Sri Lanka
State of the Economy Report 2015

Chapter 4
Economic Reforms in Sri Lanka: Political Economy and Institutions Challenges

by
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4. Economic Reforms in Sri Lanka: Political Economy and Institutional Challenges

4.1 Introduction

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 the social and environmental will need to go hand-in-hand to achieve socially desirable outcomes.

This chapter makes an attempt to examine the quest for reforms that Sri Lanka appears to be engaged in at present so that a better idea of the desired direction of change can be gained. While it attempts to touch the broader issues of reform covering political, economic, social, and environmental dimensions, the main focus is on economic reforms - the directions of which are less certain at the moment. It asserts that besides adjusting to match reforms in the political system, there are also longstanding calls for reform in the economic system itself. Hence, the chapter has a more ambitious goal that extends beyond examining the economic implications of ongoing political reforms. The chapter begins by highlighting the direction of ongoing reforms in the political frontier. Subsequent sections focus attention on the conceptual elements underlying the dominant views on economic reforms, and past experience of economic reform efforts in Sri Lanka. Finally, it makes an attempt to

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demarcate the desired direction for reforms in the economic system and complementary changes in other frontiers.

4.2 Demand for Reforms: Present Context

The ongoing popular demand and debate over reforms in Sri Lanka are most intense in the political arena. These 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: Sri Lanka's Second Republican Constitution of 1978 allows for a concentration of power in the executive arm of the government, paving the way for autocratic forms of governance. Hence, reforms to reduce powers of the executive arm by strengthening the other arms of government, namely, the legislative and judiciary, and thereby instigating checks and balances on the powers of the executive arm has been a longstanding demand of the Sri Lankan polity. The 19th Amendment passed in the Parliament in April 2015 is primarily intended to serve this purpose, by curbing the term limit of the President to two, and allowing for the establishment of a Constitutional Council to oversee appointments to independent Commissions.

Promotion of human rights: The concentration of executive power that lends itself to autocratic forms of governance also erodes the safeguarding of human rights. Hence, strengthening the rights of citizens becomes an indispensable part of democratization of government. The current demand for reforms to strengthen human rights guaranteed by the Constitution is a major pillar of the reformist agenda.

Combating corruption: Corruption impedes the social and economic progress. It affects all spheres of governance, while the economic system suffers. It is argued that autocratic tendencies in political structures of government allow corruption and cronyism to creep in. Hence, the current demand for combating corruption is closely connected to democratic reforms. This demand is to be served by setting up and strengthening institutional structures to combat corruption and by reducing political pressure and influence over them.

Ensuring rule of law: The concentration of power within the executive arm has been instrumental in reducing the independence of judiciary and law enforcement agencies thereby leading to weakening of the rule of law in the country. Hence, enhancing the rule of law by introducing reforms that strengthen the judiciary and law enforcement agencies is a major focus in the current quest for political reforms.

Enhancing transparency and accountability: Curbing the autocratic tendencies and corruption on one hand, and enhancing human rights and the rule of law on the other, are essentially dependent on how transparent the governance process is and how accountable are those vested with authority. Hence, enhancing transparency and accountability in governance structures are perceived as essential components of reforms demanded.

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

Sri Lanka's drive towards reforms, currently spearheaded by demands for political reforms, does not necessarily imply a positive momentum for change in the economic sphere. 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. Low levels of corruption, rule of law, transparency and accountability are generally viewed as drivers of economic growth, but in many countries, they were also later achievements of transformed economies. 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.

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 the social and environmental also are necessary for social progress in the current context.

Despite the fact that reform processes have already gained a momentum in the political frontier in Sri Lanka, in other spheres - economic, social and environmental - public perceptions about desired reforms appear to be vague. The aim of this chapter is to explore the prospects for reform in these other spheres, especially in the economic frontier, although not in isolation from reforms in others. In the next section, attention is focused on conceptual elements of economic reforms. Considering the relatively narrow meaning that reforms have assumed under a neo-liberal discourse, a broader definition of reforms is adopted later, accommodating multiple dimensions of social, political and environmental elements as a social process.

4.3 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

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associated with change. However, reforms are distinguished from 'revolutions' that also brings in change to social systems in terms of nature, scale and intensity of change. Revolutions imply radical changes that alter the fundamentals of a system. In contrast, reforms are less dramatic, and involve adjusting, fine tuning or addressing partial imperfections of the existing system without radically overturning it. At the same time, reforms imply something far deeper than an isolated policy change targeted at a limited segment of an economic or political system. Thus, a package of streamlined policies aimed at creating deep-rooted changes in a system can amount to reforms.

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. Driven largely by what is coined as the 'Washington Consensus', this formula inspired a wave of reforms during the 1980s and 1990s across Latin America, Asia and Sub-Saharan Africa which altered the economic policy landscape in the developing world. The collapse of the Soviet Union and the socialist economic bloc further invigorated this process by absorbing Eastern Europe and the former Soviet Republics (the so-called second world) also as 'economies-in-transition'. The message advocated by orthodox economists, technocrats and political leaders who championed this line of reforms is 'stabilize, liberalize and privatize'.[1] The said course of reforms was largely encouraged by the growing recognition in the 1970s of failures associated with heavy state involvement in the economies of developing countries, contributing to the belief that the cost of government failures could be considerably larger than the cost of market failures. The reforms of the 1980s and 1990s were largely concerned with enhancing the efficiency of resource allocation by reducing the role of the state in the economy. 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.[2]

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 - paying greater attention to the soundness of banking systems and encouraging greater transparency, better data dissemination and the liberalization of capital accounts;
- Good governance - by reducing corruption, encouraging transparency of public accounts, improving public resource management and the stability and transparency of the economic and regulatory environment for private sector activity;

[1] Rodrik, D., (2006), "Rethinking Growth Policies in the Developing World", the Luca d'Agliano Lecture in Development Economics, October 8,2004, Torino, Italy.

[2] World Bank (2005), *Economic Growth in the1990s: Learning from a Decade of Reform,* World Bank, Washington D.C.

- Composition of fiscal adjustment - reducing unproductive expenditures such as military spending and focusing spending on social sectors; and
- Deeper structural reform - including civil service reform, labour market reform, trade and regulatory reform, and agrarian reform.

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. Paradoxically, despite pro-democracy claims of the proponents of neo-liberal reforms, more autocratic regimes in developing countries appeared to be better equipped to pursue these reforms than their democratic counterparts that count more on popular will. As a result, regardless of the support of influential sections of academics, policy makers and technocrats, the outcomes of neo-liberal reforms have attracted strong criticism and is still being debated passionately by its proponents and opponents.

Criticisms have originated from within the economics discipline as well as from outside. Many vocal critics outside the economics discipline involve left-wing political groups and thinkers and activists on social and environmental issues. Within the economics discipline, besides ever evolving debates for-and-against government involvement in economic management between various schools of thought (e.g., new-Keynesian and new-classical), there are well established theories concerning market failures and market imperfections that justify government involvement in economies.[3] Recent developments in new institutional economics (NIE) offer arguments that justify institutional interventions for establishing and functioning viable markets, the very same objective the neo-liberals have been striving to achieve through their prescribed set of reforms. New institutional economics shows that efficient markets presumed by the neo-liberal camp can only be achieved when it is costless to transact. However, when transaction costs are positive as observed in the real world, institutions do matter. Institutions are not merely government organizations as perceived by many. Broadly defined, 'institutions are the humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs,

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[3] In fact, some criticisms from outside economics, e.g., on environmental issues, are supported by accepted economic theories concerning public goods, externalities, common property and market failures.

traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)'.[4] Institutions provide incentives and disincentives for people to behave in certain ways and to structure economic, political and social relations accordingly.

Institutions can be designed to serve markets in several ways. Transaction costs of acquiring information, enforcing property rights and inducing competition can prevent the emergence of markets. But effective institutions can reduce those transaction costs. Properly designed institutions channel information about market conditions that help businesses, while facilitating governments to regulate them effectively. Institutions define and enforce property rights and contracts, determining who gets what and when. Knowing one's rights to assets and income and being able to protect those rights are critical for market development. Institutions can reduce the potential for disputes and help enforce contracts. Institutions can also work to increase and control competition in markets. On the other hand, markets could fail when participants engage in fraudulent or anti-competitive behaviour and when transaction costs prevent the internalizing of technological and other non-pecuniary externalities. And they fail when incomplete information results in moral hazard and adverse selection.[5] Recognition of the wider role played by institutions to ensure viable markets has led to a broad understanding among economists today that institutions do indeed matter.

Notwithstanding failures of and criticism over a neo-liberal agenda of economic reforms, it has shaped the policy thinking in economics significantly during the last few decades. Among others, it established the primacy of markets and private sector as the engine of economic growth, replacing formerly held views about government as the prime mover of economic progress that had given rise to many nationalization movements around the developing world. It successfully supplanted inward looking thinking held by nationalist political movements and academic circles with outward-oriented views. The practical experiences of East and Southeast Asian countries that transformed themselves from agrarian societies to modern industrial economies in a relatively short period of time also invigorated the support for market-friendly reforms around the world. In practice, it encouraged the promotion of exports and opening local markets for outside competition, replacing protectionist import substitution strategies with pro-capitalist views of growth as the mainstream development thinking around the world practiced earlier by many developing countries. Overall, the neo-liberal economic reforms was largely instrumental in replacing nationalist and egalitarian views of social and economic progress backed by nationalist and Marxist movements with pro-capitalist views of growth as the mainstream development thinking around the world. Unlike in the 1970s when the first wave of liberal reforms was introduced in the midst of the Cold War, there is no prominent politically backed alternative to market-friendly reforms at present. The entire world is moving in the same direction, where the main ideological battles are waged amongst various schools of thought within the capitalist camp.

4.4 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

[4] North, D., (1991)," Institutions", *The Journal of Economic Perspectives*, 5(1): 97-112.

[5] World Bank (2002), *World Development Report: Building Institutions for Markets*, World Bank, Washington D.C.

the Second Republican Constitution in 1978 - with the declared 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.

Since the overall strategy aimed at export-led growth, the first rounds of reforms carried out during 1977-78 entailed significant trade reforms: quantitative restrictions were supplanted with tariffs and the tariff structure underwent significant revisions to achieve a greater level of uniformity; Export Processing Zones (EPZs) were set up to attract FDI, with tax holidays and other concessions granted to foreign investors.[6] These measures were complemented with reforms in the exchange rate regime and financial sector. Fiscal policy reforms came by way of cutting back on subsidies, and deregulation of administered prices. Whilst the reforms of the late 1970s were bold and swift, the momentum of reforms was however short lived. A massive public investment programme - weakening both the fiscal and external accounts - saw the country grappling with macroeconomic imbalances by the early 1980s, compounded by an escalating separatist conflict from 1983. Political uncertainty continued to dog the economy, including a Marxist party led uprising in the latter half of the 1980s that together dried out FDI and Sri Lanka's hopes for an export-driven high growth strategy.

In the late 1980s, with a change of President, 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.[7] The stabilization programme essentially entailed the reduction in the fiscal deficit. Unfinished reforms included several low profile adjustments such as further reduction in tariffs and rationalization of the tariff structure, devaluation of the rupee, tax system reforms, further liberalization of commodity and financial markets, and, liberalization of exchange controls. These reforms were designed to stimulate the economy and create a climate that was favourable for higher levels of private investments.

The third group of measures was far more ambitious, encompassing broadly privatization, export promotion and poverty alleviation. Institutional mechanisms were put in place to facilitate the process of privatization in sectors such as telecommunications, public transport, shipping and plantation management. On the export promotion front, various restrictions on ownership structure of joint venture projects outside EPZs were abolished, providing EPZ status to export-oriented ventures operating outside EPZs. Existing FDI regulatory institutions were amalgamated under a Board of Investment with the aim of creating a one-stop-shop to facilitate and speed up investment approvals.

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

6 Athukorala, P., and S. Rajapathirana (2000), *Liberalization and Industrial Transformation: Sri Lanka in an International Perspective*, Oxford University Press, New Delhi.

7 Dunham, D., and S. Kelegama (1995), “Economic Reform and Governance: Second Wave of Liberalization in Sri Lanka, 1989-93”, Institute of Policy Studies of Sri Lanka, Colombo.

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. A change of policy with regard to the privatization programme was clearly enunciated, replacing privatization with a policy of restructuring and improving the performance of state owned enterprises (SOEs). In fact, there was an expansion in the role of SOEs in the economy by re-nationalizing some previously privatized ventures, revitalizing closed-down SOEs, fresh nationalization and setting up of new government ventures. Notably in November 2011, the government passed an expropriation Bill entitled 'Revival of Underperforming Enterprises and Underutilized Assets Act' to take ownership of 37 private enterprises, including a number of foreign-invested enterprises. Sri Lanka's import tariff regime also became more protectionist over time with an escalation in the use of para-tariffs and other taxes.[8]

Despite backtracking in certain liberalization reforms, however, the Sri Lankan economy saw significantly higher GDP growth, averaging over 7 per cent per annum. 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 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.

4.4.1 Reviewing Lessons Learnt

Reviewing lessons 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: The overall outcome of reforms was significantly affected by negative developments in the political frontier. These were not connected to government interventions in economic affairs, but the results of poor management of political affairs. From the late 1970s, Sri Lanka experienced a protracted separatist conflict, a Marxist insurrection and frequent political uncertainties caused by competitive party politics. These came as a result of poor political management of domestic affairs and international relations. The resultant political violence discouraged investors, shattering the hopes for export driven growth and employment generation.

Besides political violence, the resultant deformities in the political system can be considered inimical to a healthy functioning of the economy. Achieving a stable political environment conducive for accelerated growth was a major objective for introducing the Presidential-style Constitution of 1978. However, the overwhelming powers vested with the executive arm were exploited from the outset - e.g., the decision to extend the six-year Parliamentary term in 1982 through a referendum and not a general election - with successive Presidents holding on to Constitutional guaranteed powers in spite of promises to curtail them at election times. Thus, the promised political stability of the 1978 system was to become illusory, with political manoeuvres often leading to frivolous and chaotic circumstances such as mammoth Cabinets, party

[8] Athukorala, P., (2012), 'Sri Lanka's Trade Policy: Reverting to Dirigisme?,' *The World Economy*, 35(12):1662-1686.

defections, rampant corruption and cronyism, and a breakdown of public trust in the political system. All these factors deterred efforts to redirect the economy on to the right track.

Reforms failed to attract a healthy flow of foreign investments: Sri Lanka has been far from successful in attracting sufficient volumes of FDI to support its export expansion; it recorded inflows of approximately 1.4 per cent of GDP in 2014, well below par when compared to a country such as Vietnam (5.2 per cent of GDP) that opened up its economy much later.[9]

After an initial wave of investments, especially in the T&G industry, the flow of FDI dried up and the economy drifted into a course away from export driven growth. Increased political violence and associated uncertainties was responsible for this more than anything else. In the absence of capital to recruit cheap labour, Sri Lanka has witnessed high levels of labour migration overseas, helping to keep the economy afloat with inflows of worker remittances.

Reforms failed to achieve an export driven growth: In the immediate aftermath of liberalization, Sri Lanka underwent a dynamic structural change from exporting primary agricultural commodities to more value added light industrial products such as T&G. Despite this initial momentum, export performance, especially when compared against peers, has been rather lacklustre.[10] Exports have grown in absolute terms but alarmingly, exports growth since the mid-1990s has actually been slowing down, and declining as a share of GDP. Countries such as Vietnam and Bangladesh, which opened up later than Sri Lanka have faster rates of export growth. As a consequence, Sri Lanka has also lost its global export market share.

Reforms failed to capitalize on initial advantages: Relative good achievements in human capital development supported by free education and an efficient network of health services used to be a major competitive advantage for Sri Lanka. They helped the country to rank significantly high in indices such as UNDPs Human Development Index (HDI) in spite of a lower position in terms of per capita income compared with many other developing countries. In the global competition for investments, this was a major advantage Sri Lanka could count on together with a strategic geographical location. Nevertheless, Sri Lanka's education system has not evolved adequately to meet the changing demand, resulting in a large skills gap and mismatch in the labour force. A recent World Bank survey suggests that more than 50 per cent of surveyed Sri Lankan firms believe that the prevailing education and training system does not produce skills that are relevant for their needs. Moreover, about 33 per cent consider the lack of adequate skills as one of the major constraints on operating and growing their businesses.[11] Sri Lanka's government expenditure on education is lower in comparison to countries such as Bangladesh and Vietnam, with low enrolment in tertiary education (Table 4.1).[12]

Gains in technology transfer and innovation is negligible: Sri Lanka's export basket is heavily concentrated in a few low value added products; T&G and a few manufactured items account for 62 per cent of total exports. Despite having pursued an export-oriented strategy for a period close to four decades, Sri Lanka has not been able to successfully penetrate into exporting high-technology products. Vietnam which opened up its economy years after Sri Lanka has been far more successful (Figure 4.1).

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9 World Bank (2015), "World Development Indicators 2015", World Bank, Washington, D.C.

10 See Chapter 3 of this report on "International Environment".

11 Dundar, H., *et al.*, (2014), "Building the Skills for Economic Growth and Competitiveness in Sri Lanka", World Bank, Washington D.C.

12 See Chapter 8 of this report on "Educational Sector Reforms to Bridge Skill Gaps".

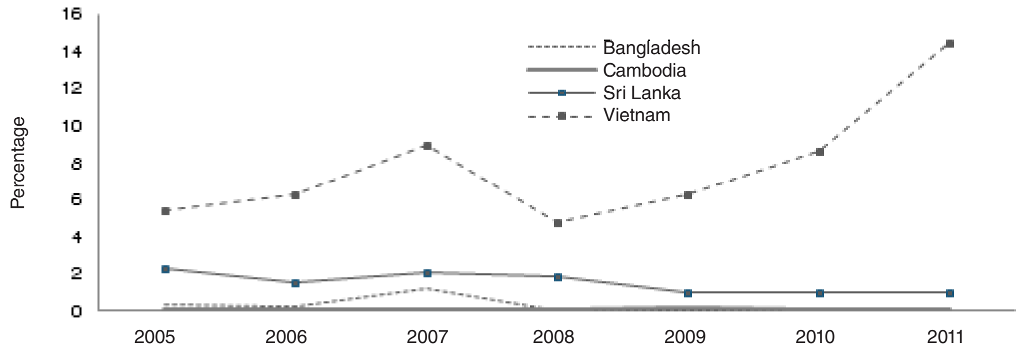
Table 4.1
Comparative Education Outcomes

Indicators	Bangladesh	India	Sri Lanka	Vietnam	Thailand	Malaysia
Government expenditure on education, total (% GDP)	2.2 (2009)	3.8 (2012)	1.7 (2012)	6.3 (2012)	7.6 (2012)	5.9 (2011)
Government expenditure per student, tertiary (% GDP per capita)	28.2 (2009)	53.8 (2012)	24.2 (2012)	41.2 (2012)	19.5 (2012)	61.0 (2011)
School enrolment, tertiary (% gross)	10.5 (2009)	24.8 (2012)	17.0 (2012)	24.6 (2012)	51.4 (2012)	36.0 (2011)
Labour force with tertiary education (% total)	-	9.8 (2010)	16.8 (2008)	-	17.1 (2012)	24.4 (2011)
Unemployment with tertiary education (% total unemployment)	15. 9 (2005)	23.1 (2010)	31.8 (2008)	-	36.1 (2012)	27.3 (2011)

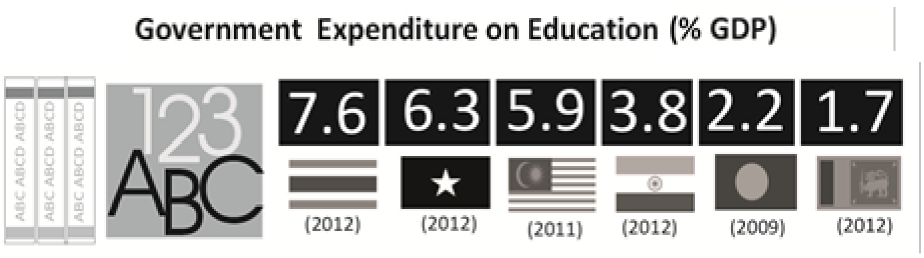
Source: World Bank (2015), "World Development Indicators Database", World Bank, Washington, D.C.

The failure on the part of Sri Lanka to penetrate higher value-added product markets can be partly attributed to the country's lack of innovation capabilities. Besides technology transfer associated with FDI flows, in all Asian growth centres, waves of innovation emerged within national academic and commercial establishments and helped the growth of local enterprises. Some of them have become MNCs and compete vigorously in global markets in high-tech value added products. Sri Lanka ranks a backward 102 out of 143 countries in the Global Innovation Index. Government expenditure on research and development (R&D) is low compared to other countries and human capital in R&D is also poor (Table 4.2). This is rather disappointing as Sri Lanka had relatively well established research facilities that had already generated some tangible outputs such as high-yielding varieties of agricultural

Figure 4.1
High-technology Exports as a Percentage of Merchandise Exports



Source: UNCTAD (2015), "Statistics Database", UNCTAD, Geneva.



crops even by the late 1970s. The country failed to capitalize on this base and subsequent developments saw limited intellectual resources drained out from the country weakening the existing capabilities even further. The only notable development in this direction was the significant growth in the IT sector led by software developers in the recent past.

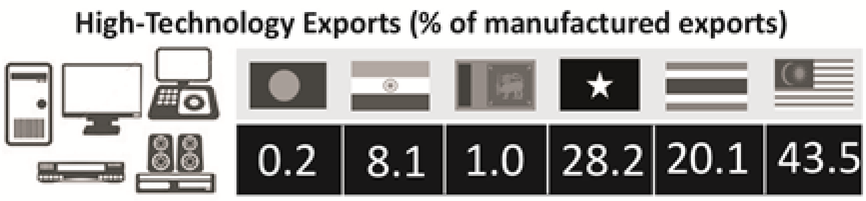
Stiff public resistance to some aspects of liberalization: Reforms in Sri Lanka encountered stiff public resistance in some areas. The highest resistance was observed in privatization and restructuring of SOEs and getting private sector involvement in education. More than a society-wide resistance, these came from immediate stakeholders such as left-wing student federations and employees of state monopolies. This resistance has prevented reforms in certain cases (e.g., state monopolies) and in some others failed to reach the expected targets (e.g., private schools and universities). In some others, more than the reforms, non-transparent and dubious methods adopted in implementing them attracted public dissent. Poorly executed reforms under scandalous circumstances of corruption and cronyism increased public discontent against reforms in general.

Poor attention to environmental threats: Another area where Sri Lanka's reforms failed to direct sufficient attention was deteriorating environmental conditions. In fact, Sri Lanka took some right steps initially by adopting the Environment Act, establishing the Central Environmental Authority and introducing environmental impact assessment (EIA) procedures by the early 1980s. Even some donor funded projects were implemented in areas such as watershed management, forest conservation and land use planning. Despite these early developments, however, there were failures to improve the system sufficiently thereafter, and

Table 4.2
Situation in Science, Technology and Innovation

Indicators	Bangladesh	India	Sri Lanka	Vietnam	Thailand	Malaysia
Innovation Index (rank out 143)	128	76	102	71	48	33
High-technology exports (% of manufactured exports)	0.2(2011)	8.1	1.0	28.2	20.1	43.5
Researchers in R&D (per million people)	-	159.9 (2010)	103.1 (2010)	113.0 (2002)	331.9 (2010)	1642.7(2010)
R&D expenditure (% of GDP)	-	0.79 (2010)	0.15 (2010)	0.17 (2002)	0.25(2010)	1.06(2010)
Technicians in R&D (per million people)	-	103.0 (2010)	89.2 (2010)	-	226.9 (2010)	158.2(2010)

Source: World Bank (2015), "World Development Indicators Database", World Bank, Washington, D.C.



environmental problems have been accumulating. Observations of environmental problems in Asia suggest that there are two major types; poverty driven problems and growth driven problems. Poverty driven environment problems in Sri Lanka - especially in rural areas - is as bad as in any other Asian country, whereas growth driven problems - concentrated in urban areas - is less severe compared with certain Asian mega cities. The latter can be considered more a result of Sri Lanka's failure to achieve growth in industries, and relatively slow urbanization, than the effectiveness of an environmental management system.

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: Notwithstanding the underachievement in attaining reform objectives, Sri Lanka's success in addressing poverty has been impressive (Table 4.3). In spite of some early efforts to rationalize the direct food subsidies and income support measures, government sponsored welfare packages as a safety net parallel to liberalization policies has been in place since the late 1980s. This is in addition to free education and health services enjoyed by Sri Lankans since the pre-independence era. Sri Lanka achieved the Millennium Development Goal (MDG) of halving the incidence of income poverty before the target year (2015), a significant accomplishment amidst a protracted violent conflict.

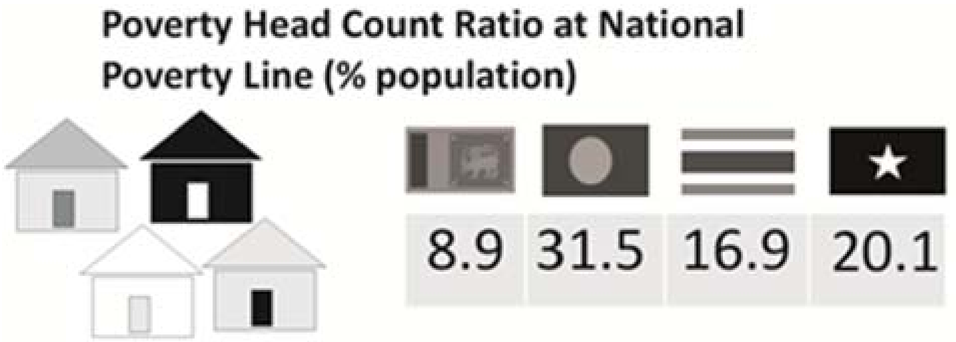
Resilience displayed by the economy and adaptability of labour force: Despite the poor performance on the export front, the Sri Lankan economy has remained resilient to external shocks, helped by its relative openness since the late 1970s. This made the country less vulnerable to sporadic shocks such as oil price adjustments, regional and global financial shocks, etc., where adjustment would have been more difficult under inward looking policies of the past. The openness of the economy facilitated outward movement of labour even when inward movement of capital declined, helping to keep the economy afloat. It has also demonstrated the adaptability of Sri Lanka's labour force. As a result of this resilience, Sri Lanka still enjoys the highest living standards among its South Asian neighbours even after a costly thirty year war.

Public adaptation to reforms: Sri Lankan society overall appears to have adapted to reforms

Table 4.3
Poverty Conditions

Indicators	Sri Lanka	Bangladesh	Thailand	Vietnam
Poverty head count ratio at US$ 1.25 per day - PPP(% population)	4.1	43.2	0.3	3.9
Poverty head count ratio at national poverty line(% population)	8.9	31.5	16.9	20.1

Source: World Bank (2015), "World Development Indicators Database", World Bank, Washington, D.C.



over time. Despite criticisms on certain aspects, the perceived advantages of being connected to the global economy and market-friendly policies have taken root in the minds of policy makers and the general public to a large extent. In the early phase, consumers benefited when import restrictions were lifted after enduring scarcities for several years under the import substitution protectionist policies. Even though reforms faced some resistance - e.g., against privatization and restructuring of SOEs - they were also well received in some instances when clear benefits in term of improved services were evident as in the case of telecom privatization. As a result, even though discontent over economic hardships remains a perennial issue, there is no broad-based political opposition to market friendly reforms. Much of the criticism is often directed at irregularities associated with implementation of reforms more so than their objectives, where the demand is for benign and clean (corruption free) implementation of reforms.

4.5 Towards a Realistic Agenda of Economic Reforms in Sri Lanka

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. It further highlights that unfavourable developments in the political frontier were largely responsible for this failure. Indeed, the current wave of reforms is driven by demands for overturning the legacy of political reforms that accompanied the launch of liberal economic reforms nearly four decades ago. The review of economic reforms underlined some implications of those political reforms on the economic system too. The whole exercise underscores the dependence of the political and economic systems on each other, and the sensitivity of one sphere of activity to changes in the other. In view of past experience and ongoing demands for political reforms, a broader view of reforms that transcends a typical neo-liberal agenda that largely guided past reforms processes, needs to be considered in setting the direction of future reforms to the economic system.

In a broader sense, reforms in modern societies are a continuous process intended to ensure the freedom, wealth and prosperity of nations and their citizens. As a complex social process, it has multiple dimensions encompassing the political, economic, social and environmental. Reforms in the political sphere are primarily intended to enhance the freedom of citizens. However, political reforms alone cannot be expected to guarantee freedom without appropriate reforms in the social sphere. Social reforms should aim at safeguarding the rights of diverse social groups and promoting social harmony to ensure the freedom of all. Neither political reforms nor social reforms, however, automatically guarantee wealth and prosperity of nations and their citizens. A set of economic reforms are necessary for this purpose. The outcomes of economic reforms,

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nevertheless, are not independent and need to be complemented by matching reforms in political and social spheres.

The final aim of enhancing wealth and prosperity is achieving 'sustainable development'. The idea of sustainable development brings in additional dimensions; natural capital as a part of a nation's wealth, and environmental quality as an essential component of prosperity and economic welfare. Recent developments in environmental and ecological economics suggest that economic reforms alone are unable to ensure the sustainability of wealth and prosperity. Hence, appropriate reforms that ensure the quality of environment also are necessary for sustainable development that can be called as 'environmental reforms'. Growing understanding on sustainable development suggests that economic and environmental reforms should complement each other to generate desired overall outcomes.

Besides capturing multiple dimensions of reforms, countries need to be mindful about transformations brought on by globalization and constant changes in IT, in rapid succession. Globalization facilitates free movement of people, goods, services and capital across boundaries of nations. Information technology expands the horizons of human connectivity breaking down all conventional barriers. Together, they change the ways in which humans interact with each other economically, politically, socially and environmentally. As a result, many ideological positions as well as practical tools of reforms are fast becoming obsolete, requiring a pragmatic approach to deal with the rapid change. For instance, globalization and IT propel changes in ways unimagined a few years ago, making it ever more difficult for national governments to exert control over economies in traditional ways. Simultaneously, it also offers new tools of e-governance to deal with the changes, perhaps more efficiently than in the past. Similarly, e-commerce and other digital tools of business and communication, swiftly transforms the ways in which economic activities are undertaken. They open up new opportunities, break down traditional barriers and bring people and resources ever more closely, making the world flatter.[13] Moreover, they increase competition, allowing only the most innovative to thrive. Hence, innovation has become the key factor of economic success in the modern world.

[13] Friedman, T.L., (2007), *The World is Flat*, Picador, New York.

The discussion to follow outlines some broad directions on future economic reforms for Sri Lanka. It 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.

Astute management of affairs on the political front is critical: Sri Lanka's past experience of reforms provide examples of how economic reforms can lose momentum owing to poor management of political affairs. From the point of economic reforms, two aspects of political management matters: (a) maintaining a relatively violence-free political environment and culture, and; (b) prudent management of politically sensitive economic reforms. Sri Lanka appears to have failed on both counts, and more so in the former. The country grappled with both secessionist and anti-state violence. Since 2009, there has been a cessation of violence, but the country has seen a polarization of polity over matters concerning democracy and governance. Hence, successful accomplishment of ongoing reforms to achieve a democratic balance in the political system has significant implications towards the success of reforms on the economic frontier too. It has to be complemented with political and social moves to reduce tensions between ethnic communities, creating conditions necessary for a durable peace.

Reforms are as good as how they are implemented: Reforms are a continuous process in which outcomes cannot be separated from means employed to achieve them. Hence, the ways in which reforms are implemented also matters greatly in determining their success. On many occasions, Sri Lanka's reform efforts suffered due to allegations of corruption, lack of transparency, cronyism, poor accountability and authoritarian manner of execution. As a result, more than the outcomes, the means employed to achieve them has led to politically sensitive issues, jeopardizing the reform process overall. Hence, the current demands for reforms to combat corruption, ensure the rule of law, enhance transparency and accountability are as equally important for a successful economic reform process as they are for ushering in a healthy political system.

Let practical realties determine the priorities than ideological stands: Given the primacy assumed by capitalist economic thought around the world, there is no strong ideological contender against market-friendly economy reforms. However, there are competing schools of thought within the capitalist camp. Many of them have pro-market, externally-oriented views, and mostly differ from each other on the policy mix advocated to achieve the final goals. Their competing claims for success are largely connected to conservative, liberal and social-democratic political rivalries in industrial countries, which often have limited relevance to practical realties faced by developing countries like Sri Lanka. Hence, rather than ideological concerns, practical realties on the ground should determine the priorities of any reform agenda. Attempts to blindly imitate and/or rhetorical championing of ideological stands can have counterproductive results.

Reforms should focus on areas where they are needed and capitalize on existing strengths: Reforms are not new to Sri Lanka and future reforms should be built upon the experiences of the past. Hence, this can be considered as a mid-term course correction in an ongoing process. It implies two things: (a) building upon existing strengths and, (b) identifying priority areas that need reforms the most. While the chapters to follow in this report address in-depth aspects of reforms in selected areas, three areas of strengths that should provide the foundation for further economic progress are:

- Building on Sri Lanka's human capital development, which despite modest achievements in recent decades is still the key strength of the country. A relatively well-educated and healthy workforce provides a definite advantage and reforms should focus on transforming this resource from a pool of cheap labour to a pool of talents (i.e., of knowledge and skills).

- Strengthening Sri Lanka's socio-economic achievements, evident in significant achievements in poverty alleviation. While tackling absolute poverty was the key challenge in the past, the country should now try to build on significant reductions in numbers of poor, focussing on multi-dimensional aspects of poverty and directing attention to other vulnerable sections such as the elderly and vulnerable.

- Protecting the interests of Sri Lanka's migrant labour force that has served the country well and continue to do so. However, their contribution has come at some social cost and reforms should aim at addressing them. Reforms should also aim at transforming them from an unskilled to a skilled labour force.

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

- Economic reforms should aim at getting the fundamentals of macroeconomic management right. Developments in recent years have seen the necessity of several course corrections in both fiscal and monetary policy. Ensuring a sustainable macroeconomic outlook for the country is critical for success in all other areas of reform.

- Sri Lanka's path to prosperity essentially lies in the success of achieving sustained growth in exports of goods and services. Hence, reforms in the trade sector are critically important. Despite some initial successes in the early phase of reforms, growth of exports has slowed down, and the trade regime in recent years has drifted towards a more protectionist stance. Revitalizing exports needs reforms in tariffs and taxes, procedural improvements as well as attracting FDI in export industries.

- The Sri Lankan tax system is not delivering potential revenue as expected with rising income. The Presidential Tax Commission report of 2010 provided a comprehensive list of recommendations to address these concerns. However, only a handful of recommendations have been implemented so far. Full implementation of recommendations are necessary to ensure a more stable macroeconomic outlook.

- Agriculture, despite its declining contribution to the GDP, is still the main source of employment. Past attempts at liberalization created both winners and losers, while heavy public investments helped to achieve self-sufficiency in rice. Despite this, Sri Lanka's food security conditions are not satisfactory even by South Asian standards and agriculture productivity is stagnating. The sector needs multifaceted reforms to address core challenges.

Complementary reforms in supportive areas:
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.

- Institutional governance is a missing link in Sri Lanka's liberal economic reforms. Institutions are not government organizations but a broad range of formal and informal arrangements (rules, laws, procedures) that influence the behaviour of economic agents. The need for institutional reforms is felt in many sectors; for example, two cross-cutting areas that need institutional reforms are market competition and land and property rights. Institutional reforms should be addressed with sectoral reforms as they arise.

- Innovation is the most critical factor that determines economic success in a rapidly globalizing world. Innovation is a result of a combination of factors; among others, R&D capacity, and skills/knowledge on science, technology, engineering and mathematics (STEM) are critical. The capacity for innovation has to be developed through external transfer of knowledge/technology and development of domestic R&D capacity. Sri Lanka's economic reforms have never focussed seriously on innovation, even as it is recognized that innovation capability cannot be developed over night. Hence, it is an area that should be accorded priority as a long-term reform initiative.

- The quality and efficacy of public sector service delivery is an essential pre-condition for the success of economic reforms, despite neo-liberal emphasis on lean governments. This is an area where Sri Lanka has limited success. Modern tools of e-government offer the opportunity to improve the quality and efficiency of public services with lean organizational structures. Sri Lanka has made strides in this direction in certain areas of public service - e.g., E-Sri Lanka programme - and their implementation should be accelerated.

- All economic activities have impacts on the environment, with growing populations leading to overexploitation of natural assets. Hence, growth-oriented economic reforms should be accompanied by environmental safeguards. Despite early preparations, environmental governance is a poorly developed area, receiving limited attention in economic policy circles. As a result, environmental issues often lead to confrontations between authorities and public/activists. This is not helpful to sustain a long-term reform process, and corrective action should be taken to ensure a more holistic approach to development.

Experiences worldwide suggest that improving the business climate by creating a conducive environment for private sector investments is the best way forward for emerging economies to sustain growth. Some sensitive economic reforms may bring about losers as well as winners in the short run. Hence, the prudent approach is to implement reforms during the early days of a new government that has secured a fresh mandate by the people.

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