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POLICY INSIGHTS

INSTITUTE OF POLICY STUDIES OF SRI LANKA

ECONOMIC REFORMS IN SRI LANKA: POLITICAL ECONOMY AND INSTITUTIONAL CHALLENGES

From the IPS Flagship Publication 'Sri Lanka: State of the Economy 2015 Report'

The run up to Sri Lanka's January 2015 Presidential elections saw an unprecedented wave of demand for political and constitutional reforms. In the end, it was contested and won over a mandate for reforms, encompassed in a 100-day programme with the abolition or scaling-down of executive powers of the President under the country's Second Republican Constitution of 1978 as the central focus of the reform efforts. The passage of the 19th Amendment to the Constitution in April 2015 with an overwhelming majority - albeit on a less ambitious scope than originally envisaged - was the first significant milestone of the reform initiatives.

It is clear that constitutional and political reforms, such as the 19th Amendment and the proposed 20th Amendment to the Constitution to change the country's electoral system, are the main pre-occupations of policy makers at present. However, social systems are complex and interconnected. Therefore, reforms in one sphere cannot usually generate desired outcomes without reforms in other spheres. For instance, reformed political structures require matching adjustments in economic systems to generate efficient outcomes. In the long run, not only political and economic reforms, but reforms in other frontiers such as social and environmental will need to go hand-in-hand to achieve socially desirable outcomes.

This Policy Insight based on the SOE 2015 makes an attempt to examine the quest for reforms that the country appears to be engaged in at present so that a better idea of the desired direction of change can be gained.

DEMAND FOR REFORMS: PRESENT CONTEXT

The current reforms have been inevitably captured under the popular slogan of 'good governance'. The reformist agenda appears to be driven by five major demands;

- Strengthening the democratic structures of government;
- Promotion of human rights;
- Combating corruption;
- Ensuring rule of law; and
- Enhancing transparency and accountability.

Political forces mobilized by the above demands for reform have recently passed the 19th Amendment to the Constitution, aimed to serve many of the above demands by altering the power structure of the political system by reducing the powers of the executive arm. Other legislative reforms that are considered complementary to the 19th Amendment, namely, the Right to Information Act (RTIA) and the 20th Amendment to reform the electoral system are being pursued.

The path to reforms is not smooth and is being intensely contested by parties with diverse interests. The experience of other countries suggests that desired outcomes of political reforms cannot be achieved through legislative enactments alone, but

"The ongoing popular demand and debate over reforms in Sri Lanka are most intense in the political arena."

"Sri Lanka's drive towards reforms, currently spear-headed by demands for political reforms, does not necessarily imply a positive momentum for change in the economic sphere."

depend largely on the steadfast commitment of diverse sections of the polity to make them practical realities.

Overall, global experience suggests that democratic political reforms do not necessarily provide an automatic push for transforming countries into economic growth centres. They could act as catalysts for growth, but economies have to undergo their own paths of reform, which are not fully independent of political reforms. Interestingly, some economies that successfully transformed themselves into centres of growth did so under autocratic regimes backed by military, communist parties or even monarchical systems at least in their early phases of transformation. Some of them have gradually adopted democratic systems later, but a few are still under autocratic regimes.

Today, economic reforms have to be enacted against the backdrop of rapidly advancing information technology (IT) and globalization that sets the pace of economic, social and political relations around the world. The conditions can be further complicated by a declining quality of the environment around the world and global threats, with potential for far reaching consequences. Climate change, the greatest of all externalities that humanity is experiencing is showing its capacity for unleashing damage on economies around the world. Hence, complementary reforms in social and environmental also are necessary for social progress in the current context.

ECONOMIC REFORMS: CONCEPTUAL ELEMENTS AND PRACTICE

The term 'reform' implies amending a system which is not performing satisfactorily. Hence, reforms are demanded due to unsatisfactory performance of a social system. The key objective of reform is changing the system from poor to better performance. Therefore, reforms are invariably associated with change. In spite of broader conceptual implications of reforms as a social process, the term has been used in recent economic literature mostly to identify a set of policy changes that have been advocated to remove certain distortions - presumably introduced by government involvement in economic activities - and open up economies to free trade and capital flows. Most economists in the neo-liberal camp and policy makers shared a common conviction that growth requires macroeconomic prudence, domestic liberalization, and outward-orientation. Thus, the core set of reforms revolved around fiscal deficit reduction, realignment of exchange rates, lifting controls on prices, deregulation of interest rates, liberalization of financial sectors, reduction of tariffs and other restrictions on imports. A reduction in the role of the state also was viewed as essential for achieving greater efficiency through reducing state discretion, downsizing governments and encouraging a greater role for the private sector. Hence, reforms aimed at privatization, deregulation, elimination of quantitative restrictions and licensing requirements, dismantling agricultural marketing boards and other forms of state monopoly became central to the reform agendas of the 1980s and 1990s. Since the early 2000s, there has been a growing emphasis on 'second generation reforms', which have been advocated strongly by the Bretton Woods Institutions. The second generation reforms aim at creating a level playing field for all sectors and implementing policies for the common good, particularly social policies that will help to alleviate poverty and provide more equal opportunities. These reforms focus on four major areas: the financial system, good governance, composition of fiscal adjustment and deeper structural reforms.

SRI LANKA'S EXPERIENCE WITH ECONOMIC REFORMS

In 1977, Sri Lanka was the first country to adopt liberal economic reforms in South Asia, led by the new United National Party (UNP) regime that came into power after defeating the centre-left United Front government headed by the Sri Lanka Freedom Party (SLFP). By then, Sri Lanka had a nearly two decades' experience of a strong nationalization movement overseen by SLFP led coalition governments. In many ways, 1977 was a watershed year in Sri Lanka's political and economic history. In the political frontier, the UNP regime introduced the Second Republican Constitution in 1978 - with the declared

"In spite of positive expectations by the proponents, the experience over nearly three decades of neo-liberal economic reforms does not fully uphold their faith. In practice, these reforms amounted to 'shock therapy' in many countries, often resulting in heavy public dissent which could not be completely ignored by political authorities."

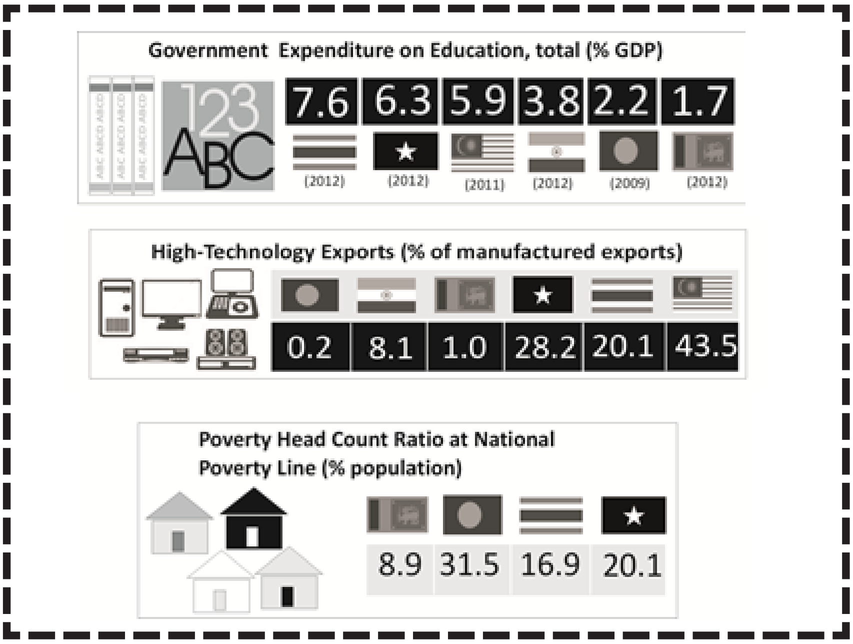
objective of ensuring political stability for accelerated growth - which the current wave of political reforms aims to amend. In the economic frontier, after more than two decades of dismal economic outcomes under a protectionist inward looking policy, the new government embarked on an extensive market-oriented economic liberalization process. The main strategy envisioned by liberal economic reforms in Sri Lanka was achieving an export driven growth supported by foreign direct investments attracted by a cheap and relatively skilled labour force.

In the late 1980s, Sri Lanka once again embarked upon a 'second wave' of liberalizing reforms, clustered around three broad areas, (1) a stabilization programme; (2) unfinished reforms; and (3) a select few high profile projects.

Significantly, transfer of political power to an SLFP-led coalition government in 1994 did not mark a change of course in reform efforts. The privatization initiatives gathered momentum, but by the late 1990s, reforms initiatives petered out under the strain of coalition politics. A short lived UNP government attempted to roll out deregulatory economic policy reforms during 2002-04, but failed to capture popular support for its reforms including expenditure cuts via a public sector hiring freeze, easing foreign ownership of land, privatization initiatives (such as the insurance sector), or efforts to strengthen the regulatory environment through the establishment of a multi-sector regulatory agency such as the Public Utilities Commission of Sri Lanka (PUCSL).

Whilst there was no stated departure from an open economic policy regime with a change of President in December 2005, there was nonetheless some change in policies and backtracking of certain reforms.

Despite backtracking in certain liberalization reforms, however, the Sri Lankan economy saw significantly higher GDP growth, averaging over 7%. Higher growth was delivered on a development policy framework that relied exhaustively on an externally debt funded public investment drive. The strategy helped the economy to take-off at the end of a costly separatist conflict in 2009, withstand unfavourable global economic developments, and international pressure on human rights violations situation that saw economic assistance being scaled back by US/EU, including withdrawal of GSP-plus concessions by the EU. Notwithstanding the above, the long-term viability of sustaining high growth on an infrastructure-led drive, without addressing economy-wide productivity enhancing reforms was questionable.



Reviewing Lessons Learnt

Reviewing the lesson from Sri Lanka's experience in reforms could offer useful insights to steer the current wave of reforms in the right direction.

- Regrettably, some are negative lessons.
- Political issues had an overriding influence over the outcome of economic reforms;
- Reforms failed to attract a healthy flow of foreign investments;
- Reforms failed to achieve an export driven growth;
- Reforms failed to capitalize on initial advantages;
- Gains in technology transfer and innovation is negligible;
- Stiff public resistance to some aspects of liberalization;
- Poor attention to environmental threats.

There are also few positive points of Sri Lanka's experience that could offer some insights into crafting future reform efforts.

- Achievements in reducing poverty;
- Resilience displayed by the economy and adaptability of labour force;
- Public adaptation to reforms;

TOWARDS A REALISTIC AGENDA OF ECONOMIC RE-FORMS IN SRI LANKA

The direction on future economic reforms for Sri Lanka draws on a broad understanding of reforms as a multi-dimensional process, taking the realities of the global context in which they will occur together with lessons from past reform experiences.

These points out that the astute management of affairs on the political front is critical, and that the reforms are as good as how they are implemented. It also points out that practical realties should determine the priorities than ideological stands, while reforms should focus on areas where they are needed and capitalize on existing strengths.

As such the reforms should focus on building on Sri Lanka's human capital development; Strengthening Sri Lanka's socio-economic achievements; and protecting the interests of Sri Lanka's migrant labour force that has served the country well and continue to do so.

While building upon the strengths in the above mentioned areas, reforms should focus on addressing gaps in the following areas as priorities:

- Aiming at getting the fundamentals of macroeconomic management right in economic reforms;
- Strengthening reforms in the trade sector to achieve growth;
- Addressing concerns on the the Sri Lankan tax system; and
- Implementing multifaceted reforms in the agricultural sector and addressing its core challenges such as food security and agriculture productivity.

Besides the key sectors earmarked above for reforms, there are cross-cutting areas that need special attention in the context of future economic reforms. Four such critical areas are institutions, innovation, e-government and environment. They are not economic sectors by themselves, but reforms in these areas are obligatory for success in economic reforms.

"The review of reform experiences in Sri Lanka suggests that liberal economic reforms that transformed the economy have failed to realize the professed objective of placing the country firmly on a path of export-oriented growth."

This policy insight is based on the chapter on 'Economic Reforms in Sri Lanka: Political Economy and Institutional Challenges' in the 'Sri Lanka: State of the Economy 2015 Report' (SOE 2015). The State of the Economy Report is the flagship publication of the Institute of Policy Studies of Sri Lanka. The complete report can be purchased from the publications section of the IPS, located at 100/20, Independence Avenue, Colombo 7. For more information, contact the Publications Unit on 0112143100.

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