



## Competing and Collaborating at the Periphery: **Small and Medium Enterprises in Post-Conflict Sri Lanka**

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## Introduction

International evidence suggests that growth and development of small and medium enterprises (SMEs) are critical for regional economic development, employment creation and increased incomes<sup>1</sup>. Contributing to 30% of Sri Lanka's gross domestic product, and 35% of employment, the importance of SMEs to the country's economy is without doubt (ADB, 2016), noteworthy. As per the Economic Census undertaken in 2013, there were over one million enterprises in 2013 employing 2.25 million people (Ministry of Industry and Commerce, 2016). Of these enterprises, 41%, 33% and 26% were in trade, industry and services respectively. Almost 92% of the enterprises were micro enterprises and only 0.2 % were large. The remaining 8% were Small and Medium Enterprises (SMEs) employing almost 1.9 million people and representing 30.5% of the workforce (Ministry of Industry and Commerce, 2016).

The Western Province is the core development region for the country, and the further towns and districts are situated from the core, the more challenging the business context becomes for SME development. In 2015, 40% of Sri Lanka's GDP contribution came from the most developed Western Province, including the capital Colombo, with the conflict affected Northern and Eastern Provinces contributing the lowest with 4.1% and 5.7% respectively (Central Bank, 2017). Data on regional per capita incomes in 2015 highlight that the two provinces had the lowest levels of income (Central Bank, 2017). Despite this low level of growth contribution and income generation, the North and East had two of the highest provincial growth rates of 11.1% and 10% respectively (Central Bank, 2017). While large businesses contributed to the provincial GDP and per capita GDP of the Western Province, the lack of large businesses in the peripheral regions suggest that the importance of SMEs for growth in the peripheral regions is higher. Therefore, promotion of SMEs can be considered as one of the most important means for long-term development of the peripheral regions. Yet, knowledge about SMEs in peripheral regions such as in the fragile post-conflict contexts of the North and East of Sri Lanka is relatively low.

This paper partially fills that void and seeks to contribute to bridging gaps in knowledge on the key challenges SMEs in the North and East face, so that region-specific and sector-specific policies can be developed for enhanced growth. It adopts a qualitative research method that considers the economic as well as sociological factors that affect the growth of SMEs by giving priority to the views of SME owners. From an economic perspective, size-induced market factors are discussed, and from a sociological perspective, social networks are discussed. Though the focus of this paper is the North and East of the country, insights from these regions, lend their relevance to other peripheral regions too such as the Uva and North Western provinces.

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See for example, Nugent and Yee (2002) on South Korea, Wu and Huang (2003) on Taiwan, World Bank (2015) on Malaysia, and Shimuzu (2013) on Japan.

## Why SMEs as an Alternative Force for Growth?

Entrepreneurs in fragile and post conflict regions generally do not embark on starting an SME after considering choices based on the availability of other alternatives, but rather out of pure necessity (Hoffmann and Lange, 2016). While their presence and success have the potential to create the business confidence to draw in investment and the entry of larger firms, often, SMEs in fragile and post-conflict regions do not grow but rather just survive with low profit margins. The reasons for this include the fact that access to resources is limited, internal markets are thin and entry to other larger external markets is difficult. From a policy standpoint, prior to developing prescriptions for SME growth, it is critical to understand the context in which SMEs operate and how different formal and informal institutions influence them. Indeed, often, while policy making generally focuses on business enabling formal institutions to improve access to finance and government procedures, SMEs are more often influenced by informal networks, personal contacts and links with powerful political elites. Economic transactions for SMEs are dependent on trust within groups and communities that identify themselves as having their own identity. In other words, the entrepreneur's identity developed because of culture and history may prevent broader engagement in markets beyond the conflict affected region. Conversely, if an entrepreneur can transcend his or her existing network, he or she may increase the chances of success of the business (Hoffmann and Lange, 2016).

Such insights from this global knowledge provide a starting point to understanding the kind of challenges businesses in the peripheral regions of Sri Lanka may need to overcome. In May 2009, Sri Lanka's conflict affected region changed dramatically when the Liberation Tigers of Tamil Eelam (LTTE) fighting for a separate state for almost three decades was comprehensively defeated by the government armed forces. Immediately afterwards the government, as part of its post-conflict development agenda for the country promoted state-led investment growth agenda. With a highly populist approach to development, regions were encouraged and incentivised to use local resources and develop sectors that had relative comparative advantages (Government of Sri Lanka, 2010). This was matched by large debt-financed infrastructure investment in roads, power and roads. The conflict affected region also saw reconstruction of public buildings and social infrastructure (Presidential Task Force, 2012). However, it was unclear if such an investment had crowded out SME growth or created the necessary enabling environment to nurture local business growth and attract private sector investment.

Supporting SMEs in these peripheral regions to overcome their challenges is critical for long term social cohesion. This is particularly so, as regional inequalities between Colombo and the lagging regions were important sources of resentment that led to the war. Sri Lanka's economic growth prior to the commencement of the conflict was slow and unequal at a regional level (Athukorala and Jayasuriya, 1994). Since the end of the war, poverty in the North and East has remained higher than in other parts of the country (World Bank, 2015).

In 2015, a new pro-private sector and reconciliation promoting coalition government came to power with Maithripala Sirisena as president and Ranil Wickremesinghe as Prime Minister. Policy decisions indicate that this current government is keen on building bridges between ethnic communities, but the economic focus remains in the Western region, rather than in the lagging

regions. The government has developed its key regional development strategy - Megapolis<sup>2</sup> – that primarily focuses on investment based around the capital, Colombo (Ministry of Megapolis and Western Region Development, 2016). This focus is expected to lead to significant public and private investment over the next 20-30 years, significantly strengthening the core development region of the country. Though being furthest from this core region, the North and East could potentially benefit from market opportunities. They could also face significant challenges due to underdeveloped markets, economic distance and the increased transaction costs. This study provides an indication of the level of stability sectors that would have to compete once external trade agreements and country investments are in place.

The government is spearheading several development initiatives that are likely to significantly affect SMEs in the country, including in those regions researched here. For example, it is eager to have free trade agreements with India, China and Singapore (Economic Times, 2018, and Singapore Business Review, 2018). Though undoubtedly free trade agreements are likely to see heightened competition not only among those in the country trying to tap export markets, but also with foreign firms focused on Sri Lankan markets.

Additionally, while the government's political efforts locally and internationally on peacebuilding have been seen positively by those expecting reconciliatory policy making, global experience suggests that durable peace is unlikely unless improvements in small business and incomes are enhanced so that peace dividends are strong and opportunity costs for a re-emergence of war are high (Bearce and Omori, 2005). In that regard, views of SMEs in the conflict affected region of Sri Lanka provide an important proxy indicator for peace dividends in the local economy since the ending of the war.

A few recent studies on SMEs, such as Miriyagalla (2014:2015) highlighted the diversity of challenges faced by different businesses in the conflict affected districts of Jaffna and Batticaloa in 2013. However, more research is required to fill gaps in the knowledge on issues faced by SMEs in underdeveloped and peripheral districts in Sri Lanka. This research partially fills these gaps and provides evidence of the need for SME growth to achieve equitable long-term peace dividends. Moreover, recognising the importance of providing actionable insights, this research is expected to help key stakeholders such as policy makers, investors, business organisations and other relevant officials to support improved business development of regional SMEs.

## Research Methods

This research adopted a qualitative research method to ensure more in-depth analysis of the context and not be constrained by standardised questions that allow for only a few types of responses (Patton, 2002). The main research question for this study was “*What are the key factors affecting SME creation, growth and sustainability in the conflict affected region of Sri Lanka*”. To ensure that the findings would be “rich”, the research study adopted a qualitative research method focusing on semi-structured interviews. The sampling method used for the qualitative part of the study was stratified purposeful sampling of SMEs in each of the district studied. This

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2 More information can be obtained through the Ministry of Megapolis Development [http://www.megapolismn.gov.lk/web/index.php?option=com\\_content&view=article&id=55&Itemid=221&lang=en](http://www.megapolismn.gov.lk/web/index.php?option=com_content&view=article&id=55&Itemid=221&lang=en)

involved selecting key sectors that were of critical importance to each district and sourcing lists of SMEs from regional business member organisations.

Business member organisations (BMOs) in the two districts were instrumental in supporting the selection of target sectors and obtaining information on members who could be contacted. Some SMEs who were not members of the BMOs were also selected to achieve representation from those not active in business associations. Stratified purposeful samples were developed and businesses contacted so that approximately five-six businesses in each sector were interviewed per district. The decision on the number of interviews per district was decided based on resources and time available, and to allow for sufficient details to be obtained to make suitable conclusions (Patton, 2002). The reason the sample was stratified was so that each strata could a homogenous group and analysed separately (Patton, 2002). The actual number of businesses from each sector varied depending on the success rate of securing interviews. Interviews were undertaken in late 2016. Thirty interviews were undertaken in each of the districts of Jaffna and Trincomalee. Of the total 60 interviews, 8 were with women.

Sri Lanka does not have a clear definition of an SME different institutions use employment numbers and/or size of capital investment as the key determining criteria. The Department of Census and Statistics in Sri Lanka defines a micro/small and medium business as one that employs less than 100 employees (Department of Census and Statistics, 2017)<sup>3</sup>. Only businesses that had between 5-100 employees were contacted for this research. Business owners were confidentially interviewed at the workplaces with the support of a research assistant who had a thorough knowledge of the the district. Details of the sectors chosen and the number of interviews for each sector are given below.

| Sectors                | Jaffna    | Trincomalee |
|------------------------|-----------|-------------|
| Tourism                | 5         | 5           |
| Agro-processing        | 5         | 4           |
| Information Technology | 5         | 7           |
| Construction           | 6         | 6           |
| Industrial             | 9         | -           |
| General Services       | -         | 8           |
| <b>Total</b>           | <b>30</b> | <b>30</b>   |

**Size-induced Market Failures, Social Networks and SMEs**

While all businesses face market-based challenges, SMEs are further constrained by factors that are related to their size – these can be termed as ‘size induced market failures’ (Vaendenberg et al., 2016). Compared to large businesses, SMEs have challenges securing finance, finding skilled workers, accessing technology and markets, and entering more profitable markets. Moreover, given that often SMEs are not provided with concessionary benefits through

3 See also National Policy Framework for SME Development, 2016

policies by governments, the cost of compliance with regulations are proportionately higher. These challenges make SMEs less able to benefit from economies of scale and be as competitive as large businesses (Vaendenberg et al., 2016).

Though one may expect that, given their size, SMEs would be able to engage in more innovative businesses and adapt to changing conditions quickly, evidence from SMEs globally suggests that most SMEs are in fact very traditional and less innovative. Therefore, their uptake of new technology and business practices is relatively low. Of those that do innovate, most simply buy new machines. Policies that can help SMEs to innovate include demand-side where incentives are provided to innovate by guaranteeing purchase from those that do, supply-side that provide loans, grants and other financial incentives for innovation, and systemic policies that help bring about innovative partnerships (Vaendenberg et al., 2016).

The lack of access to finance is one of the most important constraints that SMEs face. Without business loans, SMEs would not generally have the working capital to start or grow their businesses. The size of their businesses make them less able to show the collateral required for loans, and knowledge of loan compliance procedures is also lower. Overall, SMEs are considered riskier loan clients by banks, and therefore, they are required to pay higher interest rates. Even when concessionary credit is available such as through government backed concessionary funds, many entrepreneurs are simply not aware of their existence due to a lack of information about the credit schemes. Policies that help guarantee SMEs so that credit can be accessed, provide information on credit worthiness or allow movable property from being used as collateral can significantly help many businesses to grow (Vaendenberg et al., 2016).

SMEs are less able to attract and retain skilled staff than large businesses. Therefore, often SMEs hire less skilled persons and do not engage in on-the-job training. A high turnover of workers also leads to the perception among entrepreneurs that it is not worth training employees for fear that trained staff may simply leave for higher pay elsewhere. Indeed, given that SMEs are also less able to pay salaries on par with or higher than large businesses due to their lower profit margins, such a perception may in fact be true. However, without training and better pay, SMEs cannot expect to get the best out of their workers (Vaendenberg et al., 2016).

The cost of accessing larger, more profitable markets are simply beyond the reach of small businesses. Given that they are up against stiff competition within these markets, the risks associated with spending time and money to enter such markets may be too high. However, without entering high-end markets businesses will remain traditional and unable to move beyond their low profit markets. In fact, competition at the lower end of the value chains are not lesser than at the higher end, and therefore it is in the interest of entrepreneurs to develop themselves, take calculated risks and move up the value chains. Government schemes that provide information on export markets and how to comply with needs of high end customers can be a useful way of reducing the risks for SMEs (Vaendenberg et al., 2016).

Beyond the market-based factors that influence SMEs, social relations matter for all economic activities as well (Granovetter, 1992). Indeed, in regions that lack strong formal institutions as in this instance, social interaction and ties are essential, and could be considered even more important than economic factors in supporting businesses. The quality of social relations to which entrepreneurs have access to affects their success significantly. As Loury

(1977) suggests, “The social context within which individual maturation occurs, strongly conditions what otherwise equally competent individuals can achieve” (p. 176). Therefore, the importance of networks as well as the levels of hierarchy in social relationships should not be underestimated. Putman (1993) describes how more horizontal relationships that encourage greater collaboration can have lasting impacts on the ability of individuals to contribute to the development of their regions (Putman, 1993). This situation creates a path of dependence enabling and preventing economic opportunities within these peripheral regions. Therefore, if people have lived in a disadvantaged location for many years, poor networks handicap them from linking with economic opportunities (Polk and White, 1999).

Moreover, it is not just a case of having or not having social capital; people have different types of social capital. Building on this argument, Putnam (2000) purports that there are two types of social capital – bonding social capital and bridging social capital. Whilst the former is based primarily on relationships within a group and helps the individual to “get by” in life, the latter helps build bridges to other groups and helps them “get on” in life (Putnam, 2000). Bonding Social Capital brings a higher level of social interaction because it is based on ties to people who are similar. However, the very existence of high levels of bonding social capital can be a significant disadvantage leaving people isolated from opportunities (Shirlow and Murtagh, 2006), it is the lack of confined social capital norms that allowed people to move into other relations (Burt, 1992). Therefore, often it is the very presence of bonding social capital that reduces the possibility of gaining bridging social capital. When there is ‘closure’, there are a set of sanctions created that ‘monitor and guide behaviour’, but also bind each other within a trustworthy relationship (Coleman, 1988). At one level, greater closure will provide better information with greater trust, but at another level the isolation from more valuable information reduces one’s opportunities (Lancee, 2012).

Waldinger (1995) points out that “the same social relations that...enhance the ease and efficiency of economic exchanges among community members implicitly restrict outsiders” (p. 557). Often, people are “stuck” in ethnic based communities that are meant to provide their



opportunities, but instead result in barriers for future opportunities. Only if the immediate circle of contacts has access to information or opportunities, people will have access to economic opportunities. Portes (1998) notes another important aspect of negative social capital. He suggests that if a group's unity is based on adversity or a rejection of the mainstream society, "individual success stories undermine group cohesion because it is grounded on the alleged impossibility of such occurrences" (p. 17). In such situations, the more ambitious or successful simply leave, willingly or "by force". Being too embedded in a mono-ethnic community compels one to conform to group obligations and further enhance "downward assimilation" (Portes, 1998). Uzzi (1997) highlights the critical need to balance economic relations with social ones stating that businesses which are too wedded in their social embeddedness are unable to pick up new information.

## General SME Issues in Sri Lanka

Despite the importance of the need for studies on SMEs in Sri Lanka, national and regional based research is surprisingly uncommon. There could be several reasons for this. SMEs are diverse in terms of size, sector location and ways of operation, and thus require extensive data collection to enable robust conclusions. Accurate secondary data on SMEs is not available and thus quantitative secondary data-based research is not possible. International agencies such as the ADB and IFC do undertake analyses of the SME but often focus on economic factors such as access to finance that are directly relevant to their donor assistance mandates. Further, they often undertake research that is applicable to all SMEs rather than targeted analysis on specific sectors or regions of the country as their mandate is at a national level. Moreover, when research is conducted there is an overwhelming focus on purely economic factors.

Until recently, of the few country-wide documents that existed, three key policy documents have provided insights on issues facing SMEs in the country - the draft National Strategy for Small and Medium Enterprise Development (Ministry of Enterprise Development, 2002), the draft Small and Medium Enterprise Policy (National Enterprise Development Agency, 2009) and the National Human Resources and Employment Policy (2011). While the existence of these documents suggest that the issues surrounding SMEs in the country were well known and SME development had been prioritised, the reality was that for many years there was no finalised policy document specifically guiding the development of SMEs. This begged the question of whether, even though there had been efforts to understand the issues from a country-level perspective, SME promotion had been prioritised within the overall development agenda. Moreover, there were gaps in the documents with insufficient recognition of the opportunities and challenges of the overall post conflict context, regional and sector variations and how different SMEs could be better promoted and incentivised.

The draft National Strategy for Small and Medium Enterprise Development remains the most comprehensive assessment of the general issues facing the SMEs. It highlights that policy inertia, high interest rates and insistence of collateral, low levels of technology, absence of technical skills, lack of information and marketing skills, lack of adequate infrastructure facilities, labour legislation, competition from low priced imported goods, tax structure, conflict and government bureaucratic procedures were the most important factors affecting SMEs in

the country. While it may be argued that there have been some gains made on all these factors identified 15 years ago, the main contextual difference for a clear majority of SMEs since then has been the end of the war. This is especially the case for the conflict affected regions.

## National Policy Framework for SME Development

In 2016, a new policy document – the National Policy Framework for SME Development (Ministry of Industry and Commerce, 2016) was finalised. The document recommends six focus areas to promote SMEs: enabling environment, modern appropriate technology, entrepreneurial culture and skills development, access to finance, market facilitation, and research and development. There were no specific recommendations for peripheral regions based on contextual differences. However, the more balanced set of recommendations was noteworthy, as historically, much of the national level initiatives supporting SMEs revolved around provision of credit<sup>4</sup> rather than a more holistic approach, considering economic, social, regional and sector factors. The importance of understanding regional and sector specific issues within the SME population cannot be overemphasised. This is because while addressing general policy gaps is important, targeted interventions based on sector and regional variations are just as critical.

There have been a few recent region-specific studies outside the conflict regions. Ranjith and Banda (2014) highlighted key factors determining the success of SMEs in a region in the North-Western Province. The factors included family background of the entrepreneur, decision making ability, skills, and level of financial investment. In another study on entrepreneurial orientation and business performance of SMEs in the south of the country, Fairoz et al. (2010) found that most (52%) showed only a moderate level of enterprise orientation. Moreover, their willingness to be proactive, innovative, and take risks largely depended on their share of the market. Results further indicated there were positive correlations among proactiveness and enterprise orientation with business performance. The level of innovation and linkages to external sources of information by SMEs in the Western province was studied by Weerasinghe and Jayawardena (2015). Their research concluded that many manufacturing SMEs do not maintain links with other firms, knowledge sources and government institutions and therefore are unable to optimally innovate.

The lack of participation of women in business is another important challenge to overcome for the development of SMEs. Past research has provided some important insights on the challenges that women entrepreneurs face. Women comprise only 8.3% of small and 6.1% of medium scale business owners (Ministry of Industry and Commerce). They face significant gender specific challenges to starting and growing their businesses including the need to bear a much greater responsibility than men for household work and child care, and lack of sufficient options for travel to and from work (Attygalle, 2014). In a more detailed analysis of challenges that women face in the SME sector in the peripheral districts of Monaragala, Matale, Kurunegala and Anuradhapura, women highlighted that women did not have difficulty accessing resources such as land, labour and technology to start a business (Attygalle, 2014). Rather, accessing markets and finance was their greatest challenge. Managing their work-life balance was also a challenge due to a triple burden of obligations at the enterprise, home and in the community.

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4 See for example, International Finance Corporation (2017)

A study on the factors affecting women led businesses primarily based in Colombo found that uptake of technology could increase women's participation in entrepreneurship (ITC, 2018). However, there may be differences amongst women in peripheral regions.

## **SMEs in the War Economy and Transition to the Peace Economy**

During war years, the country achieved an average annual economic growth of 5%, which was significantly higher than others that had similar periods of violence. However, many peripheral regions, including the North and South of the country remained largely underdeveloped with the western part of the country benefiting most from growth. The primary source of this growth was government-led military spending. Moreover, successive governments had adopted expansionary fiscal policies that promoted war-related expenditure as the key contributing factor in creating growth without regionally balanced development outcomes (Venugopal, 2011).

Furthermore, the country's policy makers were unable to make effective economic policy decisions that could have had strong long-term consequences for the country (Dunham and Kelegama, 1994; and Athukorala and Jayasuriya, 1994). The conflict had prevented the effective development of any long-term initiatives that could have improved the well-being of the peripheral communities. The negative consequences of the conflict far outweighed the positive short-term measures adopted to keep the country's economy growing. In the conflict affected region of the North and East, the conflict significantly weakened regional institutions, destroyed the economic infrastructure, left much of the land area heavily mined, curtailed the skills development of people, and detracted investors.

As the war progressed over two decades with no end in sight, it slowly led to the disintegration of social and economic wellbeing. The negative effects of the conflict on the economy of the North and East after the commencement of the conflict were significant, and appreciably higher than in other rural areas of Sri Lanka (Karunanayake, 2001). During the



conflict, as the Northern Province continued its economic decline its contribution to the overall Sri Lankan economy was significantly reduced especially regarding primary production. As the table below highlights, the contribution of the peripheral regions to economic growth was significantly lower than that of the Western Province.

*Provincial GDP share in 1996-2000 (%)*

| <b>GDP Share</b>       | <b>'96</b> | <b>'97</b> | <b>'98</b> | <b>'99</b> | <b>'00</b> |
|------------------------|------------|------------|------------|------------|------------|
| Western                | 43.5       | 43.9       | 45         | 48.6       | 49.4       |
| Southern               | 8.9        | 8.7        | 9.2        | 9.4        | 9.3        |
| Sabaragamuwa           | 9.1        | 7.7        | 6.7        | 6.5        | 6.7        |
| Uva                    | 5          | 5          | 4.9        | 4          | 4          |
| Central                | 10.6       | 11.1       | 10.3       | 9.7        | 9.9        |
| North Central          | 4.5        | 3.9        | 3.6        | 4.1        | 3.8        |
| North Western          | 11.3       | 12         | 12         | 10.3       | 10.4       |
| <b>Northern (part)</b> | <b>2.4</b> | <b>2.7</b> | <b>2.8</b> | <b>2.5</b> | <b>2.1</b> |
| <b>Eastern</b>         | <b>4.8</b> | <b>4.9</b> | <b>5.5</b> | <b>5</b>   | <b>4.5</b> |

*Source: Mutaliph et al. (2002)*

Agricultural production in the North reduced significantly with the percentage contribution by the Northern Province in paddy, fish, red onion, chili, vegetable and fruits showing marked declines. As the table below highlights, the biggest declines were in paddy and fish production, a major part of the staple diet in the region. The agricultural sector was also affected due to landmines and constant displacement of people, and the fisheries sector saw a significant reduction in production due to most beach areas being demarcated as high security zones (Sarvanthan, 2003).

**Agriculture Production - Northern Province 1980-2000**

| <b>Sector</b>        | <b>% Share of Total</b> |             |             |
|----------------------|-------------------------|-------------|-------------|
|                      | <b>1980</b>             | <b>1990</b> | <b>2000</b> |
| Paddy Production     | 11.6                    | 5.4         | 3.0         |
| Fish Production      | 39.8                    | 16.6        | 3.1         |
| Red Onion Production | 55.9                    | 41.2        | 30.2        |
| Chilli Production    | 23.6                    | 10.6        | 7.6         |
| Vegetable Production | 4.3                     | 3.6         | 2.0         |
| Fruit Production     | 7.5                     | 1.4         | 0.9         |

*Source: Sarvanathan (2003)*

The effect of the war on the manufacturing sector employment was also marked. The industrial sector came to a standstill with factories deserted or destroyed. As the table below indicates, from 1980 to 2002, the industrial enterprises in the Northern Province declined from 78 to 7. In the Eastern Province, during the same period, the number reduced from 24 to 19. The biggest change was between 1980 and 1994, by when the number of manufacturing enterprises in the North was zero (Sarvanathan, 2003). Thus, employment creation in the manufacturing sector at that time was likely to have been negligible.

Number of Manufacturing Enterprises by Province 1980 – 2002

| Province      | 1980        | 1994        | 1999        | 2001        | 2002        |
|---------------|-------------|-------------|-------------|-------------|-------------|
| Western       | 1394        | 2060        | 2701        | 2797        | 3007        |
| Southern      | 126         | 118         | 186         | 180         | 201         |
| Sabaragamuwa  | 79          | 36          | 63          | 64          | 70          |
| Uva           | 17          | 31          | 44          | 42          | 45          |
| Central       | 173         | 90          | 155         | 187         | 202         |
| North Central | 15          | 27          | 37          | 38          | 37          |
| North Western | 81          | 91          | 183         | 192         | 212         |
| Northern      | 78          | 0           | 5           | 6           | 7           |
| Eastern       | 24          | 12          | 23          | 19          | 19          |
| <b>Total</b>  | <b>1987</b> | <b>2465</b> | <b>3397</b> | <b>3525</b> | <b>3800</b> |

Sources: Peiris and de Silva (2003), and Central Bank (2003)

Therefore, the environment for SME development in the conflict affected region during the war was far from conducive. The rural South also continued to remain weak with the only jobs available being low-skilled occupations such as garment factory workers and enrolment in the armed forces. As a result, and expectedly, there continued to be deep distrust and resentment amongst the Tamils and Sinhalese rural population that equal regional opportunities were not being created.

It was common knowledge that the peripheral regions attracted little to no investment during the conflict years, and thus SME growth during this time was minimal. Herath (2012) notes that the war was a ‘great leveller’ because asset loss was very high and only those who received remittances from relatives abroad did not face a rapid decrease in quality of life. Restrictions on trade of certain goods such as cement and batteries meant that the living standard dropped significantly during the period. Large private sector firms had few incentives to invest in a region, whose economy continued to erode.

The government-controlled areas of the conflict region, including Jaffna and Trincomalee, had a heavy military presence and continued to be affected directly by the war. The LTTE held areas, were almost entirely cut off from the economy of the rest of the country and had its own de-facto governance structure. Mobility into and out of these areas was heavily restricted, and there was almost no interaction between them and those outside. As existing large businesses closed, and little investment trickled in, only the local subsistence economy continued, and within that environment micro-small enterprises would have kept the rural economy alive.

The end of the war in 2009 marked the most significant shift in the economy since the opening of the economy in 1977. While an end to the war did not bring with it a political solution, there was no doubt that there were large expectations across the country that the economy would improve. However, in a study (Miriyaigalla, 2015) conducted in 2012 with 50 SMEs, 25 from Jaffna in the North and 25 from Batticaloa, insights on the initial state of the SMEs in the conflict affected districts highlighted that the situation was mixed. Of the sample of 25 businesses from Jaffna, 16 had started before the war ended, 4 immediately afterwards in the same year, and 5 thereafter. Of the 16 business that existed before the war ended, 62%

of those recorded said that their businesses had improved since the end of the war. Of the other 9 that started after the end of the war, only 33% stated that their businesses had shown an improvement over the past four years. In Batticaloa, of the sample of 25 businesses, 24 had started their businesses before the war ended. However, only 21% felt that the end of the war had improved their incomes.

The main reason for the low number was that the previously closed economy opened faster than expected and businesses could not cope with the competition. With the flood of products and services from predominantly Colombo-based businesses, profits for many SMEs declined.

## Key Findings

This section provides an analysis of the findings of the research in the Jaffna and Trincomalee districts under six sectors – Tourism, Agro-processing, Information Technology, Construction, Industry and Trade. It is important to note that each region has its own contextual differences and businesses are also significantly influenced by historical factors. Nevertheless, while a rigorous comparison is not possible, there were some noticeable common issues.

## Tourism Sector

Tourism has become the most important sector for Trincomalee. No other sector provides more lucrative backward linkages both within the sector as well as across it, primarily due to leisure seeking local and foreign tourists. The sector is also of great significance for Jaffna primarily due to the growth of business tourism because of the influx of Colombo based businesses, and foreign and diaspora tourist arrivals. This growth corresponds very well with national level data indicating that the sector had become the third most important foreign exchange earning sector after remittances and garments by 2015 (Daily News, 2016). Some businesses in Trincomalee were very pleased with the way business had improved. This was partly due to larger businesses opening in the region which promoted a growth of the sector.

However, findings from the research also suggest that heightened competition within the sector was a key factor constraining some tourism related businesses in Trincomalee. Discussions suggest that some hotels were under pressure to maintain or reduce their room rates as the number of hotels have kept increasing. Hotels were very aware of what their competition offered in terms of services and had clear target customers in relation to what others could offer. Some targeted more ‘luxury’ rooms, while others focused purely on ‘standard’ rooms. Despite the high level of competition, hotels in Trincomalee saw more opportunities for growth in the future, but they felt constrained by several other external factors. Access to finance and lack of public investment to improve the location as a destination were stated as important problems.

Hotels in Jaffna on the other hand were less pressured by competition as they seemed assured of a regular clientele. The difference related to the kind of guests those hotels targeted. The hotels have seen a steady increase in business both due to external business visitors as well as residents using their restaurants and bars. With the opening up of regional branches of Colombo based businesses in Jaffna, company representatives constitute a regular clientele who often stay in the same hotel. Another reason for the increase in business was the continuing inflow of

money from diaspora sources even after the war ended, and residents, especially youth, being keen to spend money on entertainment such as eating at restaurants. Increased visits by the diaspora was also felt to be an important contributory factor supporting SME hotels in Jaffna. As will be highlighted in latter parts of this think piece, other sectors such as agro-processing and construction have also benefitted due to connections with the large tourism value chain.

In addition, heightened pressure on the prices hotel owners can charge has resulted in many hotels not seeing an increase in profitability as initially expected. Indeed, much of the profits were used to pay off loans. Many hotel owners in the two districts indicated their pleasure that there was improved transport connectivity and communication than seen during the war, and that the overall enabling environment had improved significantly. However, hotels were concerned that changes to the tax regime were affecting their profits as they were inclined not to pass the tax on to customers, choosing to bear it as a cost instead due to competition. Tourism related activities in both Jaffna and Trincomalee were also felt to be insufficiently developed, especially in relation to tourist entertainment and facilities at cultural sites. Notably, many hotels in Trincomalee felt that greater effort was needed to ensure that the beach was clean so that guests found their stay enjoyable. Moreover, SMEs in Trincomalee felt that there was a dearth of information for tourists regarding places they could visit, particularly on historical sites. Some hotels were generally overbooked during peak seasons, but those hotels had informal networks of hotels which they could recommend to tourists when necessary. Other SMEs were worried that there now were too many hotels and that over competition would be detrimental to the industry in the future. The tourism sector in Trincomalee is clearly a sector which has intense competition as well as collaboration.

Most complaints highlighted a combination of issues: the VAT has increased, resulting in either difficulty of covering costs or the risk of losing business; the government makes no effort to clean the beach and it can lead to other problems if the private sector tries to intervene; tourists need more activities and information about places to see; there is a lack of recreational activities in the region, so the tourists remain bored.



Some respondents felt that the increased connection between the conflict affected districts and the rest of the national economy was currently affecting them in a negative manner resulting in lower incomes for the local economy. This indicates that sufficient efforts have not been made to maintain a pro-poor focus on tourism. Previously money earned within the district had remained in circulation, however, the influx of investments from outside was currently leading to a flight of profits. This trend was not limited to smaller shops and other service providers connected to the tourism industry, but extended to hotel profits themselves.

Some hotels found it difficult to access capital as banks required more documents prior to the approval of loans. Entrepreneurs felt disadvantaged compared to those who were employed and had the security of a monthly pay to use as a form of guarantee when obtaining personal loans. The lack of concessionary finance for the industry was felt to be a significant barrier for the future growth of hotels. The gap in skilled labour was of significant concern as well as labour is scarce, and performance poor and irregular. The need for training youth was reiterated. Banks (public and private) advertise for low interest loans, but people shared their difficulties in making loan applications, owing to lack of documents etc.

## Agro-processing Sector

SMEs in Trincomalee, particularly those that were involved in marketing novel products to the high-value local market, were doing well. However, others that were more focused on smaller or external markets were performing poorly. They faced significant challenges particularly due to intense competition from outside the district and increases in the VAT. External suppliers had used sales and marketing strategies such as promotions and the distribution of free samples to capture the Trincomalee market rendering local suppliers uncompetitive. Some SMEs had, however, managed to tap niche local markets that needed regular supply, such as hotels and the army and navy camps. Notably, entrepreneurs felt that market prices were being determined by large external companies which had the economies of scale to sell at comparatively lower prices.

Entrepreneurs also felt that the lack of access to finance was an important issue that had remained unaddressed resulting in poor growth of small businesses. Some businesses saw large untapped opportunities but were unable to expand without the additional finances to invest in machinery and technology. Not surprisingly, therefore, diversification in products in Trincomalee was minimal and there was little innovation or effort made by these businesses to search for new markets.

Despite these challenges, however, entrepreneurs in the agro-processing sector in Trincomalee felt that significant benefits awaited them after the war, since the ending of the war had already led to some income gains. One of the most important benefits was the opportunity to tap export markets. Entrepreneurs were confident about opportunities particularly because of their ability to considerably improve productivity. During the war, there had been significant travel restrictions. However, businesses were currently able to operate longer hours and take larger orders despite strong competition from outside and challenges to business expansion.

Jaffna based agri-businesses were performing much better compared to those in Trincomalee, and many had seen a consistent expansion of their sales, mainly from export

markets and demand from established sales centres and tourist hotels. The agro-processing sector was perhaps the most important SME sector for the Jaffna district. Though the SMEs felt challenged to find markets in Colombo or other parts of the country, it did not seem to be enticed with the considerable market opportunities in exports. SMEs that were focused on the quality of their products were particularly confident about future growth of business within the markets that they had tapped. Competition from larger businesses had been a major push factor to encourage medium scale businesses to improve on the quality of their goods. The heightened awareness of the importance of quality was felt to be a critical factor supporting the maintenance of links with established markets.

Despite the gains made and the lucrative markets that were being tapped, those entrepreneurs who were doing well also had concerns. Key among the concerns was competition from Colombo based brands, which they felt were superior in quality and could not be matched in terms of price. The few agro-based businesses in Jaffna that were struggling were pitching their products at lower-end consumers. Some could not find established formal markets and had been compelled to diversify, while others maintained very low sales prices. They viewed low income earning consumers as only being interested in price and therefore, not willing to consider quality as a factor when purchasing products. Therefore, the SMEs that focused on the lower-end consumers felt that there was little justification in increasing quality at the expense of price.

## Information Technology Sector

Trincomalee and Jaffna had seen significant and similar transformations in the Information Technology Sector since the end of the war. There has been a large growth of SMEs that provide services related to computer repairs, communications and printing. However, many were concerned that competition among the firms had resulted in lower margins, particularly due to a credit crunch among the local population. Formal businesses had also seen other costs increase such as the price of inputs, payment of taxes and employee benefits. Lower profits have resulted in an inability to afford payment of higher salaries to staff. Moreover, entrepreneurs stated that as customers became more IT literate and the technology being introduced to the market had become increasingly user friendly, customers did not require outside support from firms. Some business owners were of the view that it would be more profitable to embark on IT training rather than sales or repair of computers due the challenges of competition. Importantly, some business owners clearly identified that developing networks and engaging in marketing were the keys to their further success. Informal contacts played a large role in getting business; registered businesses that only adopted formal approaches and procedures could not achieve the profit margins to stay viable.

Interviewees highlighted that in addition to the competition within the SME sector of each district, competition between local SMEs and larger Colombo based companies that had entered Jaffna and Trincomalee was changing the business dynamics in both districts. They felt that large Colombo based businesses were able to market products of higher quality and lower price, enabling them to win tenders. These large firms had significant networks and influence, and control on prices and sales which increased their ability to tap more lucrative markets. Many SMEs were concerned that they would never be able to compete with the influence, price and quality of service of large firms. Others felt that with additional support and better marketing,



there would be fairer competition. However, some SMEs were very pleased that this influx of external businesses had provided more opportunities for partnerships. Though it was unclear whether it was a new issue, and perhaps due to the increasingly competitive environment, some businesses felt that bigger bids could not be won without corruption. This further highlighted the importance of informal networks over formal procedures.

Some SMEs had diversified their businesses to provide more specialist services such as computer design and printing, but over-competition without a large available market was of significant concern to them as well. Business owners were particularly worried that prices of goods such as paper and other inputs were also escalating due to the VAT increases, thus affecting the demand for IT related services. The increasing cost of living was also taking its toll on the demand for basic services with many consumers not being able to afford what they could earlier. Another key bottleneck for growth of IT businesses in Jaffna and Trincomalee was the dearth of machinery repair technicians and spare parts in the districts.

Other business owners felt that there was significant over-competition at the lower end of the IT sector due to the excessive number of loans provided by lending institutions. Entrepreneurs were of the view that the sector had been supported by finance companies without sufficient due diligence or knowledge of loan recipients. For example, many start-ups had been provided with loans that enabled the entrepreneurs to purchase 2-3 computers and other machines, and there was a price battle resulting in lower business viability overall. Moreover, SMEs had had to become even more price conscious due to the entry of sales representatives from Colombo who operated with lower overheads and could offer lower priced products and services.

Despite these challenges, some entrepreneurs had captured a niche market and continued to invest in new technology. The main reason for their success was the knowledge they had in the sector, not surprisingly, those SMEs which had invested in machines without knowledge to back them up were unable to succeed. One business in Jaffna had seen very rapid increases in profits and the success was attributed to its success in winning government contracts through contacts made with government departments. This highlighted the importance of networks even in high value niche markets even in a sector that appears to have large openings.

## Construcon Sector

Partly due to the government's investment in infrastructure and due to private investment, both Jaffna and Trincomalee districts saw a large initial boom in the construction sector following the end of the war. Some contractors in Trincomalee were profited by tapping into expanding markets such as building construction in the tourism sector. With growth in these other sectors, especially tourism, construction work was needed and investments in machinery that could replace labour provided useful returns. Entrepreneurs highlighted that without growth in the tourism sector, growth in construction would have been minimal. The successful construction entrepreneurs had been active in searching for markets and ways of improving the quality of work; they had regularly attended exhibitions and met with wholesalers and developed partnerships to get the best prices for inputs. Moreover, they had also developed significant personal contacts with government officials to get necessary approvals to ensure that business proceeds well.

The successful construction sector SMEs in Jaffna were tapping the building construction market including homes and felt there would continue to be good opportunities in the future if they maintained good quality at a reasonable price. The building construction market was one that offered lucrative opportunities if the required standards were maintained.

The need for construction was very high and businesses were encouraged with low interest loans to start or grow their businesses. However, the situation has changed in the recent past and SMEs faced financial constraints due to high interest loans. Many SMEs were not keen to invest further and preferred to stay within their current means of capacity particularly due to the uncertainties associated with labour, inputs, and the economy.

As in the IT sector, government tenders had been an important source of income for some new contractors, but reduced government revenues and poor payment processes had made a direct negative impact on the companies as some had not been paid for work done. Due to reduced cash flow, some SMEs have been compelled to reduce staff and lack the cash flow to bid for new projects. SMEs complained that the contractors in the North and East were allowed only a lower profit margin of 14% unlike others, which were allowed 30%. In addition to feeling disadvantaged due to the differences, the level of profit was felt to be insufficient to bear the costs of taxes and other overheads.

The contractors were also disappointed with the policies and bureaucratic decision making within the sector. They felt that there were undue benefits provided by banks to businesses from outside the provinces. This impacted local businesses because of the intense competition to secure government contracts.

For those contractors working with private sector clients, the challenges were largely due to irregularity of work and the smaller size of contracts. Competition had also significantly increased, both among the contractors in the district as well as from outside the districts. Given that all contractors were facing delays in getting payments for work done, loan payments to lending institutions had also been delayed. The shortage of labour as well as escalating labour costs were also considered key problems, particularly regarding masons and carpenters.

As with the IT, agro-processing and tourism sectors, many SMEs in the construction sector felt discouraged by their inability to compete fairly with businesses from outside their districts.



Poor marketing skills and lack of sufficient cash flow had prevented the local contractors from growing their businesses and competing effectively with external contractors. Some contractors even felt that the situation before the end of the war was better as there was less competition even though there was less work available. Others felt that it was normal to expect competition, but support was needed to make the competition fairer.

Accessing resources such as sand was also a key constraint. Permits were difficult to obtain, and prices were constantly changing. Quotes of total costs had to be kept as low as possible due to the competition and at times, the prices quoted were in fact not sufficient to ensure a good quality output. Therefore, some SMEs felt that there were few incentives to expand or even stay in the sector.

## **Industrial Sector**

The non-agro industrial sector in Jaffna had seen an increase in manufacturing enterprises focused on the local market in the recent past. Some businesses had been started by the older generation before the start of the war and had been dormant during the war years. They were subsequently revived either by the original owners or the next generation. Many of these firms had an older generation of technical staff who did not require significant training, which was considered very positive. Some entrepreneurs felt that good training of staff was the most important factor determining success in this sector. However, many entrepreneurs believed that there was a large dearth of skilled employees, which held back the growth of firms. Changes in attitude were particularly important. The continuation of older attitudes and practices regarding production was holding back entrepreneurs from deciding to invest in newer technology and competing with more competitive products in the market. Therefore, they were uncompetitive in the higher end of the market.

Though there was significant interest among entrepreneurs to start manufacturing businesses, only three out of the eleven interested businesses had managed to start-up ventures in

the industrial zone due to non-approval of their loans. The most important challenge mentioned was access to finance. Entrepreneurs surmised that support from lending institutions had been considerably low because many small industrialists had found it difficult to obtain finance to grow their businesses despite the demand for their products.

Importantly, of those manufacturing firms that had started, many were doing well and had consistently improved their businesses, particularly focusing on external niche markets particularly in Colombo. They had, however, not been competitive in the mainstream market in Jaffna due to higher quality goods coming from other parts of the country. Other entrepreneurs had tried to access new markets outside their districts, but they had faced significant challenges. Improving quality was a key challenge to tap these markets, and efforts to make improvements had been difficult due to challenges in importing quality raw materials and other inputs. Since many business owners got their inputs from outside the region, ordering and delivering production materials took a long time and was costly due to the challenging circumstances related to the transactions. However, they felt that if there was a ready market for finished goods, the incentive was strong enough to pursue their enterprises.

SMEs working in the industrial zone in Jaffna were of the view that the allocation of a specific area for industrial work had been a blessing. Other SMEs have also indicated their preference to be located within a common location and await approvals to relocate there. However, transport was still not sufficient within the zone. Policy issues were mentioned as being of significant concern for some SMEs in this sector, whereas for others it was not an issue.

Some entrepreneurs felt that being away from Colombo reduced their ability to stay up to date with industry related innovation and global best practices.

While sales have been good, some SMEs have faced challenges collecting income due to delays in payment. To maintain business, many have continued to provide large buyers with credit, but delays in payment led to negative effects on their cash flow. Some felt the need to branch out into larger markets like Colombo and one SME has even opened a sales centre in Colombo. But this venture has had mixed results due to costs in relation to distance.

As with other sectors, a couple of older companies were disappointed that the government had increased taxes and instructed them to pay employment benefits to workers. During the war, SMEs had not been obligated to do so, and therefore these companies were now seeing lower profit margins. However, they understood that it was necessary.

## **Trade Sector**

The Trade sector SMEs in Trincomalee, comprising of retail outlets, whole-sellers and distributors, have had mixed fortunes depending on the type of business they are engaged in. SMEs engaged in retail sales of general produce complained of lower profits predominantly due to the mushrooming of such stores. Given that it was relatively easy to enter the trade business, especially for the sale of general produce, retail shops had experienced heightened competition, lower profit margins and reduced sales.

Distributors were very pleased with how business had improved over the past few years. As more producers entered the market, they needed such distributors to deliver their goods

and there was growing request for them to become agents for producers. However, distributors complained that payments for delivery were not made on time, and there were a lot of outstanding payments.

SMEs that were selling more specialised produce such as curd, water or compost were also pleased with their sales. The fact that the products they sold were more specialised meant that there was fewer competing stores. Traders were conscious that selling good quality produce was essential. However, the competition came primarily from two sources – unauthorised dealers who sold their products from mobile outlets such as vans and trucks, and shops outside the region that sourced products from the same producers, thereby reducing supply of good quality products to the shops in Trincomalee. Traders felt that it was important for good regulation of informal external businesses and unauthorised dealers operating without rental costs.

Others SMEs have tapped growing value chains such as in the hotel sector and found markets for goods through such relationships. Several entrepreneurs complained about the lack of policy support for businesses. Issues such as price controls, increased taxes and lack of development plans were mentioned as affecting trade business. Many traders felt that there were no economic plans for the district that could support them. The only significant driver of development was felt to be the arrival of tourists. But even this sector was at a level that did not creating sufficient demand for SME services. Other entrepreneurs stated that the government was supportive, and officials were appreciative of the way business had improved.

Some traders were disappointed that government contracts were not fairly administered. Only those SMEs that had established networks and contacts with officials were able to get supply contracts.

## Conclusion and Recommendations

The findings of this research suggest that, in the nine years following the end of the ethnic conflict, there has been a moderate improvement in business in the post-conflict peripheral regions, though there were wide variations in terms of the sectors. The cessation of armed conflict, public investment in economic and social infrastructure immediately thereafter and the resulting private sector investment had resulted in positive changes. Many SMEs in Jaffna and Trincomalee have the desire and potential to innovate, connect themselves to the core development hubs and become important partners in the growth story of Sri Lanka. But their effectiveness in doing so is mixed. Some sectors such as tourism continued to do well even after the initial surge in optimism; others, such as construction are facing several significant challenges affecting the profitability of its SMEs. Overall, sustainability, growth and long-term viability of large sections of SME businesses in the peripheral areas appear to be in doubt. Many businesses were unlikely to move beyond their current “survival” unless there was a supportive boost from multiple fronts through their respective value chains, the policy environment and social integration.

The current level of confidence exhibited to compete in external markets is not high, particularly due to the inability of the SMEs to compete with higher quality products from outside the region, distorted local markets due to the overwhelming importance of informal networks and personal links to institutions. The current competitive business environment in the peripheral areas is tilted heavily in favour of those businesses which can secure and invest large amounts of credit and access high-value niche markets and networks, and are linked to contacts with social and political power.

From a social perspective, many businesses were locked within their traditional networks and remained focused on low value local markets. They had been unable to build relationships with larger businesses or new customers and remained disillusioned when observing other more profitable businesses that had better links. Businesses that had done well were those that had engaged in collaboration and partnership with different partners. They had attracted new customers, developed new markets, sought informal connections and made strategic investments in new technology. As a result, they were able to exploit new innovative market opportunities and secure long term high value contracts/clients. They have reached beyond their immediate social boundaries and built social ‘bridges’ for their economic gain.

From an economic perspective, significant challenges remain for SMEs in conflict-affected peripheral regions. The main concerns revolved around heightened competition, access to capital, absence of supportive policies, increased taxes and labour shortages. This study also confirms that there were other resource and geographical issues related to the North and East that are affecting SMEs in the conflict affected region. These include challenges such as a lack of established comparative advantages and economic distance. Successful SMEs had adopted new technologies and leveraged finance to expand the businesses.

While challenges to SME growth are to be expected, given that the two provinces were affected by conflict and many businesses were still learning to adapt the changing realities, it

should not be assumed that entrepreneurs would be able to overcome such challenges on their own. They may require additional incentives both from a demand as well as supply perspective, and policies to develop inter-ethnic and intra-ethnic ties. Moreover, it is important to take into consideration the intra-regional inequality of benefits accruing to the SME sector in relation to external businesses that have invested into the region. This highlights the critical need for a catered policy mix with resource and market-based stimulus for local SMEs to get better dividends, and promotion of innovative social ties. SMEs should be encouraged to take the initiative and develop strong and diverse linkages across ethnicities, sectors, and regions. Policies specifically targeting the region should be developed in a purposeful and strategic manner. SMEs would benefit from the development and support of both formal and informal institutions as well as the development of comparative advantages for the peripheral regions based on existing resources.

The question of whether SMEs in the two districts will be able to compete in the open market with a potential influx of external investments after the opening of the free trade doors and development of the Megapolis cannot be answered with certainty. Current conditions suggest that it appears unlikely that SMEs in the periphery will be able to compete in a post-free trade and Megapolis era unless there is a support structure in place so that businesses could develop and connect to the markets in a fair manner. It is important to be mindful of the fact that regional development lies at the heart of long term peace. The ability of regional SMEs to become viable and provide opportunities for income to be retained in the region in a manner that further stimulates intra-regional and inter-regional business linkages is critical. Regional inequalities must not be allowed to increase as plans for the Megapolis and free trade agreements are implemented.

SMEs can grow only within a policy enabling environment that is directed by an agreed and finalised policy or strategy document based on key issues faced by SMEs in specific regions and sectors. SME development facilitation must be encouraged based on specific interventions and regional comparative advantages. State and large business support for initiatives must continue to ensure crowd-in SME growth for lagging regions such as the North and East. Opening, expanding and improving the labour markets for SME growth is also critical as is the development of entrepreneurial confidence. While taxes are clear disincentives for SME growth, they also generate revenue for government investment in the SME enabling environment. Therefore, finding the most suitable incentive structure to meet both SME and government needs is an urgent necessity.

One cannot expect to have an equal playing field for businesses – a degree of inequality is healthy, but there must be sufficient efforts to ensure a reasonable degree of fairness. This is critical because the development of SMEs is one of the most effective ways of developing poorer regions and increasing incomes of small entrepreneurs, their workers and families. Moreover, supporting diverse SME business linkages can be an effective long-term peace promoting strategy. Overall, with the right set of economic, social, sector and regional policies, SMEs in the peripheral regions will be able to contribute to sustainable national prosperity through healthy competition and collaboration.

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The lack of presence of large businesses in the peripheral regions of Sri Lanka, unlike in the core Western Province, underscores the importance of Small and Medium Enterprises (SMEs) for regional economic growth and development. Despite their importance, knowledge about SMEs in peripheral regions such as in the fragile post-conflict contexts of the North and East of Sri Lanka remains relatively low. This paper fills an important gap in knowledge on key challenges faced by SMEs in the North and East of the country. It highlights the reasons why sustainability, growth and long-term viability of large sections of SME businesses in the peripheral areas appear to be in doubt. Moreover, it justifies the need to provide targeted and sector-based support through respective value chains, the policy environment and social integration.

The Centre for Poverty Analysis (CEPA) is an independent Sri Lankan think-tank promoting a better understanding of poverty-related development issues. CEPA believes that poverty is an injustice that should be overcome and that overcoming poverty involves changing policies and practices nationally and internationally as well as working with people in poverty. CEPA strives to contribute to influencing poverty-related development policy, at national, regional, sectoral, programme and project levels.

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