INSTITUTE OF POLICY STUDIES

WHAT TYPE OF CAPITALISM DOES SRI LANKA NEED ?

By

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A. INTRODUCTION

It is clearer today than at any point since the 'Open Economy' policy was first introduced in 1977 that Sri Lanka is firmly set on the capitalist road. Whatever reservations one may have, this must be accepted as reality for the foreseeable future. This reality has been reinforced by recent political events both within the country and externally. Domestically, all significant political parties now accept the basic notion of the Open Economy. On the global scene, the ignominious collapse of most of the former Socialist Bloc means that the outside world could no longer offer material, political or ideological support to any attempt to develop the Sri Lankan economy through non-capitalist means.

For several decades, the energies of those Sri Lankans who can contribute usefully to debate about this kind of issue have been focused very much on the grand question: 'Capitalism or Socialism?' They have not yet fully adjusted to today's question: 'What kind of capitalism?'[1] It is a valid question. Capitalism comes in many flavours, and both governments and business leaders have some scope to choose among them. Decisions affecting the kind of capitalism which Sri Lanka will have in future are being taken. Those decisions are being shaped by someone's ideas about what is desirable. But these ideas are not made explicit and have been subject to little public appraisal or debate. This paper is intended as a contribution to such a discussion.

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[1] I do not mean to imply that there has been no discussion of these issues. Indeed, in policymaking circles there appears to be a substantial consensus on one particular issue: the desirability of expanding sub-contracting relations between larger firms and smallscale, informal sector, rurally-located enterprises. While this consensus is probably correct, there appear to me to be even more important issues relating to the structure, control and performance of larger firms which are not receiving adequate attention. Sri Lanka's primary economic need is to find new sources of export earnings. Whatever the potential role of the smallscale sector in producing the new goods and services for export, the larger scale sector is going to play a dominant role in identifying export opportunities, acquiring relevant new knowledge and technology, and in marketing. The smallscale sector can only be subsidiary; its health will therefore depend on the health of the larger scale sector.

I focus on two major sets of issues. The first, treated in Sections B to G, is essentially diagnostic. What kind of capitalists exist in Sri Lanka at present? Are they appropriate and effective agents for introducing faster economic growth? Do they suffer from some generic defects? The purpose in asking these questions is to examine the logic of and the evidence for widespread claims that the Sri Lankan business community is in some sense lacking in the fibre of true capitalism. The tentative conclusion is negative. There appears to be little substance to notions that there are particular **cultural** features of either Sri Lankans in general or of particular communities - especially the majority Sinhalese, who have tended historically to be relatively under-represented in the higher rungs of business - which make them bad at business pursuits. Insofar as certain claims about perverse or unusual patterns of behaviour appear to be true, one can fairly satisfactorily explain them as 'rational' adaptations to particular features of the local business environment. Yet there does seem to be substance in the claim that Sri Lankan business is simply less activist and enterprising than it ought to be. Those who own businesses are under less pressure than they ought to be, in the national interest, to make the best use of their assets. In particular, they face incentives to maintain close personal and family control over their businesses rather than to devolve managerial responsibilities to people capable of obtaining higher returns on assets. The explanation again appears to lie in the 'business environment' - in the formal provisions of the law, in the way that the law is implemented (or not implemented), in the way in which taxes are gathered, in the structure of professional education, in government's fiscal and banking policies and practices. The implication is that Sri Lanka could perhaps have more effective capitalists if the government were willing and able to change the legal, administrative and educational environment in which business operates.

This exercise in diagnosis leads on to a set of more prescriptive issues. What kind of capitalism is feasible in Sri Lanka, and what should the country be aiming for? In attempting to answer this, I focus in particular on what I consider to be one of the major issues: the extent to which the attempt to introduce 'shareholder capitalism' is likely to make the Sri Lankan economy perform more effectively (Sections H and I). The term 'shareholder capitalism' is defined more precisely in Section H. It refers to a situation in

which firms' decisions are significantly influenced (i) by shareholders who buy and sell shares in the stockmarket in the same 'neutral' way in which they might purchase other commodities; and, correspondingly, (ii) by movements in firms' own quoted share prices.

'Shareholder capitalism' is the favoured child of the Washington-based international financial institutions which influence economic policymaking in Sri Lanka, notably the International Monetary Fund, the World Bank and the U. S. Agency for International Development. It is the type of capitalism favoured by conventional economic doctrine which predominates in such circles. Ironically, both the doctrine and the practice of shareholder capitalism are most at home in the two leading capitalist economies which have performed least well in recent decades: the United States and the United Kingdom. The star economic performers among the leading capitalist nations since World War Two - notably Japan, Germany and France - have not practiced shareholder capitalism. It seems useful to ask whether shareholder capitalism is appropriate for Sri Lanka, and whether it is adequate.

My tentative answer to the first question is that the measures taken so far to promote the Stock Exchange and shareholder capitalism are probably broadly **appropriate**. They are likely to alleviate some real problems of 'closedness' from which the Sri Lankan private sector suffers (see above). Whether shareholder capitalism is **adequate** to Sri Lanka's needs in the longer term is more questionable. Evidence from comparisons between leading capitalists countries and from the recent performance of different types of companies within Sri Lanka suggests that shareholder capitalism is unlikely to provide companies with adequate incentive and capacity to adopt **long term perspectives and strategies**. It will be useful for business leaders and policymakers to look at this evidence of successful alternatives to shareholder capitalism and see whether there are lessons for the appropriate governance of the Sri Lankan private sector.

B. THE CHARGES

Can Sri Lanka's continuing poverty be attributed to the **nature** of the business community? Are Sri Lankan businessmen[2] any less tough, aggressive, smart, enterprising or persistent than one could reasonably expect? And do they engage in the kinds of activities that they ought in the interests of profit or of the nation? Such questions are dangerously broad. They cannot be answered with any great scientific rigour. It is not always clear what would constitute satisfactory evidence to support or disprove particular claims. And the evidence is often not available, or available only in impressionistic form.[3] I depend more heavily than I would wish on deductive arguments, rooted more in logic than in factual evidence. There is always the risk of providing answers that take the form of prejudice and impression dressed up to look respectable. Yet the risk is one worth taking. The questions are in the first place intriguing. They are in the second place virtually unavoidable. For the economic strategies of successive governments have been justified in part by judgements about the character of the private business sector. In particular, the wide range of 'statist', 'interventionist' or 'socialist' economic policies that were pursued in the 1950s, 1960s and 1970s were frequently promoted and defended on the grounds that they were designed to undertake developmental activities and functions that the private sector was too weak, too short-sighted or insufficiently 'national' to undertake of its own accord. Some observers believe that the disappointing performance of the economy during most of the period since liberalisation in 1977 is due in part to the inadequacies of the private sector. There is, in sum, a widespread suspicion that there are significant flaws in the basic material from which Sri Lankan businessmen are constructed.

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2 Business people are so overwhelmingly male, especially at the levels at which I am dealing in this paper, that to use any term other than 'businessmen' would be deceptive.

3 My own impressions are however fairly solidly based on seven months spent (a) interviewing businessmen and other informants in a wide range of (larger) business enterprises; and (b) in examining in some detail the structure of a range of industrial sub-sectors - diamond cutting and polishing, finance companies, garments, gems and tea exporting.

Arguments of this general type are not uncommon in Sri Lanka. Some Sri Lankans assert that the country's problems are the result of defects in the national character: of alleged high incidence of various 'bads' and vices - murder, suicide, chicanery, untrustworthiness, etc. It is not then surprising that intellectuals, politicians, people-in-the-street and businessmen themselves should often cast aspersions on the competence and morality of the business community, and attribute national poverty to business vice. The aspersions cast at Sri Lankan business - which are in fact not very different from those cast at business in other poor countries[4] - take many forms and are expressed in various ways. However, for purposes of discussion one can usefully group them into three main sets of charges:[5]

[a] A **mercantile** orientation - a preference for simply **buying and selling**, and making a profit through **sharpness, superior market information** or **cheating**, rather than engaging in value-added activities with a long time horizon, such as production, processing or industry. The charges of **greed** and **short-term** orientation belong logically in the same set.

[b] **Lack of specialisation** and an irrational preference for **diversification** into unrelated activities, leading to the failure to cumulate and build upon expertise and knowledge.

[c] Various manifestations of **closedness** in business relations: **inability to trust** others; **unwillingness** of business leaders to **devolve** responsibilities or to

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[4] For example, Argentina is a polar case of a country that ranked among the 'developed' nations in the early part of this century but has since descended to an underdeveloped status. Among the popular explanations for this decline are "the Argentine national character in general, which is held to be egotistical, inflexible and conflictive, thus making impossible all cooperative effort, including that required for development" (P.H. Lewis, The Crisis of Argentine Capitalism, The University of North Carolina Press, Chapel Hill and London, 1990, p.1).

[5] Observers of the Sri Lankan scene may feel that this list of charges appears in some respects both generous and incomplete. For there is no mention of the apparent deep involvement of many 'businessmen', generally in association with politicians, in a range of illegal activities (or illegal extensions of legal activities), such as running large scale betting operations, smuggling, drug trading, and liquor production and sales. Such activities are widespread, undesirable in their own terms, and a significant contributor to the negative public image of private sector business within Sri Lanka. It seems likely that the existence of such opportunities diverts energy and entrepreneurship from more worthwhile activities. This paper, however, is about rather different issues.

employ specialists (accountants, managers, consultants, etc.); and a strong preference for maintaining both ownership and control of businesses within **families**. It is argued that such attitudes or types of behaviour constitute constraints on expanding the size of business enterprises, on engaging in new activities, and on the concentration of business resources in areas where they have a comparative advantage. Overall, the presumed result is lower rates of economic activity than would take place in a more open and trusting business environment.

These charges can be labelled: 'mercantile[6] orientation', 'lack of specialisation' and 'closedness' respectively. I attempt to answer three basic questions in relation to each. Are the charges true? If so, why? Are the results good or bad? It is important to clarify that I am seeking to answer questions about the adequacy and competence of the business community which are in principle independent of the overall performance of the economy. In any basically private-sector economy, business will do well when the economy grows fast, and *vice versa*. The causal relationships are however complex and difficult to disentangle. Given that we know that economic growth rates are affected by a wide range of factors, including government policy, we soon get into impossible logical tangles if we allow the rate of economic growth to be taken as an indicator of the basic competence or capacity of the private sector. What then do we take as indicators of business competence or capacity? There is no neat answer. There are many partial indicators, including for example: the comparative growth rates (assets, turnover or profits?) of firms engaged in similar activities; the rate at which firms expand into new activities; or, more controversially, the extent to which firms develop corporate structures and practices which appear likely to encourage future growth, innovation and adaptability. There are many problems in obtaining the information needed to construct such indicators on a consistent basis, as well as difficulties about making judgements about the business community of a nation on the basis of comparisons between individual firms making up that community. Such conclusions as one can draw can only be tentative.

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6 In Sri Lanka the term 'mercantile' refers to the more organised, formal business sector; I am using the term in a very different sense here.

The three main charges are examined separately in Sections D to F respectively. Since my explanations depend heavily on an appreciation of the environment within which Sri Lankan business operates, I attempt first, in Section C, to delineate the main characteristics of this business environment. There is however one aspect of that environment that requires comment here: the prevalence of what I would term unrealistic images of the nature of 'real capitalism'. For, in Sri Lanka as elsewhere, many of the criticisms of the business community appear to be based on an implicit comparison with an idealised notion of the 'real thing': an aggressive, thrusting, restless gaggle of 'workaholics' ever eager to introduce new products and practices, increase last year's profits, and undermine and out-compete their neighbours. Such a capitalist class exists only in textbooks, whether the textbooks of mainstream economics or of Marxist theory of the development of capitalism.

The nature of the 'actual existing capitalism' found in Sri Lanka has changed considerably over recent decades. The closed, cosy, British and politically-protected business networks that dominated the 'mercantile sector' in the colonial period have gone, although many of the firms and the institutions remain. The contemporary private sector is more diverse and in many ways more competitive. But there is one crucial respect in which Sri Lankan capitalists have been and are the same as capitalists throughout the world: as individuals they tend to abhor competition and want nothing more than to establish a secure market position from which they can gather a steady profit with little effort or disturbance. If they can use political connections to secure this position, so much the better. 'Competition' is not a behavioural imperative of true capitalism; it is a tactic used in appropriate contexts. The capitalist **system** remains competitive only to the extent that enough capitalists are placed in positions where competition is a sensible tactic for them to adopt in pursuit of their individual self-interests.

The relationship between politics and business can often lead to competition-suppressing arrangements. These take many forms in contemporary Sri Lanka, and are not the monopoly of any particular type of businessman: Sinhala-speaking *mudalalis* may become wealthy through government contracts effectively 'purchased' from politicians; established companies may

get a particular import tariff raised to protect their own product against competition in the local market; and urbane English-educated scions of the elite may use their family connections to sabotage a foreign investment project which threatens to provide local competition for the import agency which they control. All are displaying the normal tendency to win and preserve a comfortable market niche free from competition. The political system, which is in many respects hostile to capitalism and the private sector in Sri Lanka, can also be a powerful ally to established business interests.

C. THE BUSINESS ENVIRONMENT

The significant features of the business environment are grouped into six main categories and described in this section.

[1] Economic Structure:

[1.i] High Foreign Trade Orientation.

As in most small countries, especially those which were integrated into the world economy as commodity exporters, foreign trade accounts for a high proportion of all the business transactions which occur within the ambit of the Sri Lankan national economy. Unlike in many such countries,[7] Sri Lanka's foreign trade is mainly in the hands of national enterprises, mostly private. It follows therefore that, in a purely statistical sense, Sri Lanka's private business sector is relatively heavily involved in either directly conducting international trade or servicing it (via shipping, insurance, freight, container, port, banking and related services).

[1.ii] Small Internal Market.

Sri Lanka has a relatively small population of around 17 million people, and is classified among the forty or so poorest nations on Earth. The size of the internal market for many products is therefore relatively small. The possibilities for business expansion in particular product lines are relatively constrained outside the sphere of basic consumer goods.

[1.iii] Sophistication of Exchange Relationships.

Because of its long history of involvement in international trade, the deep impact of the colonial plantation economy, the small size of the country and the relative excellence of transport and communications infrastructure, Sri Lanka has developed much more elaborate, pervasive and systematic market mechanisms than one might expect on the basis of its low income levels and substantial agricultural orientation. Individual companies can rely to a high

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[7] Including, for example, relatively developed Taiwan, whose foreign trade is still in large part handled by Japanese general trading companies.

degree on the 'invisible hand' of the market to procure the inputs and services they need and to sell their product. For example, plantation companies can find timber contractors who will clear old rubber plantations and market the timber. Exporters of spices are supplied by elaborate networks of independent traders, can normally hire warehouse space if required, and have a good choice of enterprises to provide insurance, freight and banking services. Printing firms can contract out sophisticated processes, such as colour separation, to specialised companies. Compared to countries in which market mechanisms are less well developed, Sri Lankan firms face relatively limited pressure to diversify vertically into related stages of their existing production or distribution processes.[8]

[2] Political and Economic Risk:

Business in Sri Lanka is relatively vulnerable to various kinds of political and economic risk. One can crudely classify these risks into three categories. In the first place, and given especially the basic structural economic problem of inadequate export earnings to meet import needs, the overall health of the economy is dependent on a number of external factors which have been known to change abruptly, and are likely to do so again: the terms of trade (especially the ratio of the tea to the oil price); and the availability of 'bonus' new sources of foreign exchange earnings (tourism, foreign aid, remittances of nationals employed in West Asia, and quotas to export garments to the USA). In the second place, changes of government can result in major changes in economic policy, including changes which embody hostility to the very notion of a private sector economy. In the third place, the fortunes of particular firms can depend very heavily on the extent to which they are looked on with favour or disfavour by powerful politicians. All these factors argue in favour of diversification to reduce risks, notably a diversification of activities within the country and accumulation of assets overseas. The last factor in particular argues in favour of secrecy about business affairs.

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8 For a more general discussion of this point see S. Lash and J. Urry, The End of Organized Capitalism, Polity Press, Cambridge, 1987, pp. 47-48.

[3] The Legal and Institutional Framework:

[3.i] Company Law

Sri Lankan company law is based on British company law of the 1930s: it is relatively secretive, requiring little and infrequent disclosure of information about company affairs to either shareholders or the general public. Disclosure requirements are differentiated according to the legal status of the company, independently of size. Thus public non-quoted companies are obliged to provide less information than public quoted companies, and private companies are obliged to provide less than either. Insofar as disclosing information is seen as disadvantageous by company owners (see below), the law provides disincentives to turn private companies public or to have public companies quoted on the Stock Exchange.

[3.ii] Using the Law

Just as sophisticated market relationships have long been one of the primary mechanisms for societal regulation in Sri Lanka, a 'modern' legal system has been another. Recourse to formal courts organised by the state has been a relatively common practice - and a practice surprisingly frequent for a country in some respects so poor and agrarian. The extent to which this sophisticated legal infrastructure can be judged beneficial has frequently been questioned. For one prominent feature of the system is that the costs of involvement in law suits - costs of delay and uncertainty in addition to financial costs - tend to be high. It is disputed whether these delays and uncertainties stem more from (a) complex procedural requirements (alleged to benefit no one so much as lawyers); or (b) from more mundane deficiencies in the management of the legal system - lack of equipment, unscheduled staff absences, etc. The delays and uncertainties which are generated however can be especially punitive where commercial matters are involved. There are thus significant disincentives for businessmen either to become involved in legal action or to become involved in business relationships which might entail a risk of later involvement in legal action.

[3.iii] Implementing Law and Taxation

For much the same kinds of reasons that the legal process itself is slow and costly, many of the public institutions that are supposed to provide basic

one which was, in relation to labour relations, markedly paternalistic-cum-authoritarian. Plantation management skills were therefore rarely transferable to other sectors of the economy; the plantation economy did not generate any institutions specialising in management training and certification; and no tradition emerged of bright young men going into plantation management as a preferred career.[15]

(b) Conversely, the colonial economic and political system provided alternative, desirable professional posts which were filled largely through selection and certification in the formal education system, and which therefore attracted the brightest young men (in an academic sense). A relatively elaborate (state funded) public health system and a wealthy resident British and Sri Lankan elite provided good opportunities for medical doctors. Large scale public infrastructure works, both in the colonial and the later period, made civil engineering, in the public service, a prestigious and well-rewarded profession. The widespread use of English law and the early introduction of representative politics provided many opportunities for lawyers and lawyer-politicians.[16] The self-interest of the British colonial service ensured that public service was well rewarded at professional and senior levels. Such posts were largely taken over by Sri Lankans before Independence. Employment in these state and state-related professions - medicine, civil engineering, law and public administration - was an important route to or adjunct of elite socio-economic status. And the education system was geared largely to training and selecting young men for such professions, especially as jobs became more scarce and educational competition more fierce. Grades in pre-university examinations became the predominant mechanism for the allocation of students to faculties. Those with good maths went into medicine or (civil) engineering in particular; general arts degrees came to represent the residual once the other faculties had taken the pick of the bright students.

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15 I know of no study of the social background of contemporary plantation managers, but suspect, from casual observation, that most are from plantation owning families.

16 Until recently, law was the predominant educational and professional route to a successful political career.

(c) This tight symbiosis between an increasingly state-controlled education system and the public sector for which it was producing graduates was perpetuated or strengthened in recent decades as a result of two factors. Firstly, the increasing degree of state control of the economy tended to ensure that public sector professional jobs remained relatively attractive. The number of public sector posts continued to expand even as salary differentials shifted in favour of the private sector. Secondly, and more importantly, large scale overseas professional employment opportunities opened up in the United States, Africa, West Asia and Europe. In two cases - medicine and civil engineering - there was a complete correspondence between previous status as an elite profession within Sri Lanka and this new status as a lucrative 'transferable' overseas profession. Law and, especially, public administration, became less attractive, in part because they were not transferable overseas in this way. Conversely, accountancy became a more valued qualification - and one in which many of the overseas opportunities were in the public sector. Sri Lanka has become a significant exporter of skilled personpower. A large fraction of such emigres never return to Sri Lanka. However, their educational aspirations and experiences continue to exercise a major influence over the Sri Lankan educational and professional systems, and society more widely.

The net result of this complex of processes is that professional qualifications which have limited relevance to the management of private business in general, and even less to the management of industrial production processes, continue to both attract the brightest young Sri Lankans and to shape the formal education system. The other side of the coin is that almost all of even the larger companies recruit their executives at the pre-university level and, more importantly, from a pool which does not include many of the brightest and most ambitious young people - for they go on to university. Those recruited on leaving school have little possibility of obtaining any useful or recognised 'management training' except that which is offered by their employer.[17] The private sector management cadre is weak in terms of

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17 There is no 'business school', and current efforts to establish one will have to battle against many obstacles, including the absence of competent Sri Lankans willing to teach. Attempts by universities to provide graduates in business management have so far failed to win recognition or enthusiasm from business.

competence, status and organisation. In a country marked by a wealth of voluntary associations of all kinds, including associations of labour, business and the 'certified professions', there are scarcely any associations which even claim to represent 'management' as a distinct interest group.[18] In sum, Sri Lanka's very considerable endownment of human capital at the 'professional' level has, for a range of historical reasons, not been turned into a cadre of business managers, and especially not into a cadre of production managers with engineering expertise.[19]

[5] The Privileging of Loan Capital over Equity Capital:

At one level, as has been suggested above, there has been considerable instability in the economic policies of successive governments. However, there have also been some very significant continuities in economic policy - at the level of practice rather than of declared intent - which affect in important ways the incentives and options facing private business. In many cases these policies can be seen as the product of the vested interests of existing private sector business, politicians, and state agencies themselves, especially of the large public banking system. This is especially true in relation to policies which affect the relative costs of different kinds of investment capital.

Like businessmen the world over, Sri Lankans routinely complain about the excessive cost of loan capital. A little local flavour is sometimes added through rehearsal of an old complaint, developed and tagged onto the nationalist movement in the colonial era, and used repeatedly since by

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18 Plantation management does not constitute a real exception. The main organisations representing the estate sector have always had a rather ambiguous sociological profile, representing a mixture of what might in principle be thought to be distinct interests: British corporate owners; local corporate and individual owners; local Agency Houses managing estates on behalf of (mainly overseas, corporate) owners; and managers themselves.

19 The rising relative importance of the accountancy profession is good news, in the sense that accountants have skills that are needed in the private sector and are often the foundation for broader management ability. Technical expertise in production processes is however still rare. The Sri Lankan engineering profession is absolutely dominated, in terms of numbers, prestige and organisational capacity, by civil engineers, very few of whom work in production processes. Most mechanical and electrical engineers do either administrative or maintenance work in public utilities. Chemical engineers are few in number, and those actually working as engineers are members of a rare species.

businessmen in financial trouble who want to get government to help them out with their bank managers: that the whole banking system is dominated by 'foreign' minorities who run it for their own purposes, depriving local business, especially Sinhalese business, of reasonable access to credit. The truth is almost the opposite: loan capital has been made unusually cheap in Sri Lanka, and borrowers have generally been subsidised from other sources - by small-scale depositors, by taxpayers, and by foreign aid donors. Loan capital has been so subsidised that it has virtually driven equity capital from the market place: scarcely any private sector investment in Sri Lanka is financed through equity capital. Internally generated profits and loan capital finance all but a tiny fraction of total investment. There are several separate components of government policy which, until recently at least, have combined to bring about this result:[20]

(a) Interest payments on loans are an allowable expense against corporate taxation liabilities, while there is no equivalent provision to reduce the real cost of raising equity capital through share market issues.[21] Indeed, the practice, recently abolished, of levying stamp duty on sales of company shares tended, albeit in a minor way, to reinforce the advantages of loan capital.

(b) Especially in the period since 1977 when foreign aid has been abundantly available, long term (two years +) loan capital has been available at subsidised rates in a range of schemes through which local banks, especially the two public sector development banks, on-lend capital supplied at concessional rates through aid agencies.[22]

(c) Until recently, at least, loan defaults were virtually never foreclosed, but bank loans simply rolled over. The result was that, even for risky projects which ought to be financed through equity, private companies were willing and eager to use loans because they faced very little prospect of losing their

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[20] Within the last two years, attitudes and policy have begun to change appreciably. At the time of writing there are firm plans to place the state banks on a commercial basis; if finally implemented, this will change the picture considerably.

[21] This is standard international practice; Sri Lanka is not exceptional.

[22] One result of this is that there is no scope for local banks to raise and offer to local business long term capital raised through the market at market rates.

assets if the projects failed in a financial sense. The reason for non-foreclosure was a combination of (i) long-outdated legislation[23] which made foreclosure on collateral an extremely expensive and lengthy business for banks, such that they rarely bothered; (ii) the unwillingness for political reasons of the two main state banks, the predominant sources of credit, to foreclose. The first factor was largely reversed by a series of changes in early 1990 in the legislation on debt recovery mechanisms. It is not yet clear how far the second might change.

(d) The reason that this system remains viable in a financial sense - that the whole banking system has not been brought down as a result of accumulated bad debts - lies in the important and privileged position of the state banks. They have very large deposit bases, in part because they they have very extensive branch networks in rural areas which service a very large number of small deposit savings accounts. Such a network would not be profitable for private banks. The customers, who have few alternative means of cumulating savings in a secure and liquid form, pay a price because their money is invested in dubious loans which often cannot be serviced. The state banks manage to maintain their financial viability in part because of the large fee income they generate through their dominant role in providing financial services to the large state sector - a large number of more or less captive customers. Overall, there are few 'reality checks' in the system and, in particular, the state banks have been obliged neither to seek economic (as opposed to narrow financial) viability nor to meet international standards of loan provisioning or accounting. Since the economy has continued to grow, the banks have been able to expand their asset base sufficiently to avoid any financial crisis.[24]

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23 This legislation was introduced in the 1930s as part of a nationalist response to domination of the personal credit sector by Nattukottai Chettiar (South Indian) bankers and Afghan moneylenders. The immediate trigger was that economic depression led to the Chettiars acquiring large plantation properties from (wealthy, influential) local people unable to service their loans.

24 One could also add, along the same lines, that public sector pension funds are directed by their managing agent, the Central Bank, into low-return government securities, and thus assist the government to service its debts more cheaply than in a free market.

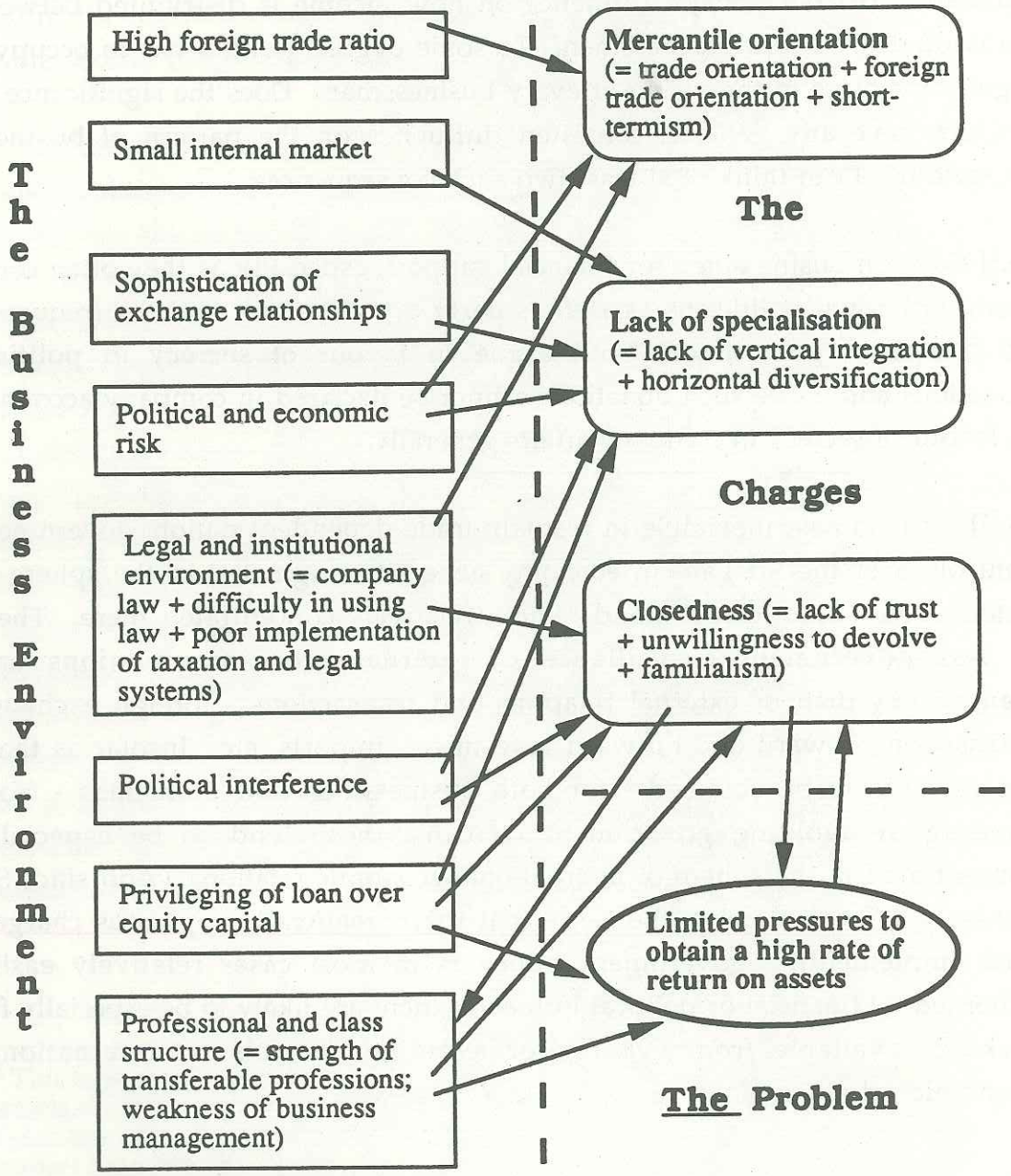
[6] Political 'Interference':

There are a great many close interactions between business and politics in Sri Lanka. Political parties and individual politicians depend heavily on business for income and are in a position, by virtue of the very extensive direct and indirect, legal and illegal, influence they exercise over the economy, to have a major influence on how income is distributed between individual firms and businessmen. To some degree, politics has to occupy a significant place in the vision of every businessman. Does the significance of politics have any general, consistent influence on the pattern of business behaviour? I can think of at least two such consequences:

[6.i] Calls on businessmen for financial support, especially as they often come from individual politicians as well as party organisations, and the frequency of change of government both argue in favour of secrecy in political donations and, since such donations cannot be declared in company accounts, in favour of secrecy in company affairs generally.

[6.ii] As is almost inevitable in a small, trade-dependent nation, government controls over the Sri Lankan economy generally originated in the sphere of external economic relations and remain relatively concentrated there. There is less government surveillance of internal economic relations and transactions than of external relations and transactions - foreign exchange transactions, inward and outward investment, imports, etc. Insofar as there are rewards to be obtained - for both businessmen and politicians - from evading or avoiding government controls, these tend to be especially concentrated in the sphere of international economic relations. And since Sri Lanka is a 'weak state' in the sense that the bureaucratic apparatus charged with implementing government policy is in most cases relatively easily suborned by financial or political influence, there are likely to be especially fat pickings available from evading or avoiding controls on international economic relations.

Figure 1: A Simplified Representation of the Main Links in the Argument



D. MERCANTILE ORIENTATION?

(The main elements in the arguments presented in this and the two succeeding sections are presented in schematic form in Figure 1). In the light of the description of the business environment presented above, I attempt to assess in this section the charges grouped together under the heading of 'mercantile orientation'. Given the virtual impossibility of evaluating charges like 'greed', one can reduce the general allegation of 'mercantile orientation' to three more specific charges: (i) focus on pure exchange or trading profit rather than on value-added activities like processing and production ('exchange orientation'); (ii) a particular focus on foreign trade; and (iii) short term orientation. Before judging whether these charges are valid, it is helpful to a make two related contextual points:

(a) There is no practicable method of measuring mercantile behaviour, much less mercantile attitudes; one has to rely entirely on impression.

(b) From the perspective of a mainstream economist, a high level of vigilance and activity by businessmen in identifying, profiting from - and thus normally reducing or eliminating - price differences between the same or similar products in different markets or locations is in itself an important component of a healthy, developed market system. One would expect all businessmen to be seeking such opportunities, including those whose main focus and source of profit lay in genuine value-added activities. From this perspective, profit-seeking through exchange only becomes problematic if it appears for some reason to divert resources away from value-added activities.

[1] Exchange Orientation

There is no hard evidence to permit one to judge whether or not Sri Lankan businessmen are excessively exchange-oriented. There are however at least two major sets of reasons why one would expect them to be more exchange-oriented than businessmen in some other circumstances.

The first set of reasons relates to the structure of the economy. Two point arise:

(a) Given that Sri Lanka's secondary (industrial) sector is relatively small, and that the primary (mainly agricultural) sector is mainly dominated by small scale enterprises, it follows automatically that larger scale business is relatively concentrated in the tertiary or service sector. And exchange is necessarily a major component of some tertiary sub-sectors, notably commercial and financial services.

(b) Foreign trade accounts for a relatively high proportion of all economic activities and therefore of all economic transactions (see Section C, 1.i). Because it involves 'arms-length' relations between business enterprises separated by distance and national (legal-cum-administrative and cultural-cum-linguistic) borders, foreign trade does in fact generate a relatively large number of associated transactions per unit of goods or services traded. Contacts have to be made with foreign buyers or suppliers; the trading regulations and procedures of at least two nation states have to be adhered to; currencies have to be changed; and relatively complex freight and insurance services have to be obtained. Brokers and intermediaries of various kinds - people rewarded for who and what they know rather than what they do - tend to play a prominent role. Foreign trade requires a relatively high intensity of economic transactions of a 'non-productive' nature, in the narrow and literal sense of the term. Any national private sector economy heavily engaged in international trade that also handles much of this trade itself will tend to feature a relatively large proportion of apparently 'non-productive' (exchange-oriented) activities.

The second set of reasons why one would expect Sri Lankan businessmen to be exchange-oriented relate to behavioural adaptations to the business environment. There are several reasons why, given a choice, it makes sense to go for profits from exchange rather than from value-added activities. It is easier to avoid taxation, for the turnover of physical goods is faster and less easy to verify in exchange, and there are no production or processing facilities

whose capacity might indicate actual levels of economic activity.[25] Where both nominal taxation levels and possibilities of tax evasion are significant (see Section C, **3.iii**), an orientation to hard-to-tax activities is rational. The ever-present prospect of being called upon to pay 'political levies' (see Section C, **6.i**) also increases the incentives to concentrate on exchange activities where profits can be hidden. And the general riskiness of the political and economic environment (see Section C, **2**) militates against investments in the physical facilities required to engage in value-added processing and manufacturing activities. Liquid assets are less vulnerable.

[2] Foreign Trade Orientation

There are powerful reasons for businessmen to seek to become engaged in foreign trade wherever possible: the combination of domestic political and economic instability (see Section C, **2**) with continuing foreign exchange control[26] places a premium on mechanisms which permit the expatriation of capital through under-invoicing of exports or over-invoicing of exports. Businesses prefer to engage in foreign rather than local trade to make use of such mechanisms.[27]

[3] Short Term Orientation

Exchange is intrinsically more of a short term operation than production/processing activities. The points made above about incentives towards exchange orientation also apply in this case.

The tentative general conclusion appears to be that there are some understandable reasons why Sri Lankan businessmen should engage to a relatively high degree in what appear to be 'mercantile' activities. These

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25 Warehousing space can easily be hired for trading activities.

26 Generally speaking, Sri Lankans can now import goods and services relatively freely, but are not permitted to transfer or own capital abroad, and are allowed limited quantities of foreign exchange for defined business, educational or tourist purposes. These restrictions have been progressively relaxed since 1977.

27 Similar motives are at work in public sector procurement. The main mechanisms are illegal payments into foreign bank accounts made by foreign suppliers of equipment or services.

reasons are however to do with the structure of the economy and the structure of incentives created by a deficient system of state regulation. There is no evidence that they are 'internal' to businessmen or their culture.

E. LACK OF SPECIALISATION?

It seems almost impossible to deny the validity of the claim that Sri Lankan businesses fail to specialise. At every level, and with every size of firm, one finds a very wide range of activities, some of which appear to bear little or no relation to one another.[28] There is an apparent preference for diversification over specialisation, and, very often it appears, for diversification into unrelated activities. Not only do firms appear to engage in a wide range of relatively unrelated activities,but vertical integration - expansion from one stage in the production/distribution chain into adjacent stages - appears relatively uncommon.[29] There are in fact several aspects of the business environment which provide a plausible explanation for the relative absence of specialisation. They generally involve some combination of structural features of the economy and of the pattern of incentives and constraints facing business.

(a) As is indicated above (see Section C, **1.iii**), the relative elaboration and sophistication of market exchange systems in Sri Lanka ignificantly reduces those incentives for companies to expand through vertical integration that

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[28] My favourite illustration is a small enterprise in premises which front onto one of the main thoroughfares in Colombo's 'mercantile' (i.e. formal sector business) quarter. The major activity is an advertising agency business. The firm also acts as distribution agent for a Swedish toothpowder, and uses the physical space available to (a) operate a photocopying service and (b) sell ice-creams and frozen chickens from a small freezer.

[29] There is in fact an historical precursor to such 'promiscuous diversification' in the large scale business sector. For in the colonial period, in Sri Lanka as in a number of other countries of South and Southeast Asia, the most prominent form of business enterprise in the 'formal' (i.e. European) commercial sector was the agency house. Agency houses conducted a wide range of business activities on behalf of a range of principals and capital owners located elsewhere, especially in Britain. They acted as managers and/or secretaries to plantation companies in particular, as well as to companies in other lines of business; they imported a wide range of consumer and producer goods, ranging from chemical fertiliser to scotch whiskey; and they were local agents for shipping and insurance companies.

However, one cannot take historical precedent as more than a marginal explanation of current patterns. The organisation of colonial trading firms was a response to particular circumstances which have largely disappeared. And Sri Lankan businesses enterprises have in many respects changed considerably in legal form, organisation and in activity patterns in recent decades. Contemporary patterns have to be explained largely in terms of the contemporary situation.

operate routinely and pervasively in environments which do not enjoy developed market systems. This can be illustrated by looking at the structure of an industry in which a relatively large number of stages in the production process are located in Sri Lanka - tea. Generally speaking, different (types of) companies were (and are) engaged in: the manufacture, installation and maintenance of tea factory equipment; producing tea; transporting tea to ports; selling tea to buyers; insuring; buying; and shipping. There was (and is) a substantial correlation between the technical separability of different stages of the production process and the boundaries between separate firms. This is a 'negative' factor, leaving companies free to respond to other incentives to diversify into unrelated activities.

(b) The relatively small size of Sri Lanka's internal market (see Section C, **1.ii**) is a (plausible) reason for diversification often cited by businessmen: it can be difficult to expand far in one activity or product line.

(c) Equally, the perceived prevalence of economic and political risk (see Section C, **2**) is also commonly given as the reason for diversification into unrelated activities. If one line of business sinks, another might thrive.

(d) The factors bearing on the availability of investment capital (see Section C, **5**) have a significant indirect effect on the issue of diversification. The linkage runs through the way in which the policies affecting availability and use of investment capital affect differentially the type of access to new capital enjoyed by different categories of business.

Loan capital is very much in demand, as it is subsidised both in relation to its real economic cost and in relation to alternative ways of raising investment capital (see Section C, **5**). However, long term lending is not a significant source of profit for banks; indeed, it can in some circumstances represent a net cost.[30] Banks do not charge market interest rates, and in many cases on-lend

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[30] Banks make their profits from fees on the services they provide rather than from loaning money. Given the relative importance of foreign trade, service fees tend to come mainly from this source. In this sense, Sri Lankan banks are as 'mercantile' as other parts of the business sector. The fact that banks have no interest in encouraging and helping companies to make long term investments is a significant component of the overall pattern of 'mercantile-ism'.

foreign aid funds at margins which they consider inadequate to cover their own costs. Given the procedural obstacles to foreclosing on bad debts, banks have limited incentives to put resources into debt recovery. Instead, they put more emphasis on protecting their own assets at the initial, lending stage. The political pressures to lend are very strong. One way of protecting bank assets is to try to insist on Central Bank guarantees for loans made under official 'development' schemes, thus shifting much of the cost of default to the general public purse or to aid donors. Another device is to try to direct lending as far as possible to known and trusted customers through unacknowledged - and perhaps even to some degree, unrecognised - routine operational means. Welcome customers can be quickly and easily accomodated; stable larger businesses rarely report any major problems with access to credit. Unwelcome customers - those who are not known, and who therefore cannot be trusted to repay; and small businesses whose needs would impose relatively high transaction costs on banks in relation to the amount loaned[31] - are therefore discouraged by simple delay and more covert 'foot-dragging', e.g. the full implementation of complex procedural requirements.

There is thus some valid basis to the frequent complaint that banks are biased against small business in Sri Lanka. The causes and remedies are however almost the obverse of those presented by the small business lobby. The solution does not lie in yet more controls on banks and preferential loans for small business. It lies rather in permitting the banks to make a profit on long term lending, and thus encouraging them to welcome or seek out requests from non-established borrowers and to assist such borrowers in developing realistic proposals which are appropriate to their circumstances.

The connection between the capital market situation and the relative lack of specialisation operates especially at the level of bigger, established firms. Sri Lanka has a relatively large number of bigger, diversified companies which have long been established as organisational and legal entities, even if their activity patterns have in some cases changed considerably over time. One of the reasons for this is that these firms, as established and known bank

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[31] Banks loaning funds under official programmes are not permitted to charge differential fees to allow for differing transaction costs.

customers, have privileged access to credit compared to smaller (and, perhaps, more specialised, firms). When information about a new investment opportunity diffuses, existing larger firms tend to have the edge because they can relatively easily raise investment capital from the banks. The clearest example is the big expansion of the tourist industry that began in the early 1970s. It seems that there is scarcely a large company or businessman without at least a share in a tourist hotel. Conversely, there is no (local) company which has become large or well-recognised in the industry by virtue of its technical expertise or experience in the hotel industry.[32] When the opportunities began to emerge, established businesses were able to use privileged access to capital to get in on the ground floor and learn through their own mistakes.[33] A capital 'market' which privileges known, larger customers encourages the growth of larger, diversified companies (or groups), and thus contributes to the overall pattern of relative lack of specialisation at the firm level.

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[32] I can think of one prominent public company which might contest this claim. It is true that the company has **become** acknowledged for good hotel management; however, it had the assets and the position to diversify into the hotel industry on a fairly large scale at a time when its main activities lay elsewhere.

[33] This may not necessarily be a bad thing: it permitted the very rapid expansion of the tourist industry in the late 1970s, although it might also have contributed to over-investment in hotels. The easy availability of subsidised long term loans is likely to reduce the level of wariness about the dangers of jumping onto a fast-moving bandwagon. It is not clear that 'jumping onto a fastmoving bandwagon' is necessarily irrational from the investors' perspective. In the particular case of the hotel industry, the 'bandwagon' generated enough political clout to obtain very favourable debt reschedulings from government when the tourist market collapsed after 1983.

F. CLOSEDNESS?

To a greater degree than the other two charges discussed above, the charge of 'closedness' represents a conflation (on my part) of several partially-distinct ideas, notably (i) lack of trust; (ii) reluctance of business leaders to devolve; and (iii) familialism. These factors must to some degree be discussed separately, although the arguments put forward below should justify my treating these factors as inter-related.

[1] 'Trust'

There is a widespread view, advanced by members of various minority communities as well as by the majority Sinhalese, that one reason why the Sinhalese have historically been under-represented in business is that they do not enjoy the relations of inter-personal trust within the community that are found within other minority communities and which are central to business success. The contribution of trust relations to business success seems beyond doubt. In Sri Lanka as elsewhere, in many spheres of business a competitive edge is enjoyed by those who can (a) obtain accurate information about the financial status, honesty, and reliability of unknown potential business partners[34] by enquiring from others in the trade; (b) quickly raise short term money on the informal money market to exploit a fleeting business opportunity on the strength of name and reputation alone, with little or no security; and/or (c) make rapid business deals on the strength of word and reputation, knowing that agreements will be honoured, and thus avoid the need to either carry large stocks of liquid cash or wait until formal bank transfers have been made until a deal can be treated as binding. Such trust relationships are especially important to success in trading.[35]

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[34] I use 'partner' here in the sense of co-transactor - one with whom one engages in a business transaction.

[35] They are also very important to the functioning of international money and commodity markets, where time is a central strategic variable and speed thus vital once a deal has been agreed.

In its extreme form, the argument that Sinhalese are somehow incapable of forming these trust relationships can be shown to be false. There are plenty of examples to the contrary. The Sinhalese traders who dominate the vegetable and fish collection and distribution systems have long term trust relationships with their suppliers and with one another. Over the past two decades or so, Sinhalese have assumed a significant role in the gem trading business, which was formerly largely a Muslim monopoly. The Sinhalese traders with whom I have spoken claim that they engage in transactions on a trust basis with one another and with Muslim traders in the same way that Muslims engage with other Muslims. There is thus little evidence for the extreme 'culturalist' argument that there is something in the make-up of the Sinhalese that makes them untrustworthy and unable to trust others, and thus incapacitates them for business in this sense.[36]

Unfortunately however, at least for those who like short and simple answers, that does not appear to be the end of the story. It is at least plausible that trust relationships are formed more easily between businessmen belonging to various minority communities than among Sinhalese. To appreciate why this is so, and what significance it may have, we have to look at the issue of trust in business rather broadly.

'Trust', in the sense in which it has been described above, does not emerge at random. It is nurtured and reproduced in particular favourable social environments. The basis of this trust lies in access to a continual flow of information about the personal circumstances of potential business partners. Inadequate or inaccurate information will lead to trust being placed in unreliable people, and will ultimately threaten the disintegration of the network. Intensive inter-personal interaction within the network provides the grid along which information flows. Relatively small groups that specialise in (particular sectors of) trade and business and interact regularly thus constitute fertile environments for the sustenance of trust relationships. Accurate information about third parties may be obtained relatively easily.

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[36] Other stereotypes can be rejected in the same way. It is for example striking that one stereotype applied to Jaffna Tamils - their conservatism and unwillingness to take risks - almost directly contradicts another - that they are unusually sharp and effective at business. Success in business requires some willingness to take risks.

And sanctions against violation of trust are in large part inbuilt. For accurate information about an act of bad faith will diffuse rapidly, and the defaulter will find himself boycotted for business purposes as a result not (necessarily) of any collective or institutionalised decision but of the self-interested behaviour of individuals within the circle, who will not wish to risk their own business reputations and interests by becoming involved with such a person. The effectiveness of such networks is all the greater to the extent that the boundaries of the business community overlap with the boundaries of a 'social' group in the narrow sense of that term. Where businessmen in the same trade are inter-related and inter-marry, meet at the same social functions, worship at the same temples, and support the same community organisations, then (i) information flows even more abundantly; and (ii) the potential costs to defaulters of community sanctions are all the greater.

These kind of 'exclusive' patterns of business-cum-social interaction are not rare. They appear to be especially pronounced and prevalent (i) in trading (as opposed to production); (ii) where the legal and political environment provides weak support for the enforcement of business contracts, and where alternative institutional arrangements are thus especially valued - which implies they are relatively common in developing countries; and (iii) where there is a long-established trade which benefits particularly from remaining outside the purview of governments (e.g. the international trade in high-value gems). Such patterns are important in Sri Lanka. They are more prominent among the various tiny minority communities which historically specialise in business, such as Bharathas, Borahs, Memons, sections of the 'Sri Lanka Muslim' and 'Indian Muslim' communities, and, formerly, Nattukottai Chettiars.[37] They are not so common among the larger communities, and especially not among the Sinhalese in general. The question of **causation** is however complex and central to any practical conclusions that may be drawn.

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the sea.[38] One important dimension of the history of the private sector over recent decades has been the gradual 'rectification' of this situation, such that the private sector is now much less unrepresentative of the range of communities than it was formerly. But community-specific social institutions continue to support and to structure business relationships to an important degree. Brit may no longer meet Brit in the exclusive Colombo social clubs, but Borah meets Borah in the community mosque, Memons have their own community association, and the Muslim traders who market valuable gemstones inter-marry and all live within a few hundred metres of each other in China Fort in Beruwala. When people meet within such communities, they discuss business, directly and indirectly.

Given that Sinhalese-in-general were not historically a 'business community' - and they could not have been so given their overwhelming numbers - there were no apex social institutions representing either all Sinhalese or whole castes which performed significant business functions. Indeed, insofar as Sinhalese both tended to specialise in politics and administration and formed a majority of the population, they have almost inevitably found themselves in situations of conflict with one another fairly frequently. Conversely, the small 'business communities' tend to have consciously eschewed active participation in politics.[39]

Differences in the historic role of different communities are at least consistent with some popular stereotypes. Because they have specialised in business, the minority 'business communities'[40] have established patterns of trust relationships; it is therefore probably true as a matter of fact that trust in

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38 This was also true **among** the Sinhalese: in the colonial period, business prominence was the special province of the small Karava caste, which was formed largely from relatively recent immigrants from India and was in many senses 'marginal' to the 'traditional' social and political order. For details, see M. Roberts, Caste Conflict and Elite Formation: The Rise of a Karava Elite in Sri Lanka, 1500-1931, Cambridge University Press, 1982.

39 They have understandably been an important source of finance for politicians and governments of all parties.

40 The contrast here is between the Sinhalese on the one side and the small business minorities on the other - the Bharathas, Borahs, Memons, Chettiars and (some) Sri Lanka and Indian Muslims. I have not included the Sri Lanka/Jaffna Tamils, because they seem to belong somewhere between the two.

business is more common within these communities. Conversely, Sinhalese have been more directly involved in politics and government, and thus in conflictual activities. It is more likely that political conflicts will enter into, and jeopardise, their business relationships.[41]

The problem about drawing practical conclusions from such comparisons is that they are based on a misleading comparison - between small business-oriented minorities and the majority Sinhalese community historically rooted in agricultural production and in government. The relevant comparison should perhaps be with particular groups of Sinhalese who do specialise in business. Once one does this, the picture changes. For there are groups of Sinhalese businessmen specialising in particular sectors who appear to interact with one another very much like non-Sinhalese business minorities. They do form 'business communities' in the sense that they inter-marry, interact socially, and share the same temples. They are less visible because the boundaries of the group do not correspond to boundaries of 'communities' in the usual sense of the term.[42]

There is no very clear conclusion to be drawn on the basis of the evidence available. My own judgement is influenced by the observation that Sinhalese businessmen have made considerable advances in many sectors in recent decades. It follows that the 'trust problem' is unlikely to be a major barrier to the business success of any particular community, although overcoming it may be a lengthy process.

That is not however to say that there is no **general** 'trust problem' within the Sri Lankan business environment. For in an environment where the 'normal' legal and governmental framework for the regulation of

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[41] Also, because display of wealth and status can be a useful tactic for communicating with and impressing a wide 'political public', it is at least plausible that there is some truth in the stereotype that, once they make money, Sinhalese are more likely than members of the minority communities to make this known through adopting an ostentatious life style, at the risk of attracting the malign attentions of the taxman or political rivals.

[42] The best-known example is perhaps the 'Panchikawatte mudalalis'. Dominating the trade in motor spare parts, they comprise a relatively distinct social group which has its origins in a particular locality of the Matara district, and a powerful, organised pressure group.

commercial transactions is deficient (see Section C, 3), businessmen have to be a little wary about the identity of the persons to whom they lend money, advance goods, and provide with information about their own business affairs, or on whom they rely for input supplies. Businessmen are vulnerable to: uncollectable debts; broken contracts; legal suits taken out for purposes of harrassment; and the leakage of confidential information to business rivals, tax authorities, and politicians in search of election funds. Such vulnerabilities must induce a certain conservatism about which activities to engage in, and with whom.

[2] Devolution

I have two responses to the widespread view that Sri Lankan business leaders are unwilling to devolve responsibility on to subordinates and specialists:

(a) This view stems in part from observations about the behaviour of successful small businessmen: their unwillingness to relax tight control over all aspects of their firms' activities even after the firms have grown such that the founders can no longer manage effectively without help. This appears to be a valid observation, but it relates to a world-wide phenomenon; there is no reason to think that there is anything unusual about Sri Lanka.

(b) There is, however, good reason to think that unwillingness to devolve is a particular problem in Sri Lankan companies. The reasons however have already given in the previous section. For unwillingness to devolve within a firm results from lack of trust in subordinates and specialists, and this in turn is, to some degree at least, a rational response to the local business environment, and a reflection of the same factors that hinder trust between firms. Where it is the norm to reduce taxation liabilities by under-stating corporate and personal incomes and the value of transactions, executives in a company may gain access to information which may be used for near-blackmail activities or passed on to outsiders with various damaging results. The same is true of over-invoicing of import values and under-invoicing export values to accumulate foreign currency abroad. For these and other reasons, real risks and costs may be incurred by giving 'outsiders' substantial responsibilities for company affairs. There is thus a general bias against

devolution, unless it is to trusted persons, who are often to be found only within the family.

[3] Familialism

In terms of ownership, control and management, Sri Lankan companies are highly familial.[43] The vast majority of companies are identified with a particular individual or family group which holds at least a controlling interest, and, more frequently, a substantial majority shareholding. Precise statistics are lacking. The vast majority of registered companies are private and their returns are confidential. Even in the case of the small number of publicly-quoted companies, obtaining access to returns is in practice difficult. A survey of publicly-quoted companies undertaken in 1984 revealed a high degree of 'closedness'. In only 10% of companies did the largest twenty shareholders between them own less than 60% of shares.[44]

The facts of familialism appears to be beyond doubt. Companies are largely owned by individual families and, perhaps more importantly, control and management tend to remain in family hands. Attitudes correspond: aversion to "losing control" or of "having to answer to other people for the colour of my tie" are the kinds of sentiments which company owners express when discussing this issue. The reason for this state of affairs does not lie in some kind of inheritance of indigenous or pre-capitalist attitudes and practices, or in any failure of 'modern' business law and practice to penetrate 'tradition'. Modern business practice and modern corporate organisation are neither new

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[43] The term 'familialism' is used here in a particular sense, to refer to the tendency to maintain ownership and control within families. It is not intended to indicate the kind of 'familialism' often claimed, for example, to be characteristic of Overseas Chinese business communities in Southeast Asia - a very strong individual commitment to the success of the family enterprise.

[44] Conversely, "In over 60 percent of the companies the largest twenty shareholders held 80-100 percent of the issued shares" (D.L.L.P. Jayawardena, Report on the Survey of Public Quoted Companies of Sri Lanka 1984, Department of Registrar of Companies, Colombo, 1988). The contrast with, for example, American and British companies is extreme. For example, in 1976, in only seven of America's 122 largest (non-financial) companies did the largest 20 shareholders between them own more than 50% of the total stock. See J. Scott, Corporations, Classes and Capitalism, Hutchison, London, 1985, p.69.

nor exotic in Sri Lanka. In the colonial period, when so many of Sri Lanka's contemporary large firms were established, familialism was not predominant in the organised (read 'British') commercial sector. The British commercial community, like the planter community, was to a large degree impermanent. Young men came out from Britain (especially Scotland) to make a career in planting or commerce and eventually retired back home.[45] Commercial firms were predominantly organised as partnerships in a legal sense, at least until the 1930s, when many started to incorporate themselves. Younger British executives with promise were generally encouraged and assisted to buy in as partners or directors when their seniors retired and sold their stock.[46] While the stock exchange itself dealt mainly in the shares of plantation companies, the purchase and sale of stock by rising and retiring executives was the normal mode of succession of ownership and control of commercial firms. While some stock was of course inherited, familialism was not the norm. It actually became so after the British were bought out by wealthy Sri Lankans in the 1940s and 1950s (in particular). Inheritance then became the standard succession mode in companies which had a history of more market-based modes. It is this change that needs explanation.

Part of the explanation is straightforward: unlike most of the former British owners, the Sri Lankan purchasers of companies had children, nephews and nieces and other relatives to look after in Sri Lanka. That answer is however adequate only in the context of a relatively stagnant economy. But the Sri Lankan economy has experienced both very considerable growth and major structural changes since the 1940s. Given the long habituation to modern institutions and practices that facilitate and encourage the distinction between ownership and management - a stock exchange with independent brokers, standard company auditing and reporting requirements, the legal recognition of the supervisory role of boards of directors - one might have expected that, as companies grew and changed along with the economy, familialism would have been gradually undermined: family ownership would be diluted as new stock was issued on the stock market to raise capital for expansion; and family

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45 Even British families with permanent links and interests in Sri Lanka normally kept at least one foot in Britain, and educated their children there.

46 Companies often had trust funds to hold stock and thus facilitate the transfer process.

management would decline in favour of hired professionals of proven ability. Neither of these things has happened to any major degree, and familialism has continued to reign. The reasons seem clear, and have largely been spelled out above:

(a) The risks involved in giving 'outsiders' access to information about company affairs is a powerful incentive to restrict management to family members.

(b) A range of interacting government policies provide strong incentives for companies to finance expansion through long term loans rather than through equity issues. There is rarely any occasion for company owners to even contemplate diluting their control by going to the share market to raise capital.

(c) A professional business management cadre does not exist, except perhaps to a very limited degree in the field of financial control and in the related field of bank management.[47] Several factors interact cumulatively. Demand for professional managers is low. Professional business management has little status, while the 'transferable professions' (see Section C, 4) have considerable status and offer substantial rewards. The formal education system is geared to recruitment into the 'transferable professions', and a high proportion of the academically more able students are placed in education and career paths which make them unavailable for recruitment into the private sector. There is no organised class of business managers - and especially no class of production management specialists with an engineering background - to put pressure on owners of capital and government to pursue policies more favourable to expansion in general, and expansion of industrial production in particular.[48]

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[47] Banking is an exception largely because of the predominance of foreign and state owned banks.

[48] The absence of such an interest group appears more significant when one considers the major political role played in the development of industry by professional engineers-cum-managers in the USA, the USSR, France and other countries. In this as in so many other respects, Sri Lanka has more in common with the UK rather than with other advanced capitalist countries that have been economically more successful in recent decades.

G. THE VERDICT

I began by identifying three sets of 'charges' that are commonly brought against Sri Lanka's private sector by its critics. It has been suggested in Section D that there is considerable validity in the charge of 'mercantile orientation': businessmen are heavily involved in buying and selling rather than in value-added activities, in trading in the international sphere in particular, and in short term activities. It is not however clear that 'charge' or 'accusation' is a helpful way of looking at the issue. For this mercantile behaviour can in large degree be explained as either an automatic reflection of the structure of the economy or as a rational adaptation to the insecurities of the business environment. It is not clear that one should either expect or want businessmen to behave differently in the circumstances. From the point of view of practical action it would be more fruitful to ask the government to improve the business environment where it is able to do so. There is no reason to view this 'mercantile orientation' as a significant, independent constraint on the economic performance of the private sector.

The charge of 'lack of specialisation' (Section E) also appears to contain a great deal of truth. But, once again, one can frame plausible explanations in terms of rational adaptations to the business environment. Insofar as government contributes by indirectly granting larger established companies privileged access to cheap long term capital, part of the solution lies in its own hands. Whether lack of specialisation is a major obstacle to company expansion and economic growth in Sri Lanka is however very doubtful. One can make a convincing case that, in some contexts at least, the opposite is true. Sri Lanka depends heavily on international trade, and will be obliged in the future to depend even more than in the past on exploiting export market opportunities which emerge suddenly and perhaps disappear equally rapidly in the new dynamic, highly competitive but also highly unstable world market which is emerging. With some adaptations, the old colonial 'managing agency' form of business organisation is in fact very appropriate to this new context. A business group which has (a) a generalist, adaptable senior management; (b) good international trading links, information networks and reputation; (c)

rapid access to credit; and (d) a flexible internal structure which permits rapid redeployment of resources and devolution of operational responsibility to line managers, is well placed to identify and rapidly exploit new export opportunities, and to adjust with minimum pain when a particular market disappears. To some degree this image fits some of Sri Lanka's more successful firms or groups. It is for these kinds of reasons that they combine diamond polishing with retail banking and real estate development; mushroom farming with sharebroking, food processing and general trading; hotel management with container services, gherkin production, printing and radio taxis; and the manufacture of activated carbon, rubber gloves and printing inks with spice processing, flower seed production, and colour photography services.

The charge of 'closedness' (Section F) subsumes a number of related phenomena, which I defined as: lack of trust; reluctance to devolve; and familialism. The notion of 'lack of trust' in fact underlies each of the three. There is no reason to think that absence of trust is a significant feature of Sri Lankan culture(s) in general; this is rather the kind of self-image that nations tend to attach to themselves in an attempt to explain what they perceive to be their 'failure' in the contemporary mode of inter-national politico-economic competition that is labelled 'development'. There are however good, rational reasons, stemming from the imperfections of the legal and institutional environment in which Sri Lankan businesses operate, why those who own and control companies are reluctant to share information and control with others. Add in the incentives created by government for capitalists to rely on loan capital and keep away from the share market, and one has a very plausible set of explanations for the 'familialism', in its various forms and dimensions, which so strikes the observer of the Sri Lankan private sector. Is familialism however a problem? It is my rather strong impression that 'closedness' - of which familialism is a major dimension - is a serious problem, in both economic and political dimensions. Let us take the economic dimension first.

Tangible evidence of the economic costs of familialism exists in the form of a definite statistical association, among the larger companies in Sri Lanka, between (a) poor long run performance and/or serious financial problems

and (b) having a history of familial management. Not all sons (and nephews and cousins) of businessmen are incompetent. Some have proved to be very able. But the laws of chance are against this happening every time. [49]

Familialism in management selection may however be more accurately seen as a symptom of underlying issues rather than as an independent cause. It reflects the fact that companies are under relatively limited pressure to make the best of their assets, maximise turnover and profits, innovate and expand. In the absence of such imperatives, it is that much easier to give into temptations and pressures to appoint a son or a nephew despite suspicions that he may not be the best person available for the job. Why do companies not make more effort to improve the rate of return they obtain on their assets? In the light of the information presented above, one can identify two main reasons:[50]

(a) Innovation and expansion tend to involve the sharing of information and control with externally recruited specialists of some kind. This can threaten the interests of existing controlling groups, who in various ways benefit from, and wish to preserve, relatively high levels of secrecy in company affairs.

(b) The 'natural' tendencies of second, third or later generations of the wealthy to prefer a degree of leisure and ease to continual effort, innovation and change are countered by neither (i) numerous and powerful shareholders demanding high dividend returns on their equity capital nor (ii) powerful

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[49] The issue of 'familialism' is complex. It is my impression that some families have found it easier to surmount this problem by adopting quasi-corporate practices *qua* family: (a) dividing company shares among members of the extended family, but selecting the company boss from among family members according to competence rather than genealogical seniority; (b) distinguishing between trusteeship of family capital assets, which is the role of a senior family member, and the management of current business operations, for which professional management may be hired. In other words, there is an unequal distribution of capacity to deal with the problems of familialism in business through innovative social arrangements.

[50] Some observers would add a third reason: the fact that the Sri Lankan internal market still enjoys a relatively high average degree of tariff protection against competing imports. This, it is argued, leads to limited competition and thus mutes the pressures that would otherwise exist for companies to expand or die. I question whether this a helpful approach. Because of the virtual absence of non-tariff barriers to imports, the Sri Lankan economy is less protected than some comparisons suggest. In addition, it is not clear how much more external competition many sectors of the Sri Lankan economy could cope with.

and articulate cadres of professional managers with a vested interest in expansion.

The economic consequence of 'closedness' is thus a muting of the pressures which are 'normally' brought to bear on companies in a market economy to generate a high rate of return on the capital they employ, and thus to expand and innovate. On average - and there is of course a wide spectrum of behaviour in reality - the organisational-cum-capital assets embodied in companies are not working as hard as they might. In consequence, they produce less output, employment, technical change and capital accumulation than would otherwise be possible. According to this analysis, the main economic deficiency of the private sector in Sri Lanka does not lie in its having abstract characteristics like 'mercantile' (rather than 'productive'), or 'comprador' (rather than 'national'), but rather that it is simply insufficiently activist.

The political dimension of the 'closedness' of the private sector is almost self-evident. Ownership and control of companies is concentrated in very few hands. Those who see this kind of monopoly as the normal or defining characteristic of the private sector economy may rejoice in the fact that appearance and reality are in complete accord in the Sri Lankan case. If however one believes (a) that a more broadbased private sector is possible and/or (b) that the long run political sustainability of a private-sector based economic strategy depends on at least 'co-opting' substantial sections of the middle classes in such a way that they believe themselves to have important direct material interests in the private sector, then there is a problem here for the policymakers to tackle.

H. IS SHAREHOLDER CAPITALISM THE SOLUTION?

The argument that the Sri Lankan private sector is too closed - in relation to the regulatory agencies, the law, professional management and incentives to obtain a good return on assets - is now widely accepted in policymaking circles. The kinds of policy measures which could reduce the degree of closedness and thus improve the private sector's economic performance and political acceptability have already been outlined above. It is a matter of changing the institutional environment to make secrecy about company affairs and narrowly-based ownership less attractive, less necessary and more costly: a more usable legal system; enforcement of taxation liabilities and company reporting obligations; more demanding information disclosure requirements for all companies; the ending of the privileged status of loan capital; and the nurturing of business management as a profession. A number of such policy measures have been introduced in recent years.[51] There is however no precise agreement on what needs to be done, and a wide range of choice about how to pursue the general objective of opening up the private sector to external scrutiny, performance incentives and talent. Very different strategies are possible. It would be possible, for example, to concentrate on reforming company law and enforcing existing legislation, aiming at greater disclosure of information, without directly touching on issues of ownership or management. Alternatively, the government could focus on issues of education and training, attempting to reform higher education to give the academically able more incentives to pursue business careers.[52] This could be combined with more direct promotion of business-

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[51] The most recent, at the time of writing, is the new requirement that all companies with an annual turnover of more than five million rupees shall be audited by qualified auditors.

[52] Discussion of exactly how this could be achieved is beyond the scope of this paper. It would probably require a radical change away from the present relationship between university education and job recruitment. Some of the main elements might be: (i) making relevant job experience a condition for university entrance; (ii) recruiting to the public sector at pre-university level on the basis of some combination of examination results and intelligence/aptitude tests; and (iii) giving all citizens a right to compete for university places after a period spent in employment. One of the objectives here is to encourage bright young people to seek private sector employment **before** they become sucked into the struggle to obtain medical or engineering qualifications. Another is to allow employment experiences and prospects to have a greater impact on choice of subject for study at university and, hopefully but less directly, on curriculum design.

relevant higher education. To a limited degree, all these issues are receiving attention at present. However, the element in the 'business reform' strategy which appears to be receiving greatest attention is the reactivation of the Stock Market and the promotion of 'shareholder capitalism'. The wisdom and limits of this strategy constitute the subject of the remainder of this paper.

What is 'shareholder capitalism'? There is no authorised definition. The core idea is that individuals and institutions (banks, pension funds, insurance companies, investment companies, mutual funds, etc) who trade in company stock should exercise significant influence over company behaviour. At the operational level, there are four main inter-related elements to the concept:

(a) The 'broadbasing' of company ownership, through the stock market, such that, at a minimum, individuals, families or closely-related groups do not exercise unquestioned control over individual companies, but are obliged to respond to the concerns of shareholders with whom they have no particularistic relationships.[53]

(b) The reform of the letter and practice of company law to give minority shareholders sufficient timely access to information about company affairs that they can effectively exercise their rights to both 'voice' - to have a say in company policy and in the selection of the Board of Directors - and to 'exit' - to sell shares.

(c) An active market for company shares, supported by an honest and well-regulated Stock Market, such that investors' judgements about company performance are reflected in share prices.

(d) Conversely, companies' policies and strategies are influenced by the actual or potential valuation of their shares in the Stock Market, via the implications for (i) the cost of raising equity capital; (ii) incentives to

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53 A more ambitious goal (and definition) - ambitious in the light of the current pattern of Sri Lankan company ownership - might be the fragmentation of shareholdings to such an extent that, as is the case with many large companies in some developed countries, control could be exercised only through coalitions formed between several of the larger shareholders.

distribute or retain profits; and (iii) possibilities of 'hostile' company takeovers through share acquisitions in the Stock Market.

While attempts to revive the Colombo Stock Market have been continuing for some time, the atmosphere has changed considerably over the past couple of years, aided very much by a boom in share prices following on the enormous undervaluation of stock in 1988 to 1989, and the (limited) re-opening of the market to foreign buyers on non-discriminatory terms. Considerable foreign assistance has gone into the re-activation of the Stock Market. Although this has yet to generate the results that really matter - substantial numbers of existing larger companies seeking public legal status and a listing in the Market - there is no doubt that many of the people now shaping Sri Lanka's economic strategy now see a major role for the Stock Market and for shareholder capitalism.

Is this desirable? My own answer, for the present, is positive. A more active Stock Market is an important component of the strategy to tackle the problem of the closedness of much of the private sector. Among other things, more active Stock Market - a shift of company shares to the Market and into active trading - should:

(a) Put pressure on relatively unambitious company managements to obtain a higher return on assets to satisfy shareholders.

(b) Help to create an influential class of investors with an interest in extending and enforcing information disclosure requirements on companies.

(c) Provide family owners of firms with a mechanism - sale of shares in the market - through which they can (gradually) realise some of their capital, reduce their interests in the company, and provide those members who have no talent for management with alternative interests and opportunities, permitting professional managers to take their place.

(d) Provide firms with a source of capital to finance risky projects. This will be a more urgent need if the state banks are placed on a commercial basis as

planned, for this will reduce the degree of access which some firms have enjoyed to relatively risk-free long term loans.

As a component of a strategy to improve the way in which the private sector currently works in Sri Lanka, measures to promote the Stock Market and shareholder capitalism seem sensible and desirable. They also seem likely to contribute to the political legitimation of capitalism by widening share ownership. I have little dispute with the principles of what has been done or advocated so far. My concern about the notion of shareholder capitalism as a strategy arises from a longer term, 'developmental' perspective: that the forms of company ownership and control intrinsic to shareholder capitalism may not provide the right incentives for companies to make the kind of long term investments that are needed for successful development. This concern is explained in the next section.

I. ALTERNATIVES TO SHAREHOLDER CAPITALISM

The economic doctrines that dominate the international financial institutions in Washington, and currently exercise considerable influence over economic policymaking in Sri Lanka, tend to place a high value on shareholder capitalism. Fot this they have a theoretical justification: the search for profit on the part of shareholders is expected to have a benign effect on companies' economic performance. Companies which hire good managers and use their assets to good effect will generate high financial rates of return on those assets, which will in turn result in large dividends for shareholders and/or high rates of appreciation of share values. Such companies will then have relatively easy access to capital for further expansion through issues of additional shares. Companies which fail to generate a good return will find that their disappointed shareholders will respond by exercising either (i) electoral 'voice' to change the Board of Directors or company strategy or (ii) the 'exit' option - selling stock, and thus driving down its price. Either the company will reorganise and perform better, or it will decline and find it expensive to raise additional capital - which is only appropriate because it uses capital inefficiently. The aggregate consequence is that economic efficiency is rewarded and encouraged, and inefficiency is penalised - assuming always that market prices provide accurate guidance as to what is economically efficient. What may be termed 'floating shareholders' - those with no special or permanent links with the companies in whose shares they trade - are thus cast as the active agents of efficient market processes.

This interpretation of the economic role of shareholders represents an application in the sphere of company ownership of the doctrine of economic liberalism - the belief in the superiority of competitive markets and market-like mechanisms which permit the maximum mobility of economic resources under the guidance of market prices and material incentives. For shareholder capitalism entails that a company's market value - the **actual** price at which it may be purchased - is both set in the stock market and may fluctuate from hour to hour according to the forces of supply and demand in

that market. Economic liberalism is sometimes labelled 'the Anglo-American doctrine', and for present purposes this is especially appropriate. For the UK and the USA represent rather extreme cases among the class of advanced capitalist countries in the extent to which they permit market transactions in company shares to shape the strategies and fates of (large) firms. Only the UK and the USA place no substantial legal and/or institutional obstacles in the way of 'takeovers' - the purchase of a controlling share of company stock by 'outsiders' through stock market transactions. The possibility of such takeovers introduces speculative or de-stabilising elements into share price formation which are absent when takeovers are not feasible: considerations of power, status, share pricing strategy and speculation all come into play.

One does not have to search far through the contemporary British and American business press to find eloquent and passionate statements **against** unrestrained market determination of company value, control and strategy, and especially against the consequences of openness to 'hostile takeovers'. The basis of these contrary arguments lies in the observation that major technological (or organisational) innovations involve a lag of several years between initial investment and pay-off. This is especially true of 'national champion' firms engaged in research and development at technological frontiers. Until the pay-offs from the investment begin to be realised, the costs will tend to depress dividends. Insofar as shareholders tend to regard their shares as a simple financial investment, and to hold shares in a wide range of companies, they have little information about - or fundamental interest in - the potential long term pay-offs from the development programmes of particular companies. Companies' long term development programmes make themselves felt to many shareholders primarily as reduced dividends and low rates of return on capital (in the short term). 'Floating shareholders' respond by selling - or showing no interest in buying - the shares of such companies. Stockmarket forces therefore tend to drive down company values. This has two deleterious consequences. One is that, since share values represent the price at which companies can finance investment by issuing additional shares, development financing capacities are impaired. The other, more dramatic consequence is that companies become vulnerable to takeovers from wealthy and well informed predators

who see that their real, long term value is greater than indicated by share prices. The biggest problem may not be actual takeovers, but the consequences of fear of them. Company managements can generally expect to be displaced after takeovers and therefore fear them. They respond by shunning long term risky investments, concentrating instead on short term profits, to maintain share prices and thus preserve their own positions. These arguments are summed up in the phrase 'short-termism'. The adverse consequences of fear of hostile takeovers are simply the more visible and dramatic component of the process. The more general point is that stockmarkets consistently tend to undervalue long term investments, and thus discourage company managements from such activities.

It is difficult to judge the extent to which these stockmarket pressures do in fact inhibit long term projects (and basic research). The case that they do so is very much bolstered by the fact that, among the leading capitalist economies, it is precisely those which practice unrestrained shareholder capitalism - the USA and the UK - which have been the least impressive performers in recent decades. The more successful economies have institutional arrangements which (i) empower stakeholders other than 'floating shareholders'; and (ii) provide these other stakeholders with an interest in the long term performance of the companies with which they are associated. The argument that it is these institutional arrangements which help explain relative economic success is highly plausible. Without going into details of differences between countries in company law, organisation, ownership and control, one can usefully sketch out three alternative patterns of 'company governance' - alternative to shareholder capitalism - which have been associated with economic success.[54]

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54 The following books are especially relevant to this section: A. Amsden, Asia's Next Giant: South Korea and Late Industrialization, Oxford University Press, New York and Oxford, 1989; R. Dore, Taking Japan Seriously: A Confucian Perspective on Leading Economic Issues, The Athlone Press, London, 1987; P. Hall, Governing the Economy: The Politics of State Intervention in Britain and France, Polity Press, Cambridge, 1986; W. Carl Hester, Japanese Takeovers: The Global Contest for Corporate Control, Harvard Business School Press, Boston, 1991; J. Scott, Corporations, Classes and Capitalism, Hutchison, London, 1985; A. Shonfield, The Use of Public Power, Oxford University Press, Oxford, 1982; and R. Wade, Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization, Princeton University Press, Princeton, 1990.

[1] The 'Governed Market' Model: France, South Korea and Taiwan

The key feature of these cases of succesful capitalist development is that, while ownership of firms has remained in private hands - and often those of small groups and families - major strategic and investment decisions by (larger) companies have been significantly influenced by government agencies concerned to promote national industrial and technological competitiveness. These agencies have been able to influence firms strategies through command of a range of resources, notably: privileged access to bank credit on favourable terms; direct subsidies for certain investments; guaranteed markets through public sector procurement; limited (and, often, time-bound) protection against import competition to new products and processes; and government assistance in breaking into export markets. The applicability of this model to Sri Lanka is questionable: it implies both a high level of competence within public industrial development agencies and a distancing between specific government interventions and partisan political considerations which would be difficult to achieve in contemporary Sri Lanka. The relevance of this 'model' to Sri Lanka is of a more abstract kind: it demonstrates that successful capitalist development is possible in circumstances where stock markets are underdeveloped and/or exercise little influence over company strategy.

[2] Inter-Company Networks: Japan

To a considerable degree, and especially in the earlier post-war period decades, Japanese industrial development agencies exercised much the same kind of influence over large private firms as public agencies did in France, South Korea and Taiwan. However, as that influence has waned, it has become clearer to outside observers how far the strategies and choices of individual (large) companies are affected by institutional arrangements which (i) are internal to the private sector itself and (ii) empower stakeholders other than shareholders, especially not 'floating shareholders'. There are three important categories of influential 'other' stakeholders: (i) company managements, who rarely own significant shareholdings and whose remuneration is not tightly linked to company profits or share prices; (ii)

employees; and (iii) other companies which form part of loosely-structured 'groups'. For present purposes, the nature of these 'groups' is of special significance. They constitute 'groups' because they engage in a range of coordinated or collective action of various kinds:

(a) There is a substantial degree of cross-shareholding between different companies within the group. Typically, no single company will own more than a few percent of the stock of any other single company. But the collective holding of group members constitute an influential or controlling interest in almost every company in the group. Other shareholders, who typically own a majority of company shares, exercise very little control, being highly fragmented.

(b) Individual companies typically direct a high proportion of their banking and overseas trading business to the bank and the general trading company which normally constitute part of the group. (This relationship is however not exclusive; a degree of competition is maintained through use of alternative channels).

(c) Group members tend to engage in inter-firm trade with one another and to cooperate in new ventures and in research and development.

(d) Powerful if somewhat invisible 'coordination' of group activities is achieved through a number of devices, including: (i) regular meetings of group managements; (ii) the existence of a clear hierarchy among managers within the group, assisted by some transfers of managerial staff between companies; and (iii) the maintenance of close social interaction between managers - virtually all of whom are employed within one group, if not one company, throughout their working life.

(e) Where individual companies face serious problems, support and intervention may be organised at the group level.

It is plausibly argued that these kinds of institutional arrangements have made a significant contribution to Japanese economic growth by providing those actors who shape company strategies with both the incentives and the

capacity to resist temptations to focus on short term profits, to take a long term perspective, and thus to continually invest in the kinds of research and development programmes which have given (larger) Japanese companies a world lead in so many areas of technology and production organisation. The following are among the main mechanisms at work:

(a) Lifetime employment and restriction of company pension fund assets to the individual companies' own shares provide employees at all levels with a strong interest in the long run success of the company. Conversely, the unimportance of current company profits or share prices in determining managerial rewards means that managers have little incentive to take a short term view.

(b) The relatively dense networks of social relations, business transactions and co-ownership arrangements which exist between companies within groups provide tangible economic benefits, notably (i) general coordination of activities; (ii) high levels of information and trust, and thus the scope to engage in cooperative arrangements - including research and development - without fear of being cheated.

(c) Cross-shareholdings within groups provide a high degree of insulation against hostile takeovers, leaving company managements free to concentrate on long term concerns without being distracted by a need to protect share prices in the short term. Hostile takeovers are rare in Japan; companies within the 'groups' are totally immune. More generally, 'floating shareholders' have little influence on corporate strategy.

There is much more that could be said about the issue of corporate governance in Japan, and considerable debate about the relative importance of the kind of factors listed above. The significant point for present purposes is that there exists a model of corporate governance in a highly successful capitalist economy that departs substantially from the fundamental tenets of shareholder capitalism.

[3] Development Banks: Germany

After World War Two, both Japan and (West) Germany were occupied by representatives of the victorious Anglo-American alliance. In both cases, the occupation authorities attempted to break up the concentrations of economic power which, in accordance with Anglo-American liberal doctrine, were believed to have been partly responsible for creating and sustaining the authoritarian, militaristic regimes which led Japan and Germany into war. Some success was achieved in Japan. The large, hierarchical, closely-controlled groups-under-holding-companies (*zaibatsu*) which had dominated the Japanese economy were replaced in the 1950s by the loosely knit groups described above (*keiretsu*). In Germany the target was a small number of very large general banks which played a dominant role in the economy by virtue of their large shareholdings in major firms. Here the attempt to impose liberal doctrines of company governance in the course of military occupation proved less successful. The old system was largely reconstituted when occupation ceased.

Key components of this system are (i) the small number of large general banks (three); (ii) the widespread practice of private shareholders assigning their voting rights to their banks; and (iii) use by the banks of their accumulated voting power to place their own representatives on the boards of larger companies; and (iv) the active concern of bank professional staff with the performance of these companies. Banks are able to take a long term view of the performance of individual companies because they (the banks) are sufficiently large to take risks and are able to assure themselves of the soundness of company strategies through participating in shaping and overseeing those strategies. Banks have the information and staff to participate, and are able to use their financing power to influence company policy. The shareholdings controlled by banks constitute a formidable obstacle to hostile takeovers.

The German model differs from that of Japan. Its strength lies in the way in which the concentration of control of shareholders' votes in banks combines with the banks' financing power to create an external stakeholder which has both an interest in long term company performance and the knowledge and

capacity to translate that interest into influence on company policy. At a more abstract level, the German and Japanese models share two important institutional mechanisms: (i) those which insulate company strategy from the consequences of short term share price movements; and (ii) more positively, those which empower stakeholders (other than 'floating shareholders') who have an interest in company performance in the long term.

In relation to issues of long term development, Anglo-American ideas about company governance are increasingly challenged in the industrialised countries, especially in their own heartlands. For the evident success of competing countries, especially Japan, has induced a search for alternative ways of organising economic activity, and new kinds of theories about effective economic organisation.[55] It is a little ironic that, just as these ideas are going out of fashion at home, they are being accepted in Sri Lanka, and throughout much of the Third World, as part of the general package of economic liberalisation. What is ironic is however not necessarily wrong. I have suggested above that some shift to a more open, Stock Market-oriented private sector would be desirable for Sri Lanka. The real challenge is to know how far to go, and when to dissent. It is likely that the problem of 'short-termism' will become to be seen as more serious in Sri Lanka, and that attention will turn to possible remedies. I do not think it appropriate at this stage either to make detailed prescriptions or to suggest wholesale adoptions of either the Japanese or the German models of corporate governance. For they emerged over a long period of time in particular historical and cultural circumstances. Replication is not feasible. Neither is it politically feasible to think of major, state-sponsored reform of corporate governance in Sri Lanka.

What is needed at this stage is for Sri Lankan business leaders and bankers, in particular, to consider possible institutional mechanisms to promote 'long termism' in business. One issue requiring particular attention may be the incentives bearing on corporate managements. Here, recent local experience seems relevant, especially that of the three large locally-owned companies

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55 For an alternative approach to economic theory, which draws heavily on Japanese and other experiences in which social organisation can be seen to have played an important role in fostering economic growth, see M. Best, The New Competition; Institutions of Industrial Restructuring, Polity Press, Cambridge, 1990.

which are almost universally acknowledged to have been clear successes since 1977 - in terms of growth, diversification into new activities, earning foreign exchange and Stock Market performance.[56] In terms of strategy, all three have tended to take long term views. In terms of corporate governance, all three, although quoted companies, were marked by the concentration of shareholdings in the hands of a small **group** of people who were simultaneously the senior executives. Ownership and management were thus largely concentrated in the same hands but, unlike in the typical Sri Lankan company, this dominant group was not constituted on a familial basis. Recruitment and promotion to the group reflected a mixture of inheritance and intra-company mechanisms to transfer shares to promising and senior executives, especially at the point at which shareholding executives retired. Those familiar with company management in Sri Lanka will realise that this system of non-familial executive recruitment and intra-executive share transfers was exactly the 'traditional' practice in the (colonial) mercantile sector - a practice which has in most cases been superseded by simple familial inheritance after established British mercantile firms came under Sri Lankan ownership in the 1940s and 1950s (see Section F).

It seems likely that there is a causal connection between (i) the 'long termism' and success of these three 'star' firms and (ii) their system of corporate governance. I suggest that the following mechanisms were of especial importance:

(a) The system of intra-company share transfer to successful and promising executives both helped create a loyalty to the company among executives generally and ensured that control of the company stayed in the hands of those who had demonstrated executive ability.[57]

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56 I refer to Aitken Spence, Hayleys and John Keells.

57 This raises the question of employee share ownership more generally. While I am in favour, I believe it would be naive to expect that the ownership of small shareholdings by ordinary employees will significantly affect employee motivation in most Sri Lankan companies. Hierarchical differences and levels of distrust between executive and manual cadres are too great to be significantly bridged through such devices. The problem is serious and needs attention, but one cannot expect much short term change.

(b) The association of senior executive position with shareholding rather than with performance bonuses tied to current profits (or current share prices) encouraged 'long termism'.

(c) In general, information about the prospects for particular new lines of business tends to be highly imperfect in Sri Lanka, especially because foreign collaboration and technology is so often involved. The resulting uncertainty can be a constraint on investment. However, senior owner-managers, who necessarily inform themselves thoroughly and typically establish a direct personal relationship with potential overseas business partners, are less constrained by ignorance and uncertainty, and so relatively willing to make a positive decision.

It is ironic that progress toward shareholder capitalism in Sri Lanka actually militates against the maintenance or extension of this apparently-successful system of corporate governance. The activation of the sharemarket and the limited number of 'star' companies has meant a heavy demand for their shares and major sales by owner-managers to outsiders. In the long run, the controlling interest held by the senior executive cadre is being diluted, possibly opening the way to the possibility of hostile takeovers. Equally, increasingly-rigorous regulation of the Stock Exchange diminishes the scope for company managements to have any say in the disposal of company shares. Once a company is quoted, the 'traditional' system of share transfer between retiring and succeeding Directors becomes illegal. It may not be easy for individual companies to combine the benefits of both a Stock Exchange listing and a mechanism to ensure a continuing association between senior executive status and ownership of a substantial block of shares. There are however few limits to institutional and legal ingenuity. One would hope that those concerned with the regulation and promotion of Sri Lanka's private sector will not be too obsessed with the advantages of extending shareholder capitalism, but will also pay attention to other successful experiences of corporate governance and to the apparent lessons from Sri Lanka's own 'star' companies, and try to find mechanisms which will encourage company managements to adopt strategies which pay adequate regard to the long term.