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Transforming Conflict with an Economic Dividend

The Sri Lankan Experience

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Abstract

Peace can generate an economic dividend, which can be further increased by appropriate economic reform. This dividend can in turn be used to raise popular support for conflict resolution measures along the road to achieving a final political settlement, a strategy that characterizes the recent period in Sri Lanka. However, despite an increase in economic growth following the cessation of hostilities between the Liberation Tigers of Tamil Eelam (LTTE) and the government, no substantial dividend materialized for either government supporters in the South or LTTE supporters in the war-torn Northeast. The causes of this failure include delays in disbursing aid which would have eased adjustment to economic reforms—resulting in cuts to public spending that affected Southern households—and weak institutions that impeded the effective use of aid in the Northeast. The Sri Lankan experience highlights some important lessons for both government and donors on making use of an economic lever for consolidating a peace process and conflict resolution. It also highlights some of the dangers in relying too much on economic levers to consolidate a peace process when levels of mistrust are very high.

Keywords: Sri Lanka, conflict resolution, economic dividend, foreign aid

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1 Introduction

There is a growing body of literature and practice on the characteristics of war-torn economies and the policies of post-conflict reconstruction. This has led to substantial policy initiatives and new mechanisms for peacebuilding. Surprisingly, however, there is little systematic analysis of the ways in which economic factors contribute to the success or failure of peace agreements (Woodward 2002; Addison 2003). Sri Lanka's experience over 2002-03 provides a good case study of the potential to use economic levers in conflict resolution.

By 2001, Sri Lanka had experienced nearly two decades of conflict with the Liberation Tigers of Tamil Eelam (LTTE) waging war for a separate state in Northeast region. A severe economic crisis resulted and when a conflict resolution package was introduced in early 2002 and peace talks initiated, steps were taken simultaneously to revive the economy. This process initially sidestepped the most controversial political issues and focused instead on confidence building of which an 'economic dividend' was an important element, consisting of (i) economic rebuilding (ii) a new institutional set-up for the Northeast with the LTTE being an equal partner for the first time and (iii) increased foreign aid, including an IMF programme, for economic revival as well as for relief and reconciliation work, thereby bringing international actors into conflict resolution efforts.

The resolution process was mediated and influenced by the Norwegians, and Jan Peterson, the Norwegian Foreign Minister commented, 'Most armed conflicts … have their origin in poverty and discrimination. But it is increasingly clear that lack of economic opportunities and pure greed are prominent causes as well. Hence, in preventing and resolving armed conflicts, we must focus on the economic dimensions of the war' (Jan Peterson quoted in IPA 2002: 17).

Sri Lanka's economy was broadly back on track, but delivering on the promised economic dividend to lock-in the peace process and to build support for the government proved difficult and complex. Impediments on both the government and rebel sides, as well as in donor policies, are the cause. The LTTE complained that the Northeast's economic dividend was too little and too late. The peace talks faltered in April 2003, and the government lost the 2004 elections, but the war did not resume. And the tsunami in December 2004 added to the complications, while also devastating the economies and communities of coastal areas.

This paper evaluates the role of the economic dividend in the conflict resolution process, and why the dividend itself turned out to be disappointing. An exercise of this nature has certain limitations. First, we are dealing with a relatively short period (2002-03), and the economic benefits of peace take time to emerge. This may be true, but even within a two-year period it is possible to see whether the economic dividend is working, and this is the focus of this paper. Second, the peace process was put into effect at a time of uneasy cohabitation between the president (Chandrika Kumaratunge from a centre-left political party) and the government, and the power base of the prime minister (Ranil Wickremasinghe from a centre-right political party) was weak. This may have influenced the final outcome, in addition to problems with the economic dividend.

The paper is organized as follows: section 2 reviews the background work done in preparation for the economic dividend. Sections 3 and 4 analyse the economic dividend in Sri Lanka from the perspective of the South and Northeast, respectively. Section 5 examines the political economy of the peace process, and section 6 concludes.

2 Background to the peace process

Sri Lanka's economy at the start of the millennium was in dire straights. After a number of military reversals, Sri Lanka recorded a negative growth rate of -1.4 per cent, the only country in South Asia to do so in 2001. Poor performance was due to external factors as well as domestic economic mismanagement (IPS 2002; Kelegama 2003 and others). The IMF standby package signed in early 2001 fell apart, the budget deficit was nearly 11 per cent of GDP, the ratio of public debt to GDP was more than 100 per cent, and the inflation rate was in two-digits.

Given the burden of the defence budget (running at 5-6 per cent of GDP) and diminishing opportunities for short-term revenue generation (most of the 'cash cows' available for privatization had been exhausted) the new government, formed in late 2001 by the United National Front (UNF), concluded that peace with the LTTE was the only way to revive the economy and to attract foreign direct investment (FDI) again. For its part, the LTTE leadership was faced by a dwindling cadre of members and general war weariness, and was sensitive to a hardening of global attitudes to terrorism following the 9/11 attacks on the United States. Thus, the Tigers wanted a breather to re-group and disassociate themselves from terrorism (Gunaratna 2003). Consequently, this 'win-win' situation steered both parties towards peace talks.

2.1 Basic steps for confidence building

The government turned to reviving the economy following the signing of a ceasefire agreement (CFA) and the setting up of the Sri Lanka Monitoring Mission (SLMM). The government and donors acknowledged the LTTE as an important political player in developing the Northeast and for building peace. Accordingly, the peace package lifted the embargo of Southern goods to the Northeast and opened up a major highway (A-9) to ease the movement of goods, services and labour.

After this initial phase, the government and LTTE conducted five rounds of unconditional peace talks, without either party having to decommission weapons. For the division of power, the government-controlled areas at the time of the CFA were classified as 'high security zones' (HSZ) while the LTTE-controlled areas reflected the situation as it had been in early 2002. Donors assisted with the removal of landmines and building a framework for resettlement of internally displaced persons (IDPs) and related measures in the areas of land and water rights as well as fishing rights to rebuild livelihoods. The government's aim was to negotiate a political solution once the preliminary phase of confidence building and reconstruction of war-torn areas had been concluded, and once an economic dividend for the Northeast had arrived (see later discussion).

2.2 Institutional structure for building peace

The previous government's attempts to provide assistance to the Northeast were based on a '3-Rs' strategy (relief, reconciliation and rehabilitation) in which relief efforts were coordinated between government, aid donors and NGOs. But the LTTE had been left out of the process because the government refused to recognize the parallel administration in areas under the LTTE control. Moreover, the '3-Rs' framework neglected the issue of fishing and land rights of returning IDPs (JBIC 2003: 58). The LTTE perceived the government to be using relief to woo people away from their areas. These concerns needed to be addressed by creating new institutional structures.

The Secretariat for Coordinating the Peace Process (SCOPP) was established in January 2002, while the LTTE Peace Secretariat (as a counterpart to SCOPP) was opened in December 2002. A joint taskforce was set up to deal with relief, resettlement, and development, and the LTTE was treated as an equal partner in the taskforce. However, the taskforce was not demarcated properly, and was abandoned in late 2002 in favour of three subcommittees: the Sub-Committee on Immediate Humanitarian Relief and Rehabilitation (SIHRN); the Sub-Committee on Military De-escalation (SMD), and the Sub-Committee on Political Issues (SPI) to provide support to the war-affected people.

The UNF government's political power was shaky; the legislation was in conflict with the executive and the state system was not very stable. The constitution precluded the prime minister from embarking on any radical and innovative measures to resolve the issues underlying the Northeast conflict. Thus, the government initially was reluctant to introduce proposals for new institutional structures, and the subcommittees were all set up as individual bodies without legislative status. Constitutional problems precluded follow up on the initiative contained in the UNF manifesto for an interim administration in the Northeast.

SIHRN was entrusted with the allocation of the finances needed for prioritized activities, selection of the appropriate implementing agencies, and identification of the humanitarian and reconstruction needs. The activities initiated by SIHRN were to be financed with the so-called the Northeast Reconstruction Fund (NERF) vested with the World Bank.

2.3 Economic revival package

By the start of 2002 the disintegrating IMF standby package had to be rescued, the budget deficits reduced, aid utilization improved, and the economy put back on a growth track. Although the March 2002 budget implemented measures to this effect, these had very little to offer the poor, with the government relying on economic growth to reduce poverty.

Second-generation reforms were greatly delayed in the Sri Lanka. Although privatization had been introduced, it covered only a few utilities such as gas, telecom, seaports and airlines. Many public utilities needed restructuring but this was delayed by the 1999 provincial elections and the 2000 general elections and it was up to the newly elected UNF government to get on with reforms. Legislative reforms to support the market economy, institutional change, and deregulation to stimulate private sector growth were the main elements of the new policy package, although these were not without political costs for a government with a small parliamentary majority.

The results were impressive. The economy grew by 4 per cent in 2002 and 5.9 per cent in 2003, and there was a remarkable pick-up in tourism which had been deterred by the war. In the Northeast, total fish catches doubled as a result of relaxed restrictions and rice production increased fivefold. Net FDI inflow increased from US$82 million in 2001 to US$300 million by 2003 and a large inflow of portfolio investment pushed the stock market beyond its 1994 peak.

2.4 Donor assistance

The government saw the donors as vital to the peace process. As Moragoda, a leading member of the peace process (2003b: 261) states: ‘the international community should recognize that they too have a stake in the outcome of these negotiations, that we believe, is our surest guarantee of success’.

Donor assistance has contributed since 2002 to the rehabilitation of the Northeast region with the construction of 45 km of a major highway, hundreds of kilometres of small roads, irrigation tanks, water wells as well as 55 schools, 25 health facilities, and the relocation of over 32,000 IDP families.

Donor assistance increased once the terms of IMF’s standby package had been met by the end of 2002. The IMF approved a poverty reduction and growth facility (PRGF) and an extended fund facility (EFF) totalling US$567 in April 2003 to run until 2006, with fiscal conditionality requiring reduction in the public debt and structural reforms to reduce the public sector’s role. The World Bank committed US$2.7 billion for 98 different projects, while the Asian Development Bank loans totalled US$2.7 billion. The World Bank lending programme through to 2006 consists of about four projects per year, totalling US$800 million. The European Commission approved €3.27 million in support of Sri Lanka’s peace process.

By mid-2003 the rate of aid utilization had increased from 13 per cent in 2001 to about 21 per cent (CBSL 2003: 197). The reforms and the government’s medium-term economic strategy outlined in the *Vision and Strategy* document (RSL 2003) received strong support at the Tokyo meeting with donors in June 2003 with pledges worth US$4.5 billion (25 per cent of 2003 GDP), of which 16 per cent was earmarked for the Northeast’s reconstruction (ERD 2004). The Norwegians also supported aid mobilization for the peace process.

Release of funds was contingent not only on the implementation of reforms, but also on positive developments in the peace progress—which was not clearly defined (Ladduwahetty 2004). Donors generally prefer to tie aid disbursement to improvements in human rights, democracy and good governance. Japan’s aid is, for example, linked to such measures as strict compliance with the CFA and rulings of the SLMM; progress on human rights in the Northeast, the return of child soldiers to their families (and an end to recruitment), and progress in democracy and pluralism in LTTE-controlled areas (JBIC 2003). In summary, the finance provided by foreign aid was crucial to securing an economic dividend. Moragoda (2003a: 261) has commented:

> There is no doubt that without donor support from the outset, economic recovery could turn out to be a distant prospect. If we are unable to demonstrate now, in a preliminary way, the dividend that the peace will bring we risk the negative effect of frustration among the parties, a breakdown of negotiations, and the resumption of hostilities. By allowing the flow of assistance to commence now we could begin to show to every section of our people, including the LTTE, that a peaceful accommodation of interests will bring tangible prosperity and a better quality of life to all.

The economic dividend was expected to help sustain the stability of the government, both through the support of the population in the South as well as the large Northeast constituency who would benefit from the dividend. It is therefore to the economic dividend itself that we now turn.

4 The economic dividend in Southern Sri Lanka

The war had high economic costs which prevented growth reaching its target of 6-8 per cent (Kelegama 1999; Arunatilake, Jayasuriya and Kelegama 2001). Nevertheless, the economy managed to expand on average by 5 per cent per annum from 1983 to 2000, mainly due to sectors such as tea, ready-made garments, worker remittances, etc., which were unaffected by the war. The war burden fell mostly on the middle class, through defence-related taxes and the high interest rates that were necessary to meet growing defence expenditures (almost 6 per cent of GDP in the late 1990s).

Funds for rural development were reduced by higher military spending, although the war also had benefits for some rural households such as an increase in remittances from family members in the military which rose when the war escalated and recruitment went up. These remittances (plus those from workers in the Middle East or employed in garment factories) kept rural families alive as agriculture contracted (Dunham and Edwards 1997).

Hence the economic dividend for the South from peace could have been substantial. However, its realization was undermined by three factors. First, the IMF's adjustment programme was initiated by the Alliance (PA) government in March 2001, but stalled when the PA coalition deteriorated in June 2001, after which management of the coalition took priority until the December 2001 general elections (Kelegama 2003). In order to secure the much needed aid package, the IMF standby package had to be salvaged by the new UNF government, resulting in some tough decisions including depoliticizing and better targeting of the poverty alleviation programme (*Samurdhi* allowance); increasing utility charges; cutting fertilizer and petroleum subsidies; introducing a new VAT (value added tax) tax system; and freezing public sector recruitment and downsizing the workforce in public enterprises. Given the seriousness of the economic situation by the end of 2001, there was no alternative but to implement these measures, but aid needed to come in rapidly to ease the economy's adjustment and this did not materialize on the scale expected. Although the US$4.5 billion aid package was substantial, only US$557 million was disbursed in 2003 (ERD 2004) when the need for more aid was crucial. Thus, the impact of the SAP was not effectively cushioned in the short run, and there was no dividend for rural households in the South.

Second, most of the fiscal adjustment required by the IMF turned out to consist of expenditure restraint rather revenue mobilization (which turned out to be disappointing). Defence costs did not fall significantly despite the end of hostilities, barely resulting in any savings for capital expenditure, and the insignificant defence savings were absorbed by the costs of refugee rehabilitation, leaving capital expenditures on rural infrastructure to take brunt of the expenditure cuts. Fiscal tightening through expenditure restraint therefore occurred at precisely the time when the public finances should have been orientated to building peace. Addison (2003: 4), analysing Africa's post-conflict scenario notes that: '… unrealistic and excessively tight targets for the overall fiscal deficit should be avoided when it endangers essential development spending'. Over-obsession with fiscal targets therefore proved to be counter-productive in terms of delivering the immediate economic dividend that could have helped the peace progress.

Third, the uneasy cohabitation between the president and the prime minister, together with fears that the LTTE could resume hostilities, resulted in the private sector adopting a wait-and-see attitude which deterred investment in risky and long-term projects, precisely the investment needed to create jobs. Unemployment was compounded by cutbacks in public-sector employment. Consequently, there was little economic dividend for the South

5 Economic dividend in Northeast

Balasingham (2004: 395) has stated that: 'If the hardships of the people are not remedied and their humanitarian needs are not met, the momentum, the optimism and confidence that arose from the peace process will be severely undermined'. We argue here that all three stakeholders—the government of Sri Lanka, the LTTE, and aid donors—obstructed realization of the economic dividend.

There is no denying that as a consequence of the CFA, some economic improvement did occur in the Northeast with improved security, better relations between communities, greater access to goods and services, IDP resettlement, and increased school enrolment (IPS 2003). But the dividend could have been much more. Currently the Northern Province accounts for less than 2.5 per cent of GDP and poverty is high. Only 3 per cent and 64 per cent of the population have access to piped water and electricity, respectively, compared with 52 per cent and 93 per cent in the Western Province (ADB 2005).

From the LTTE perspective, a serious concern was the high security zones (HSZ). According to the LTTE, the Sri Lankan army, contrary to the CFA terms, continued to occupy public buildings in the HSZ, impeding the right of people to return home (Balasingham 2004: 382-3). However, according to the Satish Nambiar report, the withdrawal of armed forces from the HSZ was conditional on the LTTE decommissioning its long-range weapons, which they flatly refused to do (Godage 2004). This was a major problem that contributed to the demise of the Sub-Committee on De-Escalation and delayed the economic dividend in the Northeast.

On the government side, there were procedural delays in tendering for contracts in the Northeast and bureaucratic slowness with the line ministries. The same problems that plagued aid utilization were evident in projects earmarked for the Northeast (IPS 2001).

The LTTE claimed that confidence among the Tamil people in the peace process was eroded by delays in humanitarian relief and resettlement as well as bureaucratic inertia in the SIRHN (Balasingham 2004: 415-6). Although SIRHN had identified the immediate needs of the people, funds were not readily made available, and provisional mechanisms lacked substantive implementing powers and personnel resources (Ferdinands *et al. 20*04).

There is merit to Balasingham's (2004: 438) criticism that the *Vision and Strategy* document (RSL 2003) failed to understand the causes of poverty and the scale of the Northeast's devastation. Twenty years of war had weakened local state institutions. Even though government funds for relief and rehabilitation had grown after 1999, many felt that these had failed to make any appreciable impact on the quality of life of the people (Sivanathan and Thillainathan 2004). The absorptive capacity of the state's development institutions had diminished to such a low level that they 'were unable to utilize more than 20-30 per cent of the allocations for rehabilitation' (JBIC 2003: 30).

In April 2003, the LTTE, claiming that government administration was ineffective and there was no concrete progress in the Northeast, walked away from the peace talks, demanding the establishment of an interim administration in order to control finances and developmental matters.

But the realization of the economic dividend was also impeded by problems in the LTTE's own institutions and its military-like system of governance. LTTE taxes on all travel on the A-9 highway increased the prices of commodities, and the checkpoints added almost three days to the travel-time between Colombo and Jaffna, making effective delivery of goods and services impossible. Moreover, banks were reluctant to give loans without collateral, but most collateral was unacceptable to banks because it was vulnerable to LTTE control.

In the territories under its control, the LTTE restricted the movement of people, particularly those of military age. This led to a mass exodus of talented people (contrary to expectations of a migration to the Northeast), and undermined local capacity to undertake rehabilitation and reconstruction. This inadequate capacity to absorb assistance posed a major dilemma for the donors. By April 2003 when the LTTE pulled out of the SIHRN, 642 projects had been identified in six districts of the Northeast (Godage 2005), but whether these projects could have been implemented in the given circumstances is questionable.

The LTTE did not strengthen the efforts by international relief organizations over 1990-2001 to prevent hunger in the war-affected areas. Moreover, the economic programme of the LTTE's Tamil Eelam Economic Development Organization (TEEDO) was unclear, and no attempt was made to encourage the return of entrepreneurs from border areas such as Vavuniya (little has also been done to woo expatriate Tamils). Rebuilding infrastructure was essential for the Northeast's reconstruction, but the LTTE insisted on a percentage commission from contractors, a policy not viewed favourably by donors. If more foreign aid is to be mobilized, there must be transparency, accountability and economic freedom—all unfortunately non-existent in the Northeast (Sarvananthan 2003). The LTTE is yet to realize that running an efficient economy is a different ball game from executing a guerrilla war.

Donor constraints exist as well. The well-known multilateral ‘needs assessment’ approach is based on the assumption that the nature of conflicts is generally similar and that they are culturally insensitive (JBIC 2003: 49). According to Bastian (2003: 150), ‘they ignore specific histories, struggles and evolution of societies … Sri Lanka, Uganda, and Afghanistan [are seen] in the same breath …’. It was assumed that market forces would prevail, triggering an effective private sector response, but this was largely not forthcoming in the Northeast where missing markets and institutions as well as limited democratic administration exist.

There was also an infrastructure bias; a Marshall Plan type of approach was applied to reconstruction strategies, whereas immediate relief for agriculture, poultry, and fisheries was a more urgent priority (Shanmugaratnam 2003). The question therefore remains of who has actually benefited from the funds—the people of the war-torn region, or a network of local and foreign firms bidding for large infrastructure projects? (Rajasingham-Senanayake 2003).

According to the World Bank assessment of Bosnia and Herzegovina, donor-assisted reconstruction programmes are most effective in sectors where the priorities have been jointly agreed with the local authorities (Woodward 2002). However, in Sri Lanka the needs assessment approach marginalized local skills and undervalued local knowledge as well as socio-political analysis. This is unfortunately a systemic problem across many post-conflict countries. Donors’ geo-strategic interests have generated a complex and often contradictory agendas, a problem that is not confined just to Sri Lanka (Addison and McGillivray 2004; Ferdinands *et al*. 2004). Current international support for post-conflict peacebuilding needs to be strengthened at a global level through greater coherence across the major policy areas (Tschirgi 2004).

Pressure from donors and civil society groups to ensure that pledged funds would be somehow linked to a political settlement and human rights, posed problems for the LTTE, given its continuing abuse of human rights. The LTTE reacted by reneging on its intent to link the peace talks to progress in the political settlement and human rights protection. These issues were factored in by donors in late 2003, as we shall now discuss.

6 Political economy dynamics of peace

6.1 Problems for the peace process

Although the necessary measures were in place—including institutional structures, aid mobilization, and confidence-building measures—managing the peace process was difficult, and it is worthwhile to examine the sequencing of events.

The prime minister favoured offering an immediate economic dividend so that people disgruntled by war could form an anti-war coalition and thus weaken the LTTE. Negotiation of the core (political) issues would then come next. In short, the conflict was to be turned around with economic advancement, but as this was not enough, the UNF government offered the political concession of a federal structure for the Northeast in the Oslo Declaration of December 2002 (although the lack of minutes from the five peace rounds prevents verification of this point; Balasingham (2004: 403) argues that there is no such document as the Oslo Declaration, only a suggestion for exploring a solution based on federalism).

In contrast, the PA prior to 2002 based its strategy on war-for-peace, where core issues were immediately put on the table. The result was a head-on confrontation with the LTTE, whereas the UNF peace strategy was more tolerable to the LTTE. While the PA plan was to isolate the LTTE from the Tamils and to use military force to weaken and bring them to the negotiating table (Ofstad 2002), the UNF viewed the LTTE as equal partners and started the process with confidence building, while deferring politically sensitive issues for later.

It has been questioned whether this sequencing was realistic: should economic development have preceded the core activities? According to Sriskandarajah (2003), this is tantamount to putting the cart before the horse. Core issues could have been gradually introduced after the federal solution had been mooted in the Oslo Declaration, but it would have been difficult to start negotiations with core issues, as there was a large humanitarian problem and the LTTE was committed to a separate state (the right to self-determination, recognition of a Tamil homeland, and recognition of Tamil nationalism). Moreover, the Southern electorate would not have been immediately agreeable to accommodating LTTE demands through a fundamental restructuring of the state. From this perspective, the prime minister's strategy was correct, but there were shortcomings in the process.

Despite a memorandum of understanding being in effect, the LTTE continued to eliminate its rivals, recruit child soldiers, ignore SLMM directives, and breach the CFA over 1,900 times (Godage 2004). Monolithic, with no tolerance for democracy, the LTTE forcibly acquired the status of the 'sole representative of the Tamil community in Sri Lanka'. The LTTE was suspected of wanting to use relief and rehabilitation work to strengthen itself, and any democratic-pluralistic mechanism that undermined this was not acceptable. This in turn disturbed the Southern electorate, who questioned the credibility of the peace package.

On the government side, the opposition was excluded from the peace talks; the conditions of the Muslims in the East were not fully discussed, and core issues were postponed until later. Core issues were, in fact, omitted until the very end, instead of taking them up after the Oslo Declaration. The peace talks leveraged an economic dividend under a vague framework and were perceived to be a confidence-building effort without a specific agenda, thus enabling the LTTE and the Norwegians to shape events. Given this situation, the LTTE, together with the Norwegians, smartly narrowed the focus to a single element: the creation of an interim administration with full autonomy, obviously an issue where the final political solution became imperative.

All of these factors diluted the economic peace dividend. Local and foreign investors who in early 2002 were interested in Northern Sri Lanka became pessimistic by early 2003, as uncertainty engulfed the peace talks.

6.2 An international safety net for the peace process

The peace package's economic dividend was going to be the prime minister's ticket back to power, but when it was realized that the Northeast's economic dividend was not materializing, a new interim administration structure to replace the SHIRN was proposed in June 2003 to speed up the reconstruction process. But the LTTE rejected it on the grounds of insufficient self-autonomy. The government asserted that any proposed institutional structure had to comply with the constitution and that this could be worked out through negotiations.

When all efforts to rescue the peace talks failed, an international safety net was created and the peace process internationalized (see Moragoda 2003b: 244). This gave more international visibility to LTTE activities. An aid package of US$4.5 billion was successfully mobilized at the June 2003 meeting of donors in Tokyo. With the international safety net in place, the prime minister felt that the 'no-war, no-peace' scenario would create its own dynamic, making it hard for the LTTE to revert to war. Meanwhile, the LTTE started preparing a proposal for an interim self-governing authority (ISGA) for submission to the government by the end of October 2003.

But there have been drawbacks, too. According to critics, 'over-internationalization' enabled donors to dictate terms to the government, pressuring it to negotiate with the rebels on LTTE terms; the safety net influenced the power balance between the parties and disturbed the existing status quo (Ferdinands *et al*. 2004), by strengthening, for example, patriotic forces who were opposed to the government's peace package in the South. The opposition in fact threatened to abandon the CFA to topple the government.

Moreover, as discussed earlier, donors were tardy in delivering on their aid promises and shortfalls in aid disbursement precluded cushioning the costs of the stabilization programme for the poor, giving rise to hardship through 2003 (CBSL 2003: 198). Furthermore, each donor followed its own policy regardless of the general agreement in Tokyo to release funds against progress within peace process, with each donor varying in how they interpreted progress (or lack of) in human rights, good governance, and pluralism.

6.3 Setbacks to the peace process: ISGA and electoral defeat

As 2003 wore on, the president increasingly felt that placating the LTTE was threatening Sri Lanka's unitary status, and in November she took over three ministries, including defence, a use of executive power that substantially shook the government. At the time, the LTTE put forward an ISGA as a counter-proposal to the government's June 2003 interim administration. The LTTE saw the ISGA as an absolute necessity to ensure the fulfilment of both short-term development needs and long-term demands for internal self determination (Stokke and Shanmugaratnam 2005).

The issues debated in five rounds of talks were finally reduced to a single issue: namely the establishment, through extra constitutional means, of the ISGA with full plenary powers of governance over the Northeast under LTTE's hegemony—described by experts as basically a blue-print for a separate state (Gunasekera 2004; Godage 2004; De Silva 2004). But as the LTTE lacked legitimate status, granting financial and political power to a body in its control would have been difficult under the constitution.

The prime minister had hoped to capitalize on the economic dividend in the elections of April 2004. But its absence contributed to the ruling party's defeat, despite the UNF's reputation for greater fiscal competence than the PA, so the appeasement of the LTTE may also have undermined UNF support. Negotiations with the LTTE could have been more effective had the prime minister inherited a healthier economy and stronger parliamentary support. But the lack of institutions and structures, especially in war-affected areas, imposes limitations on realizing economic progress so quickly, while many of the political, cultural, and sociological issues take more time to address.

7 Concluding remarks

Some progress was made in achieving peace and preventing the reoccurrence of LTTE hostilities. But there was no concrete economic dividend, nor significant progress towards conflict resolution. The outcome in Sri Lanka needs to be examined from the perspective of each party concerned: government, rebels, and donors.

The government adopted a ‘top-down’ approach which involved little consultation with civil society and no widespread discussion. Nor was political opposition included. It was an open-ended approach, consisting basically of confidence-building negotiations in which the government was prepared to see how matters evolved. The lack of a specific agenda gave the LTTE the upper hand in dictating the peace process towards the ‘single-issue’ trajectory of the ISGA. The public viewed the government’s increasing sensitivity to LTTE dictates as appeasement, a stand also taken by moderate Tamil politicians (Anandasangari 2005).

The assumption that an economic dividend would quickly arise once the necessary measures were taken was undermined by missing markets and institutions in Northeast, and the aid that was received was therefore less effective than it could have been. Despite the increase in growth, the distribution of benefits largely bypassed the poor. Aid pledges for the war-ravaged areas were received before the creation of an effective mechanism for utilizing the funds. Ignoring core issues meant that major tasks became the responsibility of substitute structures (the SIHRN, for example) that lacked capacity and political clout. And the institutional structure was not linked to an ultimate resolution such as federalism.

The LTTE was generally not interested in relief and reconstruction measures, unless it controlled their delivery. A strong economic dividend with no ownership was bound to weaken the LTTE’s political stronghold in the Northeast and undermine its ultimate objective of self-determination; the LTTE thus feared marginalization, a fear that the government failed to address effectively. Whether the LTTE was honestly seeking a political settlement within the framework of a united Sri Lanka is an open question. The CFA enabled the LTTE to add to its military strength, since decommissioning weapons was not part of the negotiations, thereby in some eyes serving their goal of ultimate secession. If this were the case then no amount of economic dividend in the Northeast could have produced a political solution within the framework of united Sri Lanka.

In any new agenda for foreign aid, aid absorption must be strengthened by capacity-building especially in war-torn areas which lack human resources and institutions. Thus, the problem is not limited finances but the recipient’s inability to create an environment conducive to the best utilization of aid, an issue which is important not only for Sri Lanka (Tschirgi 2004: i).

Ultimately, the issue boils down to creating a minimum level of trust between the parties, and an economic dividend—while certainly desirable—may be an inadequate tool for resolving conflicts between groups with deep-rooted mistrust. Thus, in order to make the economic dividend more effective, other factors must be addressed simultaneously. Only then can the hoped-for dividend strengthen peace and achieve conflict resolution.

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