

SRI LANKA: THE POLITICAL ECONOMY OF FAILURE

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Sri Lanka is one of the spectacular Third World failures, a tragedy of epic proportions. The roots and symptoms of failure pre-date the explosion of violent ethnic conflict in 1983: they reach back at least to the 1950s. Ceylon was in many ways Britain's model colony, well prepared for independence and starting the post-colonial era with high hopes and great promise. But by the 1970s economic policies of fiscal and monetary profligacy, import-substitution and rampant state intervention had reached a dead-end. In addition, systematic discrimination in favour of the Sinhalese majority had driven the Tamil minority into emigration and internal alienation. This erupted into full-blown ethnic conflict and civil war in 1983, which continues a quarter-century later. To make matters worse, there have been two bloody uprisings in the Sinhalese south. The last one almost toppled the government in Colombo before it was brutally crushed in 1989. Given this accumulation of bad news, it comes as no surprise that so many of Sri Lanka's best and brightest have left the homeland and are contributing to the wealth and cultures of other countries, not their own.

The one bright spot on the policy landscape is the progressive liberalisation and deregulation of the economy since 1977. This has clearly boosted growth; and without it the country would have collapsed many years ago. But economic opening has been carried out in a stop-go and often incompetent manner, and has suffered generally from endemic political failure. Its effects have been blunted by political instability and ethnic conflict of course, but there is more to it than that.

By 2001, Sri Lanka had its back to the economic wall. Then came a ceasefire, which brought relative calm to the island for the first time in nearly twenty years. Economic

conditions and prospects improved almost immediately. Sri Lanka seemed to be clawing its way out of its failure trap, and appeared to be finally on the verge of fulfilling its early golden promise. But it was not to be. The ceasefire became more tenuous in 2004. Then came the tsunami on 26th December 2004, devastating poor coastal communities in the Sinhalese south, and even more so in the Tamil north and east. It left 35,000 dead and many more homeless and destitute. By 2005 the ceasefire was unravelling, and by 2006 it had effectively collapsed.

Sri Lanka is now back to square one: civil war has returned, with over 2,000 dead this year – to add to a total of over 80,000 since 1983. Public finances are in a parlous state, and kept afloat on a sea of foreign aid. Debt servicing and increasing defence expenditure crowd out desperately-needed investments in education, health and infrastructure. The writing may be on the wall for another bloody upheaval in the Sinhalese heartland, which would be one short step from the collapse of the state and a headlong descent into anarchy. Sri Lanka would then be in the same category as some sub-Saharan states, caught in a vicious trap of failure and misery.

How has this come to pass? Is there a better Sri Lankan prospect – an alternative, realistic vision for peace, stability and economic growth that would benefit the poor majority? And what Sri Lankan lessons of politics and economic reform are there for other countries – if only “negative” lessons of what pitfalls to avoid?

The first section of the paper summarises economic policy since independence to the state of play today. It wraps up with a broad assessment, bringing in comparisons with the rest of south Asia and east Asia, notably Malaysia. The final sections look first at what needs to be done in Sri Lanka, and then extract lessons from the Sri Lankan experience for politics and economic-policy reforms elsewhere.

1. Politics and economic policy since independence

a. *The colonial legacy*

At independence in 1948, Ceylon (the British-colonial name for the island until 1971) was by far the most prosperous country in South Asia, and much more prosperous than most other Asian countries. Per-capita income was a fifth higher than the south-Asian average. Ceylon's wealth had been built on the export of plantation crops, the foundations for which were laid in the 1820s and '30s by an early British governor, Sir Edward Barnes. The British lavished attention on the island. When Leonard Woolf (the future husband of Virginia Woolf) was a colonial administrator in Ceylon in the first decade of the twentieth century, there were over 200 British officials governing a population of about three million – compared with less than 1000 members of the covenanted Indian Civil Service ruling a population of several hundred million. From the 1920s the British nurtured a local political elite to assume the responsibilities of home rule.

Thus, come independence, Ceylon had, by developing-country standards, a well-developed infrastructure, an efficient public administration and judiciary, and a democratic Westminster-type political system. Unlike India, there was a peaceful handover of power in stable political conditions. In addition to a prospering plantation economy, there were significant achievements in health and education. The literacy rate, for example, was the highest in Asia outside Japan and the Philippines. The one black spot – in the eyes of development economists at the time – was the lack of industrialisation.

In the first decade after independence, visiting economists such as Sir John Hicks and Joan Robinson could not help but wax lyrically about Ceylon's superb initial conditions. The challenge, as they saw it, was to maintain relatively high living standards in the face of a fast-rising population. Lee Kuan Yew, visiting Colombo on his way back to Singapore in the early 1950s, observed how orderly, clean and prosperous the city was, and wished Singapore could graduate to this standard.

b. State intervention, import substitution, welfarism, ethnic discrimination: 1950s-1977

The combination of political stability, good economic health and democratic politics bred a redistributive rather than a growth-maximising mentality – in particular a focus on expanding the welfare state for the Sinhalese majority. This included free health care and free education, and extensive state subsidies on consumer goods and services. Total recurrent and capital expenditure on welfare services took up over 25 per cent of government expenditure in the 1950s and '60s, and subsequently escalated further. Human development indicators (e.g. on infant mortality, life expectancy, primary school enrolment and adult literacy) improved markedly. This resulted in rapid population growth, from 7.5 million in 1950 to 14.7 million in 1980, and about 20 million today.

Government intervention in the economy increased significantly after 1956, when S.W.R.D. Bandaranaike's Sri Lanka Freedom Party (SLFP) won power from the United National Party (UNP). Over the following two decades, successive SLFP and UNP-led governments pursued import-substitution policies, with tightening controls on imports and foreign exchange, and generally expanded the role of the state in the economy. There was a short-lived attempt at gradual liberalisation in 1965. Then, from 1970 to 1977, the SLFP-led government pursued more radical policies of state intervention and import substitution. State planning, price controls, nationalisation of the plantation sectors and other "commanding heights" of the economy, much higher restrictions on imports and inward investment, and rigid foreign exchange controls, were the order of the day. The government's professed objective was a self-reliant socialist economy. There was a distinct urban industrial bias, which effectively taxed both domestic agriculture and exports.

Overall, from the mid 1950s to the mid 1970s, Sri Lanka (as it was renamed when it became a republic in 1971) followed the Indian path of macroeconomic profligacy, rampant government intervention and inward-looking protectionism. By the 1970s, Sri Lanka had its version of the Indian license raj. Trade as a proportion of GDP had shrunk

by half between 1950 and 1975 (from 70 per cent to 35 per cent of GDP). State-owned industries accounted for 50 per cent of employment and 60 per cent of value added in the manufacturing sector. Sri Lanka had decidedly not followed the east-Asian path of macroeconomic prudence and openness to the world economy (from selective opening in northeast Asia to free trade in Hong Kong and Singapore).

By the mid 1970s these policies had run into the sand. Growth had come to a halt, while welfare expenditures were still increasing. Government transfers had to bail out haemorrhaging state-owned enterprises. A bloated public sector concentrated on capital-intensive production and generated little employment, while exports shrank further. Red tape, rent-seeking, patronage politics and corruption were pervasive. This was a time of rising unemployment, stagnant savings and investment rates, balance-of-payments crises, acute shortages and rationing of consumer goods, and growing popular dissatisfaction. That paved the way for a change of government and policy reforms in 1977.

The picture up to 1977 is far from complete without an account of pernicious ethnic politics. S.W.R.D. Bandaranaike, the archetypal “brown sahib” who came from the high-caste Sinhala landholding elite and had been President of the Oxford Union, played the populist ethnic card to curry favour with the Sinhalese majority and win the 1956 election. Sinhala became the official national language, at the expense of Tamil and English. Affirmative action policies for the Sinhalese were rolled out in government departments and schools. These deliberately discriminated against the Tamil minority, and became more restrictive in the 1960s and '70s. Resentment among Tamils grew, particularly among the Jaffna Tamils in the north. Opportunities for advancement were closed off, petty discrimination increased and human-rights abuses (especially by the police) proliferated. Middle-class Tamils started to emigrate, and the seeds of internal rebellion were sown.

Myopic and populist Sinhalese politicians did not realise they were strangling the golden goose. Historically, the Jaffna Tamils had been the productive indigenous engine of the national economy, with a pronounced work and education ethic – akin to the Chinese

minority in Malaysia. The rural Sinhalese, in contrast, like the Malays, had a more laid-back culture. Sinhalese political dominance after independence inevitably translated into demands for a bigger share of the economic pie. The question was whether an accommodation could be reached with the Tamils, perhaps along the lines of the *modus vivendi* between Malays and Chinese in Malaysia. The failure to reach such an accommodation is of course central to the Sri Lankan tragedy.

But it would be simplistic and misleading to attribute Sri Lankan failure to ethnic conflict alone: disastrous economic policies fuelled by populist politics are at least as much to blame. Not least, the latter have probably exacerbated political conflict. In essence, the wrong economic model allowed successive governments to spend like there was no tomorrow while running the economy into the ground. Welfarist policies churned out a burgeoning class of educated youth from the poorer sections of Sinhala and Tamil communities, with rising expectations of life and work. But a stagnant economy did not create job openings for them – in contrast to east-Asian policies oriented towards growth maximisation. Disaffection led many to extremism and violence, not just in the incipient separatist Tamil Tiger rebellion in the north, but also the JVP (Janathip Vimukthi Perumana) uprisings in the Sinhalese south.

c. Stop-go liberalisation and ethnic strife: 1977-

Sri Lanka led the way in south Asia in switching from import substitution to export-orientation, and more generally in market-led reforms that (re)opened the national economy to the world. But reform has proceeded in stop-go fashion, and has often been botched on the way.

The initial phase of internal and external liberalisation witnessed deregulation of internal controls, slashing of tariffs, abolition of quantitative trade restrictions and state-trading monopolies, and removal of foreign-exchange restrictions on current-account transactions. But this was not accompanied by macroeconomic prudence. Rather domestic spending continued to increase and fuelled inflation as well as the budget deficit. Huge aid inflows for large-scale irrigation projects induced predictable Dutch

Disease effects. By the mid 1980s, macroeconomic instability combined with the eruption of ethnic war had led to stalled reforms. The second, more decisive, phase of liberalisation started in 1989, in response to another macroeconomic crisis. An IMF stand-by loan was negotiated, contingent on macroeconomic stabilisation and further liberalisation. These reforms lasted until 1993. Further partial liberalisation took place from the mid 1990s: tariffs were reduced; foreign equity restrictions relaxed in key services sectors such as finance, mass transport, telecommunications and professional services; and there was privatisation, notably in telecommunications and insurance. Another IMF stand-by loan was negotiated in 2000. Civil war, a collapse in tourism, escalating defence expenditure and a pre-election spending splurge led to a budget deficit of 10 per cent and yet another macroeconomic crisis by late 2001. A new UNP government, with a ceasefire in place, revived market-based reforms in 2002; but these stalled and were subject to creeping reversal after a change of government in 2004.

Despite civil war, macroeconomic instability and stop-go reforms, the opening of the economy since 1977 has delivered better economic performance compared with the previous two decades of *dirigisme* and import substitution. At the time of reforms in the late 1970s, Sri Lankan per-capita income had come down to the south-Asian average. By 2000, it was slightly more than twice the regional average. The manufacturing share of GDP had risen from 11 per cent in the early 1980s to 20 per cent by 2000, about two percentage points higher than the share of agriculture. Employment in the formal manufacturing sector more than doubled in this period. The share of manufacturing in total merchandise trade had increased from 5 per cent to over 70 per cent in the same period, ending the historic dependence on primary commodity exports. Key to export-oriented industrialisation was the emergence of a strong, labour-intensive garments sector in the early 1980s, a direct product of import- and inward-investment liberalisation.

d. The state of play: focus on trade policy

Since a return to SLFP-led government in April 2004, there has been backtracking from previous trade liberalisation. The government espouses a shift to a mixed economy, and

specifically calls for protection of agriculture and small and medium-sized enterprises. Take a closer look at trade-related policy.

There are five tariff bands, from zero to 28 per cent. Some products enter duty free; raw materials are subject to very low duties; but there are higher tariffs on processed goods; and most finished products are taxed at 28 per cent. Overall, Sri Lankan average tariffs (approximately 10 per cent for all goods) are lower than the south-Asian average and the average for low-income developing countries, and on a par with the average for middle-income developing countries. This applies to both manufacturing and agriculture (see tables on tariffs).

However, the tariff structure remains over-complicated and restrictive, especially compared with east-Asian countries. A planned reduction and simplification of tariffs into two bands never happened. Tariffs are changed frequently in an ad hoc and seemingly arbitrary manner. Tariff escalation (higher tariffs on processed and finished products) means effective rates of protection are much higher than nominal rates. There is also a paraphernalia of additional import taxes: an Export Development Board (EDB) levy of 10-20 per cent on finished goods (effectively increasing charges on most finished- goods imports to 48 per cent); general import surcharges (now 10 per cent); and assorted specific levies and excise fees. Import licensing still affects about 300 items, and is also subject to discretionary and unpredictable changes. Government protection of agriculture through tariffs and subsidies remains substantial.

Exports are governed by a panoply of laws and regulations. There are several tax and non-tax incentives to attract foreign investment and promote export-oriented industries, e.g. duty drawbacks, duty exemptions, export-processing zones and tax holidays. These involve a dense bureaucracy of several government agencies, and add to the regulatory discretion mentioned above.

Sri Lanka is much more liberal than the rest of south Asia in services, as a result of major liberalisation and deregulation since the 1990s. Full foreign ownership is allowed in a range of services sectors, including banking, insurance, telecommunications,

tourism, stock brokerage, construction, water, mass transport, energy and some professional services. There are 12 foreign banks operating in Sri Lanka. The state-owned insurance company has been fully privatised. Telecoms is Sri Lanka's most dynamic services sector. The fixed-line operator, Sri Lanka Telecom, has been part-privatised, and has lost its monopoly on international telephony. The rest of the sector is in private hands.

Still, anti-competitive barriers in services hamper efficient delivery and restrict growth. The two state-owned banks have high levels of non-performing loans and are in need of major restructuring. State intervention in transport is substantial. The national airline, Sri Lankan, is still majority state-owned. Another state-owned company has the monopoly on airport services. Sri Lanka Telecom continues to own most of the national telecommunications infrastructure. It and other incumbents restrict right of interconnection for other operators, thus restricting overall competition. A new competition law was passed in 2003, but it lacks teeth. Inefficient state-owned monopolies also dominate oil and electricity provision.

Last, foreign traders and investors complain of opaque, discriminatory and corrupt public- procurement practices and customs administration.

e. Sri Lankan politics and economic policy: an assessment

To run through some basic economic indicators (see sections two and three in the attached tables):

Sri Lankan GDP per capita at market prices, at \$1200 in 2005, is about twice that of other south-Asian countries, though the gap with India in particular is much narrower when measured in terms of PPP. It is still considerably below that of middle-income east-Asian developing countries. Poverty is much lower than it is elsewhere in south Asia. Sri Lanka's ranking on the UNDP's Human Development Index (0.751, in 93rd position) is the best in south Asia, but lags behind east-Asian scores. The Fraser Institute ranks Sri Lanka the 83rd country in the world in terms of economic freedom,

with a score of 6.0. This is better than it is for other south-Asian countries – except India, which now has a higher score (6.7). Trade in goods and services is about 90 per cent of GDP, over twice that of other south-Asian countries. Three-quarters of goods exports are of labour-intensive manufactures; and nearly all the rest are of primary products. Industry and services account for above-average shares of GDP, and agriculture a below-average share, by south-Asian standards. Middle-income developing countries, however, have a much higher share of industrial value-added in GDP. Finally, Sri Lanka's business-climate indicators are mixed by south-Asian standards and bad by east-Asian standards. Overall in south Asia, it is ranked above Pakistan and Bangladesh but below Nepal and India.

A standard "Washington Consensus" account of Sri Lankan economic performance would make the following points. Aggregate and per-capita income growth since the late 1970s, averaging 6 per cent per annum, has been remarkable, especially in light of ongoing political instability and recurring macroeconomic instability. This is directly related to internal and external liberalisation. Manufactured exports, particularly garments, and then services from the 1990s, have been the growth engines. Growth has enabled Sri Lanka to maintain relatively high human-development indicators by south-Asian standards.

However, the growth-and-development record does not look so good when east-Asian comparisons are brought into play. East-Asian countries have done better in the 1980s, '90s and into the new century. When comparisons are stretched back 50-60 years, the differences are much starker. Sri Lanka's per-capita GNP was higher than that of other major Asian countries except Malaysia in 1955. South Korea and Thailand were behind Sri Lanka even in 1960. By 1995, Thai real incomes were twice as high, Malaysian real incomes three times higher, and South Korean real incomes nearly four times higher.

One sign of relatively weak economic performance is the lack of export diversification. Tea and garments dominate exports, and they are dependent on two markets, the USA and EU. Garment exports account for half of export earnings. Despite all kinds of government incentives, Sri Lanka has not broken into world markets in electronics, food

processing and other labour-intensive niches. It has great potential in services outsourcing, but has failed to attract big-ticket investments. Tourism is a big foreign-exchange earner, but it is still 1 per cent of GDP and stuck in the low-value charter tourism market.

Economic growth is also dangerously unbalanced. It is concentrated overwhelmingly in the western province, in and around Colombo. This region accounts for about half of GDP, attracts nearly all inward investment, and has poverty rates that are half those for the country as a whole.

Relatively poor economic performance is a result of disastrous economic policies from the mid 1950s to the mid 1970s, but also a product of policy and institutional deficits in the last three decades. Governments have never managed to sustain macroeconomic stability. Public debt is over 90 per cent of GDP, and interest payments absorb over half of tax revenues. Debt servicing and defence expenditures have driven up real interest rates and crowded out private investment, as well as long-term investments in education, skills and infrastructure. Trade and FDI liberalisation could have gone further. "Second-generation" structural reforms have lagged behind. State control of land, unclear private property rights in the countryside, and a host of different subsidies hamstring agricultural efficiency. The public sector is still too large and inefficient. State-owned enterprises keep the cost of key services inputs, as well as of power and electricity, high, with inefficient delivery. Sri Lanka's government is still one of the biggest in the world in per-capita terms, employing around one million people. The executive comprises nearly 60 ministries, nearly 40 of which are of cabinet rank. Too many government agencies with overlapping jurisdictions and turf battles cripple policy formulation and implementation, and make the delivery of public services a joke. Labour-market regulation is not as restrictive as it is in India, but it is still far from flexible, given the influence of urban-based public-sector trade unions. Over-regulation, regulatory opacity, bureaucratic discretion, frequent and unpredictable regulatory changes, and corruption keep the costs of doing business high (as the World Bank's Doing Business scores for Sri Lanka indicate). Last, there is of course the fiscal burden and investment-deterring effect of the civil war and the lack of a lasting political

settlement. This could be costing the economy 2-3 percentage points of growth per annum.

Let us add a touch of politics to the explanation. Hopeless, wantonly destructive Sinhalese politics is at the root of Sri Lankan failure, both in the pre-1977 growth-restricting phase and the post-1977 growth-promoting phase. Rival factions within a narrow Sinhala elite have squabbled and warred to win political power and then distribute the spoils of office through patronage politics. Welfare populism and ethnic chauvinism have been used to vie for Sinhalese votes in the game of electoral politics. Big Government and (inter- and intra-) communal conflict have become entrenched and difficult to reverse. Colombo politics has become violent and criminalised across the political spectrum. It has also become evermore balkanised, as building a governing majority depends on pandering to a plethora of rent-seeking and chauvinist constituencies – all potential blocking minorities in economic *and* security policies. The incumbent President, Mahinda Rajapakse, owes his election to such a coalition of interests. His SLFP-led government relies on the same coalition for its slim parliamentary majority.

Finally, a political-economy comparison with Malaysia is especially revealing. Initial conditions in the 1950s were similar. Both had similar per-capita incomes, small multi-ethnic populations, abundant land and plantation export sectors.

Malaysia pursued outward-looking policies, maintaining an open economy underpinned by conservative fiscal and monetary policies. Growth was combined with redistribution (in favour of the Malay majority). Stable political-economic conditions and an open economy allowed for flourishing plantation and mining exports, and then diversification into labour-intensive manufactures and higher-value processing activities (e.g. in rubber and palm oil). As a result, Malaysia is now an advanced middle-income country in which poverty has almost been eradicated. The wealth generated has financed transfers to the Malay majority through broad-based affirmative action policies and agricultural subsidies (especially for rural rice farmers). Efficient export sectors exposed to global competition have propped up inefficient domestic sectors shielded from such competition (and

generally owned and run by politically well-connected Malays). An accommodation between Malay-dominated politics and Chinese-dominated business has ensured political stability.

In contrast, Sri Lanka pursued inward-looking policies that favoured redistribution (to the Sinhalese majority) over growth. Low growth and extensive, indiscriminate consumer subsidies were the fast track to macroeconomic turbulence. Protectionist policies strangulated exports. Market-led reform arrived in the late 1970s, but it came too late and proceeded too partially and fitfully. Lack of economic opportunities drove disaffected, educated youth to the extremes of communal violence. There was no political settlement between the Sinhalese majority and the Tamil minority. Rather the latter, the most productive component of the population – its animating spirit of industry -- was driven to emigration and internal rebellion. Sri Lanka, unlike Malaysia, remains a low-income country with poverty and lack of opportunity, especially for the rural poor outside the western province. Its growth and public finances are fragile and lopsided. It is run by a myopic, incompetent, venal Colombo elite. The state has palpably failed. And now two generations of Sri Lankans – overwhelmingly the poor spanning the communal divide – have the lifelong scars of violent conflict.

2. A better Sri Lankan prospect?

Sri Lanka is back to civil war. Public finances are again getting out of control – helped by the huge influx of aid after the tsunami. Investor confidence is deteriorating. The garments export engine faces more competition after the abolition of MFA quotas. There is backtracking on previous liberalising reforms. Politics is stuck in a quagmire of parochial rent-seeking and ethnic chauvinism. At a time when parts of India, particularly its cities in the south and west, are charging ahead, Sri Lanka is being left behind. Is there an alternative? A long-term “vision” for Sri Lanka would look something like the following:

- Island-wide peace, with a long-term accommodation between the Sinhalese majority and the Tamil minority. This would create a peace dividend for the

economy. A realistic, clear-sighted Colombo government would concede effective control of the north to the Tamil Tigers, perhaps dressed up in a federal political structure. This would be a worthwhile price for political stability.

- A tolerant, multi-cultural society eschewing ethnic discrimination and emphasising meritocratic advancement.
- Public policy should be kept as simple as possible, concentrating on getting the basics right rather than intervening left, right and centre. Above all, people should be free to go about their daily business free of arbitrary political interference. Sri Lanka's perennial problem is that it has far too much politics at all levels of society. This cramps individual freedom, particularly for the poor citizen without good political connections; and it stymies wealth-creating enterprise.
- Significantly increased economic growth, closer to 10 per cent than 6 per cent per annum. This would not be unrealistic, given comparative advantage in labour-intensive exports in manufacturing, agriculture (e.g. food processing) and services (notably business-process outsourcing). Such levels of growth would make serious inroads into poverty, especially outside the western province.
- Macroeconomic stabilisation: Monetary policy needs tightening to reduce inflation; and major fiscal surgery is even more important. This requires: removal of an array of producer and consumer subsidies; downsizing the civil service; an across-the-board increase in GST; a move to full market pricing for electricity, oil and petroleum products; and, not least, swingeing cuts in the defence budget. This is necessary for manageable debt servicing; weaning the exchequer off foreign aid to plug the deficit; lowering real interest rates; and giving the private sector the incentive to do business.
- Freer trade: Trade and FDI should be liberalised as much as possible, though this can be phased in according to a set timetable. Tariffs should be reduced and harmonised to a simple, uniform tariff of say 5 per cent, and locked in through WTO commitments. Additional import taxes and remaining non-tariff barriers (quotas, import licenses and product bans) should be removed. Most remaining restrictions on inward investment should be abolished, with investors given full national treatment under local laws and recourse to international arbitration.

Investment approval procedures should be quick and automatic. This should apply to both goods and services sectors. Many of these measures should be locked in through stronger WTO commitments. Free trade agreements with major trading partners might also make sense, but these should be strong, with comprehensive coverage, "WTO-plus" disciplines to underpin market access, and liberal rules of origin.

- Privatisation: There should be full privatisation of Sri Lanka Telecom, the two state-owned banks, and the oil and electricity monopolies. These should target strategic foreign investors to bring in capital, skills and technology.
- Industrial policy: Much bureaucracy and public money is wasted on selective incentives for foreign investors. These should be scrapped. Rather government should concentrate on the basics to attract investors: an open door to trade and FDI; light, transparent domestic regulation; security of property rights and enforcement of contracts; flexible labour markets; political and macroeconomic stability. "Soft" industrial policy could complement the package. For example, the Board of Investment should act as a one-stop-shop facilitator of inward investment, e.g. disseminating market intelligence at home and abroad through exhibitions, matching domestic and foreign partners, short-circuiting domestic red tape etc.. "Hard" industrial policy, i.e. picking winners through selective promotion and protection, would be quite the wrong approach, and the wrong lesson to draw from east-Asian success.
- Decisive stabilisation and liberalisation will have serious short-term revenue implications. Bridging aid from the IMF, World Bank and other donors might therefore be necessary.
- Domestic deregulation: This includes labour-market deregulation, removal of remaining price controls, and shortening procedures for setting up new businesses and registering property.
- In the medium-term: Public investment is needed in transport infrastructure, education, health and vocational training, but there has to be more reliance on private investment, including FDI, and competitive private suppliers. Reform of public administration and the judiciary is also important. And there should be a build up of independent, well-resourced agencies to enforce pro-competitive

regulation. This includes a Competition Commission with teeth to deal with monopolies, cartels and other restrictive business practices throughout the economy; and specific regulation for key services sectors. Finally, the vast discretion enjoyed by ministers and officials, e.g. to vary tariffs, offer investment incentives and allocate licenses, needs to be drastically reduced.

- Branding: The Sri Lankan brand should be a coherent package of thoroughgoing policy and institutional reforms, centred on political and macroeconomic stability, limited government, light regulation, competition and openness to the world (preferably something close to free trade). This would make Sri Lanka stand out and attract big-ticket foreign investment. It would enable a better plug-in to global consumer markets and global supply chains, especially via an expanding India and across to east Asia.
- All the above would appear Utopian given the current state of Sri Lankan politics with its multiple and entrenched blocking interests. It would require a determined politician to take charge, and invest wide-ranging powers with an economic-policy supremo, supported by a team of clean and competent technocrats. They would need to take advantage of a window of opportunity – probably a macroeconomic crisis – to ram through necessary short-term reforms, and establish a bridgehead to more complicated and politically-sensitive medium and long-term reforms. Hence the importance of having a long-term vision of where the country should be heading, and what to do to get it there in stages.

3. Lessons for policy reform elsewhere

Since the Sri Lankan story is one of failure, the main lessons to draw for other developing countries are negative. Sri Lanka points to traps to be avoided. These are:

- A multi-ethnic society needs a *modus vivendi* among its constituent communities to ensure political stability. In particular, a politically dominant majority community must not strangle the golden goose of a more economically productive minority. The Malaysian example points to relative success; the Sri Lankan one to absolute failure. (One should add that there are still big dangers

in going too far with affirmative action policies, as Malaysia shows. They end up as a fiscal and competitive drag on the economy; entrench a rent-seeking elite that waddles comfortably at the junction of business and politics; and spread a culture dependent on handouts and hostile to the bourgeois virtues of work, responsibility and self-improvement.)

- A single-minded focus on maximising growth is preferable to an overriding focus on redistribution. Growth creates the conditions for fairer distribution, though it does not automatically ensure it. Growth is the necessary, if not sufficient, condition for poverty reduction and human-welfare improvement. Again, Malaysia and the wider east-Asian experience point to relative success; Sri Lanka and the wider south-Asian experience to relative failure.
- Public policy should be about getting the basics right: macroeconomic stability; openness to the world economy; a favourable domestic climate for doing business; investment in public goods; and a state that performs core functions well (or at least not too badly). These are the chief lessons to draw from east-Asian success. Sri Lanka points in the opposite direction: disastrous economic policies from the 1950s to 1977, which helped fuel inter and intra-communal conflict; and pro-market policies post-1977 that were stop-go and had big gaps.
- Getting the basics right is far more important than industrial policy of the picking-winners variety. That is also the right lesson to draw from east Asia. Sri Lanka, on the other hand, has a mess of industrial-policy measures administered by a complex bureaucracy, while retaining all sorts of domestic and trade-policy restrictions on doing business.
- Removing domestic obstacles to doing business is as important as external liberalisation, though the latter should spur the former. These obstacles deter external trade and FDI, not just internal trade. Hence this agenda is "trade-related". Some reforms to simplify business procedures are relatively simple; others are of the more difficult, protracted "structural" variety. Most developing countries have such unfinished business on domestic, trade-related reforms. Sri Lanka has more than most, compared with east-Asian countries and now with the more advanced Indian states.

- Countries that are or become abundant in cheap labour have the potential to plug into globalisation and grow fast through labour-intensive manufactured exports, and now labour-intensive services exports too. That happens through open doors to trade and FDI, as China, Hong Kong and southeast Asia have shown (though in northeast Asia it happened through export-orientation without FDI in the early phases). To a lesser extent, it happened in Sri Lanka post-1977, despite political and macroeconomic instability. It is happening now in India, and would go much further if India were to step up internal and external liberalisation. But factor endowments and initial conditions matter: recent history shows it is much more difficult for land- and resource-abundant countries to integrate into global markets, sustain fast growth and make it spread to the poor. Put another way: a Latin American, Middle Eastern, Central Asian or African country beset by internal strife, macroeconomic instability and severely malfunctioning government would probably not be able to repeat Sri Lankan-style growth through external liberalisation alone – if for the simple reason that it would find it far more difficult to break into job-rich manufactured exports.
- Initiating far-reaching policy reforms usually requires a crisis that concentrates minds and provides a window of opportunity that would not be available under conditions of “normal” politics. Sri Lanka shows that a crisis is not always enough. Long-standing political crisis and successive macroeconomic crises have not proved sufficient for the reforms that are needed. The existence of the foreign-aid business, all too willing to lend on the promise of future reforms, may make matters worse by providing incentives to delay or avoid reforms.

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Sri Lanka

1. Tariff rates	2
Table 1-3. Average MFN Applied Tariffs and Bound Rates	2
Table 4. Average MFN Applied Tariffs and Bound Rates	2
2. Sri Lanka and the countries in the region	3
Table 5. Human Development Index	3
Table 6. Degree of economic freedom	3
Table 7. GDP and GDP per Capita	3
Table 8. GNI and GNI per Capita	4
Table 9. Exports and Imports of goods and services	4
Table 10. Economy Rankings	4
Table 11. Economic Indicators South Asia	5
Table 12. Economic Indicators	5
3. Sri Lanka key economic indicators	6
Table 13. Sri Lanka key indicators	6
Graph 1. Type of Export	6
Graph 2. Allocation of GDP by Sector	7

1. Tariff rates

Table 1-3
Average MFN Applied Tariffs and Bound Rates
(All Goods)

Country	Bound Rates	Applied Tariffs	Binding Coverage
1. Sri Lanka	29,8	10,2	37,8
2. Low Income Countries	61,2	13,3	51,5
3. Middle Income Countries	32,7	10,8	91,7
4. South Asia	74,0	17,5	42,9

(Agriculture)

Country	Bound Rates	Applied Tariffs	Binding Coverage
1. Sri Lanka	49,7	15,4	100,0
2. Low Income Countries	77,2	17,1	99,8
3. Middle Income Countries	50,4	15,8	99,9
4. South Asia	112,5	19,0	98,2

(Manufactures)

Country	Bound Rates	Applied Tariffs	Binding Coverage
1. Sri Lanka	19,3	9,6	28,3
2. Low Income Countries	39,1	12,7	44,1
3. Middle Income Countries	28,3	9,9	90,4
4. South Asia	31,2	16,8	34,5

Table 4.
Average MFN Applied Tariffs and Bound Rates

	All Goods		Agriculture		Manufactures	
	Average Tariff Rate	Bound Tariff Rate	Average Tariff Rate	Bound Tariff Rate	Average Tariff Rate	Bound Tariff Rate
1. Sri Lanka	10,2	29,8	15,4	49,7	9,6	19,3
2. Low Income Countries	13,3	61,2	17,1	77,2	12,7	39,1
3. Middle Income Countries	10,8	32,7	15,8	50,4	9,9	28,3
4. South Asia	17,5	74,0	19,0	112,5	16,8	31,2

Sri Lanka: 2004. **Low Income Countries:** World Bank category 1, 2000-2004. **Middle Income Countries:** World Bank category 2, 1998-2004. **South Asia:** India, Sri Lanka, Pakistan, Bangladesh and Nepal, 2003-2004.

The figures are simple unweighted averages of the tariff rates. Source: World Bank Trade Databases:
<http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/tar2005a.xls>

2. Sri Lanka and countries in the region

Table 5. Human Development Index (HDI), South Asia

Country	HDI-Index	World Rank
India	0.602	127
Sri Lanka	0.751	93
Pakistan	0.527	135
Bangladesh	0.520	139
Nepal	0.526	136

The human development index (HDI) focuses on three measurable dimensions of human development: living a long and healthy life, being educated and having a decent standard of living. Thus it combines measures of life expectancy, school enrolment, literacy and income to allow a broader view of a country's development than does income alone.

Figures are from 2003, Source HDR 2005: <http://hdr.undp.org/statistics/>

Table 6. Degree of economic freedom in South Asia

Country	Level of Economic Freedom	World Rank
India	6.7	53
Sri Lanka	6.0	83
Pakistan	5.7	95
Bangladesh	5.7	95
Nepal	5.2	118

The Economic Freedom of the World project employs a variety of data to rate the degree of economic freedom in a country. The ratings are based on a zero to ten scale, with ten being most free and zero the least.

Figures are from 2004, Source: Gwartney, James and Robert Lawson (2006). *Economic Freedom of the World: 2006 Annual Report*. Vancouver: The Fraser Institute. Data retrieved from www.freetheworld.com.

Table 7. GDP and GDP per Capita

Country	GDP in billion US \$ Current prices	GDP per Capita in US \$ Current prices	GDP per Capita in US \$ PPP
India	775.4	714	3344
Sri Lanka	23.5	1199	4384
Pakistan	118.5	769	2628
Bangladesh	61.5	403	2011
Nepal	7.5	323	1675

Figures are from 2005, Source IMF: <http://www.imf.org/external/pubs/ft/weo/2006/01/data/dbginim.cfm>

Table 8. GNI and GNI per Capita

Country	GNI in Billion US \$	GNI per capita in US \$
India	793.0	720
Sri Lanka	22.8	1 160
Pakistan	107.3	690
Bangladesh	66.2	470
Nepal	7.3	270

GNI and GNI per capita are measured by the Atlas method.

Figures are from 2005, Source World Bank:

<http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20535285~menuPK:1192694~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html>

Table 9. Exports and Imports of goods and services (percent of GDP)

Country	Imports of goods and services (% of GDP)	Exports of goods and services (% of GDP)
India	21.0	19.0
Sri Lanka	45.5	36.4
Pakistan	14.9	16.0
Bangladesh	20.8	15.5
Nepal	20.6	17.6

Figures are from 2004, Source: World Bank

<http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20535285~menuPK:1192694~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html>

Table 10. Economy Rankings - South Asia

Ease of Doing Business Rank	Starting a Business	Dealing with Licenses	Employing Workers	Registering Property	Getting Credit
Pakistan	<i>Sri Lanka</i>	Bangladesh	Bangladesh	Nepal	Bangladesh
Bangladesh	Nepal	<i>Sri Lanka</i>	<i>Sri Lanka</i>	Pakistan	Pakistan
<i>Sri Lanka</i>	Pakistan	Pakistan	India	India	India
Nepal	Bangladesh	Nepal	Pakistan	<i>Sri Lanka</i>	<i>Sri Lanka</i>
India	India	India	Nepal	Bangladesh	Nepal

This table shows the ease of doing business rankings for economies in the region. The table is based on an index that is calculated as the ranking on the simple average of country percentile rankings on each of the 10 topics covered in Doing Business in 2006. The ranking on each topic is the simple average of the percentile rankings on its component indicators.

Source: World Bank Doing Business 2006 report.

Table 11. Economic Indicators South Asia

	India	Sri Lanka	Pakistan	Bangladesh	Nepal
GNI, Atlas method (current US\$)	680.4 billion	19.5 billion	90.7 billion	61.3 billion	6.6 billion
GNI per capita, Atlas method (current US\$)	630	1010	600	440	250
GDP (current US\$)	694.7 billion	20.1 billion	96.1 billion	56.6 billion	6.7 billion
GDP growth (annual %)	8.5	5.4	6.4	6.3	3.4
Inflation, GDP deflator (annual %)	4.2	9.4	7.8	4.2	5.0
Agriculture, value added (% of GDP)	19.6	17.8	22.3	21.0	39.9
Industry, value added (% of GDP)	27.3	26.8	24.9	26.6	21.7
Services, etc., value added (% of GDP)	53.2	55.4	52.7	52.4	38.4
Exports of goods and services (% of GDP)	19.0	36.4	16.0	15.5	17.6
Imports of goods and services (% of GDP)	21.0	45.5	14.9	20.8	30.6

Figures are from 2004, Source: World Bank

<http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20535285~menuPK:1192694~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html>

Table 12. Economic Indicators

	Sri Lanka	Low Income Countries	Middle Income Countries	South Asia
GNI per capita, Atlas method (current US\$)	1010	507.0	2265	586
GDP growth (annual %)	5.4	7.4	7.2	6.0
Inflation, GDP deflator (annual %)	9.4	7.9	6.3	6.1
Agriculture, value added (% of GDP)	17.8	22.1	10.0	24.1
Industry, value added (% of GDP)	26.8	28.1	37.3	25.5
Services, etc., value added (% of GDP)	55.4	49.8	52.7	50.4
Exports of goods and services (% of GDP)	36.4	23.7	34.7	20.9
Imports of goods and services (% of GDP)	45.5	26.2	32.3	36.6

Low Income Countries and **Middle Income Countries**: World Bank definitions. **South Asia**: India, Sri Lanka, Pakistan, Bangladesh and Nepal.

Figures are from 2004, Source: World Bank

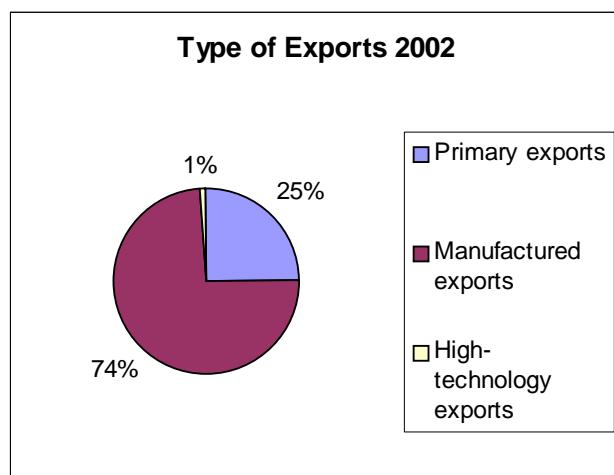
3. Sri Lanka key economic indicators

Table 13. Sri Lanka key indicators

Population		
Inhabitants	20.4 million	2003
Urban population	21.1 %	2003
Annual population growth	1.3 %	1975-2003
Annual population growth	0.7 %	2003-2015
Economic Indicators		
GNI	22.8 billion US \$	2005
GNI per capita	1 160 US \$	2005
GDP in current prices	23.5 billion US \$	2005
GDP per capita in current prices	1199 US \$	2005
GDP per capita (ppp)	4384 US \$	2005
Current account balance	-648 million US \$	2004
Inflation	10.6 %	2005
Trade figures		
Exports of goods and services	34.0 % of GDP	2005
Imports of goods and services	45.6 % of GDP	2005
Rank in world trade		
Merchandise Exports	79	2004
Merchandise Imports	75	2004
Commercial services Exports	84	2004
Commercial services Imports	72	2004

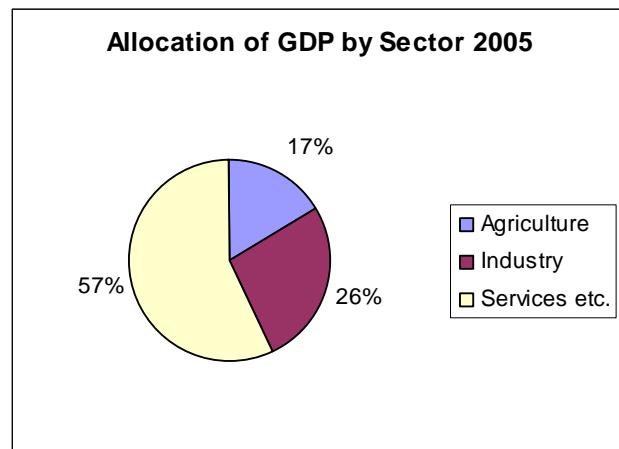
Source: World Bank, WTO and IMF

Graph 1. Type of Export



Source HDR 2005: <http://hdr.undp.org/statistics/>

Graph 2. Allocation of GDP by Sector



Source: World Bank