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Chapter 8
Reinforcing Growth with Better Institutions

by
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8. Reinforcing Growth with Better Institutions

8.1 Introduction

Achieving and sustaining a high level of inclusive socio-economic growth is a core policy priority in Sri Lanka, particularly in its post-conflict phase of development. The most crucial foundation that underpins all facets of socio-economic growth is the nature and quality of a country's institutional framework. Whilst the role of institutions in stimulating and sustaining growth is summarily referred to in Sri Lanka's domestic policy discourse, the primacy of the institutional framework has not received due attention in the policy process. Moreover, there are significant gaps in knowledge on the contours and dynamics of institutions as they relate to the Sri Lankan policy space. This Chapter addresses crucial questions including, what are institutions; how are institutions situated in the policy process; what is the link between institutions and socio-economic growth; which institutions matter and why; and, how do you build high quality institutions that are sustainable over time.

> ***"Political commitment and the nature of the political leadership are central to the building of high quality institutions; institutions that foster sustainable socio-economic growth"***

Mapping out and unpacking complex phenomena such as a country's institutional framework is not a linear exercise, given the web of interdisciplinary threads that underpin it. As such, this Chapter will specifically focus on four key policy areas that are crucial for Sri Lanka to stay on the growth trajectory and discuss the underlying institutional framework that needs to be in place for development to be sustainable. The four areas that will be analyzed in detail are: state capacity and taxation; the role of land titles in enhancing agricultural sector productivity; public and private investment in physical infrastructure development; and, building institutions to enhance industrial sector productivity through the development of SMEs. It is argued that unpacking the institutional underpinnings of each of these four areas will help understand the nature and contours of institutions required to get to a sustainable level of growth in these specific policy subsectors, whilst also bridging at least some component of the existing knowledge gap on institutions as they relate to the policy process in Sri Lanka.

The next section of this Chapter provides a conceptual framework for the analysis of institutions and growth. This section sets out the analytical basis for the exploration of the four specific policy areas in the Sri Lankan context in Section 5.3. Policy conclusions and the way forward are discussed in Section 8.4.

8.2 Institutions and Socio-economic Growth: A Conceptual Framework

Understanding the role of institutions in socio-economic growth is now recognized by development thinkers and practitioners as being crucial in shaping the policy process and outcomes. The centrality of institutions in the development process is evidenced by the vast and growing literature on this subject. The complexity of the subject is seen in the web of multidisciplinary threads that are woven together to define, explain and operationalize institutions and their interactions in the broader socio-economic growth process. However, whether it is the 'old institutional economics' strand of thinking propagated by scholars such as John Commons and Thomas Veblen, 'new institutional economics' associated with works by Douglass North and Oliver Williamson, or 'institutionalist political economy' as coined by authors such as Ha-Joon Chang, the debate is no longer whether institutions matter or not in the policy process.

As demonstrated by the awarding of the Nobel Prize in Economics to numerous scholars in new institutional economics over the years – Ronald Coarse (1991), Douglass North and Robert Fogel (1993), and Elinor Ostrom and Oliver Williamson (2009) – institutions are firmly ensconced in any meaningful discourse on development. The relevant questions for policy makers are how to define institutions and their dynamics in the policy process,[1] how to determine which institutions matter to stimulate and sustain socio-economic growth, and how to acquire and embed high quality institutions that promote sustainable development.

8.2.1 Conceptualizing Institutions and Institutional Dynamics in the Policy Process

Institutions as discussed in this Chapter follow the definition adopted by North (2005),[2] which emphasises and distinguishes between the role of both individuals and organizations as well as both formal and informal institutions in the policy process:

> 'Institutions are the rules of the game - both formal rules, informal norms and their enforcement characteristics. Together they define the way the game is played. Organizations are the players. They are made up of groups of individuals held together by some common objective.' (p.22)

A schematic depiction of North's conceptual framework is illustrated in Figure 8.1. This framework provides a useful template to understand the dynamics of institutions in the policy process. For instance, entities such as the state and the market are con-

[1] See Chang, Ha-Joon (ed.), (2007), *Institutional Change and Development*, United Nations University Press, New York; Rodrik, D., (2007), *One Economics Many Recipes: Globalization, Institutions and Economic Growth*, Princeton University Press; Shirley, M., (2008), *Institutions and Development*, Edward Elgar, U.K.

[2] North, D., (2005), "Institutions and the Performance of Economies over Time," in C. Menard and M. Shirley (eds.), *Handbook of New Institutional Economics*, Springer, Netherlands.

ceived as organizations that continuously interact with both formal institutions such as the Constitution, laws and property rights structures of a country, and informal institutions such as the level of trust, power and corruption - what scholars refer to as 'social cohesion.'[3]

What is important to note is that more often than not, social cohesion or the nature of informal institutions are key determinants of the efficacy of a country's institutional framework as a whole. A noteworthy feature in post-conflict societies for example, is that whilst formal institutions such as the legal framework maybe solid, informal institutions or factors of social cohesion, such as trust, may well be eroded and power relationships maybe inimical to sustainable growth -- further emphasising the fact that informal institutions play a more important role in shaping policy outcomes.

A second crucial feature set forth in North's framework is that there is a mutually reinforcing causal link between individuals/ organizations and institutions. Constructs such as path dependence and mental models/cognitive perceptions of individuals' interpretation of real world phenomena influence the nature and contours of institutions and the manner in which institutions relate to the policy process.[4] Figure 8.2, adapted from the writings of Jenkins (1993) and Hill (2009) on the policy process, while incorporating North's conceptualisation of institutions, provides a useful framework to understand the dynamics of institutions in the policy process -- in this instance, the devising and implementation of pro-growth policies.

Although this schematic is a stylized portrayal of the complex and multi-layered nature of the policy process, it provides a number of useful insights that help to unpack the 'black box' of public policy. The diagram sets out the key components and configurations of the policy space -- a socio-economic and political arena where institutions, organizations and individuals interact in a dynamic fashion to influence public policy.

First, the policy space as illustrated in Figure 8.2 includes both the 'internal' policy process consisting of the chain of interactions from policy objectives to policy outcomes as well as what is termed the policy 'environment,' which consists of the broader social, economic, political and cultural context within which the policy process is embedded. This 'external' environment and the 'internal' policy process are complex constructs that mutually re-inforce one another over time, with path dependence playing a vital role in these interactions. Moreover, institutions -- both formal and informal - can be a part of both the external environment and the internal policy process as shown in Figure 8.2.

Second, the political system consists of two non-transparent, interrelated mechanisms: the decision system and the organizational network. The decision system comprises authoritative actors -- for example an Executive President -- who have the capacity or power to make direct policy choices. These actors in turn operate within the parameters of institutional and organizational layers such as the electoral system, legislative and judiciary branches of the state, and bureaucratic networks. As such, any policy decision made within the 'black box' of the po-

[3] Easterly, W., Ritzan, J. and Woolcock, M., (2006), "Social Cohesion, Institutions and Growth", Working Paper No. 94, Center for Global Development, Washington D.C.

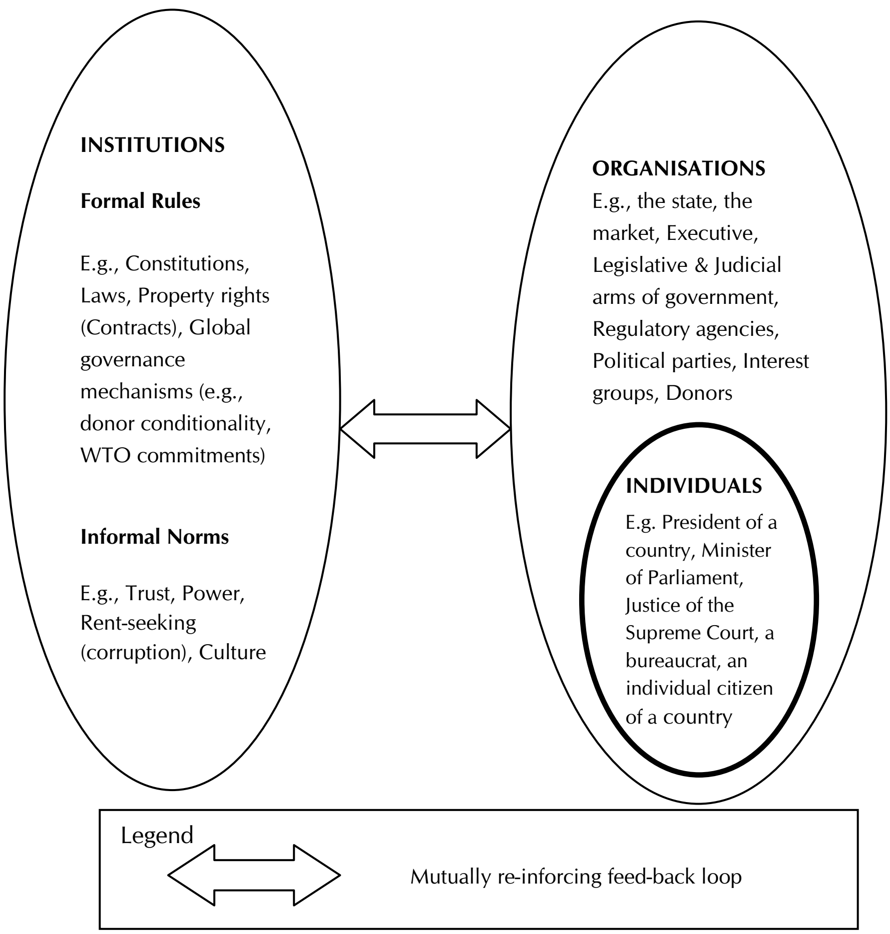
[4] See Jenkins, B., (1993), Policy Analysis: Models and Approaches, in M.Hill (ed.), *The Policy Process: A Reader*, U.K: Prentice Hall, UK.; Hill, M.,(2009), *The Public Policy Process*, Pearson Education Limited, UK.

litical system rests on the outcome of a dynamic interaction between the decision system and organizational networks.

Third, there is a bi-directional flow between the political system and policy objectives such as the demand for inclusive and sustainable socio-economic growth, for instance through various individuals and organizations defined here as 'mediating variables.' Further, these policy objectives impact on, and are in turn impacted upon by the institutions that make up the external environment.

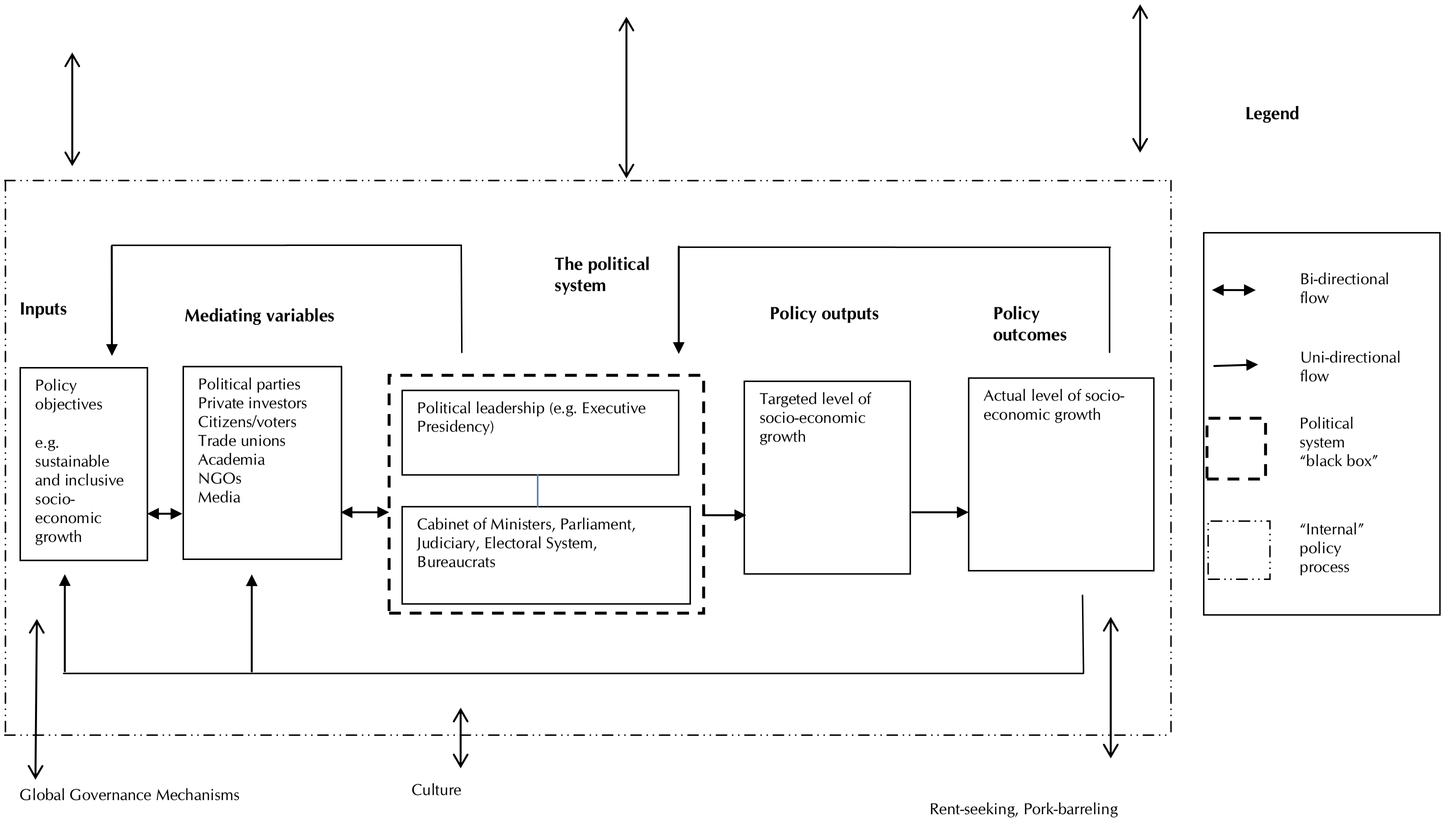
Fourth, policy decisions and choices coming out of the political system result in policy outputs - or the direct outputs of political choices. These policy outputs then have real world consequences or policy outcomes (both intended and unintended) - including those that arise from political inaction. In this context, the 'policy gap' is conceptualized as the gap between policy outputs and policy outcomes. What is clear from this depiction of public policy and of the interactions between institutions and the policy process is that context matters; the socio-

Figure 8.1
Defining an Institutional Framework



Source: Knight-John, M., (2011), "Privatization, Competition and Regulatory Governance: A Case Study of Sri Lanka's Telecommunications Sector", PhD Thesis, University of Manchester.

Figure 8.2
Situating Institutions in the Policy Process: A Schematic



Source: Knight-John, M., (2011), "Privatization, Competition and Regulatory Governance: A Case Study of Sri Lanka's Telecommunications Sector", PhD Thesis, University of Manchester.

political and economic characteristics of a particular country matters. In light of the analysis in this Chapter, there is no universal recipe for sustainable socio-economic growth, and a policy transfer of any kind needs to take note of the formal as well as informal institutional structures that prevail in a particular society.

8.2.2 Understanding the Role of Institutions in Socio-Economic Growth

A straightforward application of basic economic principles would indicate that socio-economic growth is linked to the ability of a country to increase its human and physical capital and improve its technology. However, this leaves open the question as to why some countries have less human and physical capital and technology and also make less effective use of their factors and opportunities. The development literature is replete with debates on the differences in socio-economic growth amongst countries. Why have countries such as Brazil, Russia, India, and China recorded impressive growth rates whilst other countries in Sub-Saharan Africa, Latin America and South Asia have stagnated? How are differences between the industrialized and newly industrialised countries (NICs) and poorer lagging regions explained? What are the fundamental causes for these significant cross-country variations?

Geography and initial resource endowments are recognized in the literature as being necessary conditions for socio-economic growth; and, cross-country differences in these variables are considered to be important explanatory factors in determining whether a particular society is rich or poor. However, how a society uses favourable geographical factors and its resource endowments relate again to a country's institutional framework. Additionally, whilst the importance of growth engines such as sound macroeconomic policies, investment and innovation, and education is acknowledged, it is argued that these factors are proximate and not the ultimate causes of growth. In the final instance, there is general agreement across the development literature, that institutions are the fundamental cause of socio-economic growth and that differences in the nature and quality of institutional frameworks explain cross-country variations in growth.[5]

In contrast to Acemoglu and Robinson (2012) who argue very strongly that particular forms of institutions are clearly linked to specific outcomes, economists such as Ha-Joon Chang (2007) suggest that there is a considerable knowledge gap in the understanding of which institutions and in what form, are necessary and sufficient for sustainable development. This gap broadens in view of the fact that the contours and dynamics of institutions are context-specific and that blue-prints are often futile in development practice, emphasizing the need for more country case studies to enhance understanding on the subject. The argument posited by Acemoglu and Robinson (2012) is fundamentally that 'inclusive' economic and political institutions are essential for sustainable development. They argue that it is these types of institutions -- in contrast to 'extractive' socio-economic and political institutions -- that enforce property rights, create level playing fields, encourage investments in new technologies and skills, and facilitate innovation. Interestingly, the Chinese success story in this analysis is not a sustainable one; it is only a matter of time before social cohesion shaped by an authoritarian political regime undermines the growth process.

[5] See Acemoglu, D. and J. Robinson (2007), "The Role of Institutions in Growth and Development," Commission on Growth and Development, Working Paper No. 10, World Bank, Washington D.C; Acemoglu, D. and J. Robinson (2012), *Why Nations Fail: The Origins of Power, Prosperity and Poverty,* Crown Publishers, New York.

Whilst there is consensus in the institutional literature on the centrality of political institutions in shaping and sustaining the growth process, the position adopted by Acemoglu and Robinson (2007, 2012) in advancing the case that democratic political systems are crucial for sustainable development is debatable. The political system, whilst central to the policy process, is only one element in the dynamic web of interactions amongst institutions, individuals and organizations that shape policy choices and outcomes (see Figure 8.2). It is conceivable therefore, that a 'democratic political system' can co-exist with informal institutions of rent-seeking and power that are 'extractive' in the way they function; or alternatively that an 'authoritarian political system' can be constrained by forces of social cohesion that are 'inclusive.'

Box 8.1
Whither State Capitalism?

The notion of state capitalism, associated with the British East India Company, has over recent years been resurrected and reengineered in emerging economies with remarkable success. The high levels of growth achieved by countries such as China, Brazil and Singapore over several decades for instance, point to the sustainability of this model of development.

What in essence is state capitalism and what needs to be in place for this approach to work well? As described in "The Special Report," *The Economist*, January 21st, 2012, p.3, state capitalism:

> "....tries to meld the powers of the state with the powers of capitalism. It depends on government to pick winners and promote economic growth. But it also uses capitalist tools such as listing state-owned companies on the stock market and embracing globalization."

The critical factor for success in this model is a competent state. A state that has the capacity to use capitalist tools to achieve sustainable economic growth – as in the case of China where the state has been successful in converting industries into companies run by professional managers and avoiding the pitfalls of crony capitalism. The Chinese success story with the commanding heights of the economy directed by a one party state (Chinese Communist Party) does not fit the recipe for sustainable growth propounded by scholars such as Acemoglu and Robinson (2012). However, China's GDP has grown at an average of 9.5 per cent over the past 30 years with international trade recording 18 per cent growth in volume terms. This is no mean achievement. What this does imply is that the manner in which institutions function are not necessarily linked to their form, as assumed in the orthodox development literature. In Chinese SOEs for example, the government exercises control through ownership of shares rather than through the traditional mode of reporting directly to government ministries. Brazil, which has a democratic political system, has a different albeit successful version of state capitalism – acquiring minority shares in a broad spectrum of SOEs and channelling resources into a handful of national champions in natural resources and telecommunications.

Whilst state capitalism has its flaws – for instance, principal agent problems associated with regulating companies that it also owns and manages – the evidence from around the world suggests that this model is here to stay. Moreover, the pitfalls associated with 'extractive' institutions – such as corruption, nepotism and political capture inimical to sustainable growth – are not alien to liberal capitalism. As such, it is up to individual nations to foster 'inclusive' institutional structures and processes that will lay the foundation for sustainable socio-economic growth.

The questions remain as to which institutions matter to stimulate and to sustain growth, and how a society can acquire and embed a sound institutional framework that will facilitate stable, inclusive and sustainable socio-economic development. Two important caveats highlighted in this regard is that whilst high quality institutions may well be a result of economic prosperity, as they are their cause,[6] a growing body of empirical research suggests that institutions are very strong determinants of aggregate incomes. For instance, a society that is able to establish rules of the game that strengthen the property rights of investors and entrepreneurs, has a greater chance at achieving a long term increase in productive capacity.

As argued in Chang (2007), the problem arises from the fact that the mainstream development literature fails to distinguish between the forms and functions of institutions. As such, forms of institutions such as democracy, independent judiciary, and absence of state ownership, for example, are confused with the functions they perform – such as the rule of law, respect for private property, enforceability of contracts and restraints on corruption. This confusion has resulted in reductionist thinking that preempts the reality of the type of state capitalism practiced in China and Brazil for instance, that has undoubtedly shown results for over two decades (see Box 8.1). The rise and success of state capitalism has also exposed the futility of maintaining intellectual divisions between the constructs of states and markets -- a case in point being the rather narrow conceptualization of institutions set forth in the 2002 World Development Report on "Building Institutions for Markets."[7] As will be further evidenced by the Sri Lankan case studies analyzed in Section 8.3, states and markets play an inherently complementary role in the development process.

However, as noted in Rodrik (2004) and reiterated in Chang (2007), there is a tendency towards what they term 'property rights reductionism' in the mainstream development literature. In response to which institutions matter to stimulate and sustain socio-economic growth, the orthodox literature has tended towards over-simplifying what is meant by the institutional framework by focusing almost entirely on formal institutions of property rights. The problem with this approach is that at an empirical level, it cannot accommodate real world cases such as China's development story – where high and sustained levels of growth have been achieved with a complex assortment of private, public and hybrid ownership patterns and with relatively unclear property rights structures. What is important to note is that property rights, in terms of sustainable socio-economic growth, need not necessarily be the Western-style structures propounded in works such as the World Bank (2002). In essence what matters is the manner in which these institutions function to create incentives that facilitate growth and development.

Extending this line of thinking further to the question of what type of institutions are important to achieving and sustaining socio-economic growth and reflecting on the discussion above on forms and functions, it is argued that informal institutions in a given society, such as trust, power, corruption and culture, play a more important role than formal institutions such as laws and property rights in shaping policy outcomes. This line of thinking can lead to rather sticky policy insights which are context specific and not

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6 Rodrik, D., (2004), *Institutions and Economic Performance - Getting Institutions Right,* CESifo DICE Report, Ifo Institute for Economic Research, University of Munich.

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

readily amenable to generalization, given that local values and norms shape informal institutions and their dynamics. However, on a positive note, getting to a deeper understanding of the local context provides for a far better chance at getting institutions right – which in turn lays a more solid foundation for inclusive, stable and sustainable growth. Once again, this reiterates the need for specific country cases, such as the four policy issues in the Sri Lankan context, analyzed in detail in Section 8.3.

8.3 Institutional Requirements for Sustained Growth in Sri Lanka

As set out in Sections 8.1 and 8.2, the drivers of growth cannot be generalized across all economies. Case specific studies of individual economies are important as the ground realities of different countries vary from each other. What follows is a discussion of the institutional imperative in terms of the Sri Lankan economy. Four distinct areas for discussion are selected, given the significant role played by each in the overall economy and their potential to contribute to the envisaged growth momentum in the country.

8.3.1 Taxation and State Capacity in Sri Lanka

Post-conflict Sri Lanka has seen an increasing role of the state in development oriented activities. The government has taken the lead role in many economic activities such as the provision of physical infrastructure through programmes like 'Gama Naguma' and 'Maga Naguma' and livelihood development schemes such as 'Divi Naguma.' This has resulted in a sharp rise in government expenditure in recent years (Table 8.1).

To sustain this investment drive and to provide the high quality formal institutional framework required to sustain targeted levels of growth, the state requires resources. Taxation is the main process through which a government raises revenue. Any force which hinders this process undermines state capacity for resource mobilization, thereby limiting the ability of the state to provide capital for development programmes as well as desirable formal institutions for the public. State capacity to mobilize resources to meet the growing demand for capital and the provision of high quality institutions for sustained growth is a key issue in Sri Lanka. Issues of revenue collection and public service delivery need to be addressed in order to achieve and sustain the targeted level of growth. Current weaknesses in revenue generation can be attributed to three major reasons: the limited tax base, poor decentralization of revenue collection authority, and weak tax administration.

A key reason for declining government revenue is its limited tax base. Tax evasion among corporates, traders and professionals by means of non-filing of returns, under-reporting of income or over-statement of expenses is a common phenomenon in the

Table 8. 1
Government Investment in Infrastructure (as % of GDP)

	2008	2009	2010	2011
Total	5.2	6.4	6.0	5.8
Physical infrastructure	3.8	5.3	5.0	4.8
Social infrastructure	1.4	1.1	1.0	1.0

Source: CBSL, *Annual Report 2011*.

country.[8] As the World Development Report (2002) indicates, developing countries have a:

'...disproportionate reliance on tax revenue from large firms, which are more visible and easier to tax...High tax burdens, along with harassment by tax officials and unnecessary cost of compliance can contribute to a firm's decision to exit the formal economy.'(p110)

In Sri Lanka, weak corporate disclosure can be observed due to the above reasons. Out of over 30,000 registered companies, only 255 are listed in the share market.[9] A similar trend can be seen among professionals such as doctors and lawyers with private practices.

Successful lobbying by powerful stake holders to deter or subvert taxes is another source of revenue loss for the government. This also harms the doing-business environment by sending negative signals to investors as such actions signify state capture at the hands of a few successful companies. In other words, this is an instance where Sri Lanka has fallen victim to crony capitalism unlike China (see Box 8.1). Sri Lanka has also seen ad hoc tax exemptions by the Board of Investment (BOI) to attract foreign investors. While this only led to a marginal improvement in FDI, the loss of government revenue due to these exemptions is calculated to be as much as 1 per cent of GDP per annum.[10]

The 13th Amendment to the Constitution of Sri Lanka, enacted in 1987, is widely recognized as the first attempt at decentralizing administrative authority. It instituted Provincial Councils (PCs) which were delegated the authority to take administrative and fiscal decisions at the provincial level. Devolution of power at the local level can be beneficial as it enables authorities at the grass roots level to provide development programmes and public services tailor made for a particular locale. Thus, Sri Lanka at least has nominal formal institutions in place for sustained local level development.

Table 8.2
Fiscal Operations of Provincial Councils

	2007	2008	2009	2010	2011
Tax revenue as a percentage of total expenditure	18.9	21.6	19.1	21.3	23.2
Central government transfers as a percentage of total expenditure	78.1	74.1	72.1	73.5	74.8
Current expenditure as a percentage of total expenditure	82.0	85.9	85.4	81.9	81.8
Capital expenditure as a percentage of total expenditure	18.0	14.0	14.5	18.1	18.1

Source: Based on data from CBSL, *Annual Report 2011*.

8 Waidyasekera, D. D. M., (2009), "The Role and Importance of Taxation", *Daily News*, URL: http://www.dailynews.lk/2009/03/05/bus15.asp (accessed on May 1, 2012).

9 Kelegama, S., (2011), "Political Economy of Taxation in Sri Lanka", paper presented at the "International Conference on Taxation and State Building", November 3-4, 2011, Colombo.

10 Kelegama S., "Tax Issues - Current System Not Delivering Needed Revenue", *The Sunday Times*, URL: http://sundaytimes.lk/101121/BusinessTimes/bt10.html (accessed on May 1, 2012).

However, the role played by the PCs in the country's provincial development has been limited. As Table 8.2 indicates, these institutions have over the years been dependent on central government grants for their expenditure. It also shows that the share of capital expenditure at the provincial level has been very low compared to current expenditure.

The 2011 Budget restructured revenue allocation, reassigning their main source of revenue -- the Turnover Tax (TT) -- to the central government, and allowing other transfers to be made from the central government to local authorities to compensate for the loss of TT. These include (i) one-third of revenue collected from the Nation Building Tax (NBT) by the central government; (ii) entire stamp duty collected; and (iii) 70 per cent of revenue generated from motor vehicle registration fees.

These recent changes have left the PCs weaker in terms of their power to make any meaningful contribution to the economic development of the provinces. This is an instance where forms differ from functions; although the formal institution of local authorities has been set up, its functions have been curtailed, leaving the PCs ineffective.

The failure on the part of PCs to enhance their capacity for greater revenue mobilization also lies in the fact that they are not sufficiently incentivized to exhibit better performance. For example, empowering local governments would encourage local authorities to perform better, leading to better provision of public goods. However, as pointed out above, local level authorities are increasingly deprived of their autonomy to engage in better provision of public goods. Also, performance is not naturally guaranteed by delegating authority; the necessary checks and balances also need to be there. Authorities would not be incentivized if they are not held accountable to the public. In this regard, developing a state-citizen nexus at the local level is crucial. However, this is lacking in Sri Lanka, especially at the local level.

Local government expenditure should ideally be tied to their revenue collection, thus creating a transparent fiscal process. As stated above, authorities should be held accountable to the public. In Sri Lanka though, this process is hindered by the dependence of PCs on the central government. Moreover, societal apathy can be observed among the public towards the operations of the PCs. While PCs themselves do not actively engage in information sharing with the public, agencies responsible for the provision of information, such as the media, show similar apathy. This is largely created by the disconnect between the internal policy environment and the external political environment as portrayed in Figure 8.2. Citizens lack a sense of social cohesion which leaves public involvement minimal in the political process. Also, much of the political attention in Sri Lanka is held by the centre, which is becoming increasingly powerful. Both these factors leave PCs with no real commitment to greater revenue generation at the local level. As indicated in Box 8.2, this fact contrasts with the practice of a country like South Africa where the citizens 'felt' a direct link between revenue collection and public service delivery. As such, increasing the revenue pool by expanding the tax base, proper incentivizing of tax administration and greater decentralization of authority remain the challenges in expanding state capacity for better provision of institutions and public services for sustained development.

Box 8.2
Political Economy of Tax Administration - The South African Success Story

Since 1960, South Africa has maintained the ratio of tax collection to GDP above 20 per cent. It was the highest among middle income countries in the period from 1960 to 2000. The period between 1997 and 2002, saw average tax revenue of over 25 per cent compared to the middle income country average of 15 per cent. What factors led to this remarkable performance in revenue collection?

- Firstly, tax reforms have been supported by two of the most significant stake holders; the state and 'upper-income white groups, especially because these segments were made to understand the benefits that can be delivered through a greater revenue pool.
- Secondly, automation of tax collection facilitated more efficient tax administration at all levels.
- The introduction of a pay-as-you-earn (PAYE) tax, the collection of which was facilitated by employers.
- Revenue collection bodies, the Inland Revenue, Customs, and Excise Department were integrated to form one revenue collection authority – the South African Revenue Services (SARS).
- Lastly, greater information sharing occurs between the fiscal management authorities, namely, the Finance Ministry, Central Bank, and SARS.

This scenario is in direct contrast to developing countries like Sri Lanka where tax administration has failed to garner stakeholder support, is infested with cumbersome and extended procedures, has minimal information sharing, and has been stagnant in its revenue structure.

Source: Chang, Ha-Joon (2007), *Institutional Change and Development*, United Nations University Press, New York.

8.3.2 Land Titling and Agricultural Productivity

Although Sri Lanka's agricultural sector contribution to GDP has been dropping consistently, a significant share of the population is still employed in this sector. Therefore, enhancing productivity in the agricultural sector has strong implications on sustaining the country's growth momentum.

The literature suggests that establishing well-functioning agricultural markets are especially significant in relation to productivity. Property rights and land titling is a key determinant of dynamic agricultural markets, and establishing secure land titles leads to increasing agricultural productivity. It creates opportunities for easy access to credit, thus increasing the level of investment in agriculture. This process, as argued for instance, in the World Development Report (2002), also enables land transfers from inefficient parties to more efficient ones. Moreover,

> 'Land is considered as the basic asset of the poor and in theory secure property rights to land are identified as the key to the realization of economic and non-economic benefits through greater

> investment, increased access to credit markets, increased transferability and transactions, decreased risk and fear of expropriation and sustainable management of resources.'(pp. 103-104)[11]

In Sri Lanka, nearly 82 per cent of land is controlled by the state, while close to 27 per cent of peasants suffer from landlessness.[12] Land allocation in Sri Lanka occurs both through formal and informal institutions. Formal land distribution is mainly governed by the state under the State Land Ordinance, Land Development Ordinance and Land Grant (Special Provisions) Act. However, poor targeting of land distribution by the authorities has led to the neglect of poor farmers who are interested in agriculture; it is common practice for land to be distributed among cronies of officials, who have no interest in agricultural activities. Absentee landlords have acquired land through corrupt practices of regulatory agencies. There are numerous authorities which control land in Sri Lanka. These include the Forest Department, Department of Wildlife Conservation, Mahaweli Authority, Plantation Companies, Southern Area Development Authority, Coast Conservation Department and Urban Development Authority. The lack of a clear mandate for these individual institutions has led to overlapping functions, allowing space for malpractice in land distribution and ineffective governance of land in Sri Lanka.

While formal property arrangements and land markets can be seen in the urban and plantation sectors, informal arrangements in land transfers and land use are highly prevalent in rural agriculture. This is due to inflexible legal restrictions imposed by the state on rural agricultural land with regard to inheritance, sub-division and transfer. As a result, informal institutions have developed in the above transactions as well as in land mortgages, leases and sales. This is a prime example of where both informal and formal institutions are at play. However, instead of leading to the efficacy of formal institutions, these informal arrangements have emerged because formal institutions have failed to guarantee agricultural sector growth.

As argued earlier, well-functioning land markets lead to increased agricultural productivity. Indeed, studies have shown that non-functional formal land markets are positively related to the reduction of the extent of paddy cultivated in Sri Lanka.[13] The key drawback is in not establishing proper land titling, especially with regard to alienated and encroached land.[14] Rigidities in property rights in Sri Lanka are (i) segmentation of the land sales market; (ii) reduced access to land by the poor; (iii) prevention of land sales even when the current owner fails to succeed at farming; and, (iv)reduced access to credit as such land is not accepted by the formal financial system as collateral. All

[11] Samaratunga, P., (2008), "Achieving Economic Efficiency and Equitable Distribution of Land Use through Reforms and/or Market Discipline", in S. Kelegama and D. Gunewardena (eds.), *Economic and Social Development under a Market Economy Regime in Sri Lanka: Buddhadasa Hewavitharana Felicitation Volume II,* VijithaYapa Publications, Colombo.

[12] IPS, (2004), "Land Policy in Sri Lanka", in *Sri Lanka: State of the Economy 2004*, Institute of Policy Studies of Sri Lanka, Colombo.

[13] Samaratunga, P., and D. Marawila (2006), "Rural Land Sector in Sri Lanka: Major Characteristics, Determinants and Implications for Land Policy", Institute of Policy Studies of Sri Lanka, Colombo.

[14] A "Land Titling and Related Services Project" implemented from 2001 to 2006 aimed at building the institutional framework by improving titling methods and identifying the legal constraints to the operation of efficient land administration and making necessary recommendations. Although it failed to achieve the intended outcome within the duration of the project, it made draft recommendations to the Registration of Title Act (1998) which can be adopted to improve the legal basis for title registration, and was successful in linking title and deed registration through the Registrar General's office. A total of 19,458 land parcels were surveyed and given titles under this project [Centre for Poverty Analysis, (2006), "Putting Land First: Exploring the Links between Land and Poverty", Colombo].

these factors eventually lead to productivity issues in the agricultural sector.

Informal land rental markets have emerged in rural areas as an alternative to this issue. These informal arrangements have led to the creation of larger operational holdings, higher investment, greater use of technology, more commercialization of production, and increased displacement of inefficient cultivators.[15] Perhaps a possible policy measure would be to adopt and legalize the existing informal land market arrangements which are obviously better suited for local needs.

As suggested by the literature pertaining to Sri Lanka, land titling in itself is not a concern of the rural agricultural sector. However it can certainly be seen as a means to an end in overcoming the drawbacks prevalent in agricultural land markets that are outlined above, which adversely affect productivity in the sector.

8.3.3 Public-Private Partnerships in Physical Infrastructure

Post-conflict Sri Lanka has seen a heightened infrastructure development drive. Government involvement in infrastructure, both at the national and rural level, is being driven by various programmes, with a sharp rise in public investment in infrastructure. With total public investment in infrastructure hovering in the range of 5 per cent of GDP, Sri Lanka appears to be in line with suggested investment requirement in infrastructure for a developing country, estimated to be around 5.5 per cent of GDP.[16] In Sri Lanka, nearly all requirement of investment in infrastructure is being provided by the government.

While infrastructure development is crucial for sustaining high growth, the current infrastructure drive is mainly financed through foreign grants and loans which come with a hefty price tag. Therefore, promoting private participation in infrastructure development remains crucial for Sri Lanka. In fact, the CBSL states:

> 'In 2011, policy measures were initiated by the government to improve the performance of SOEs to increase their return on investment through the development of an economically feasible cost reflective pricing structure, and thereby reducing the reliance on the government budget. SOEs are also expected to explore innovative Public-Private Partnership (PPP) strategies and attract private investments to catalyze the development process.' (p.60)[17]

The case for private investment in infrastructure is also justified by the fact that like many developing countries, public monopolies in infrastructure provision in Sri Lanka has led to poor service quality and drain of public finance. The CPC made a loss of Rs. 94 billion in 2011 compared to Rs. 27 billion in 2010 and the CEB saw a financial downturn with a loss of Rs. 25.5 billion from a profit of 4.8 billion the year before. Box 8.3 outlines some of the factors which led to this fiscal drain.

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[15] Jogarathnam, T., (2001), "Allocation of State Land for Peasant Agriculture in Sri Lanka: Towards an Employment Strategy Framework in Sri Lanka", URL: http://ilo-mirror.library.cornell.edu/public/english/region/ asro/colombo/ download/ jogprf01.pdf (accessed on May 1, 2012).

[16] World Bank (2005), *Infrastructure and the World Bank: A Progress Report,* URL: http://siteresources.worldbank.org/DEVCOMMINT/ Documentation/20651863/DC2005-0015(E)-Infrastructure.pdf (accessed on April 28, 2012).

[17] CBSL, *Annual Report 2011.*

Box 8.3
Key Issues of Selected SOEs in Sri Lanka

The CEB, CPC, SLR and SLTB have been among the main SOEs which are famous for having suffered from chronic financial failure, as the numbers below indicate.

Financial Performance of Selected SOEs (Rs. bn.)

	2009	2010	2011
Operating loss of SLR	4.8	3.2	4.1
Operating loss of SLTB	8.0	8.4	3.8
Operating loss of CPC	26.2	27.0	94.0
Operating loss of CEB	11.0	-4.8	25.5

Source: CBSL, *Annual Report*, various years.

While there are many case-specific reasons for this poor fiscal performance from one SOE to another, a few key factors which are common among these can be identified. When it comes to CEB and CPC, they have been victims of price manipulation. As opposed to many countries that let the forces of demand and supply decide the price of utility, energy, and power prices, in Sri Lanka the rates have always been maintained by the state below the cost of supply. This practice, which is fuelled by short term political economy interests, has not allowed state utilities to follow global practices of conducting revisions based on a pricing formula which factors in international prices, exchange rate and various taxes payable at customs. Unlike in the case of the CPC, the Public Utilities Commission of Sri Lanka (PUCSL) introduced such a tariff calculation formula for the CEB to be instituted every six months. However, apart from its initial exercise in January 2011, the PUCSL has failed to continue with the tariff revisions.

In the case of the SLR and SLTB, the two salient factors which are common to both remain the problem of overstaffing and poor maintenance and upgrading of infrastructure. Successive governments in Sri Lanka have used entities such as the SLR, SLTB and even CPC and CEB to absorb surplus workers, leaving them heavily overstaffed with under qualified employees.

In addition, both SLR and SLTB have suffered from a lack of maintenance and upgrading of infrastructure. Although the road network is now improving, the railroad network is yet to be improved and integrated with the road transport network. Moreover, apart from a few *ad hoc* attempts, no regular effort has been made to raise the quality and quantity of the assets of SLR and SLTB, mainly due to capital constraints.

As discussed earlier, an SOE does not necessarily have to be a white elephant. As evidenced in Box 8.1, China has managed to channel its resources to SOEs and sees them making profits. However, this success is largely dependent on the manner in which the institutions function as opposed to the type of institutions (i.e., form versus function), and Sri Lanka does not follow the Chinese footsteps of retaining the public structure while functioning as a competitive firm.

Therefore, many countries, including Sri Lanka now look towards PPPs in attracting the necessary capital for developing these sectors. PPPs allow the government to draw necessary investment and management skills while maintaining a presence in ownership and strategic policy setting.[18] In terms of institutions, the key areas which need focus in order to establish successful PPPs as indicated in Figure 8.2 are: (i) political and regulatory reform (formal institutions or internal policy framework); and (ii) enhancing credibility by strengthening the external policy environment.

Building effective regulatory agencies is a prime catalyst in attracting private investment in infrastructure. However, Sri Lanka is behind in establishing the required formal institutions for PPPs. Firstly, there seems to be a general lack of understanding of the concept of PPPs and its implementation. This is clearly seen in the failure to set up a one-stop-shop for the assessment and implementation of PPP projects. This is in direct contrast to South Korea which has seen over a decade of successful PPPs in infrastructure. South Korea has set up the necessary judicial framework in the form of the Act on Public-Private Partnerships in Infrastructure, and its PPP projects are governed by a central agency, namely, the Public and Private Infrastructure Investment Management Centre (PIMAC).[19]

Although the BOI is positioned as the premier investment promotion agency of Sri Lanka, with line agencies obtaining necessary clearances to facilitate speedier investment approvals and implementation, no concrete steps have been taken in this regard. However, the enactment of the Strategic Development Projects (Amendment) Act, No. 12 of 2011 can be considered a positive step in setting up the legal framework to bring in investment to key projects. This Act allows the BOI to select and recommend investment projects which are of strategic significance to the economy, for various benefits such as tax exemptions for 25 years. A salient feature of this Act is the fact that instead of a ministry, the power to approve a project lies with the Parliament, thus increasing its public accountability.

Secondly, necessary regulatory agencies need to be established in each of the sectors of physical infrastructure. Currently, only the telecommunications sector and electricity sector have 'independent' regulatory agencies, namely, the Telecommunications Regulatory Commission of Sri Lanka (TRCSL) and the PUCSL. Although two utilities, petroleum and water, are assigned to the PUCSL on paper, they do not come under the regulatory purview of the Commission in practice. The National Transport Commission (NTC) regulates the transport sector although it has not been instituted as an independent regulator.

Thirdly, capacity building in regulatory agencies for efficient regulatory governance is equally important. Most regulatory agencies in Sri Lanka lack the necessary human resources as well as the technical know-how for implementing regulatory mechanisms. A prime example is the fact that despite a greater degree of private investment in electricity generation, Sri Lanka has failed to guarantee cost effective prices to the consumer owing to the initial power purchase agreements (PPAs) signed with power producers. These PPAs were initially negotiated at a high price. As such, currently one of the largest items of expenditure for the CEB is the power purchase bill of independent power producers (IPPs). The gross generation of electricity by IPPs as a percentage of the total was 40 per cent in 2010.[20] There has been a failure as yet to establish reasonable

[18] D. Jeffery (2009), *Private Sector Investment in Infrastructure: Project Finance, PPP Projects and Risk*, Kluwer Law International, Netherlands.

[19] "Knowledge Sharing on Infrastructure Public-Private Partnerships in Asia - PPPI Series" (2009), Post-event Statement URL: http://www.adbi.org/event/2965.korea.ppp/ (accessed on April 30, 2012).

[20] The Ceylon Electricity Board, *Statistical Digest 2010*.

PPAs with the IPPs despite numerous discussions.

Apart from setting up the formal institutions, enhancing the credibility of the political and regulatory framework is equally important for attracting private investment. Creating investor confidence in the political and regulatory regime is perhaps the single most important factor which brings in private investment. The re-nationalization of some key entities in recent years -- for instance, Shell Gas, Sri Lanka Insurance, and Apollo Hospitals – and the Revival of Underperforming Enterprises and Underutilized Assets Act of 2011 (more commonly known as the Expropriation Bill), which brought in 37 'underperforming' enterprises within government purview, are some measures which can hinder investor confidence.

The doing-business environment of a country is a key concern for investors in making investment decisions. Sri Lanka moved up the ranking in the World Bank Doing Business Index, from 98 in 2011 to 89 in 2012.[21] However, it ranks fairly low in the Corruption Perceptions Index (CPI), where Sri Lanka ranked at 86 in 2011 with a CPI score of 3.3.22 Similarly, local opinion polls conducted by a leading business magazine (LMD) indicate a drop in the LMD-Nielsen Business Confidence Index (BCI), from 170 a year ago to 135 by April 2012.[23] Policy actions such as the Expropriation Bill had some bearing on investor confidence, especially in view of perceived lack of transparency in policy decisions within the 'black box' of the political system, which results in policy gaps.

Independence of regulatory agencies is of equal significance for improving the business environment as well as investor confidence. Several instances of regulatory failure and lack of regulatory independence can be observed in Sri Lanka. As pointed out above, there has been a failure to assign the petroleum and water utilities to the independent regulator (PUCSL) specifically set up for that purpose. Moreover, arbitrary political decisions often seem to over-ride regulatory independence in the country. For example, the PUCSL has drawn up a Roadmap for Tariff Rebalancing which was to be implemented from 2011. This requires the PUCSL to revise electricity tariffs every six months to eventually move to cost reflective prices by 2015. However, apart from its initial exercise in January 2011, the PUCSL has refrained from revising tariffs mainly due to political expediency. Electricity consumers, especially the household category, constitute a solid voting bloc. The TRCSL has performed equally poorly. The Telecom Regulatory Environment (TRE) Survey, a multicountry study assessing the perceived regulatory efficacy of telecommunications regulation, indicates that Sri Lanka has failed to reach even the average of the five-point scale of assessment. The survey results cite the lack of workable independence and transparency in regulatory procedures to be among the main regulatory bottlenecks in the telecommunications sector.[24]

Addressing the above issues remains a crucial policy challenge for Sri Lanka in attracting more private participation in infrastructure development. More often than not, creating competition by bringing in private in-

[21] The World Bank, (2012), *Doing Business in Sri Lanka*, URL: http://www.doingbusiness.org/data/exploreeconomies/sri-lanka?topic=getting-credit (accessed on April 30, 2011).

[22] Transparency International (2011), *Corruption Perception Index 2011*, URL: http://cpi.transparency.org/cpi2011/ results/#CountryResults (accessed on May 5, 2012).

[23] Lanka Monthly Digest (2012), "Biz Confidence Index Plummet", URL: http://lmd.lk/2012/04/01/business-sentiment-8/(accessed on April 30, 2012).

[24] Brahmanage, B. and H. Weerasekera (2011), "ICT Sector Performance Review for Sri Lanka",URL: lirneasia.net/wp-content/uploads/ 2010/07/LK_SPR_Final_Draft.pdf (accessed on April 29, 2012).

vestment in infrastructure leads to high quality service delivery. According to the World Bank (2002), countries such as Argentina, Brazil, Chile, and Peru, enjoy the benefits of competition in electricity transmission. Sri Lanka's own telecommunications sector is another example for this where increased private investment has provided users with high quality service delivery combined with the latest technology.

8.3.4 Increasing Industrial Productivity through SME Development

The significance of the SME sector in any country is evidenced by the major role played by these entities in many successful economies. For example, the SME sector in South Korea, which was in fierce competition with China, found innovative ways of surviving by exporting to China; by 2003, South Korea managed to emerge as the second leading exporter to China. A similar significant role was played by SMEs in the development of Taiwan and post-World War II Japan.

The SME sector in Sri Lanka is a significant development thrust area for several reasons. SMEs constitute the bulk of the industrial sector in Sri Lanka, with around 91 per cent of industries in the country identified as SMEs. They account for 26 per cent of industrial employment. Therefore, given the significance of the sector, it is imperative that the institutional set up for its smooth functioning be strengthened to boost the contribution to Sri Lanka's economic growth.

Numerous benefits to the SME sector have been provided by the government (Box 8. 4). However, several key areas still remain

Box 8.4
Existing Incentives Granted to the SME Sector in Sri Lanka

Incentives granted by Budget 2012:

- Reduce expenses of the pre-establishment year from the income of the first year in which tax becomes payable (for SMEs with an annual turnover of less than Rs.500 mn.)
- Four year tax holiday for small scale enterprises in selected activities with a minimum investment of Rs. 25 mn.
- Tax holiday of up to six years for medium scale enterprises depending on the size of the investment.
- Three year tax holiday for existing enterprises in selected activities with a minimum investment of Rs. 50 mn., on or before March 31, 2015.
- Exemption from Economic Service Charge (ESC) up to Rs. 100 mn. for SMEs with a quarterly turnover of less than Rs. 500 mn.
- Reductions and exemptions from custom duties on imports, value added tax (VAT), and NBT.

Other Incentives:

- Initiation of the Technology Development Fund (TDF) for SMEs, to facilitate commercialization of research activity by the Ministry of Industry and Commerce and National Enterprise Development Authority (NEDA).
- Provision of support services to selected industrial clusters such as the Moratuwa Wood Cluster, Wewaldeniya Cane Cluster and Batticaloa Handloom Cluster.
- Provision of research services from state institutions at a nominal fee for SMEs.

Source: Wijesinha, A., (2011), "Strong Steps, but Tax Relief is Half the Story," *Talking Economics Digest*, July-December 2011, Institute of Policy Studies of Sri Lanka, Colombo.

neglected, in order to transform SMEs in Sri Lanka to a similar growth engine as in countries such as Japan and South Korea.

The chief deficiency in the SME related policy space is the lack of a formal definition for SMEs in Sri Lanka. Different political and financial institutions have their own definitions which vary from each other, making it difficult to implement comprehensive policies related to SMEs. For example, categorizing enterprises as small and medium is a difficult task as the scale would differ based on the industry; while a particular enterprise may fall into the 'medium' category based on investment, the same enterprise would not fall into the medium category based on the number of employees.

While definitional issues render it difficult to set up a broad policy framework, the lack of a comprehensive policy framework itself remains a crucial policy gap in the current SME scenario. Several institutions in the country are mandated to implement SME related policies. These include the Ministry of Industry and Commerce, Ministry of Traditional Industries and Small Enterprise Development, Ministry of Economic Development, Ministry of Local government and Provincial Councils, Ministry of Finance and Planning and the CBSL. The existence of concurrent jurisdiction among these various institutions has compelled entrepreneurs to consult several agencies in enterprise set-up and operation. This drives up the cost of production as entrepreneurs have to deal with the bureaucratic red tape of several agencies in obtaining approvals.

The ill effects of the lack of clear mandates for different institutions can be mitigated by establishing a comprehensive, all-encompassing SME policy which clearly demarcates the specific functions of the institutions involved in SME development. However, apart from an SME White Paper in 2002 and the 'Draft SME Policy 2010,' no substantial steps have been taken toward this goal. Moreover, the draft of the policy document in 2010 appears to be largely overlapping with the recommendations of the SME White Paper in many areas, and is in essence a 'reinvention of the wheel.'

Sri Lanka is also lagging behind in setting up specialized financial institutions and strengthening the existing institutions that cater to the needs of SMEs.[25] More often than not, banks and other financial institutions lack the technical know-how in dealing with SME-related financial needs which are different from those of big corporate firms. Similarly, information sharing and awareness about various financial instruments available, such as those outlined in Box 8.4, remains low. Empirical evidence emerging from public-private dialogues held with the cut-flower industry in Nuwara-Eliya, for example, reveal that not a single PPD participant was aware of the special loan schemes offered by the CBSL to the SME sector.[26]

Another need highlighted by the same focus group was the need for holistic support for market and business development. Many of them are unaware of the function of value chains both locally and regionally and how to plug into them. While a few champions find their way into the markets, many struggle with the inability to do so. Therefore, the selected institutions mentioned above should be clearly mandated to provide the required support services in finding markets and mov-

[25] As per Budget 2005, the SME Bank was set up in Sri Lanka with a view to addressing the need for a specialized financial institution. This was amalgamated with the Lankaputhra Bank in 2007. In 2010, six rural regional development banks around the country were merged to form the Regional Development Bank, mandated to assist rural SMEs as well as microenterprises.

[26] Wijesinha, A., (2011), "Strong Steps, but Tax Relief is Half the Story", *Talking Economics Digest*, July-December 2011, Institute of Policy Studies of Sri Lanka, Colombo.

ing up the value chain. The same applies to business development as well. Sri Lanka needs to set up institutions or mandate the existing ones to promote better business practices such as improving management and accounting practices and technology upgrading.[27]

As set out previously, apart from getting the above formal institutions right for the development of the SMEs, informal institutions are of equal significance, if not more so. Improving the overall business climate by establishing anti-corruption and anti-rent seeking practices is of great importance for the development of SMEs. Indeed, it is perhaps more crucial for the SME sector as it is more vulnerable to the risks emerging from a negative business climate.

8.4 Policy Conclusions

The discussion in this Chapter has focused on crucial policy issues relating to Sri Lanka's institutional framework. The Chapter has analyzed key policy questions pertaining to the definition of formal and informal institutions in the policy space, and the manner in which institutions are embedded in the policy process. The four case studies selected to unpack the complex dynamics of institutional forms and functions in Sri Lanka -- taxation and state capacity; land titles and agriculture sector productivity; PPPs in infrastructure development; and SME development -- provide rich insights on the link between institutions and socio-economic growth, and on the type of institutions that matter for sustainable growth.

The case studies build on and elaborate the specific ramifications of the conceptual framework -- reiterating the point that context matters and that there is no universal blue print solution to address institutional gaps. As such, whilst understanding the workings of formal institutions in other countries is useful for policymakers, the prevalence of informal institutional forces renders policy transfer a difficult exercise. Addressing the policy question of how to build high quality institutions that are sustainable over time requires in-depth analysis of specific case studies, each providing useful lessons for policymakers. Whilst the specific facts gathered from case studies may not be generalizable across time and space, the accumulation of empirical knowledge constitute extremely useful insights for the policy community.

The specific policy conclusions coming out of the analysis are as follows. In enhancing state capacity to attain the growth objectives of the country, policy measures such as increasing the tax base, creating effective decentralization for local economic development, as well as adopting efficient methods of tax administration, are significant. In relation to policy measures to increase agriculture productivity, setting up formal institutions with clear mandates as well as establishing proper land titling matter will facilitate more efficient allocation of resources in the sector. Similarly, in order to attract private investment, understanding PPPs as well as creating PPP-oriented institutions in the country is the need of the day. The SME sector of the country requires a holistic policy and institutional framework to be put in place to facilitate its growth. More importantly, the theme highlighted in the discussion is the need to promote informal institutions such as accountability and the doing-business environment for promoting growth in all these sectors. This will lead to establishing the missing link between the external and internal policy environments in Sri Lanka, and consequently lead to a solid

[27] *Ibid.*

institutional set-up which will help sustain the growth targets for the country.

At a more general level, the analysis emphasises some key ingredients critical to the process of building high quality institutions that are sustainable over time. Policy continuity underpinned by strong political commitment and transformational political leadership is vital to foster inclusive formal and informal institutions. However, this does not imply that particular forms of political systems -- such as democracy for example -- would necessarily facilitate institutional structures that are amenable to inclusive and sustainable socio-economic development. Neither, as seen in the case of state capitalism in China, is it necessarily the case that one-party states are prone to dismal levels of socio-economic development.

The nature of informal institutions or social cohesion matters; it may well be the case that the prevalence of perverse interest group dynamics and rent-seeking behaviour undermines and offsets expected functional outcomes. What is important is to identify policy levers to enhance social cohesion in a society; to build an inclusive informal institutional framework. Whilst this exercise is not an easy one, or one that can be instituted over the short term, it is crucial for sustainable policy outcomes. Further, given the prevalence of path dependence, once a 'virtuous policy cycle' is set in motion and embedded in the policy space, it is likely that it will continue over time.

Building informal institutional structures that are conducive to inclusive and sustainable growth requires the presence of a vibrant and informed civil society; a bottom-up social force that engages actively in the policy space. Moreover, the state has a crucial role to play in shaping the context and milieu within which civil society is organized. In the final instance, therefore, political commitment and the nature of the political leadership are central to the building of high quality institutions -- institutions that foster sustainable socio-economic growth.