in the 10th income decile.

Nominal monthly income per income receiver was Rs.5,760 and Rs.10,910.40 in 1996/7 and 2003/4 respectively. Nominal values deflated by the Sri Lanka Consumer Price Index (1997=100 and the 2003/4 data were deflated using the average of the monthly index numbers over the July 2003-June 2004 period).

3. The Direct Impact of Trade on the Poor

In the short and medium term, trade and trade policy can have a direct impact on the welfare of the poor from different dimensions.

3.1 Price Effects on Consumer Goods and Producer Goods

Trade affects the poor by affecting the prices of the goods they consume and the goods they produce. Import liberalisation generates more competition and pushes down retail prices, helping poor consumers. Removing anti-export bias raises export prices of goods helping poor export good producers. However, these benefits are conditional on the trade-affected border prices filtering down to the poor. If there are imperfect markets, then price gains may be captured by monopolistic distributors. In addition, it is often the case that a particular import liberalisation (say of rice) may benefit one poor sub-group (poor urban rice consumers) while at the same time hurting another (rural poor paddy producers).

Besides price effects, poor consumers also benefit from trade through access to a new set of products as well as to new varieties of existing products.

3.2 Effects on Wages and Employment Opportunities

The traditional story that trade should raise the incomes of the poor in a developing country comes from a simple Heckscher-Ohlin framework, with a two-country (industrialised US – developing Sri Lanka), two factors (high skilled workers – low skilled workers) and two goods (skill intensive good – low skill intensive good). According to this model, the developing country would have a comparative advantage in producing and exporting goods intensive in the use of low skilled workers because of a relative abundance. The poor are owners of such low skilled labour and benefit from trade with a country relatively scarce in low skilled workers, regardless of the sector in which they work.

However, this result relies on labour being able to easily move from contracting import-competing sectors to expanding export sectors, which is more relevant in the longer term. If we allow for labour immobility (as is often the case in the short run and modelled in the specific factors model), then any tariff reduction will lead to a fall in wages of workers in that sector and a rise in unemployment.[4] (Prices and profits of the protected good drop, reducing the demand for those workers). Likewise, an increase in the export sector activity will increase wages and reduce unemployment in that sector, as has been the case in the garment sector. Work on India and Colombia (Harrison, 2005) shows that potential negative effects of tariffs in the short run are eliminated when there is more labour market flexibility (in terms of reduced labour regulations) so that workers can move more easily from contracting import-competing industries to expanding export industries.

Wages also increase through tariff reform-induced productivity increases. Competition from imports leads to rationalisation of firms, as inefficient firms close down and the remaining ones increase productivity to maintain competitiveness. Over the 1990-99 period, there is evidence that wages in the manufacturing sector have risen with productivity increases (Yatawara, 2004).

3.3 Income Volatility and Job Insecurity

Closer integration with world markets implies that countries are susceptible to international shocks beyond the control of national players. On the one hand, trade allows the reduction of volatility in goods prices due to domestic supply shocks like adverse weather, by allowing imports to suppress high domestic consumer prices.

On the other hand, it also argued that trade makes the demand for labour more elastic, through increased foreign product market competition, substitution for foreign workers, and by threats of internationally mobile capital. This reduces the bargaining power of labour, weakening unions and heightening job insecurity. Thus although wage levels may increase, trade is likely to lead to more job reallocation and dislocation.

[4] Further, the standard mechanism breaks down if we allow for more goods or more countries. For example, if we introduce a third country like China, the incomes of the low skilled poor may decrease as we import low skill intensive goods from China, and may not be able to export our low skill intensive goods to the US. Tariff reduction may also hurt poor low skill workers in low skill abundant countries if initial tariffs were placed on these potential export sectors.

4. Current Trade Policy Issues

4.1 Ad-hoc Agricultural Tariff Changes

Since most of Sri Lanka's poor are rural poor, trade policy towards agriculture and overall agricultural policy is vital for poverty alleviation. Although agriculture is the most protected sector in the economy (with ad valorem tariff averaging 21 per cent compared to 9 per cent for manufactured goods), it is not the tariff *level* that has had the major policy impact. Instead, it is the frequent *fluctuations* in the tariff that have affected behaviour. The record of accomplishment of successive governments has been one of gross policy inconsistencies and ad-hoc tariff policy changes that send confusing signals to potential investors. For example, tariffs on rice and coconut oil have fluctuated immensely, with tariffs on rice being adjusted over ten times since 1996. In addition, tariff reductions in 1996 on many agricultural products like chillies and potatoes were frequently modified and reversed in 2002 as imports increased and domestic output declined. These fluctuations partly reflect the government's efforts to deal with its conflicting dual goals of trying to have low food prices for consumers and high producer food prices for farmers. This has discouraged long-term new investment in agriculture, and induced behaviour that maximises short-term profit.

Very often, trade policy is not the main issue driving poverty in the agricultural sector. For example, paddy farmers have suffered as the sector has become increasingly unprofitable because farm-gate prices of paddy have not kept up with the rising cost of paddy production. This mainly reflects the strong bargaining power of monopolistic rice millers, and the weak position of cash constrained, indebted paddy farmers with inadequate storage facilities after harvest.

The agricultural sector has suffered from the absence of a clear and consistent agricultural strategy for the country over the last decade. The result has been low agricultural productivity (real value added per agricultural worker is 40 per cent of the value added by a worker in manufacturing and services), an annual output growth rate of less than 2 per cent over the last decade (compared to a 7 per cent growth in manufacturing and a 5 per cent growth for services) and persistent rural poverty.

Recent calls for increased blanket trade protection for all agriculture are disturbing. They are often only justified by the fact that developed countries protect agriculture too – the high cost of doing so is rarely considered. Moreover, it detracts from addressing fundamental issues facing the agricultural sector, such as low productivity, lack of efficient extension services and technology dissemination, as well as ineffective credit and insurance markets. Trade protection cannot compensate for these domestic failures.

A dynamic consistent strategy for agriculture should be a 'hand up' strategy instead of a system of 'handouts'. Such a policy would include a tariff policy that has credibility as a signal of the government's long-term policy towards particular sub-sectors. Even if the government seeks to insulate changes in food prices in times of shortfall and surplus, it should adopt a more rules-based predictable system, such as price bands. Innovative new instruments such as forward sales contracts need to be evaluated to check whether they are helping the poor, and if so, should be expanded. Consistent with food security objectives, incentives should be provided to promote the production of crops that would be profitable to farmers given the natural conditions in their area. Land reforms – including land titling coupled with insurance mechanisms to prevent landlessness – could also stimulate new investment and appropriate land use. New reforms should be aimed at increasing the likelihood of the price benefits of trade reaching the poor producers, and stimulating new investment in agriculture.

4.2 Elimination of the Apparel Quota System

The most dramatic trade policy issue facing the Sri Lankan nation is responding to the January 2005 final component of the phase out of the apparel quota system under the Agreement on Textiles and Clothing (ATC), which allowed for managed access to industrial markets. The end of designated quotas for apparel producing countries will lead to much greater competition in trying to penetrate American and European markets, with competition from China likely to be very strong. While some Sri Lankan factories are internationally competitive, many smaller firms were sustained by the guaranteed access through the quota allocation. There will be an inevitable rationalisation of the garment industry with adverse employment consequences, as low productivity firms close. This is especially of concern because the apparel sector was a growing industry that registered a 40 per cent increase in employment from 1998 to 2001 (see Table 1). Some firms have already begun their adjustment by investing in China and other countries with preferential trade access to the North American market such as African Growth and Opportunity Act (AGOA) members and other least developing countries.

Given that 88 per cent of the total employed in the industry are women, plant closures will hurt female earning power the most. Further, since most of the low productivity garment factories are outside the Western Province, the regional consequences will also be noticeable. Assistance in the form of productivity enhancing techniques and technology is needed, as well as assistance in improving quality and marketing products abroad.

Table 1. Employment in the Apparel Industry and Poverty

District	Employees 2001	Employ-ment	Employment growth 1998-2001	% of Poor Households 2002	Change in % of Poor Households*
Colombo	91,228	23.3	14.5	5.9	-3.1
Gampaha	133,200	34.0	54.8	13.8	2.4
Kalutara	27,222	7.0	74.2	21.8	1.5
Kandy	12,332	3.1	57.3	25.7	-10.6
Matale	4,926	1.3	122.8	31.1	-14.6
Nuwara Eliya	9,705	2.5	38.6	21.7	-7
Galle	15,605	4.0	44.1	17.8	-14.3
Matara	8,490	2.2	75.5	29.5	-5.3
Hambantota	7,147	1.8	87.0	37.8	7.5
Vavuniya	701	0.2	10.6	n.a.	n.a.
Batticaloa	1,395	0.4	77.3	n.a.	n.a.
Amparai	1,394	0.4	-22.8	n.a.	n.a.
Trincomalee	2,349	0.6	155.6	n.a.	n.a.
Kurunegala	18,343	4.7	26.7	30.5	1
Puttalam	10,722	2.7	35.4	23.6	-8.9
Anuradhapura	9,090	2.3	19.3	29.5	3.9
Polonnaruwa	4,139	1.1	47.3	29.0	1.7
Badulla	5,440	1.4	27.6	37.7	10.6
Moneragala	3,784	1.0	64.7	33.8	-13.9
Ratnapura	11,735	3.0	41.0	37.4	-6.7
Kegalle	12,735	3.3	79.4	31.5	-4
Total	**391,682**	**100.0**	**41.5**	**23.9**	**-2.8**

Source: Sri Lanka Garments Magazine-Issue 80, Preliminary Report Household Income and Expenditure Survey 2002

* Compared to the 1995/96 survey. Negative sign indicates reduction in poverty.

Achieving market access will be a key complementary strategy and intensive efforts should be made to secure duty free treatment for Sri Lanka's exports to the United States (US) and the European Union (EU). This could be through the European Commission's (EC) New Special GSP+ (Generalised System of Preferences) for 2006-2015 (which grants zero duty for all GSP eligible goods provided that Sri Lanka complies with 27 international conventions). Due to Sri Lanka's high compliance with International Labour Organisation (ILO) standards, the country has received since February 2004 privileged treatment through the application of the current EC-GSP 'social clause' scheme. Duty free access for apparel and other products should be sought in the framework of tsunami aid relief from industrialised countries.

Sri Lanka offers preferential tariffs under of four regional integration arrangements, namely:

i) SAARC Preferential Trading Arrangement (SAPTA)[5]

ii) Bangladesh, India, Myanmar, Sri Lanka and Thailand Economic Cooperation (BIMST-EC)[6]

iii) Bangkok Agreement[7]

iv) Indian Ocean Rim Association for Regional Co-operation (IORARC)[8]

The first two have restarted initiatives to push towards a free trade area by an ambitious target of 2006.[9] Generally, preferences in these groupings have not been significant, and particularly in the case of SAPTA, Sri Lanka has given its partners preferences in products, which are largely irrelevant to their bilateral trade. Thus, the overall impact, and consequently the impact on the poor, has not been significant.

However, deeper integration efforts are seen in the pursuit of bilateral free trade agreements (FTAs) with India and Pakistan, and these are likely to affect the poor.

5 SAPTA members are Bangladesh, India, Pakistan, Sri Lanka, Maldives, Nepal and Bhutan.

6 Bhutan and Nepal joined in 2004.

7 Bangkok agreement's original signatories are Bangladesh, India, Laos, South Korea and Sri Lanka, with China joining in 2000.

8 The Indian Ocean Rim Association for Regional Cooperation is made up of 19 countries with the three key players being India, Australia and South Africa.

9 The Agreement on the South Asia Free Trade Area (SAFTA) was signed in January 2004.

Sri Lanka has a bilateral FTA with India (ISLFTA), with negotiations underway to extend it to a Comprehensive Economic Partnership Agreement (CEPA) that would extend liberalisation beyond trade to selected services and investment. Sri Lanka also signed a FTA with Pakistan in February 2005. These FTAs reduce Sri Lankan tariffs for imports solely from the partner countries. In the same manner, Sri Lankan exports receive deeper tariff preferences beyond what other World Trade Organization (WTO) members receive to the markets of partner countries.

Poor local producers may be adversely affected to the extent that preferential tariff reduction leads to increased competition from imported Indian and Pakistani goods. However, the poor gain as consumers of cheaper products from India and Pakistan, as well as producers with greater opportunities to export their products to the vast Indian and Pakistani markets, thus stimulating employment and incomes. As suggested earlier, agricultural liberalisation will be of key importance to the poor. Agricultural protection was significant in the ISLFTA (with most of agriculture placed on a 'negative list' which involves no liberalisation). However, in negotiations with Pakistan, some liberalisation of the sector was negotiated.

Pakistan lobbied to get preferential access for its citrus fruit, basmati rice and potatoes in return for liberalisation of the Pakistani tea market. Besides tea, Sri Lankan exports of betel, rubber and coconut products, spices and paper products should grow due to preferential access. Sri Lankan spice exporters (particularly, exporters of cinnamon, pepper and cloves) have also been successful in penetrating the Indian market, due to the preferential access granted by the ISLFTA. However, now the government faces the issue of how to deal with the differences between the Indian and Pakistani agreements. Careful analysis should be made of the impact on the agricultural sector before streamlining the two agreements, and giving India the same preferences as Pakistan in agriculture.

It is important for the government to have a strategy for agriculture before pushing forward with free trade agreements. If they do not, Sri Lankan agriculture will be shaped by negotiation capabilities of external trade partners.

Work has also progressed on bilateral FTAs with Egypt, Singapore and the US. During the 2002-4 period under the United National Front government, Sri Lanka embarked on a rampant journey of securing bilateral free trade agreements with all interested parties, apparently in a bid to expand tea export markets. In fact, a FTA consisting of preferential treatment on just a handful of goods was almost signed with Thailand, thwarted only due to changes in the government.

While the increased activity in trying to penetrate new markets was welcome, it was not clear that a bilateral FTA was necessary or sufficient to promote trade. In fact, it would be quite dangerous. The preferential agreements (regional and bilateral) create a complex system (a "spaghetti bowl") of preferences (by product, by partner, by varying timetable to full liberalisation), which coupled with varying rules of origin create an administrative nightmare for customs as well as business. In such an environment, resource-constrained small and medium enterprises that employ the poor are unlikely to know under which agreement it would be most profitable to export to markets such as India which come under more than one agreement. For example, it is more advantageous to export cloves under SAPTA than under the ISLFTA.

While blind bilateralism is not recommended, there are clear advantages of the FTA with India and a possible one with the US. Although India continues to dismantle its import protection apparatus multilaterally, deeper integration with one of the fastest growing economies is going to be beneficial for Sri Lanka. Sri Lankan growth was hampered due to the stagnancy in India in the 1970s and 1980s, and should benefit from the increasing demand for goods, services (including tourist services) and investment opportunities, as the Indian economy expands and incomes rise.

FTAs are also useful in securing market access. It has been shown that when countries witness reversals to protectionism, FTA partner countries are exempt from new trade barriers. This was the case when the US imposed steel tariffs but exempted Mexico and Canada – its NAFTA (North American Free Trade Agreement) partners, thus leading to much greater Canadian and Mexican penetration of the American steel market.

A combination of a few important FTAs could make Sri Lanka an attractive investment location, stimulating employment creation and poverty reduction. For example, the FTAs with India and Pakistan may encourage Pakistani investment in Sri Lanka to penetrate the Indian market, as well as Indian investment to penetrate the Pakistani market. In this context, an FTA with the US would be attractive as it may lead to more US investment in Sri Lanka, as Americans use Sri Lanka as a base to penetrate the large Indian market. Although the traditional selling point of Sri Lanka as a gateway to India is a little passé, Sri Lanka may still be able to attract investors based on a better educated labour force, better infrastructure (especially the port) and a more transparent rules-based system. In addition, Indian and Pakistani investors may come to Sri Lanka to penetrate the US market. Encouraging investment from more than one large country will also allay local fears of a single foreign country becoming a very dominant investor in Sri Lanka.

4.4 Responses to 'Less than Fair Value' Imports and Import Surges

Currently Sri Lanka has no legislation to respond to the dumping (products sold in Sri Lanka below the market price in source countries) of goods by foreigners, as well as to imports that have received substantial support of foreign governments that make it unfair competition to domestic import competitors. Appropriate responses to such imports are needed. The traditional approach taken by developed and developing countries have been anti-dumping duties and countervailing duty legislation. However, the procedures to embark on such cases tend to be very expensive and have generally been taken on only by larger sectors in developing countries, such as the pharmaceuticals and steel industries in India.

The challenge in Sri Lanka is to come up with procedures that are fairly streamlined and cheap so that they are accessible to small and medium enterprises that will most likely be adversely affected by such 'unfair' imports. An alternative approach may be to build such procedures into the dispute settlement mechanisms in free trade agreements. While formal anti-dumping legislation may not be in Sri Lanka's interests as anti-dumping duties have often become hijacked by protectionist interests, inactivity in this area is also unacceptable. This is because it is likely to most adversely impact small and medium enterprises (SMEs), throwing their employees into poverty. A first step is to enact "safeguards" legislation, which provides temporary protection for domestic producers from import surges.

4.5 Trade-Related Safety Nets

Trade agreements should have a trade adjustment assistance component to help those adversely affected by developments in trade policy. Not only must this be enacted, but also the public must be made aware of its existence and the established means to access the assistance. For example, assistance may be required for potato and citrus fruit farmers after the Sri Lanka-Pakistan FTA comes into effect. This assistance could take the form of techniques to increase productivity, or even diversification into alternative products.

5. Making Trade and Growth Work Better for the Poor

It is widely argued that the 2004 election loss in spite of robust economic growth of the incumbent government in India (and some would argue in Sri Lanka too), reflected the protest vote of the poor, because the benefits of growth were not reaching the poor (fast enough), and sufficient policies were not in place to protect the losers from reform. Democracy gives the poor a voice, and they are a constituency that should not be ignored. Trade and trade policy produce both winners and losers among the overall population, as well as among the poor.

If governments want to garner support for their trade policies, they must put in place additional policies that will 1) compensate losers from the policy and 2) address distortions that lead to insufficient gains for anticipated winners. In terms of the former, Sri Lanka has a system of social safety nets but since trade liberalisation as well as trade protection create winners and losers among the poor, these government interventions have to be well targeted. Targeting and administration difficulties, as well as occasional politicisation have plagued poverty alleviation programmes. Sri Lanka clearly has to be integrated with the world economy, but that does not imply blanket trade liberalisation. There are multiple frameworks that would be consistent given other national objectives such as food security. This section outlines some complementary policies that would increase the poor's access to the opportunities and gains offered from trade.

5.1 Increased Labour Market Flexibility

An often-cited obstacle to benefiting from the opportunities of integrating with world markets is the level of excessive labour regulations in Sri Lanka. While the problems in the labour market cannot be blamed squarely on the labour laws, laws such as the Termination of Employment Act and political interference in wage bargaining do reduce the flexibility of employers to respond to changing market conditions, and to move from low productivity to high productivity sectors. These reallocations are essential for any dynamic economy, and have the potential to stimulate job growth and productivity growth, and as a result, wage growth and poverty alleviation.

Although there has been no robust empirical work on Sri Lanka's labour regulations, recent work on Indian states (Besley and Burgess, 2002) shows that states that amended the Industrial Disputes Act in favour of workers experienced lower productivity, employment, investment and output, as well as increased poverty. Further, other work (Topalova, 2005) shows that in Indian states with lower labour market regulations, tariff reductions did not hurt the poor. It is also consistent with this argument that the Sri Lankan estate sector, which has a much-regulated labour market, had the highest headcount poverty ratio in 2002. Using the national absolute poverty line, 30 per cent of the estate population were estimated to be poor in 2002, compared to 24.7 per cent of the rural population and 7.9 per cent of the urban population.

Labour market flexibility is desirable but the movement to it should involve two features. First, less job security should be compensated with higher wages to workers. Second, Sri Lanka should develop an unemployment insurance system that would ease the ill effects of job insecurity. Developing a credible system of worker adjustment assistance, which includes income support, worker training and job search assistance, would be an appropriate accompaniment to any major changes in existing labour laws. Some form of social insurance will reduce job insecurity and perhaps ultimately facilitate reform of the bloated public sector. It appears as if successive governments treat public employment as a pseudo social insurance scheme, absorbing new cadres during times of low economic growth and before elections.

5.2 Infrastructure Development

The development of roadways / highways is important for getting the products of the poor to main markets, for receiving new and cheaper products and for labour markets to respond to new opportunities. However, for over a decade, capital expenditures have been declining in government budgetary allocations. In fact, actual capital spending has been below budgetary targets, as governments try to trim budget deficits while maintaining or expanding spending on current expenditures like wages, interest and pensions. Finally, a positive sign was seen in the 2002 budget, which actually marked an increase in capital spending. Lowering budget deficits at the expense of growth-enhancing capital expenditures is not optimal fiscal policy.

Following the tsunami, coastal infrastructure such as roads, railways, power, telecommunications, water supply and fishing ports will have to be reconstructed. Besides the benefits of linking the poor to markets, the reconstruction process can be a significant source of local job creation and hence tenders should be given to firms that use labour intensive techniques.

5.3 Access to Capital Markets

The substantial share of rural credit is through the informal sector with very high interest rates, putting a large burden on the poor. While rural banking with subsidised credit has expanded, spearheaded by the two State banks and rural development banks, it has often resulted in bad debts. The regular waiving of loan repayments by the government during bad harvests, have created a culture where default is prevalent.

Hernando de Soto (2000) also argues that the key to helping the poor borrow and invest, is not to reduce collateral requirements for them but to secure property rights under the rule of law for the poor's assets, so that they may be effectively collateralised. This is a key factor in Sri Lanka, where land distributed by the government under various arrangements does not contain freehold rights. While this has prevented landlessness, it has also resulted in inefficiently small cultivated plots, and contributed to low investment in the land. More secure property rights also need to be combined with insurance mechanisms so that poor farmers do not lose their land after one bad harvest.

5.4 Promotion of Small and Medium Enterprises (SMEs)

SMEs are increasingly becoming an important segment of the industrial sector in Sri Lanka. In fact, SMEs in Sri Lanka with fixed assets of Rs.16 million or less, account for 90 per cent of total establishments, 70 per cent of employment and 55 per cent of gross value added in the private sector. SMEs create employment at low investment costs, produce basic consumption goods using domestic raw materials, and raise incomes for large segments of the lower income population.

Encouraging entrepreneurship and the expansion of the SME sector is a vital element in enhancing the existing industrial base, export performance, job creation and income generation in both rural and urban areas. It is likely that SMEs will be more vulnerable to the forces of trade liberalisation than many of their larger counterparts. As a result, supportive measures for the development and growth of this sector need to be adopted. This is particularly important because the country still has no anti-dumping duty, countervailing duty or safeguards legislation that can address unfair trade practices and import surges.

5.5 Policy Priorities and Innovative Policy Design

The human and physical devastation caused by the 26th December 2004 tsunami should reorient any government's priorities toward reconstruction and rebuilding the livelihoods of the survivors. The government has the opportunity to rally the nation on a pro-poor growth agenda. This would involve overhauling the agricultural sector onto a dynamic growth acceleration, and an unprecedented regional focus in expanding industrial development outside the Western Province. While a regional focus has been often mentioned, the fact that national output figures are not even reported by region reflects the commitment to this regional focus.

The tsunami crisis has put increasing demands on policymakers. It is important for technocrats to focus their efforts on equitable rebuilding strategies and attacking the most significant constraints to growth and poverty alleviation. It would be unwise to divert scarce human and physical capital in the technocracy on a vast array of institutional reforms that would only have a marginal impact on growth and poverty. A concentrated effort is needed, and failure to prioritise this task will not be forgotten at the polls.

Too often policy making in Sri Lanka lacks imagination. A reliance on markets over planning by bureaucrats does not imply a passive approach to development. Blanket trade liberalisation is not a strategy to help the poor – neither is blanket trade protection under the guise of a national production strategy. The country needs strategies and institutions that are grounded in solid economics and are locally appropriate to address local concerns. For example, while it is widely accepted that a big problem in paddy cultivation in the wet zones is the small size of the cultivated area, no creative institutional arrangement has been designed to promote some cooperation among farmers in production and encourage investment. Such arrangements may have reduced the need for changes in land policy. Likewise, no policy innovations have been developed to reduce the role of middlemen and monopolistic grain millers, so that paddy farmers acquire greater gains. Some degree of policy experimentation and creating showcases of reform is needed. The past tendency has been to borrow institutional arrangements from successful countries, and best practice knowledge from multilateral financial institutions. Unfortunately, institutions rarely travel well. It remains the job of the technocrat to design locally appropriate, economically viable mechanisms to promote growth and alleviate poverty.

5.6 Stability of the Macroeconomy, Policy and Polity

Poverty alleviation and growth require effective macroeconomic management, policy consistency and stable politics. Maintenance of responsible monetary and fiscal policies is needed to prevent high inflation and unsustainable debt burdens. Fiscal irresponsibility has led many governments to curtail (potentially growth-enhancing) public investment (such as infrastructure development), while maintaining non-productive current expenditures (including interest payments). It has led to reversal of trade liberalisation as import surcharges have been imposed for revenue-raising reasons. New challenges are also likely to arise with greater inflows of foreign aid, and their tendency to lead to appreciating real exchange rates.

Policy consistency is key because it reduces an element of uncertainty in an unstable global economy, and sends a signal to businesses and labour upon which long-term investment commitments are made. Fluctuations in policy lead to greater uncertainty and fear of investing in the country.

Fragile coalition governments are also bad for the poor as they draw attention and resources away from the process of economic growth and poverty alleviation, and towards power maintenance and politically motivated, short-term support for particular groups.

A great source of uncertainty and deterrent to investment and growth in the island has been the ongoing conflict with the LTTE. A well-designed peace will lead to reduced budget deficits, a stimulated tourist industry, greater overall economic activity, more foreign investment and therefore reduced poverty. However, an ill-conceived peace would only postpone the burden to a later generation, bequeathing them with perhaps a far graver crisis.

6. Conclusion

Perhaps the most useful message of this brief is the importance of not generalising how trade and trade policy will impact a heterogeneous group like the poor. Trade (as well as restricting trade) will produce both winners and losers among the poor. Therefore, specific government interventions will be required to help the losers and address domestic distortions that lead to insufficient gains to anticipated winners. Thus, it is often seen that trade liberalisation is most beneficial in the presence of complementary policies.

As a small economy, Sri Lanka must be integrated with world markets. However, blanket trade liberalisation is not the solution to poverty and lacklustre agricultural performance. It is also not the cause of it. Similarly, reverting to trade protection will not remedy the poverty situation. The key to poverty alleviation is robust economic growth, and to the extent that trade stimulates growth, trade alleviates poverty. In light of the devastation caused by the tsunami, poverty reduction should be a policy priority, and a more focussed approach to policy making is needed. Technocratic policy makers should identify only the most significant constraints to a growth take-off and then channel resources and gather coalitions in a concentrated manner to eliminate them.

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