Sri Lanka
State of the Economy Report 2014

Chapter 4
The Asian Developmental State – 'Getting the Interventions Right'

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4. The Asian Developmental State - 'Getting the Interventions Right'

4.1 Introduction

The French poet Paul Valery is thought to have believed that 'if the state is strong, it will crush us; if it is weak we will perish' hence an 'ideal' must rest somewhere in-between these two extremes.[1] States carry out many roles, some social, some political and some economic. Ever since Adam Smith (1776) published his seminal book, 'An Inquiry into the Nature and Causes of the Wealth of Nations' almost three-and-a-half centuries ago, the discourse centring around the role of the state in economic affairs has been a highly contentious one.[2]

Throughout the major part of contemporary economic history, two dominant development paradigms prevailed, one focused on markets, and the other on government and planning. Classical economists who drew their intellectual underpinnings from Adams Smith's 'invisible hand' took the view that markets would lead to efficient outcomes. 'Getting the prices right' was fundamental. With right prices, everyone would have the incentive to make the socially desired resource allocation. All that governments needed to do was to 'get out of the way'. At the opposite end of the spectrum, were those who had little faith in the market and looked to governments to ensure resources were deployed in a way that promoted growth.[3]

Contrary to these two dominant orthodoxies, the latter half of the 20th Century witnessed the strong emergence of a number of East Asian countries which followed neither of these two extremes. The policy orientation of these economies was mixed in

!Stop! Wait! Government's no longer the problem —it's the solution!"

1 Tanzi V. (1997), "The Changing Role of the State in the Economy: A Historical Perspective," IMF Working Paper, WP/94/114, Washington, D.C.

2 *Ibid*.

3 Stiglitz J.E. (1996), "Some Lessons from the East Asian Miracle", The World Bank Research Observer, pp. 151-177.

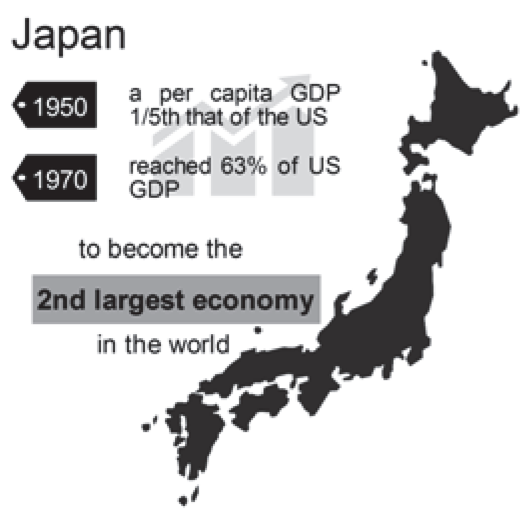
nature, where the state played a central role in facilitating structural adjustment.[4] The models of economic policy and practice adopted by many of these successful East and Southeast Asian economies, particularly at the height of their rapid industrialization and growth, has become known widely in the summary expression of 'developmental state'.[5]

Though it had gone somewhat out of favour from the 1970s, the recent decade has seen some revival of interest in the 'developmental state', owing in large part to the failure of neo-liberalism to deliver the much hyped rapid, sustained, inclusive growth and poverty reduction it had once promised amongst the majority of late industrializing countries.[6] From about 2005, the government of Sri Lanka too has embraced a 'look East' approach in its policy orientation. Though not explicitly stated, some similarities in the policies advocated under the development state model could be seen in the current phase of Sri Lanka's policy drive for rapid economic growth and development. Policy practices from at least some of the successful East and Southeast Asian countries are being selectively emulated in this endeavour.

In the preceding context, the literature on the developmental state in light of the East Asian experiences is revisited in an attempt to draw policy lessons for Sri Lanka. Understanding what these policies were, why they were adopted, and their successes and failures in bringing about economic growth in the context of the East Asian Miracle, would come a long way in providing insights for Sri Lankan policymakers. This would assist to formulate and implement interventions better in catalyzing long-term sustained, inclusive economic growth in Sri Lanka.

4.2 Explaining the East Asian Miracle: A Case of 'Developmental State'?

Japan, a developing country in the 1950s with a per capita GDP one-fifth that of the US, reached 63 per cent of US GDP by 1970 to become the second-largest economy in the world. Japan's unprecedented ascendance was largely a result of sustained annual GDP growth in excess of 9 per cent during the 1950s and 1960s, driven predominantly by the transformation of its economy from an agrarian to an industrial economy, and the continuous upgrading in key manufacturing sectors. Using a similar outward-oriented, market-friendly development strategy, the Asian 'tigers' - South Korea, Taiwan, Hong Kong and Singapore - followed closely by Malaysia, Thailand and Indonesia also saw their economies growing in excess of 7 per cent annually between the early 1960s and the early 1990s, demonstrating that it is possible to maintain impressive growth rates and to close the gap with more advanced economies.[7]



[4] *Ibid*.

[5] Lakshman, W.D. (2009), "A Developmental State Model for Sri Lanka", Professor Sirisena Tilakaratna Memorial Oration, National Library Auditorium, Colombo.

[6] The notion of neo-liberalism is primarily associated with reducing the role of the state in economic affairs.

[7] Lin, J.Y. (2012), *New Structural Economics: A Framework for Rethinking Development and Policy*, World Bank, Washington, D.C.

More recently, China has embarked on a similar transformation. At the time of making the transition from a planned to a market economy in 1979, it was a poor, inward-looking economy with a per capita income of US$ 182 which was less than one-third the average in Sub-Saharan African countries at the time. Since embracing a market-oriented stance, China's economic performance has been nothing short of miraculous. For a period spanning over three decades, China has been able to record annual GDP growth averaging 9.9 per cent and is now a middle-income country, with a per capita GDP of US$ 4,260 in 2010. Along with its growth trajectory, China has been successful in pulling more than 600 million people out of poverty.[8]

The remarkable success of the East Asian economies has, over the years, stimulated a whole array of studies to explain the causes of East Asia's economic ascendance. The greater majority of the literature adopts what could be called the mainstream, neo-liberal or 'Washington Consensus' interpretation, where they attribute a major part of East Asia's success to the role played by the respective governments of getting the economic fundamentals right. These studies take the view that growth is a natural or inherent element of capitalist economies, and that governments have an important role to play in providing public goods such as law enforcement, infrastructure, macroeconomic stability and education which are viewed to be difficult to be arranged through private contracts.[9]

The widely quoted World Bank (1993) study titled 'The East Asian Miracle: Economic Growth and Public Policy' is one of the leading proponents of the Washington Consensus interpretation. Firstly, the four-hundred-page report, finds that in large part, the growth of the eight High Performing Asian Economies (HPAEs) was achieved by getting the basics right, along with heavy, sustained government investment in social infrastructure and education. Secondly, the report finds that the HPAEs benefited from a government-led push for export manufacture; and thirdly, that well-directed selective credit programmes were effective in promoting exports as well as promoting research and development (R&D). However, a somewhat controversial fourth assertion was that sectoral industrial policies to support specific industries generally did not work, and therefore have little promise for other developing countries.[10]

Though the report placed greatest emphasis on getting the basics right, it was amongst the first mainstream narratives of the East Asian success story to acknowledge the existence of industrial policy in the non-Japanese East Asian economies.[11] In short, the contemporary mainstream view advances the case that countries should not have a vertical or sectoral industrial policy, but at most should have a horizontal, generic or sector-neutral policy, such as supporting SMEs and R&D. The default role of the state should be restricted to macroeconomic stabilization, trade liberalization and creating the right institutions. It assumes that the optimum industrial upgrading and changes in production structure will occur 'automatically' if the government gets prices and institutions right.[12]

The other wave of literature explaining East Asia's success attributes a slightly more different interpretation, going beyond the standard Washington Consensus prescription of 'getting the fundamentals right'. Also dubbed the 'Post-Washington Consensus', the heterodox

[8] *Ibid*.

[9] Wade, R. (1992), "East Asia's Economic Success: Conflicting Perspectives, Partial Insights, Shaky Evidence", *World Politics*, Vol. 44, No. 2, pp. 270-320.

[10] Wade, R. (2003), *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*, Princeton University Press, New Jersey.

[11] Chang, H.J. (1999), "Industrial Policy and East Asia: The Miracle, the Crisis, and the Future," paper presented at the World Bank workshop on "Re-thinking East Asian Miracle", San Francisco, 16-17 February 1999.

[12] Wade, R. (2010), "After the Crisis: Industrial Policy and Developmental State," presentation made at the International Monetary Fund, Washington, D.C.

Whilst acknowledging the limitations of the market but rather than replacing them, East Asian economies went on to promote, complement and use the markets by way of intelligent manipulation of economic policy.

interpretation of East Asia's success story attributes it to proactive governments, which leveraged industrial policy to facilitate structural adjustment and industrial upgrading in their respective economies. For markets to yield efficient outcomes, several preconditions must be satisfied. These include, the absence of externalities and public goods, the presence of perfect competition, and a complete set of markets extending infinitely far into the future and cover all risks. A market failure is said to arise if at least one of these conditions are not met. More in-depth studies show that for markets to perform efficiently, there also has to be no imperfections of information, no changes in the information structure, and no asymmetries of information. Since developing economies are often plagued by underdeveloped (missing) markets and imperfect information, and given that the development process is associated with acquiring new technology (new information), governments have a greater role to play in correcting market failures to facilitate the market to structurally adjust and achieve industrial upgrading.[13]

What the East Asian economies did differently to that of the former-Soviet Union was that, whilst acknowledging the limitations of the market but rather than replacing them, they went on to promote, complement and use the markets by way of intelligent manipulation of economic policy. Their role was confined to: (1) policies that actively sought to ensure macroeconomic stability; (2) making markets work more effectively (e.g., regulating financial markets); (3) creating markets where they did not exist; (4) helping to direct investments to ensure resources were deployed in ways that would enhance economic growth and stability; and (5) creating an atmosphere conducive for private investment and ensuring political stability.[14]

Nobel Prize-winning economist Joseph Stiglitz very succinctly sums up the current understanding of this decades long debate on the role of the state by noting that "the ideological debates should [by now] be over; there should be agreement that while markets are at the centre of the economy, governments must play an important role. The issue is one of balance, and where that balance is, may depend on the country, the capacity of its government [and] the institutional development of its markets".[15]

Each of the successful East Asian economies is unique both in terms of their characteristics and respective pathways to structural change. Each economy differs in its geography, culture and history. Some are small city states, whilst others are large, some were granted independence after centuries of colonial rule, whilst others re-emerged from the ashes of war, some are racially and culturally homogenous, whilst others such as Malaysia are

[13] Stiglitz J.E. (2004), "Redefining the Role of the State: Joseph Stiglitz on Building a Post-Washington Consensus", *World Economy*, Vol. 2, No. 3, pp.45-86.

[14] Stiglitz J.E. (1996), "Some Lessons from the East Asian Miracle", The World Bank Research Observer, pp. 151-177.

[15] *Ibid*.

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- *Joseph Stiglitz*

cultural melting pots. There exists no 'unique East Asian model' per se; what they share in common is the proactive nature in which the respective governments pursued economic policy in catalyzing their development. At the very heart of the developmental state was also, proactive 'industrial policy'.

4.3 Government in the 'Developmental State' Model

4.3.1 Market Failures: Rationale for Government Intervention

As noted earlier, developing economies are ridden with market failures, hence the state must take on a much broader role than what a pure laissez-faire approach would advocate. The presence of information externalities raises one such issue. Economic innovations, whether successful or not, yield information about profitable or unprofitable market opportunities. This information is however not only available to the innovators themselves, but also to their competitors and potential imitators who do not bear any costs, resulting in innovation being under-supplied by the market. By subsidizing such costs, governments could play a key role in spurring innovation and offsetting this first mover disadvantage.

Coordination failures are another important market failure which necessitates government intervention. Developing economies lag behind developed ones, not only in terms of technology and industrial structures, but also in terms of human capital, infrastructure and institutions. For countries to grow and structurally adjust, these complementary factors also need to develop and evolve concurrently to facilitate adjustment. As technology becomes more complex, capital requirements increase, the scale of production and market size increase, and market exchanges are more frequented through arm's length transactions. A flexible smooth transition requires simultaneous improvements in education, finance and legal institutions and infrastructure. Owing to their public good characteristics, individual firms clearly cannot internalize these changes cost effectively. Moreover, coordination amongst many firms to bring about the

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Table 4.1
Governance Indicators - 2012

	Voice & Accountability		Political Stability & Absence of Violence/Terror		Government Effectiveness		Regulatory Quality		Rule of Law		Control of Corruption	
	Governance Score	Percentile Rank	Governance Score	Percentile Rank	Governance Score	Percentile Rank	Governance Score	Percentile Rank	Governance Score	Percentile Rank	Governance Score	Percentile Rank
Southeast Asia												
China	-1.6	4.7	-0.5	28.4	0.0	56.0	-0.3	43.5	-0.5	38.9	-0.5	39.2
Japan	1.1	83.4	0.9	78.2	1.4	88.5	1.1	83.7	1.3	87.2	1.6	91.9
Malaysia	-0.3	37.9	0.0	44.5	1.0	80.4	0.5	69.9	0.5	65.9	0.3	65.6
Singapore	-0.4	35.6	1.3	96.7	2.2	99.5	2.0	100.0	1.8	95.7	2.2	97.1
Thailand	-0.3	37.4	-1.2	12.8	0.2	60.8	0.2	57.9	-0.2	50.2	-0.3	46.9
Taiwan	0.8	72.0	0.9	73.9	1.1	83.7	1.2	86.1	1.0	82.9	0.7	73.7
South Asia												
Sri Lanka	-0.6	29.9	-0.7	22.7	-0.2	45.9	-0.1	48.3	-0.1	52.1	-0.2	51.7
India	0.4	58.3	-1.2	11.8	-0.2	47.4	-0.5	34.0	-0.1	52.6	-0.6	34.9
Bangladesh	-0.4	34.1	-1.4	9.0	-0.8	22.5	-1.0	19.6	-0.9	19.4	-0.9	21.1
Pakistan	-0.9	23.7	-2.7	0.9	-0.8	23.4	-0.7	24.9	-0.9	19.0	-1.1	13.9

Notes: a. Estimate of governance is measured on a scale from approximately -2.5 to 2.5. Higher values correspond to better governance; b. Indicates rank of country among all countries in the world. Zero corresponds to lowest rank and 100 corresponds to highest rank.

Source: World Bank (2013), "Worldwide Governance Indicators".

required changes are often impossible, hence governments can play a lead role either by taking steps to introduce such changes or to coordinate them.[16] The presence of these types of market failures provide a clear rationale for governments in developing economies to kick-start growth through the pursuit of proactive economic policy.

4.3.2 Governance

A state that is accountable, transparent, and provides predictability in the application and enforcement of rules, set the environment to encourage investment, productivity, and research and development which are also driving forces of economic growth and development. Some key governance indicators are given in Table 4.1. All selected East and Southeast Asian countries with the exception of China, Thailand and Singapore

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[16] Lin, J.Y. and H. J. Chang (2009), "Should Industrial Policy in Developing Countries Conform to Comparative Advantage or Defy it? A Debate between Justin Lin and Ha-Joon Chang", *Development Policy Review*, Vol.27, No.5, pp. 483-502.

(only in the 'voice and accountability' indicator) perform better in the reported indicators compared to South Asia. Japan and Singapore perform the best in a majority of the indicators. 'Rule of law' is particularly important given that it provides the basic underpinnings of all economic activity. Apart from China and Thailand, all other Asian economies rank above South Asian countries in this indicator. However, India and Sri Lanka perform better than China or Thailand in this category.

4.3.3 State Capitalism

State involvement in enterprises is not new, and despite extensive state reform and privatization, state capitalism is still at large in developed and developing countries.[17] In fact, it has undergone a dramatic revival with some state-owned enterprises (SOEs) which were little more than government departments in the emerging economies of the 1990s, developing into high value, large firms.[18] State backed firms accounted for 80 per cent of the stock market value in China and for a third of the emerging countries' FDI in 2003-2010;[19] in 2010, there were four SOEs among the top ten firms of the Global Fortune 100 list as opposed to none at the top in 2005.[20] SOEs apart, there has been a rise of 'hybrid capitalism' where minority investments are made in companies by development banks, pension funds, sovereign wealth funds and sometimes by the government itself. The debate is on whether hybrid capitalism is a means of solving market failures as justified by governments in emerging economies, or as the private entities see it, whether private companies backed by government loans are a threat which can be used by governments to influence markets.

Table 4.2
Government Expenses as Percentage of GDP[a]

	2000	2005	2010	2012
Japan	n.a.	16.0	18.1	19.3
Malaysia	16.5	17.7	18.8	21.6
Thailand	n.a.	16.4	18.6	21.0
Singapore	16.0	12.8	12.8	13.2
South Korea	16.6	19.7	19.9	20.4

Note: a. Expense is cash payments for operating activities of the government in providing goods and services. It includes compensation of employees (such as wages and salaries), interest and subsidies, grants, social benefits, and other expenses such as rent and dividends.

Source: World Bank (2014), "World Development Indicators 2014".

While supporters of state capitalism are of the view that it can produce stability and growth by addressing market failures and by diverging from pure profit-maximizing goals, others underscore the resulting inefficiencies of such involvement: when the government favours a group of companies, others can fail (i.e., the larger SOEs can soak up capital and talent in the market); the use of capital by state companies is less efficient than private entities - they grow more slowly, and are less competitive.[21] Further, state capitalism works well only when directed by a competent government and hence, is not a guarantee of stability.

A brief examination of the East and Southeast Asian economies in terms of government expenditure and public sector employment shows that government involvement in the economies is substantial. A glance at government expenditure in a few selected Asian countries show that government expenses as a percentage of GDP has generally increased

[17] Musacchio, A. and S.J Lazzarini (2012), "Leviathan in Business: Varieties of State Capitalism and their Implications for Economic Performance", Working Paper 12-108, Harvard Business School, US.

[18] *The Economist*, (2012), 'Emerging-Market Multinationals: The Rise of State Capitalism', January 21-27 2012, available at http://www.economist.com/node/21543160.

[19] *Ibid*.

[20] Musacchio, A. and S. J. Lazzarini (2012), "Leviathan in Business: Varieties of State Capitalism and their Implications for Economic Performance", Working Paper 12-108, Harvard Business School, US.

[21] *The Economist*, (2012), 'Emerging-Market Multinationals: The Rise of State Capitalism', January 21-27 2012, available at http://www.economist.com/node/21543160.

over the 2000-2012 period, except in the case of Singapore (Table 4.2). The rate remained close to, or over 20 per cent in the other economies of Japan, Malaysia, Thailand and South Korea. The level of public sector employment (as a percentage of total employment) for a few selected countries show that it is highest in Malaysia and Thailand, accounting for 13.2 per cent and 8.9 per cent, respectively, for the latest year of which data is available (Table 4.3). It is notably low in Indonesia and Bangladesh.

Table 4.3
Employment in the Public Sector as a Percentage of Total Employment

Country	%
Bangladesh	4.5 (2005)
Japan	7.0 (2006)
Indonesia	3.8 (2003)
Malaysia	13.2 (2008)
Singapore	6.3 (2008)
Thailand	8.9 (2008)

Note: Data for the latest available year is given within brackets.

Source: ILO (2014), "LABORSTA Internet", available at www.laborsta.ilo.org.

Box 4.1
The Asian Financial Crisis and the East Asian Developmental State

The 1997/98 financial crisis highlighted several weaknesses in the institutional arrangements of the East Asian developmental state model in an era of financial liberalization. The Asian financial collapse is attributed largely to macroeconomic flaws in the financial sector of the affected economies, particularly in Thailand and Indonesia. The crisis also underscored some key weaknesses of governments and other institutions in the developmental state.

Crony Capitalism
The East Asian financial crisis saw some of the state-business relations maintained in the developmental states being disparaged as forms of 'crony capitalism'. Crony capitalism in some East Asian economies, visible in the form of 'give-away privatizations' to the political leaderships' relatives and cronies, granting of artificial monopoly rights, direction of credit to government-favoured and politically connected entities is perceived by some analysts to have led to moral hazard of firms, misallocation of investments, falling returns to investment and a fragile financial system.

Weak Legal System
At the onset of the financial crisis some Southeast Asian countries like Indonesia, the Philippines, Malaysia and Thailand suffered from weak legal systems including weak property rights. Strong legal systems are key in drawing foreign investments, reducing transaction costs and attracting external finance to a country as they promote dynamism, competition, transparency and choice in an economy. These developmental states lacked such institutional arrangements.

Little Weight on Sound Financial Sector Policies
Financial sector policies of the developmental state placed little emphasis on proper auditing, accounting, credit rating, disclosure requirements, or experience and independence. This led to fragilities in the financial sector and is seen as weakness of the developmental state model.

As will emerge from the proceeding sections, the key to an effective developmental state is the capacity of the state to formulate and implement developmental policies. A state needs both a competent bureaucracy and an effective relationship with its business community to achieve this.

Source: Crafts, N. (1999), "Implications of Financial Crisis for East Asian Trend Growth", *Oxford Review of Economic Policy*, Vol. 15, No. 3; Lee, E. (1999), "The Debate on the Causes of the Asian Crisis: Crony Capitalism versus International System Failure", *International Politics and Society*, Vol. 2.: Park, Y. C. (1994), "Concepts and Issues", in H. T. Patrick and Y. C. Park (eds.), *The Financial Development of Japan, Korea, and Taiwan: Growth, Repression and Liberalization*, Oxford University Press, New York.

4.4 Government Intervention in Economic Policy

This section analyses the government's role in formulating and implementing industry and trade policy, investment, education and infrastructure development in the developmental state. Key interventions are analyzed in the following section in order to draw policy implications for Sri Lanka.

4.4.1 Industry and Trade Policy

Export success has been an underlying factor of many of the East and Southeast Asian economies' growth performance. Firms and industries have been encouraged to aim for export success from a very young stage, and the provision of protection, subsidized credit, tax benefits and other support has been often conditional on satisfactory export performance.[22] However, in some of the East Asian countries such as Japan, it is difficult to isolate unique trade policies as their focus on industrial policy has aimed at supporting the growth and competitiveness of industry in its entirety, with the objective of catching up with the West. Some of these key policies are discussed in the subsequent sections.

Efficient allocation of resources

Government intervention in East Asian economies is known to have been effective at driving development through re-allocative effects of resources. This is widely visible in Japanese policy where economic growth was pursued through industrial policies which aimed at efficient allocation of resources. Economic efficiency was defined in terms of world markets (not on domestic markets), competitive prices, high quality and other non-price factors.[23] The Ministry of International Trade and Industry (MITI) designed and implemented the industrial policy of the country with the goal of reaching the same position a market solution would reach, but at a faster pace, and in the case of a declining industry, at a lower social cost.[24] MITI officials believed they could better anticipate the long run strategic needs of the economy than the market-place. They identified the key sectors of the economy such as semiconductors, computers, telecommunication and other high-tech industries, and offered a comprehensive package to support these to make Japan a major economic force. The support included accelerated depreciation allowances,[25] R&D funding, tax benefits, and loans.[26] Furthermore, the policies tried to anticipate and use the market itself to draw incentives from, rather than replacing market incentives with other forms of instruments to allocate resources and to drive businesses in the desired direction such as import restrictions.

Driving competition and economies of scale

Policies in Japan for instance also encouraged competition among firms and created space to reap economies of scale. Although at the early stages, non-Japanese firms were not allowed entry into the market, it was accepted that there was adequate competition in the economy to make firms efficient. Although this was not an ideal neo-classical model of perfect competition, firms were competing in dynamic oligopoly market structures. As a result, Japanese firms during this time, built their competitiveness more than the other nations did,

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22 Kokko, A. (2002), "Export-Led Growth in East Asia: Lessons for Europe's Transition Economies," National Europe Centre Paper No. 31, Australian National University, Canberra.

23 Patrick, H. (1986), "Japanese High Technology Industrial Policy in Comparative Context", Working Paper No. 1, Center on Japanese Economy and Business, Columbia University, US.

24 *Ibid*.

25 Accelerated depreciation allows greater deductions in the earlier years of an asset and is used to minimize taxable income. Among other things, it encourages businesses to purchase new assets.

26 Patrick, H. (1986), "Japanese High Technology Industrial Policy in Comparative Context", Working Paper No. 1, Center on Japanese Economy and Business, Columbia University, US.

In East Asia, firms and industries have been encouraged to aim for export success from a very young stage, and the provision of protection, subsidized credit, tax benefits and other support has been often conditional on satisfactory export performance.

protected behind import barriers, and achieved international competitiveness in a range of products, from consumer electronics to steel and small cars.[27] Despite consumers having to pay relatively high prices during the initial stages of any particular industry, agencies such as MITI stimulated pressure on firms (often via the threat of eventually losing protection) to increase efficiency and productivity to become internationally competitive, which subsequently lowered domestic prices as well. There were, however, exceptions to this such as the petroleum refining industry, which failed to realize low-cost production and optimum scale.

Facilitating structural adjustment

The governments encouraged sectors which were weak and uncompetitive to make structural adjustments. In the case of products such as petrochemicals, aluminium, and textiles in Japan, the rationale was that it was more efficient to close the firms which were the least efficient, while the government encouraged firms to achieve scale economies through mergers than bankruptcy.[28] Similarly in Singapore, motor vehicle assembly plants were closed by 1980 when it was apparent that the plants were unable to survive without constant assistance.[29] As it has been aptly summarized, the role of the government in Singapore has been one that is interventionist but runs things on a profit making basis, with intervention mainly taking the form of advice and implicit pressure.[30]

However, this is not to say that there was no protective policy. In fact, it was widespread in East Asia, if less so than in other countries.[31] However, contrary to other countries, these protective policies are not known to have blocked structural change of the economy. What particularly distinguished East Asian protective policy from others was the forward-looking nature of policies. It was made explicit that the objective of providing protection was not to preserve these sectors, but rather to phase them out in an 'orderly manner' or to upgrade technologically. Moreover, as Chang (1999) explains, the protective policies came with well specified performance targets which prevented the "policies from turning into 'nursing homes' for declining industries".[32] The design and implementation of these policies are known to have promoted rather than hindered structural change in East Asian economies.

27 *Ibid*

28 *Ibid*.

29 Roberts, B. (1988), *The Timing and Sequencing of a Trade Liberalization Policy: The Case of Singapore*, World Bank, Washington, D.C.

30 Industry Commission, (1990), *Strategic Trade Theory: The East Asian Experience*, Government of Australia, Canberra.

31 Chang, H. (1999), "Industrial Policy and East Asia - The Miracle, the Crisis, and the Future", paper presented at the World Bank workshop on "Re-thinking the East Asian Miracle", San Francisco, US.

32 *Ibid*.

Nudging markets

Apart from providing fiscal incentives for specific products and protection linked to performance, the East Asian state also 'nudged' markets, encouraging firms, both local and transnational, to switch to local suppliers and to enter into higher value-added production. Some East Asian countries employed what is called 'below-the-radar' kind of policy which formed an important segment of the region's development strategy. Taiwan employed this effectively, where nudging policies included a mix method of 'jaw-jaw' and promises of goodwill for future ventures, fiscal incentives, and at times higher tariffs where the government's capacity to manage trade have been used to encourage or discourage trade.[33] Taiwan's Industrial Development Bureau for instance, hired around 200 engineers and associated professionals and economists who had engineering and finance skills to analyse input-output chains and monitor imports of a particular raw material, the buyers of the import products, and the capacity of the country to produce the specific input, etc.[34]

These professionals also spent several days visiting firms in the field to identify 'nudging opportunities' for import replacement and export promotion. The officials used various administrative methods to encourage the large players to switch to local suppliers. Established sectors of the economy were also 'nudged' to provide markets for firms in innovative enterprises, thereby driving and accelerating innovation in the country. While the nudging policies have been carried out at a sectoral level, on a case-by-case basis rather than across-the-board, these were employed only when the local suppliers could meet the price and quality of the imports.[35] This required a group of competent, dedicated and honest public officials, and a range of instruments to draw from.

Facilitating technology transfer

Authorities used a variety of ways to acquire technology which included mechanisms such as the purchase of patents, careful study of scientific papers, importation of new technology-embedded capital goods, and 'reverse engineering' which involved the dismantling and reproduction of the technology.[36] While some East Asian economies were apprehensive of foreign investment, others such as Singapore, Hong Kong and Taiwan acquired new technology via foreign affiliates or joint ventures. Studies have found convincing empirical evidence between productivity and imported technology in Japan and other dynamic Asian economies.[37] Similarly in China, special incentives were given to exporting companies in order for the companies to absorb local labour and to draw on the capital and technical know-how of foreign investors.

4.4.2 Coordinating Investments

Effective resource mobilization within the public sector

The developmental state was successful in effectively mobilizing resources from the public sector, thereby stimulating private investments into their economies. The East Asian countries have enjoyed very high levels of public and private savings and the capacity to mobilize these were enhanced through high levels of public investment. The Singapore government for example, intervened directly in the years following its independence,

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[33] Wade, R. H. (2003), *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*, Princeton University Press, Princeton.

[34] Wade, R. H., (2005), "Bringing the State Back: Lessons from East Asia's Development Experience," in Dauderstädt, M. (ed.), *Towards a Prosperous Wider Europe: Macroeconomic Policies for a Growing Neighborhood*, Friedrich-Ebert-Foundation, Bonn.

[35] *Ibid*.

[36] Industry Commission, (1990), *Strategic Trade Theory: The East Asian Experience*, Government of Australia, Canberra.

[37] Chen, E. K. Y. (1979), *Hyper-Growth in Asian Economies: A Comparative Study of Hong Kong, Japan, Korea, Singapore and Taiwan*, Macmillan, London.

investing substantially in selected sectors. From July 1968 to December 1970, Singapore increased its financial commitments dramatically, from US$ 45 million to US$ 340 million.[38] These were made in the form of loans, equity, investment and others, with one-third of the entire financial commitments made in selected economic sectors.

Effective bureaucracy

In examining the political economy of countries, cross-national evidence directs to certain common political features of countries with high public savings and high growth. A relatively high degree of political order, an anti-socialist and anti-populist ruling coalition and a relatively effective state bureaucracy are some common political features.[39] While these features may be more pronounced at one particular time period than another, public savings and growth can be expected to be higher in the more pronounced period. The example of Brazil is commonly identified in the literature, which in the period 1964-1974 was identified as a 'developmental state' in these terms. Brazil experienced remarkable levels of public savings and growth during this time. However, from 1985 onwards, the country which has been beset by an incoherent democracy, experienced public savings much below the average of developing countries and very low average growth.[40]

Coordinating investment

The Korean and Taiwanese governments in the 1960s managed to engineer a significant increase in the private return to capital by not only reducing barriers to investment and establishing a sound investment climate, but more importantly by clearing coordination failures which had blocked economic take-off.[41] This was done through strategic interventions by the governments which included investment subsidies, and the use of public enterprise and administrative guidance. With Taiwan announcing the Nineteen-Point Reform Programme in the 1960s, the simplification of administrative procedures and liberalizing regulative measures on economic matters became an official goal.[42] Similarly in South Korea, the signal was sent out that entrepreneurs who undertook investments in line with the government's priorities would be richly rewarded. The initial advantageous conditions of favourable human capital endowment stimulated the effectiveness of government intervention.

In order to drive investment, governments provided investment subsidies of different forms to firms such as low lending rates and tax subsidies. In South Korea, credit provided at negative real interest rates was the chief form of investment subsidy. Credit was provided based on the priority of the particular economic activity. The investment plans, technology, domestic linkages and scale economies were considered, and funds were allocated to those with some track record, resulting in the expansion of the manufacturing sector stemming from established firms rather than from the entrance of new firms, which was also the case in Taiwan.[43] Investments in selected sectors in South Korea were also subsidized via the socialization of investment. For example, the government provided a guarantee that the selected entrepreneurs would be bailed out if circumstances threatened the profitability of investments, and this is said to have invigorated the 'animal spirit' of large businesses, encouraging them

[38] Young, A. (1992), "A Tale of Two Cities: Factor Accumulation and Technical Change in Hong Kong and Singapore," NBER Macroeconomics Annual 1992, Vol. 7, pp. 13- 64, MIT Press.

[39] Wade, R. H. (2003), *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*, Princeton University Press, Princeton.

[40] *Ibid*.

[41] Rodrik, D. (1995), "Getting Interventions Right: How South Korea and Taiwan Grew Rich", *Economic Policy*, Vol. 10, No. 20, pp. 53-107.

[42] *Ibid*.

[43] *Ibid*.

to expand aggressively.[44] The government guaranteeing of external borrowings, subsidized infrastructure and financial guarantees of orders drove firms such as Hyundai to successfully embark and complete building one of the world's best shipyards. Nevertheless, the provision of implicit investment subsidies had to be contained as a result of the financial difficulties experienced by some of the investments.

Governments also played a direct role in co-coordinating investment decisions and organizing entrepreneurs into investments that would not have been made otherwise. It was the Taiwanese government that took the initial steps in establishing industries such as textiles, steel, plastics, fibre and electronics in the country. In South Korea too, every major shift in diversification in the 1960s and the 1970s was initiated by the government.[45]

The governments also used public investment and public enterprises to enhance the profitability of private investments. The availability of key inputs for private producers downstream was ensured with the state establishing new industries upstream. Glass, plastics, steel industries in Taiwan and Pohang Iron and Steel Company (POSCO), Korea's state-owned steel mill are examples of sectors that received such assistance. When the South Korean government request for a loan from the World Bank was turned down on the grounds that the country did not have comparative advantage in producing steel, the South Korean government went ahead, providing POSCO with capital assistance, infrastructure subsidies (i.e., to build water supply facilities, railway lines, etc.) and provided support to downstream enterprises to guarantee demand for POSCO's production. POSCO subsequently became one of the most efficient producers of steel. Further, it stimulated a wide range of other enterprises, ranging from capital goods to spare parts.[46] However, the role of government in redressing the coordination failure in some sectors such as steel has been a highly contested issue. Trade is seen as an alternative to the traditional justification of coordinating both upstream and downstream industries.[47]

4.4.3 Infrastructure

Infrastructure plays a key role in supporting a government's development policy. However, whether East Asian countries went about providing the necessary infrastructure at the onset of their development process or whether they simply responded to specific sector requirements is a point of contention. In other words, was infrastructure a causal factor in growth or a support mechanism to sustain growth?

Identifying and prioritizing infrastructure requirements

Many policy makers drawing lessons from the East Asian development experience see infrastructure as a key determinant of growth. They argue that as infrastructure investment in these countries is significantly higher than in many other countries and economic growth in these countries is also very high, the assumption that infrastructure was a catalyst in the development process of these countries can be justified. However, closer examination of these countries and their development process highlights that they did not aim to have the entire gamut of infrastructure necessary in place before attracting investors. It was a gradual process in which infrastructure developed to complement the structural changes that were taking place in the economy. While they did attempt to meet the demand ahead of time in some occasions, it was primarily a focused attempt to address needs as and when they arose.

44 Hong, W. (1993), "Trade and Development: The Experience of Korea and Taiwan" in G. Hasson (ed.), *International Trade and Development*. Routledge, London.

45 Amsden, A. (1989), *Asia's Next Giant: South Korea and Late Industrialization*, Oxford University Press, UK.

46 Rodrik, D. (1995), "Getting Interventions Right: How South Korea and Taiwan Grew Rich", *Economic Policy*, Vol. 10, No. 20, pp. 53-107.

47 Stiglitz, J. E. (1996), "Some Lessons from the East Asian Miracle",The World Bank Research Observer, pp. 151-177.

For instance, South Korea emerged from the Korean War with two-thirds of its production capabilities demolished and significant damage to its physical infrastructure. The first Five Year Plan (1962-1966) focusing on light industry and import substitution, followed by the second Five Year Plan (1967-1971) on export promotion was established. During this time, the government invested in infrastructure needed to promote these selected economic sectors, which primarily included better transportation (several railways and highway projects) systems. The Seoul-Pusan highway was a milestone Korean infrastructure development project that was essential to improve business activities between the two cities at the time. This highway project is considered as the "cornerstone of Korea's industrial corridor".[48] It also spurred the rise of the construction industry in South Korea that has since then become a key contributor to construction and infrastructure development projects worldwide. By the early 1970s, South Korea had reached full employment, but needed to catch up on developing its infrastructure. The third Five Year Plan (1972-1976) required the country to develop its airports, seaports and telecommunications. In 1972, South Korea introduced a Ten Year Plan in which regional planning was given significance, and to promote these efforts, industrial estates with deep-water harbours were built and many port projects were initiated. In the 1980s, South Korea looked to policies that involved more private sector development and thus spending on transport, electricity and telecommunications were high as they were priority areas for improvement at the time.

In Japan, road construction became a priority by the early 1960s as a result of rising vehicle numbers and increasing business. In order to address this demand for better transportation, the Japan Highway Public Corporation (JH) was set up and a law titled the 'Japan Highway Public Corporation Law' was enforced. The JH along with other institutional bodies such as the Metropolitan Expressway Public Corporation, Hanshin Expressway Public Corporation, and Honshu-Shikoku Bridge Authority took the role of coordinating and implementing road development projects. Today, the length of roads is more than 1,171,645 km and the highway system in Japan contributes to 6 per cent of total transport and 24 per cent of total domestic cargo transport.[49]

In the case of East Asia, infrastructure development was often closely linked to their economic policies.

In the case of East Asia, infrastructure development was often closely linked to their economic policies. As these policies had distinct priorities, infrastructure development projects could also be prioritized to suit the needs of the time. As exemplified above, infrastructure projects by these countries were often implemented to address the infrastructure requirements that arose in the process of development. As the economies were flexible and willing to manage with the infrastructure they had, this did not severely hinder their growth. Industrial policy was also useful in financing infrastructure development and targeting resources to the right industry at the right time. Prioritizing investment in infrastructure helped them concentrate their resources to address the more pressing issues, build infrastructure along the way, and still achieve industrialization.

48 Reinfeld, W. (1997), "Tying Infrastructure to Economic Development: The Republic of Korea and Taiwan (China)" in A. Mody (ed.), *Infrastructure Strategies in East Asia: The Untold Story*, World Bank, Washington D.C.

49 *Ibid.*

Box 4.2
Financing of Infrastructure Projects and Attracting PPPs in East and Southeast Asia

Most infrastructure projects in the developmental state were funded by various levels of government. Internal sources of funding were pursued by these governments and these could be accommodated to a large extent, due to high rates of domestic savings in the East Asian economies. However, private sector financing of infrastructure development projects, though relatively small compared to the level of government investment, was also used as a funding strategy by some of these countries.

The Shajiao Power Plant for example, was the first build-operate-transfer (BOT) power plant in China. As there was a resource constraint that restricted China from financing this project, a private company in Hong Kong agreed to finance this project under the agreement that they would be given operational capabilities and ownership of the plant during the concessionary period in which the private company will recover its cost. Malaysia has also used a BOT method for many of its infrastructure development projects, particularly related to highway construction. The North-South highway is a case in point in which the Malaysian government took the initiative to privatize the latter stage of the project as the Malaysian Highway Authority was unable to complete the project as planned. Due to the failure of the Malaysian Highway Authority to complete the project, the Malaysian government decided to privatize construction and operation during the concessionary period.

Hong Kong also has a successful history of drawing in private sector for infrastructure development. For example, electricity is provided by two companies that are fully owned by private investors. However, the government thoroughly screens financial aspects of these companies. Drawing the private sector in to develop infrastructure has been a fairly recent strategy adopted by some East and Southeast Asian countries. However, even in these private sector financing efforts, the government plays a significant role by providing direction to these investments.

Source: Merna, T., and C. Nijru (2002), *Financing Infrastructure Projects*, Thomas Telford Publishing, London; Cao, A., K. Solh and H. Anderson (1993), *Infrastructure Project Financing in Asia Lessons Learned*,: Price Waterhouse, US.; Kai-Sun, K. (1997), "Private Participation with Strong Government Control: Hong Kong", in A. Mody (ed.), *Infrastructure Strategies in East Asia: The Untold Story*, World Bank, Washington, D.C.

4.4.4 Human Capital Development

At the onset of their development process, the East Asian countries focused on improving higher levels of education and ensuring that the education system was addressing labour market demands. Much like the infrastructure development strategies, developing human capital was also closely linked to the growth policies pursued at the time. As a result, education planning has played a crucial role in improving the human capital stock in East Asia. Education planning is often intertwined in economic planning. The education policies in many of the East Asian countries were integrated into the growth strategy of the country at the time and, therefore, the education system was geared to meet the labour market demands and minimize the potential occurrence of a skills mismatch.

Ensuring quality and relevance of education to meet the needs of a growth strategy

Singapore for instance, had a large unskilled supply of labour at the time of independence. While the initial stage of development looked to attract labour intensive industries, in order to facilitate adjustment to the next stage of development, the government recognized that low skilled labour would not suffice and made a conscious effort to mobilize higher levels of skill in the prioritized sectors.[50] Thus, the education policies that followed went hand in hand with the growth and development policies, and skill development for future target sectors took prominence. For example, in the 1970s, Singapore had to grapple with a rising labour shortage and as such, resorted to attracting skilled foreign labour to meet the short-term demand. In their long-term plan, the government remodeled the education system to meet the demand for high skilled labour. Skills needed to promote the technology sector were given prominence as the Singaporean government was keen draw in more investment into this sector.

Education policies went hand in hand with the growth and development policies, and skill development for future target sectors took prominence.

Careful planning of investment in human capital to meet the needs arising from structural change is a key feature in Singapore. Every six months, a ministerial committee (ranging across various ministries) evaluates supply and demand of skills in the country, and institutions such as the Workforce Development Agency (WDA) and Economic Development Board (EDB) are responsible for carrying out necessary action to ensure that the supply meets the demand.[51] This focused attempt at filling in the coordination gaps and ensuring the industry demands are met, has proven to be extremely successful in the case of Singapore. This exemplifies the state's level of commitment to keeping up with the demands of the economy.

Taiwan was fortunate to have a modern education system left behind after gaining independence from Japanese rule. Since 1966, a Manpower Development Plan (MDP) has provided the necessary guidance and coordination needed to build human capital. The first plan used projections of sector specific growth to project the skill requirements needed in these sectors. The planning process brought together various stakeholders from the government to discuss the problems at hand. The institutions responsible for carrying out the plans were given strict deadlines to implement them. For example, as a measure to address the increasing economic need for semi-skilled labour, in 1963, the MDP attempted to shift the number of students enrolled in high-school from 60 per cent to 40 per cent and the number of students in vocational schools from 40 per cent to 60 per cent. Due to the successful implementation of this plan, by the 1970s, the student enrolment in high school was 48 per cent and enrolment in vocational schools was 52 per cent. By 1980, the figures had changed to 34 per cent and 66 per cent, respectively, as the MDP had changed the target to 30:70 over time.[52]

Vocational training was a major success in Taiwan. This is largely owed to the role of government in improving this area of human capital development. The government was wise in taking on the role of facilitating vocational schools and filling in the

50 Tilak, J. (2002), "Building Human Capital in East Asia: What Others Can Learn", World Bank, Washington D.C.

51 Powell, M., and J. Lindsay (2010), "Skill Development Strategies for Rapid Growth and Development: The East Asian Economic Miracle", Centre for Employment Initiatives, Wales.

52 Woo, J. (1991), "Education and Economic Growth in Taiwan: A Case of Successful Planning", *World Development*, Vol. 19, No.8. pp. 1029-1044.

coordination gaps, while allowing industries to decide on the type of training received. In addition to this, the industry worked closely with the government on planning matters related to vocational schools. The success of these vocational school trainings is evident by the very low rate of unemployment of graduates (only 4 per cent) from vocational schools.[53]

It is also important to note that while these East Asian countries did invest in education early, their investment in levels of education other than primary education were lower than some Latin American and South Asian countries even during the rise of their growth momentum.[54] Despite East Asia increasing its investment in education over the next few decades, what distinguishes their expansion of human capital as a key resource for growth, was the quality and relevance of education in tapping into and exploiting their latent comparative advantage.

For example, in 1960, Hong Kong and Taiwan invested 2.1 and 2.4 per cent of GNP respectively, in education. South Korea had significantly higher public investment in education in the 1960s but the share came down drastically after that. Singapore started with high investment but was unable to sustain it for long and therefore saw a reduction in public investment in education. In comparison, some advanced Western countries were spending over 5 per cent of GNP on education.[55] Taiwan however, is mandated by law to allocate at least 15 per cent of the national budget on education, making its share of public investment in education significantly higher than many other East Asian countries.

The role of the private sector in financing education is significant in nearly all these economies, but the level of private sector involvement varies according to the level of education. While primary education is provided almost entirely by the state in nearly all developed East and Southeast Asian economies, the role of the private sector in secondary education is also extremely limited. However, the private sector plays a significant role in meeting the demand for higher education in many of these countries.

Even the countries with significant private sector presence in education are often a form of a public private partnership (PPP) rather than solely private institutions. The government plays a crucial role in ensuring that there is effective coordination between private education institutions and economic policy/ structural changes pursued by the government.

4.5 Lessons for Sri Lanka

Analyses of economic policy in the recent years points to some key features of the Sri Lankan state's role in the economy. The end of the armed conflict in 2009 generated a surge of optimism about the economic prospects for Sri Lanka, and the government was well entrenched with a commanding majority in the legislature and popular support. The development strategies presented by the government such as the 'Mahinda Chinthana: A Vision for the Future' emphasized the role of the state. Privatization of key SOEs was ruled out in areas such as banking, power, energy and transport. Rather, the government has been focusing on carrying out management reforms within SOEs and on forming PPPs, particularly in the case of infrastructure projects. There is also an expansion of SOEs in the economy via majority state holding of previously privatized ventures, revitalizing of closed-down SOEs and initiating new-state controlled ventures. The 'Revival of Underperforming Enterprises and Underutilized Assets Act' passed in November 2011 also enabled the government to acquire and manage 37

[53] *Ibid.*

[54] Page, J. (1994), "The East Asian Miracle: Four Lessons for Development Policy", in S. Fischer and J. Rotemberg (eds.), NBER Macroeconomics Annual 1994, Vol. 9, MIT Press.

[55] *Ibid.*

Table 4.4
Public Expenditure as a Percentage of GDP

Item	2005-2007	2008-2010	2011-2013
Total Expenditure	24.2	23.7	20.8
Recurrent	18.0	17.3	14.8
Capital	6.2	6.4	6.0

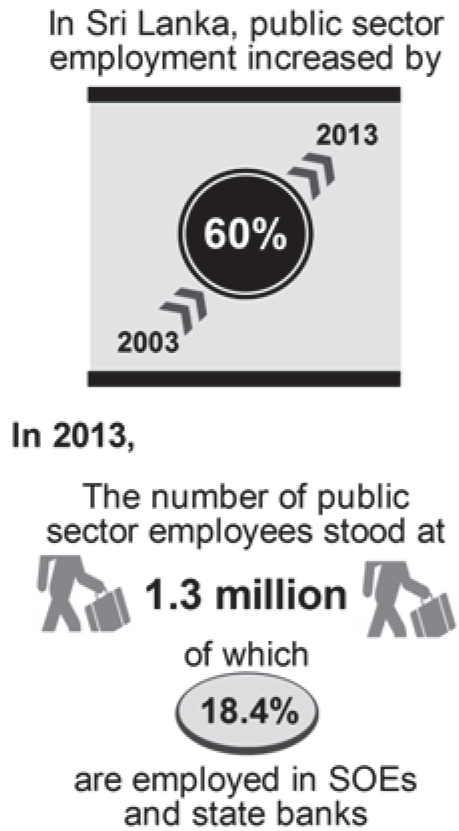
Source: Ministry of Finance and Planning, "Annual Report 2013".

'underperforming' or 'underutilized' private enterprises. Underpinning a greater state role in driving economic development, particularly in infrastructure, government expenditure on public investment has risen sharply in recent years as evident from Table 4.4.

Public sector employment too has increased over time in the past decade - by 60 per cent in 2013 compared to 2003.[56] The total number of public sector employees stood at 1.3 million in 2013,[57] of which 18.4 per cent are employed in SOEs and state banks while the majority of the others are in public service. Public sector employment as a percentage of total employed increased from 13.5 per cent in 2006 to 15.3 per cent by the last quarter of 2013. As previously highlighted (Table 4.3), this is in comparison to 6.3 per cent in Singapore, 13.2 per cent in Malaysia and 8.9 per cent in Thailand for 2008. The government has attributed the need to increase public sector employment to the acceleration of the development process.

As depicted in Table 4.1, in terms of governance, Sri Lanka performs better than other South Asian nations in the indicators 'political stability and absence of violence/terror', 'regulatory quality' and 'control of corruption'. It follows India closely in 'rule of law' and 'government effectiveness'. However, Sri Lanka has been unable to score a positive governance score in any of the indicators unlike the case of other East Asian countries.

Governments of successful East Asian economies played a leading role in their development and growth process which went beyond the standard neo-classical interpretation of getting the 'fundamentals right'. These countries proactively pursued industrial policy in bringing about structural adjustment and upgrading their respective economies. In Sri Lanka, despite the initial momentum created by the outward-oriented policy stance, industrial upgrading has failed to take-off and move beyond the apparel industry. The majority of the country's workforce is still absorbed in low productive sectors such as agriculture and low/semi-skilled labour absorbing industrial sectors.



[56] Ministry of Finance and Planning (2013), *Annual Report 2013*, Ministry of Finance and Planning, Colombo.
[57] DCS (2013), "Quarterly Report of the Sri Lanka Labour Force Survey 2013: Fourth Quarter", Department of Census and Statistics, Colombo.

Over the last decade or so, the government having recognised the need to move ahead and industrialize beyond the standard labour-intensive manufacturing sectors, has taken a proactive stance. The government can also effectively drive development by pursuing policies aimed at efficient allocation of resources, by encouraging competition among firms and by encouraging sectors which are weak and uncompetitive to make structural adjustments.

In terms of infrastructure, the recent progress in the development of infrastructure in Sri Lanka is commendable given its importance to support growth and development. Nevertheless, effective prioritization of infrastructure investment is essential given that the investment needs are often large and that it takes a long time to realize the economic returns of such projects. If not, financing of large investments can have significant economic repercussions. As the discussion on the East Asian development in this Chapter saliently highlights, rather than promoting enterprises that are consistent with taking advantage of infrastructure, these economies formulated policies at promoting businesses that are consistent with their latent comparative advantage, and directed policies at upgrading factor endowments and build infrastructure to complement these industries to structurally adjust and upgrade.

Taking advantage of the country's strategic geographic location, the government in Sri Lanka has invested heavily in mega infrastructure projects to spur economic growth. The 'five hub + tourism' concept has been formulated with the aim of developing industries which are consistent with taking advantage of the country's geographic location in terms of its proximity to major international shipping lanes and the Indian subcontinent. In hindsight, administering interventions let alone resourcing such interventions to assist them structurally adjust across six vastly different hubs seems a daunting challenge, given that each sector necessitates vastly different factor endowments and infrastructure requirements. Focusing on one or two closely related sectors as embraced by the majority of the East Asian economies would be a more prudent approach. A more streamlined approach would not only help minimize the investment outlay in bringing factor endowments up to the required level, but also ease the coordination interventions by freeing up more government resources to be concentrated in a particular thrust sector. Competitive bidding and transparency of the awarding of projects and evaluations can further improve the outputs of infrastructure projects.

In education, despite impressive performance of Sri Lanka in access to education, challenges remain in terms of improving the quality of education, access to higher education levels and the relevance of education.[58] In the developmental state, education policies and skill development were geared to complement future target sectors. For example, Singapore remodelled the education system to meet the demand for high skilled labour. Likewise, it is necessary for Sri Lanka to gear its education policy to complement its long-term growth strategy and aspirations of its workforce.

It is, however, important to note that although the developmental states in East Asia have taken on a broader role than the standard neo-classical interpretation of government, markets were at the core of the developmental model. Rather than replacing the market, the developmental state nurtured and guided the private sector to become globally competitive. While encouraging FDI at the outset in order to penetrate international markets, to infuse much needed capital and transfer of

[58] Arunatilake, N. (2013), "A Comment on 'New Educational Policies and Proposals' for General Education in Sri Lanka", available at www.ips.lk/talkingeconomics.

In the case of Sri Lanka's current development approach, it is important that the government enhances private sector participation instead of depending on a largely state-driven strategy.

technology, the state also supported local entrepreneurs to forge backward linkages with the multinationals.

In the case of Sri Lanka's current development approach, it is important that the government enhances private sector participation instead of depending on a largely state-driven strategy. FDI in particular needs to be encouraged to kick-start the industrialization process. This would make the development process a more sustainable one than a debt financed investment and consumption-led growth strategy. In a bid to attract FDI and other private sector investments, governance and macro-economic stability become crucial elements. Unlike resource-seeking investments which would flow to even more volatile regions in the world such as Sub-Saharan Africa, the type of FDI Sri Lanka needs to aim for (export-oriented) may be more sensitive to the above.

5. Demographic Challenges of an Ageing Asia

5.1 Introduction

Asia is the fastest growing region in the world. The emergence of Asia as an economic force over the past 40 years has been one of the most successful economic development stories in recent history. With Asian growth projected to account for more than 50 per cent of global GDP by 2050, and per capita income expected to rise six-fold by then, it is envisaged that the region will come to dominate the 21st Century.[1] However, Asia faces numerous risks and challenges that could impede this growth momentum if not adequately addressed. One such challenge is the rapid demographic changes the region will experience over the next few decades.

Asia is on track to become the oldest region in the world, with the elderly population projected to reach 922.7 million in 2050.[2] A rapidly ageing population could be a drag on economic growth. The rise in the elderly population will increase the fiscal burden on healthcare and social welfare. In addition, a shrinking working age population would create labour supply shortages, and have an adverse impact on total factor productivity which would adversely impact GDP growth.

Demographic change is a particularly relevant issue in Asia for two reasons. Firstly, Asia is ageing at an unprecedented pace. The transition in the population age structure in Asia will happen significantly faster than it did in the West, giving less time to prepare for the new demographic landscape. Secondly, the demographic dividend - where the proportion of working age population is significantly larger than the dependent population (those below 15 years, and 60 years and above) - was an important ingredient that contributed to the growth of many East and Southeast Asian economies. These favourable demographics are now turning less favourable, and the countries that experienced the demographic dividend must now prepare to face the 'demographic tax', and take measures to effectively accommodate this demographic change while ensuring productivity gains for growth.

Sri Lanka, for example, is currently at the tail end of its demographic dividend, which is expected to end

Asia is on track to become the oldest region in the world, with the elderly population projected to reach 922.7 million in 2050.

[1] ADB (2011), *Asia 2050 - Realizing the Asian Century*, Asian Development Bank, Manila..

[2] *Ibid*.

in 2017, where the proportion of elderly will increase to around 15 per cent.[3] The elderly population of Sri Lanka is expected to reach over 20 per cent of the total population by 2031 and will further increase to a point where one in every four persons in Sri Lanka will be elderly by 2041.[4]

In this context, this Chapter seeks to examine the demographic challenge Asia faces in the coming decades. Section 5.2 examines the current status of demographics in Asia and its implications. With Sri Lanka about to end its demographic dividend and enter a phase of population ageing, the demographic patterns and trends for the country are discussed in Section 5.3. Finally, Section 5.4 discusses some emerging issues and challenges in the areas of social protection, health and labour markets, and suggests policy options to face the demographic transition in Sri Lanka.

5.2 Asia's Demographic Transition: Boon or Bane?

As a consequence of falling fertility rates and improvements in life expectancy, Asia as a whole is experiencing a demographic transition towards older population structures. Within the region there is demographic heterogeneity, with various countries at different stages of the transition. As a result, the share of the elderly in the population is rising throughout the region, but not uniformly. Population ageing is most advanced in East Asia. Countries like Japan and South Korea are at advanced stages of their transition, while India, Indonesia and the Philippines are on the verge of realizing their demographic dividend.

Figure 5.1 illustrate the decline in fertility rates and the rise in life expectancy of Asian countries in recent decades. Countries in the advanced stages of their demographic transition, like Japan, Singapore and South Korea, have reached high levels of life expectancy rates due to advances in health and sanitation, as well as changes in social conditions such as urbanization. However, the increase in population shares of the elderly has been largely driven by the declining fertility rates in Asia, and intra-regional disparities in the age distributions resulting due to the differential decline in the fertility rates (Figure 5.1).

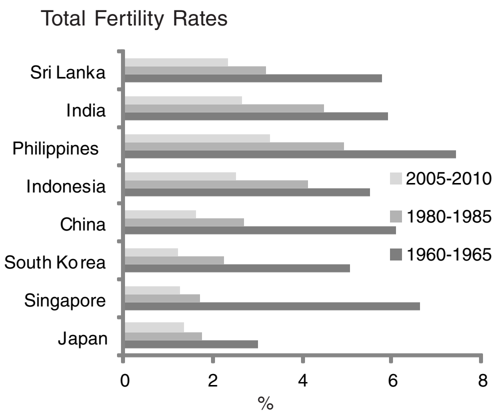
Changes in fertility rates and life expectancy have led to changes in the population structure of Asia, and this will continue to change in the coming decades. In Japan, the proportion of the population aged 65 and above, which stood at 7 per cent in 1970, is projected to reach 41.1 per cent in 2050. South Korea will also experience a rapid increase in the proportion of the 65 and over age group, where the proportion which stood at 3.3 per cent in 1970 is expected to rise to 39.3 per cent in 2050. China will go through a similar rise in the 65 and above proportion, though not as rapidly as Japan and South Korea (Figure 5.2).

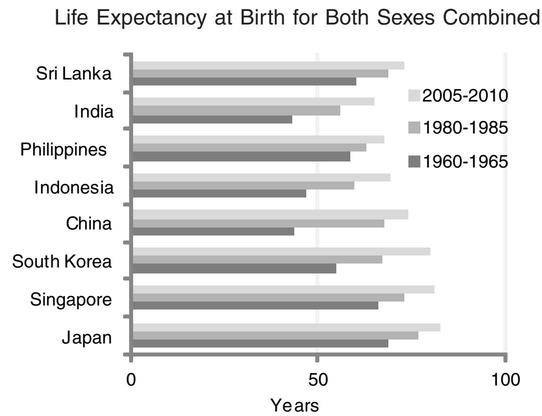
As can be seen in Figure 5.2, the decline in the below 15 age group started in Japan in the 1970s, where the proportion stood at 24.1 per cent. South Korea and China experienced a similar decline in the 1990s, where the proportions stood at 25.6 per cent and 29.3 per cent, respectively. The populations of India and Indonesia are also experiencing declines in the 15 and below age group, but due to the fertility rate peaking at a later stage, the proportions will be higher than in East Asian countries. In the 1990s, the below 15 age group was 36.4 per cent of the population in Indonesia and 37.5 per cent in India. As a result, these countries are entering a period of increasing demographic dividends as fertility rates continue to drop, reducing the youth dependency burden and increasing the size of the labour force.

3 De Silva, W. I. (2012) "The Age Structure Transition and the Demographic Dividend: An Opportunity for Rapid Economic Take-off in Sri Lanka," *Sri Lanka Journal of Advanced Social Studies*, Vol. 2, No. 1.

4 *Ibid*.

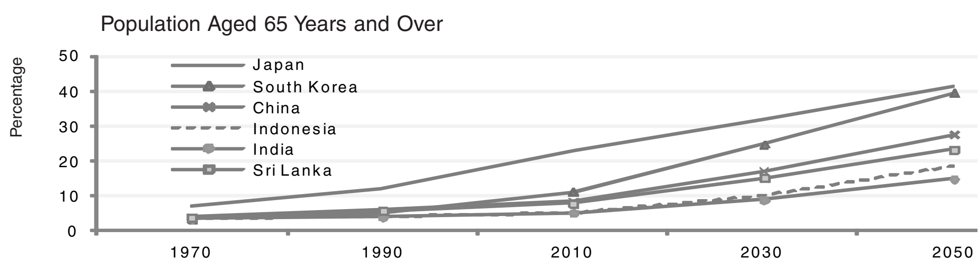
Figure 5.1
Fertility Rates and Life Expectancy at Birth for Selected Countries

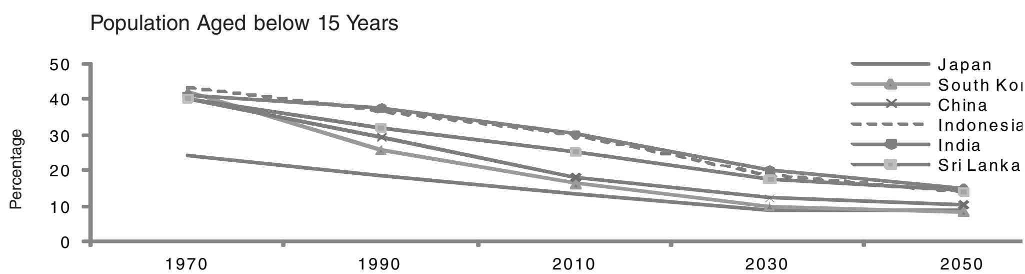




Notes: Fertility rate refers to children per woman.
Source: United Nations, Department of Economic and Social Affairs, Population Division (2013). World Population Prospects: The 2012 Revision.

Figure 5.2
Population Aged 65 Years and Over and below 15 Years in Selected Countries, 1960-2050

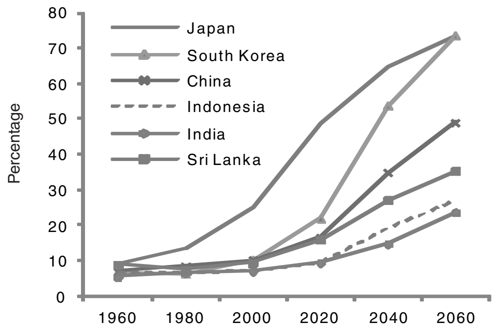




Notes: Projections are based on UN low fertility estimates.
Source: United Nations, Department of Economic and Social Affairs, Population Division (2013). World Population Prospects: The 2012 Revision.

With the percentage of older persons in the population rising, the old-age dependency ratios - i.e. the ratio of persons above the age of 65 years to the number of people in the 15-64 year working age group - are projected to increase in many Asian countries (Figure 5.3).

Figure 5.3
Old-age Dependency Ratios for Selected Countries



Source: United Nations, Department of Economic and Social Affairs, Population Division (2013). World Population Prospects: The 2012 Revision.

The old-age dependency ratios will reach higher levels in East Asian countries like Japan and South Korea due to them being in a more advanced stage of the demographic transition. China will also experience a sharp rise in the old-age dependency ratio, partly due to the one-child policy introduced in the 1970s, causing fertility to peak early. The old-age dependency ratios will grow at a slower rate in countries like India and Indonesia with younger populations.

Based on current population projections, the demographics will be diverse in Asia. Ageing will be most advanced in East Asia while, with the exception of countries like Singapore and Sri Lanka, South and Southeast Asia will have a younger age profile. The economic implications of Asia's demographic transition will be explored in the next section.

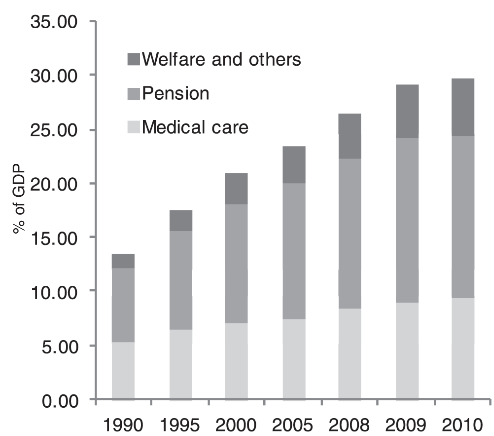
5.2.1 Implications of the Demographic Transition

As Asia advances through the demographic transition, an ageing population will have an impact on the economy. The impact would be transmitted mainly through public finance pressures (particularly related to social protection, health, etc.) and the implications ageing would have on the labour force.[5]

As the old-age dependency ratios rise in Asian countries, substantial increases in age-related public expenditures like pensions and healthcare are expected.[6] In Japan, total public expenditure has soared. The fastest rising expenditure item is social security (pensions, medical insurance, welfare programmes), with pension payments taking up the largest share in social security expenditure (Figure 5.4). In 2010, 68.1 per cent of total social security expenditure went towards those over 65 years of age.[7]

While Asia relies less on the public sector for old-age support compared to Europe and Latin America, public transfer programmes in East Asian countries like Japan, China and South Korea amount to a substantial proportion of old-age support (Figure

Figure 5.4
Social Security Expenditure in Japan, 1990- 2010



Source: NIPS (2014), "Public Expenditure Database", National Institute of Population and Social Security Research, Japan.

[5] McMorrow, K., and W. Roeger (2011), "The Economic Consequences of Ageing Populations", Directorate-General for Economic and Financial Affairs - European Commission, Brussels.

[6] *Ibid*.

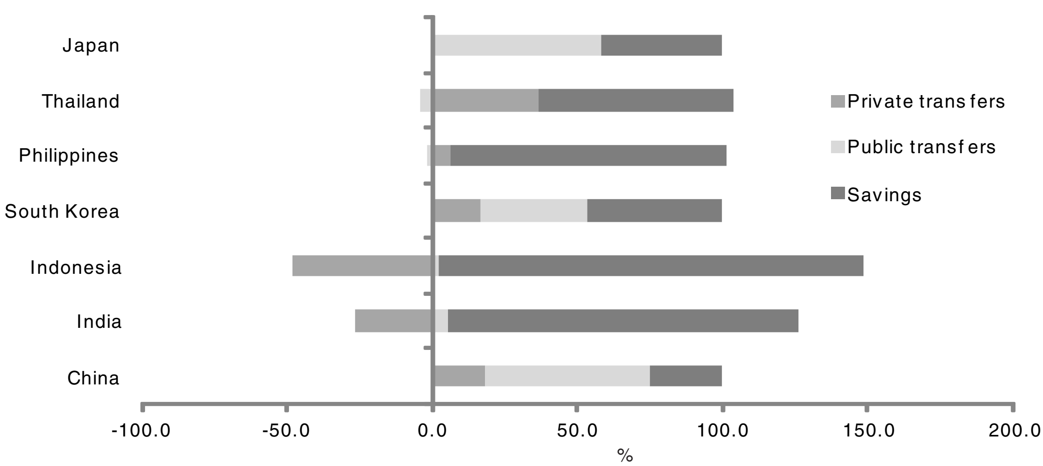
[7] NIPS (2014), "Public Expenditure Database", National Institute of Population and Social Security Research, Japan.

5.5).[8] Therefore, the continuing rise of old-age dependency would be a major fiscal burden. To ensure the sustainability of the public-pension system, Japan enacted reforms in 2004. The reforms introduced an automatic adjustment of benefit levels to changes in demographic structures. This macro indexing will cut benefit levels in accordance with population ageing, and contribution rates will be increased moderately until 2017, where it will be set at a constant rate of 18.3 per cent of income.[9]

An ageing population of a country would also have several implications on its labour force too. In 1995, Japan's working age population (15-64 years) peaked at 87 million, representing the height of its demographic divided. Since then, Japan's working-age population has been falling in both relative and absolute terms (proportion and number of the working-age population falling) as evident from Figure 5.6, where it is projected to drop to 73 million by 2020. In 2050, Japan's labour force will shrink to 50 million (50 per cent of the population).[10] In the next couple of decades, South Korea would also go through a reduction in the proportion of the working-age population, where in 2050 it is projected to drop to 52.3 per cent. By contrast, India's labour force population will continue to grow up to 2030, creating a favourable demographic environment.

A shrinking labour force may lead to lower output if productivity does not rise. The decline in the demographic dividend will start to weigh on the economy, and a country like Japan that is at an advanced stage of the demographic transition would have to achieve large productivity gains to remain competitive. In addition, a shrinking labour force will increase the burden upon each worker to support the growing elderly population in the form of

Figure 5.5
Support System for Elderly in Selected Countries



Notes: For those 65 years and above.
Source: ADB (2011), "Asian Development Outlook 2011 Update: Preparing for Demographic Transition", Asian Development Bank, Manila.

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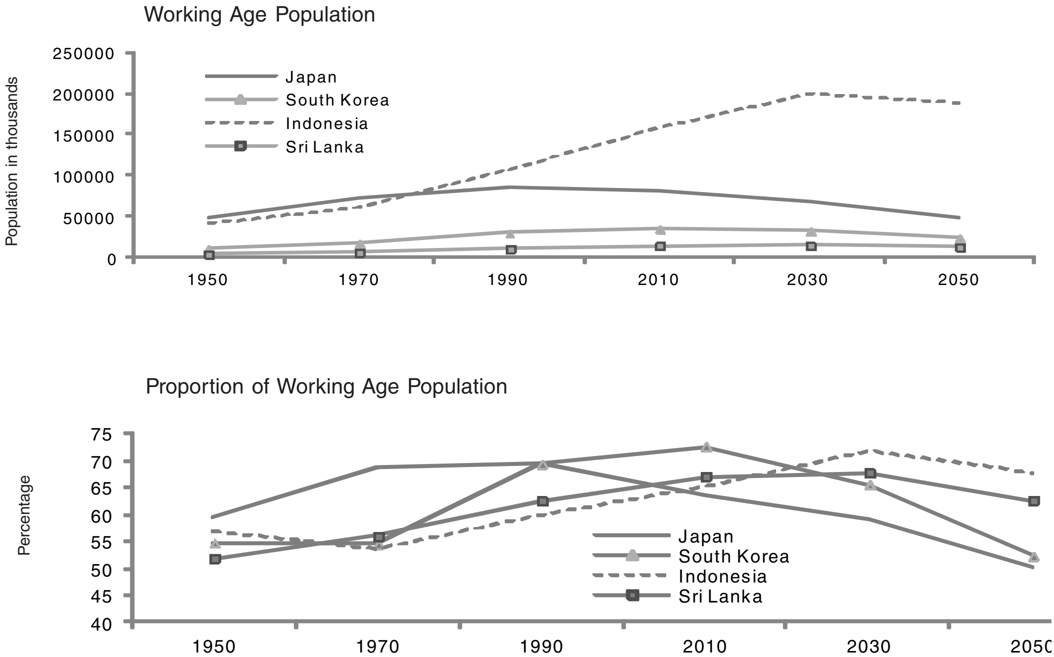
[8] ADB (2011), "Asian Development Outlook 2011 Update: Preparing for Demographic Transition", Asian Development Bank, Manila.
[9] IMF (2012), "Japan: Selected Issues", International Monetary Fund, Washington.
[10] NIPS (2014), "Japan Population Database", National Institute of Population and Social Security Research, Tokyo.

Figure 5.6
Working Age Population for Selected Countries, 1950-2050



Notes: Population in the 15-64 year age group. Projections based on UN low fertility estimates.
Source: United Nations, Department of Economic and Social Affairs, Population Division (2013). World Population Prospects: The 2012 Revision.

increased taxes and social security contributions.[11] An ageing workforce would also reduce innovation, risk taking and mobility, which may influence the dynamism of the economy.[12] Further, it would create limitations in vertical mobility, putting younger workers at a disadvantage. Geographic mobility would also be hampered by an ageing workforce, which would limit the adaptability of the labour force to structural changes in the market.[13]

5.3 Sri Lanka: From Demographic Dividend to Demographic Tax?

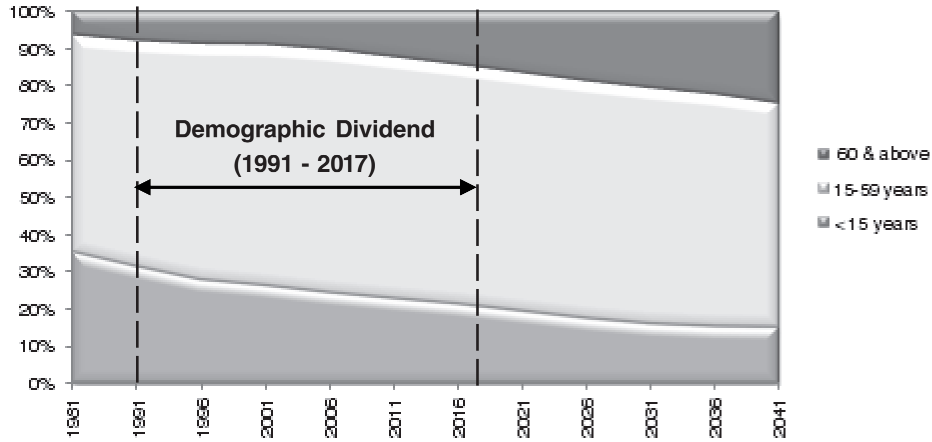
Similar to many East Asian countries, Sri Lanka is currently undergoing a rapid demographic transition. The child population that was over 35 per cent of the total population in 1981 declined sharply to 22.8 per cent in 2011 and is projected to decrease further to around 15 per cent by 2031 (Figure 5.7). The

[11] Lee, S., A. Mason, and D. Park (2011), "Why Does Population Aging Matter So Much for Asia? Population Aging, Economic Security and Economic Growth in Asia", ERIA Discussion Paper Series, Economic Research Institute for ASEAN and East Asia, Jakarta.

[12] Jackson, R. (2003), *Germany and the Challenge of Global Ageing*, Center for Strategic International Studies, Washington.

[13] Hagemann, R., and G. Nicoletti (1989), *Population Ageing: Economic Effects and some Policy Implications for Financing Public Pensions,* OECD, Paris.

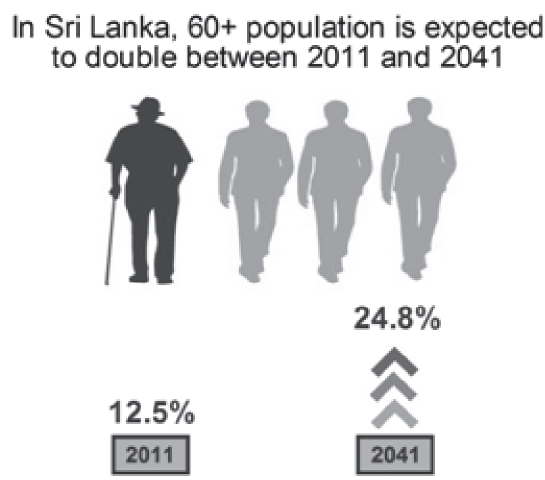
Figure 5.7
Age Structure Transition and Demographic Dividend in Sri Lanka



Source: De Silva,W.I (2012), "The Age Structure Transition and the Demographic Dividend: An Opportunity for Rapid Economic Take-off in Sri Lanka," *Sri Lanka Journal of Advanced Social Studies*, Vol. 2, No. 1.

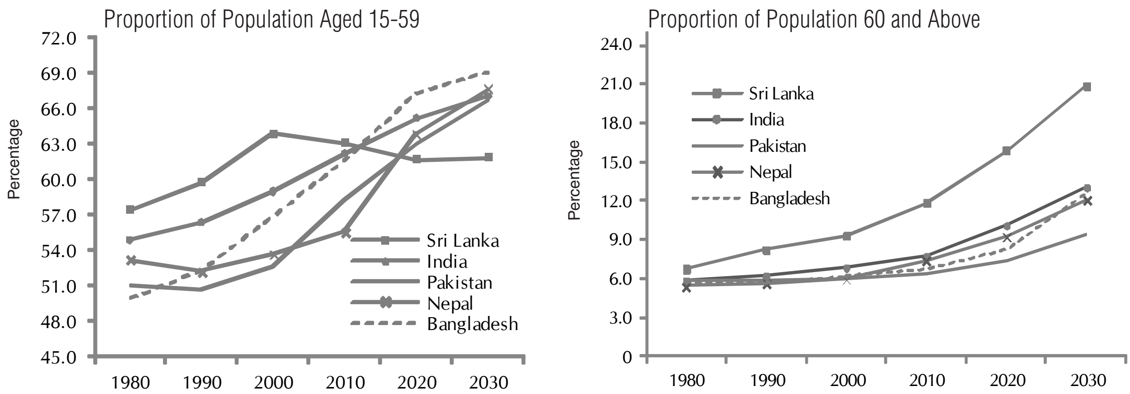
share of the elderly population (60 years and above) has almost doubled since 1981 reaching 12.5 per cent in 2011. The proportion of the working age population reached its peak in 2006 (65.1 per cent) and will continue to fall over the coming decades. Consequently, the total dependency ratio, defined as the ratio of the dependent population (those below 15 years, and 60 years and above) to the working age population (15-59 years), was at its lowest in 2006 at 53.6 per cent.

The above age-structure transition in Sri Lanka led to a demographic dividend (or demographic bonus) - where the proportion of the working age population is significantly larger than the dependent population - much earlier than the rest of South Asia. This demographic dividend that started around 1991 is projected to end within the next few years (by 2017).[14] With the end of the demographic dividend, the country will experience a rapid ageing of the population along with a shrinking working age population. The 60 years and above population is expected to double between 2011 and 2041, reaching nearly 5.4 million. The share of this age category will rise to 24.8 per cent by 2041 (from 12.5 per cent in 2011) indicating that one-in-every four people in the country will be an elderly person.



[14] In Sri Lanka, elders are defined as those of 60 years and above. This is particularly relevant because the retirement age for the state sector as well as for most in the private sector is 60 years. The UN defines the elderly as those 65 years and above. As per the UN definition of elderly population, the demographic dividend in Sri Lanka that started in 1991 will end by 2030 (De Silva, 2012).

Figure 5.8
Proportion of Population Aged 15-59 Years and 60 Years and Above

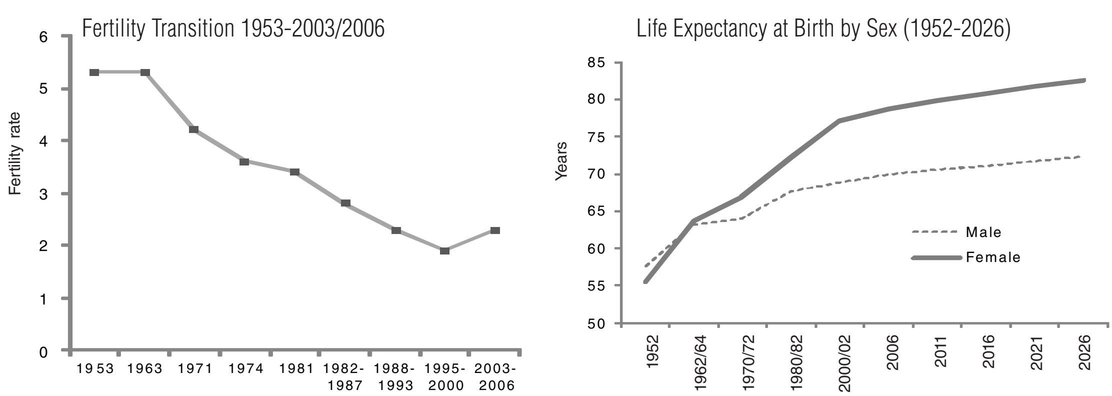


Source: United Nations, Department of Economic and Social Affairs, Population Division (2013). World Population Prospects: The 2012 Revision.

As already mentioned, Sri Lanka experienced the demographic dividend much earlier than other South Asian countries. South Asian countries like India, Pakistan and Bangladesh are currently entering the demographic dividend while Sri Lanka is at the tail end of its demographic dividend. As shown in Figure 5.8, by 2020, Sri Lanka will have the lowest proportion of the population aged 15-59 in the region. Moreover, Sri Lanka has had the highest proportion of the elderly population in South Asia since 1980 - remarkably higher than the rest of the countries in the region.

Sri Lanka experienced the demographic dividend much earlier than the other South Asian countries.

Figure 5.9
Key Determinants of the Demographic Transition: Fertility and Life Expectancy



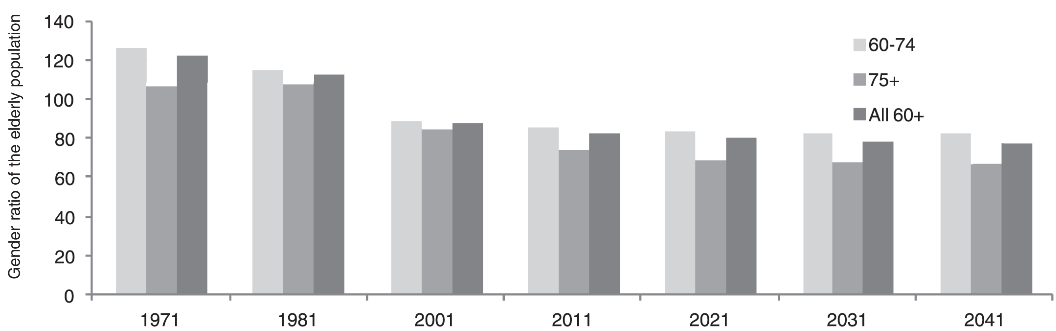
Source: Gunasekera, H.R., (2008), "Life Tables for Sri Lanka and Districts," Department of Census and Statistics, Colombo; De Silva, W.I (2012), "The age Structure Transition and Demographic Dividend: An Opportunity for Rapid Economic Take-off in Sri Lanka", *Sri Lanka Journal of Advanced Social Studies*, Vol. 2, No. 1.

Sri Lanka has had the highest proportion of the elderly population in South Asia since 1980 – remarkably higher than rest of the countries in the region.

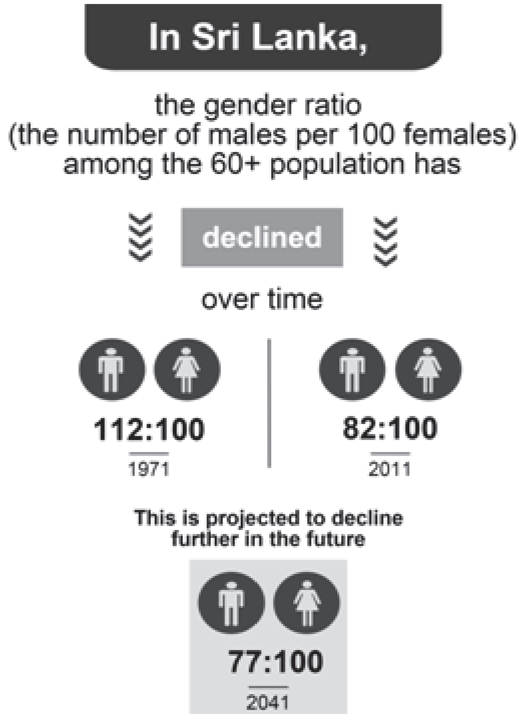
The demographic transition in Sri Lanka is primarily the outcome of a decline in fertility rates, rising life expectancy at birth, and increasing out-migration (particularly among the younger people) during the past several decades. As shown in Figure 5.9, fertility rates started to decline in the 1960s and have come down to around 2 per cent in 2000. Life expectancy at birth - for both males and females - has been on the rise since the 1950s, and is projected to rise further in the coming decades (Figure 5.19). However, life expectancy for females has been higher than that of males and the gap is projected to widen further in the next two decades.

The above patterns have also contributed to some structural changes among the elderly population. As shown in Figure 5.10, the gender ratio (the number of males per 100 females) among the elderly population (60 years and above) has declined over time, from 112 males for every 100 females in 1971 to 82 males for 100 females in 2011, indicating a rapid increase in the proportion of females in the elderly population in Sri Lanka. This gender ratio is projected to decline further to around 77 by 2041. The higher proportion of females compared to males is more significant among the elderly aged 75 years and above. The gender ratio for this age category declined sharply from around 106 in 1971 to around 74 in 2011, and is projected to decline further in the next three decades. This is primarily due to the higher life expectancy of females compared to men. This brings several challenges as many females are less likely to have adequate social protection, particularly old-age retirement benefits, due to the continuing low female labour force participation rate in the country. In addition, old-age retirement benefit schemes at present are largely confined to the formal sector, while only a smaller share of the informal sector workers have access to (contributory) pension schemes. The economic and social implications of the above demographic patterns will be discussed in detail in the next section.

Figure 5.10
Gender Ratio of the Elderly Population in Sri Lanka, 1971-2041



Note: Gender ratio = number of males per 100 females.
Source: De Silva, W. I. (2012), "The Age Structure Transition and Demographic Dividend: An Opportunity for Rapid Economic Take-off in Sri Lanka", *Sri Lanka Journal of Advanced Social Studies*, Vol. 2, No. 1.



5.4 Issues, Challenges and Policy Options

As Sri Lanka experiences a demographic transition, it will face the challenge of handling the social protection and health needs of a rising elderly population, and the potential constraint a shrinking workforce may impose on growth. This section examines key issues and challenges related to social protection, health, and the labour market and suggest policy options to better face the demographic changes in the coming decades.

5.4.1 Social Protection

The current social protection system in Sri Lanka is far from adequate to cater to the needs of the rising elderly population in the coming decades. The available programmes for the elderly are largely old-age retirement benefit schemes with a primary focus on the formal sector workers. These include the Public Servants' Pension Scheme (PSPS) - a non-contributory pension scheme covering all permanent public sector employees - the Widows, Widowers and Orphans Pension Scheme (W&OP) - a mandatory contributory scheme under the PSPS - and the Public Servants' Provident Fund (see Table 5.1). All formal workers in the private sector are mandated to contribute towards the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF). Moreover, a handful of contributory and voluntary pension and social security benefit schemes are available for the informal sector workers. Inactive membership, poor coverage, inadequacy and irregularity of benefits (inadequate level of replacement income), insufficient funding and concerns over the sustainability of these schemes are some of the drawbacks of the pension schemes for informal workers.[15]

In addition to the old-age retirement benefit programmes, an elderly assistance programme targeted towards elders from low-income groups is carried out by the Ministry of Social Services, under which a monthly cash transfer of Rs. 1,000 is given

The current social protection system in Sri Lanka is far from adequate to cater to the needs of the rising elderly population in the coming decades.

[15] Eriyagama, V. ,and R. Rannan-Eliya (2003), "Assessment of Pension and Social Security Benefit Scheme for the Self-Employed Persons in Sri Lanka", Demographic Transition and Pensions Series No.5, Institute of Policy Studies of Sri Lanka, Colombo; Eriyagama,V.,and R. Rannan-Eliya (2003), "Assessment of the Farmers' and Fishermen's Pension and Social Security Benefit Scheme in Sri Lanka", Demographic Transition and Pensions Series No.4, Institute of Policy Studies of Sri Lanka, Colombo.

to eligible elders aged 70 years and above. Poor and disadvantaged elders (aged 60 years and above) are also covered under the Samurdhi cash transfer programme and the Public Assistance Monthly Allowance (PAMA). However, inadequacy of monthly benefits, and benefits not being indexed to inflation, are key weaknesses across all existing social assistance programmes.

With a significant increase in the elderly population in the coming decades, reaching over 4.5 million by 2031, it is crucial to improve the coverage and the quality of the existing old-age benefit programmes while ensuring their long-term sustainability. Currently, only around 40-50 per cent of the elders are covered under some form of social protection/old-age benefit programme like pension schemes, provident funds or monthly cash transfers.[16] Moreover, the bulk of the government spending on old-age retirement benefits and social protection in general goes towards pensions for public sector workers, covering only around 25 per cent of the total elders in the country. The number of pensioners and expenditure on public sector pensions has increased in recent years and, at present expenditure on public sector pensions accounts for about 1.5 per cent of GDP. The non-contributory nature of the pensions would be a

Table 5.1
Social Protection Programmes for Elders

Programme	Description	Beneficiary Numbers 2012	Expenditure (Rs. mn.) 2012
Public Servants Pension Scheme (PSPS)	Non- contributory pension scheme for permanent public sector workers. The entitlement arises after 10 years of service.	379,927	90,500
W&OP	Mandatory contributory pension scheme under PSPS where dependents will be entitled to a pension following the death of the public servant.	130,416	20,117
Public Servants Provident Fund	Contributory fund for public servants not entitled to the pension. Benefits received in the form of a lump sum at retirement.	6,845	1,000
Employees' Provident Fund (EPF)	Mandatory contributory fund for formal private sector workers. Benefits received in the form of a lump sum at retirement.	115,654	48,700
Surekuma Pension Scheme of the Social Security Board (SSB)	Contributory, voluntary pension scheme for informal sector workers. In addition to pension, death and disablement gratuity is also covered.	12,252	9
Farmers' Pension and Social Security Benefit Scheme	Contributory voluntary pension scheme for farmers owning not more than 10 acres of farming land and not paying income tax.	124,192[a]	1,464[a]
Elderly Assistance Programme of the Ministry of Social Services	Monthly cash transfer of Rs. 1,000 is given to identified elders who are 70 years or above from low-income groups.	179,910[b]	179[b]

Notes: a. Data for 2011; b. Data for 2013.
Sources: Department of Pensions, National Secretariat for Elders of the Ministry of Social Services, Social Security Board and other relevant institutes.

[16] Calculations based on the beneficiary numbers.

substantial fiscal burden. Given the rapidly increasing elderly population, rising expenditure on pensions, and the need to expand old-age benefit schemes to cover a larger share of the elders (beyond the public sector/formal sector workers), pension reforms are necessary to ensure the sustainability of the programmes in the long run. Reforming the non-contributory system to a contributory or pay-as-you-go (PAYG) system would help reduce the fiscal burden and ensure financial sustainability of the pension programmes, while allowing the utilization of additional funds to cater to the needs of other elderly groups (e.g., those in the informal sector), and other sectors (e.g., health sector). This should be accompanied by other parametric reforms such as raising the official retirement age and indexing the benefit levels. Other Asian countries experiencing rapid population ageing like Vietnam have also undergone pension reforms in the mid-1990s from non-contributory to a PAYG system.[17]

Given that the overall coverage of social protection programmes for the elderly is low, and the available monthly cash assistance programmes are limited in coverage as is the size of the benefits, measures are required to improve coverage and benefits to address old-age income insecurity in Sri Lanka. The experience of other Asian countries like Thailand has shown that well-designed old-age assistance programmes or 'social pensions' can lead to significant reduction of poverty among the elderly. In Thailand, the old age allowance system (or 'B500 pension scheme') introduced in 1993 as a means-tested old-age income guarantee programme targeted at the elderly from low-income groups was extended to a universal programme in 2009. It covered all elderly aged 60 years and above who are not receiving a permanent income as a salary or a pension, or who are not living in public elderly homes. Currently, this programme covers over 5 million elderly, and the costs remain around 2 per cent of the government's total expenditure.[18]

5.4.2 Health

With the onset of rapid ageing, Sri Lanka will have to make adjustments to its health care system to accommodate the growing health care needs of the elderly. Population ageing has been projected to add 0.4 per cent of GDP to national health expenditure by 2050. Total health spending is expected to reach 6-8 per cent of GDP once the age structure of the population stabilizes, similar to Japan.[19] Many of the elderly in the population lack social security coverage as previously mentioned. Given dwindling traditional family support for old people, the burden of care will increasingly switch to the national health care system. In addition, the current health care system may not be adequately oriented towards meeting the health needs of the elderly.[20]

Expenditure on non-communicable diseases (NCDs) is presently a major component of health care expenditure in Sri Lanka. It is expected to rise further, as the prevalence of NCDs increase with population ageing. Expenditure for cardiovascular disease, chronic respiratory disease and diabetes mellitus are projected to increase in line with the health expenditure patterns of developed economies.[21] Sri Lanka offers free health care, but the level of public health financing is low compared to other countries with similar health indicators. In addition, out-of-pocket expenditure remains a major source of health care funding in the country, and health insurance is inadequately developed with low coverage. In 2011, household out-of-pocket expenditure accounted for 41.7 per cent of total health expenditure and 83.5 per cent of total private

[17] ADB (2012), *Social Protection for Older Persons: Social Pensions in Asia*, Asian Development Bank, Manila.
[18] *Ibid*.
[19] Rannan-eliya, R. (2008), “Population Ageing and Health Expenditure”, Institute for Health Policy, Colombo.
[20] World Bank (2008), *Addressing the Needs of an Ageing Population*, World Bank,Washington, D.C.
[21] Rannan-eliya. R. (2008), “Population Ageing and Health Expenditure”, Institute for Health Policy, Colombo.

health expenditure.[22] People in lower income categories use public health care facilities more than those in higher income categories. More importantly, the World Bank Sri Lanka Ageing Survey (2006) revealed that the elderly utilize public healthcare facilities more than the younger age groups.

While Sri Lanka has a prevention-based strategy to combat NCDs, cost-effective management of NCD patients is limited in the health care system. This is due to under-financing and having limited access to cost effective medication to manage NCD patients. Therefore, a prevention-based strategy will have to be combined with a sufficient increase in public funding with a focus on providing long term care to effectively manage NCDs. In addition, increasing health insurance coverage would be important to reduce the burden on state finances. For example, introducing a long-term care insurance scheme similar to Japan would help to minimize the financial risk arising from rising medical costs.

5.4.3 Labour Market

Sri Lanka's labour force increased from 4.5 million to 8.5 million between 1971 and 2012, while it is projected to increase to 9.3 million in 2021.[23] However, the absolute size of Sri Lanka's labour force will start to shrink after 2030.[24] Similarly, the working age population of the country too will continue to grow in absolute numbers until 2026, after which it will start to decline. However, as discussed in Section 5.3, Sri Lanka's working age population (15-59 years) as a percentage of the total population peaked in 2006 and has been gradually declining since then. The proportion of the working age population will decline to 63.8 per cent of the population in 2021 and 63.2 per cent of the population in 2031. This decline along with the projected increase in the old-age dependency ratio can have a negative impact on GDP growth.

A country with a large dependent population relative to its labour force will, on average, have lower productivity growth. Old-age dependency has been found to adversely affect per capita GDP growth in many Asian countries.[25] For example, in China from 2001-2020, the increase in the old-age dependency ratio is expected to reduce the total factor productivity (TFP) growth rate by 0.21 per cent. The effect is similar in ageing countries like Singapore and South Korea. Germany faces a similar situation with the decline in the working population expected to reduce long-term productivity by about one-third.[26]

Labour market reforms with strategies to boost the labour force participation rate, increase the mandatory and effective retirement age, as well as structural reforms to boost productivity through effective human capital development can help address the challenges arising from the rapid ageing of the population and a shrinking working-age population.[27]

Increasing female labour force participation (FLFP)

Increasing female labour force participation (FLFP)[28] is an important strategy to counter the effects of a shrinking working-age (and hence

[22] IPS (2014), "Sri Lanka National Health Accounts 2010-2011", Institute of Policy Studies of Sri Lanka, Colombo.

[23] DCS, "Sri Lanka Labour Force Surveys", Department of Census and Statistics, Colombo; Ministry of Labour and Labour Relations and Central Bank of Sri Lanka (2011)," Labour and Social Trends in Sri Lanka".

[24] Vodopivec, M., and N. Arunatilake (2008), "The Impact of Population Ageing on the Labour Market: The Case of Sri Lanka", Institute for the Study of Labour, Bonn.

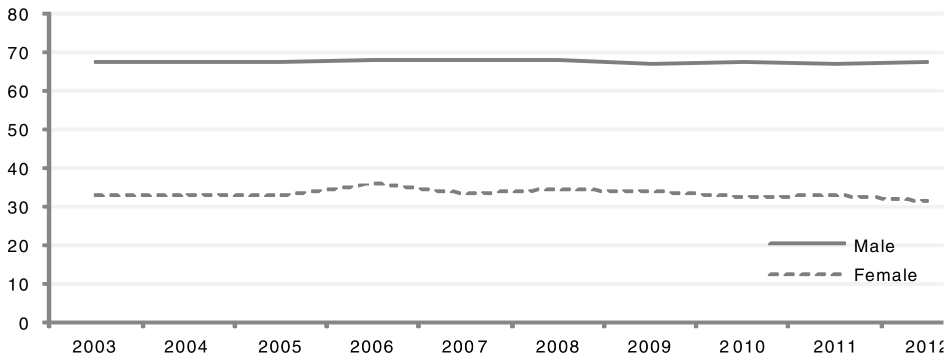
[25] Park, D., and K. Shin (2011), "Impact of Population Ageing on Asia 's Future Growth", ADB Economics Working Paper Series, Asian Development Bank, Manila.

[26] Börsch-Supan, A. (2002), "Labor Market Effects of Population Ageing", Mannhein Research Institute for the Economics of Ageing, Mannheim.

[27] McMorrow, K., and W. Roeger, (2011), "The Economic Consequences of Ageing Populations", Directorate-General for Economic and Financial Affairs (ECFIN), European Commission, Brussels.

[28] The labour force participation rate is defined as the percentage of the current economically active population (or labour force) to the total working age population. The current economically active population is defined as people who are employed or unemployed during the reference period of the Labour Force Survey. It does not take into account migrant workers, where female migrant workers constitute approximately 50 per cent of total migrant workers in Sri Lanka.

Figure 5.11
Labour Force Participation Rates in Sri Lanka 2003-2012



Source: DCS (2012) "Labour Force Survey 2012".

labour force) population. In Sri Lanka, the FLFP rate has remained stagnant in recent decades (Figure 5.11). The rate has been around 30-35 per cent of working age women, which is low considering the low fertility rate and high education attainment of the female population. Sri Lanka is behind South Asian countries like Nepal, Bhutan and Bangladesh in terms of FLFP.

The time constraint women face in playing the role of care-giver for children and the elderly is one of the barriers to greater participation in the labour force. This is a common phenomenon in many Asian countries. A survey conducted on married women in South Korea under the age of 45 revealed that 61 per cent of them quit their job after getting married.[29] Low FLFP rates amongst married women may reflect weak support systems for working mothers as well as workplace inflexibilities.[30]

Affordable childcare services have been found to increase FLFP rates.[31] Sweden has universal childcare access which has helped the country to have one of the highest FLFP rates in the world.[32] While Sri Lanka has traditionally relied upon the extended family culture for child support, the transition to a more nuclear family culture has increased the cost of childcare in Sri Lanka over the last decade.[33] Therefore, subsidizing childcare would encourage higher female labour force participation.

Labour market supply-side biases such as structural rigidities and wage discrimination may also be a contributing factor to the low FLFP rates. In Sri Lanka, on average, men earn more than women, irrespective of their productive capacity. In the private sector, the earnings gap was greater than 35 per cent in 2009, while there was gender parity in the public sector.[34] In addition, men have higher

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29 Jackson,R., N. How and K. Nakashima (2007), *The Ageing of Korea: Demographics and Retirement Policy*, Center for Strategic and International Studies, Washington, D.C.

30 IMF (2012), "Japan: Selected Issues", International Monetary Fund, Washington, D.C.

31 Jaumotte, F. (2004), *Labour Force Participation of Women: Empirical Evidence on the Role of Policy*, OECD, Paris.

32 Garcia-Moran, E. M. (2010), "Childcare Costs , Female Labour Force Participation and Public Policy", mimeo..

33 Premaratne, S. P. (2011), "Household Labour Supply in Sri Lanka for an Urban Young Couple with Pre-school Children", *South Asia Economic Journal*, Vol. 12, No. 2.

34 Chowdhury, A. R. (2013), "Low Female Labour Force Participation in Sri Lanka: Contributory Factors, Challenges and Policy Implications", World Bank Discussion Paper Series, World Bank, Washington, D.C.

returns to education of 8 per cent compared to 3 per cent for women.[35] The unemployment rate among the educated group with G.C.E (A/L) and above was higher for women at 10.8 per cent compared to only 4.5 per cent for men in 2012.[36]

In order to increase the FLP rate, labour market institutions and practices should be designed in a way that reduces gender earnings disparities, while ensuring sufficient flexibility to attract women to the labour force. However, reducing the gender wage disparity is a particularly difficult issue to solve. South Korea introduced legislation in 2006 that required all firms with more than 1,000 employees to draw up an action plan to promote gender equality. The initiative was unsuccessful, with the programme failing to reduce the gender wage gap (females were only paid 60 per cent of what male workers earned). South Korea was more successful in encouraging flexible working schedules to accommodate parents with children. The Equal Employment Opportunity and Work-Family Balance Assistance Law allows parents with children under the age of six to request for shorter working hours, which has benefited firms by reducing the turnover of skilled workers.[37] In Sri Lanka, it is difficult to implement flexible work arrangements due to the highly protective labour laws in the country at present. The high severance costs restrict job flows, while discouraging employment growth in the formal sector.

Raising the retirement age

Parametric reforms such as increasing the effective and mandatory retirement age has the double benefit of reducing the number of retirees and

Table 5.2
Mandatory Minimum Retirement Ages for Selected Asian Countries

Country	Men (Year)	Women (Year)	Revisions
Japan	61	61	Retirement age was raised from 55 to 60 years in 1998. From 2013, retirement age will increase at a rate of 1 year every 3 years until 2025, when the minimum retirement age reaches 65 years.
China	60	50 or 55[a]	China's current retirement age has been the same since 1950. Currently planning on gradually raising the retirement age to 65 years by 2020.
South Korea	55[b]	55	The current contractual mandatory retirement age is typically set by firms at 55 years of age. In 2013, the government passed legislation that phased-in a minimum retirement age. By 2017, it will be set to 6 years.
Singapore	62	62	Statutory minimum age of 62 years set in 2012 through the Retirement Age Act (RAA). Retire and Re-employment Act now replaces the RAA, which require employers to offer re-employment to eligible employees who turn 62, up to the age of 65 years.

Notes: a. Fifty-five years for a white-collar job; b. There is no mandatory retirement age in South Korea. The mandatory retirement age set by firms is typically 55 years.

Sources: Japan - Ministry of Health, Labour and Welfare; China - Ministry of Human Resources and Social Security; South Korea - Center for Strategic and International Studies; Singapore - Ministry of Manpower.

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35 Sinha, N. (2012), "Demographic Transition and the Labour Market in Sri Lanka", World Bank Discussion Paper Series, World Bank, Washington, D.C.

36 DCS, "Sri Lanka 2012", Department of Census and Statistics, Colombo.

37 Jones, R. S., and S. Urasawa (2013), "Labour Market Policies to Promote Growth and Social Cohesion in Korea", OECD Economics Department Working Papers No. 1068, OECD, Paris.

increasing the labour force. Thus, it would help to reduce the fiscal burden of old-age support, while ensuring economic growth is maintained amidst a graying workforce. Many countries in Asia have initiated plans to raise their mandatory retirement ages (Table 5.2). Implementing measures to raise the retirement age in South Korea has been particularly challenging and brings out some pertinent issues that other countries should consider before raising the retirement age. In 2013, South Korea passed legislation to increase the minimum retirement age to 60 years in response to an ageing workforce and a comparatively low retirement age. The law will take effect from 2016 for large firms and 2017 for small firms.

The seniority-age system in South Korea incentivized employers to dismiss old-age employees, whom they deemed to be too costly. Reforming the compensation structure in order to extend the longevity of employment has become a policy focus for the government. Further, the South Korean government is considering drafting an Equal Employment Opportunity Act to monitor and penalize age discrimination in terms of employment and retirement, which would be needed to reinforce longer working lives in the long run.[38]

In Sri Lanka, the mandatory retirement age is 60 years. The World Bank's Sri Lanka Ageing Survey (2006) revealed that the mandatory retirement age was a significant push factor for retirement,[39] with around 40 per cent of respondents sighting it as a reason for their retirement. Workers in the public and private sector retire early, mostly due to mandatory retirement. However, casual and self-employed workers continue to work into very old ages. Moreover, similar to other countries in Asia,

To counter the effects of labour force reduction, Sri Lanka should design policies to increase participation rates, particularly among women and the elderly.

the Sri Lanka Ageing Survey (2006) identified labour market inflexibilities, such as the inability to adjust working hours, as one of the main obstacles to working at old-age. This discourages part-time employment, which is one of the most effective ways to encourage longer working lives.[40]

In addition, as mentioned previously, the highly protective labour laws in Sri Lanka would induce employers to stipulate mandatory retirement in employment contracts in order to reduce the cost of lay-offs. This has been an issue in Japan, Singapore and South Korea, which prompted their governments to introduce measures to reduce the cost of retaining old-age workers. In South Korea, the government set employment quotas for older workers and offered subsidies to firms that hire and retain them.[41] In Singapore, the Retire and Re-employment Act, introduced to re-employ workers between the ages of 62-65 years, offers

[38] Asian Productivity Organization (2011), *Population Ageing and Productivity in Asian Countries*, Asian Productivity Organization, Tokyo.

[39] Vodopivec, M., and N. Arunatilake (2008), "The Impact of Population Aging on the Labour Market: The Case of Sri Lanka", Institute for the Study of Labour, Bonn.

[40] Jones, R. S., and S. Urasawa (2013), "Labour Market Policies to Promote Growth and Social Cohesion in Korea", OECD Economics Department Working Papers No. 1068, OECD, Paris.

[41] Jackson, R., N. How and K. Nakashima (2007), "The Ageing of Korea: Demographics and Retirement Policy", Center for Strategic and International Studies, Washington, D.C.

considerable flexibility to employers to make adjustment to their employment contracts in terms of wages and benefits in order to reduce the cost of re-hiring.[42]

To counter the effects of labour force reduction, Sri Lanka should design policies to increase participation rates, particularly among women and the elderly. Many East Asian countries have already implemented policies to increase participation rates, recognizing the detrimental effects a shrinking workforce could have on economic growth. As a country that is facing a shrinking labour force, Sri Lanka would benefit by introducing measures to make labour markets more flexible, reduce the cost of labour protection, and incentivize employers to extend retirement ages.

5.5 Conclusion

Rapid demographic change is one of the key challenges faced by Asia in the coming decades. Many countries in the region, and East Asian countries in particular, are experiencing a rapid ageing of population alongside a decline in their working-age population, which would be an impediment to Asia's growth momentum. While the rapid ageing of population could raise the fiscal burden of social protection and health care services, a shrinking working-age population could lead to shortages of labour supply and have adverse impacts on productivity and GDP growth.

Similar to many East Asian countries, Sri Lanka is undergoing a rapid demographic transition. The 'demographic dividend' or the 'demographic bonus' that the country experienced over the past two decades is expected to end by 2017. Sri Lanka will then be faced with a rapid ageing of population, where by 2031, the elderly population will reach over 20 per cent of the total population. By 2041, one-in-every-four people in the country will be an elderly person, with a disproportionately higher share of females amongst them.

Along with the demographic transition, Sri Lanka will face several economic and social challenges, particularly in meeting the social protection and health care needs of the rising elderly population, and addressing the implications of a shrinking working-age population on the growth of the country.

Given the rising elderly population in Sri Lanka, it is vital to improve the current social protection programmes for elders - their coverage, quality of benefits, programme design, and sustainability. Less than a half of the elders are covered by existing old-age retirement benefit programmes at present like pensions, provident funds and cash transfer programmes, while the bulk of the social protection expenditure is on pensions for public servants that cover only one-fourth of the total elders in the country. Given the rising cost of pensions in Sri Lanka, reforming the current non-contributory system to a pay- as-you-go (PAYG) system along with some parametric reforms on retirement age are important to ensure its long-term sustainability. This would also allow utilizing the additional funds for other social protection programmes (e.g., cash transfers). In particular, it is important to improve the benefit amounts, and gradually extend the coverage of the existing cash transfer programmes to include all elders who are without a regular income (e.g., pension or salary), like in the case of the old-age allowance scheme in Thailand (or 'B500 pension scheme). These measures are crucial to ensure old age income security in Sri Lanka in the coming decades.

Improvements to Sri Lanka's health sector are also needed to accommodate the growing health care needs of the elderly. Given that the prevalence of NCDs is likely to increase with an ageing population, resources have to be allocated for NCDs. Moreover,

[42] Ministry of Manpower, Singapore.

expanding the health insurance sector (which has not been adequately developed) would be important to help minimize risks arising from increasing medical costs, and help reduce the burden on state finances.

Furthermore, labour market reforms with strategies to boost the labour force participation rate, in particular amongst females, raising the current retirement age (above 60 years), and measures to boost productivity through effective human capital development are important to address the challenges arising from the rapid ageing of population, and the shrinking working-age population in Sri Lanka.