Asian Studies Center

Backgrounder

The Heritage Foundation • 214 Massachusetts Avenue, N.E. • Washington, D.C. 20002 • (202) 546-4400 • Telex: 440235

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NOW, A SRI LANKAN FREE MARKET ECONOMIC MIRACLE

INTRODUCTION

Achieving economic growth is the greatest challenge facing developing countries. How to do so is a matter of great debate. On the one hand are those arguing that growth requires elaborate blueprints developed and controlled by a central government with its emphasis on welfare services, state ownership, and income redistribution. Strongly disagreeing with them are those who point to prosperous Taiwan, South Korea, Singapore, and Hong Kong as proof of the success of the free market-private enterprise strategy with its emphasis on competition, incentives, and opportunity. The latest success story is Sri Lanka, where a bold experiment in democratic capitalism began in 1977, confirming once again that free markets and private enterprise can be the engine of growth.

This is particularly significant for American foreign policy, for the Reagan Administration and the governments of the United Kingdom and West Germany have been advocating a development strategy based on free market-private enterprise competition which in turn fosters democracy. At the same time, Third World nations have begun reassessing development strategy and policies in reaction to the development experiences since the 1950s. Evidence indicates only a few successes, all based on free market strategies. The many failures have relied on strong state intervention.

For a long time, critics of market economies have tried to dismiss the development successes of South Korea, Singapore, the Republic of China (Taiwan), and Hong Kong, arguing that these nations benefited from special circumstances not relevant to most other Third World states. Among the circumstances cited are (1) special socio-cultural factors (Confucianism and its bias to education, authority and the work-ethic in Chinese-populated Hong

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Kong, Singapore, and Taiwan); (2) the tiny size of the city-states of Singapore and Hong Kong; (3) favored political and economic links with the West because of the geopolitical significance of Southeast and East Asia, such as the U.S. security guarantees of South Korea and the Republic of China, the colonial status of Hong Kong, the key role of Singapore; (4) absence of fully democratic governments; and (5) an international economic environment in the 1960s and early 1970s when these four countries began developing compared to the harsh international economic atmosphere since then with its protectionism, reduced foreign investments, and energy cost volatility.

Whatever the "special circumstances" enjoyed by Hong Kong, South Korea, the ROC, and Singapore, the critical elements in their economic rags-to-riches saga has been their commitment to private enterprise, an open economy linked closely to the international economy, and a government committed to economic growth. The resulting growth has reduced poverty by providing prosperity at all income levels.

It is this model which Sri Lanka has been trying to duplicate. Even the skeptics cannot argue that Sri Lanka is a special case because of special circumstances. It is a typical developing country, not particularly favored by geopolitics and not particularly blessed by natural resources. Its inhabitants are not Confucian and, except for their high literacy rate (87 percent) and longer life expectancy (about 70 years), are barely different from a billion other inhabitants of the South Asian sub-continent. With typical Third World political and socio-economic conditions and problems, Sri Lanka thus provides a test case that confirms free market and free enterprise strategies of development. What is fast emerging is a Sri Lankan model of economic growth to which the Third World and development experts must pay close attention, as Sri Lanka's new strategy moves it out of the ranks of stagnant non-developing nations.

SRI LANKA: THE BACKGROUND

Sri Lanka is an island nation of about 25,000 square miles and a population of 15 million. Located at the center of the Indian Ocean, off the southern tip of India, it straddles the sea and air lanes from the Middle East to Southeast and East Asia. Trincomalee on its east coast is one of the world's largest natural deep water ports. The U.S. has just begun constructing one of the Voice of America's largest relay stations in Sri Lanka. It uses Colombo, the capital, and Trincomalee for frequent U.S. Navy ship visits. Sri Lanka has received about $900 million in U.S. economic assistance between 1953 and 1984. U.S. investments in the island total about $10 million.

Sri Lanka has enjoyed universal adult suffrage since 1931. After winning independence from Britain in 1948, the multi-ethnic and multi-religious society inherited a strong, prosperous economy

with a large, active private sector and linkages to the international economy through its major exports, tea and rubber. The British had left a developed physical infrastructure of roads, railways, ports, airfields, and a communications network. Inherited from the British also was a strong bureaucratic state with a large social welfare program of free education and health, food subsidies and rationing. At independence, therefore, Sri Lanka was in better shape for economic development than were Singapore, Taiwan, or South Korea.

Much of this legacy was squandered in the three decades after independence as successive governments, led by the left-of-center Sri Lanka Freedom Party (SLFP) or the conservative United National Party (UNP), increased government control over the economy, expanded welfare state programs, and pursued policies of income redistribution. Foreign trade was controlled to generate more government revenue, leading to foreign exchange crises that led to exchange controls and import and export controls. Rationing was expanded and national planning was introduced. As in many other Third World states, Sri Lanka was moving rapidly toward a controlled and closed economy based on import substitution. The stated goal was establishment of a socialist political and economic system.

QUASHING THE PRIVATE SECTOR

Nationalization of bus transport, ports, insurance, and petroleum in the 1950s and 1960s and the establishment of state owned industries with Soviet bloc aid rapidly increased the size of Sri Lanka's state sector. In the early 1970s, private ownership of land was limited, with remaining land and plantation companies nationalized. A ceiling on housing ownership resulted in "excess" housing being nationalized. Many private industries ranging from restaurants to factories were nationalized.

A government led by the left-of-center SLFP in coalition with the Communist Party and the Trotskyite Party was elected in 1970 and held office until 1977. Its platform was socialism and an anti-Western (particularly anti-American) foreign policy. The 1970-1977 period witnessed the high-point of a socialist economic development strategy in Sri Lanka and the low-point of economic and political achievements.

International trade and exchange controls were increased. A two-tiered exchange rate system of controls (with a third tier, the black market) stifled imports needed for production as well as incentives to export. Export and import controls as well as internal trade controls were introduced. State-owned trading corporations were established with a virtual monopoly over exports and a nearly complete monopoly over imports. This spawned corruption and black markets for government-issued permits and inefficiencies, high costs, and shortages.

Almost all prices were set by the government. Food subsidies, rationing, and the increasing direct involvement of government in production and distribution of goods and services (through state enterprises and so-called cooperatives controlled by the government) destroyed incentives and any vestiges of market forces. The subsidies and controls predictably depressed the agricultural sector, especially the production of food, primarily rice. As the welfare state widened, by 1977 about 10 percent of gross domestic product (GDP) went to subsidize consumption irrespective of the level of income. By that year too, the government sector of the economy accounted for 70 percent of GDP.

The remainder of the economy was indirectly controlled. The government sector accounted for over 70 percent of industrial value added, up from less than 2 percent in 1961. The private sector was unable to function, given government control of international trade and the foreign exchange system, high taxes, and nationalizations. Only politically privileged individuals and groups were able to benefit from the few available economic opportunities. This of course stifled entrepreneurism and initiative.

Economic growth from 1970-1976 averaged less than 3 percent annually while the vital agriculture sector grew at less than 2 percent leading to large increases in food imports. Per capita income growth was less than 1 percent leading to declining consumption levels. By 1976 unemployment had reached almost 25 percent of the labor force, leaving 1.5 million unemployed in a population of 15 million. Per capita income stagnated at around $190 per annum in the early 1970s.

To fund government expenditures, taxes were increased, wiping out incentives to work, save, and invest. Tax rates reached a confiscatory 80 percent at the top. A futile effort was made to extract savings from already low incomes and output through steeply progressive income taxes.

In a failing political system caused by a failing economy, the government resorted to a continuous state of emergency, abrogating basic human rights vital to a democracy. Economic coercion and nationalizations became routine, while press freedoms were curtailed. The Parliament began to set prices instead of providing national security and law and order, and the legal system was undermined.

THE TURNING POINT--1977

The July 1977 campaign for national elections presented the electorate with two clearly defined, competing economic programs for the first time since independence. At previous elections the major political parties had competed to outdo each other by pledging to increase subsidies, welfare expenditures, and the size of the state sector with the promise of employment creation.

The leftist SLFP then in office presented the standard program of continuing government controls. The opposition United National Party (UNP) led by J. R. Jayewardene presented a program of democratic capitalism composed of free markets and private enterprise. Apparently fed up with economic stagnation, Sri Lanka's voters endorsed the UNP, which won 51 percent of the vote compared to 30 percent for the SLFP. The UNP won the presidency and gained a commanding five-sixths majority in Parliament. The mandate provided public support for diverting subsidies away from consumption toward investment with free markets and private enterprise creating incentives and opportunities for the entire population.

NEW ECONOMIC STRATEGY

The new UNP administration of President Jayewardene initiated far-reaching political and economic reforms to trigger economic growth. A system of elected District Councils was created to shift government as well as the budget to the district level and below. Constitutional guarantees of human rights were established. The economic reforms included free trade, a floating exchange rate, a free market economy, a primary role for the private sector, and a role for government that would encourage these reforms.

The Sri Lankan currency, the rupee, which had been fixed at an overvalued exchange rate, was allowed to float and almost completely free convertibility was permitted. The exchange rate reform provided incentives for foreign investment to producers, especially exporters, and undermined the black market in foreign exchange. These reforms also provided for a flow of workers to Middle Eastern countries for employment.

The international trade sector was moved toward free trade with tariff reforms and the ending of import and export licensing and high export taxes. A decades old import substitution strategy was abolished. Relaxing the restrictions on imports encouraged the import of capital goods and other inputs needed to produce goods for export. The monopoly of state enterprises in imports and control over exports was ended. Maximum import tariffs on capital goods were reduced to promote efficient and competitive domestic production. The import tariffs were liberalized to remove the bias against exports as capital goods (machinery and raw materials) were allowed to be imported with low tariffs, while some agricultural and industrial production goods were allowed in duty free, providing incentives for export and domestic production. Though export taxes initially increased, they later were reduced to provide greater incentives to exporters of tea, other agricultural products, and other goods. Meanwhile, the floating exchange rate increased earnings for exporters.

The protective trade and foreign exchange policies of the previous administrations had acted as a tax on consumers of imports (including food) and an equivalent subsidy for inefficient domestic producers of import substitutes, often higher priced

and of lower quality. The new leadership abolished the high tax and subsidy elements. Costs of imports were reduced and the export strategy forced domestic industry to be competitive with market incentives and returns.

Almost all price controls were ended. Prices were allowed to rise to market levels, providing incentives to producers both agricultural and industrial. In agriculture, where prices and internal trade were controlled by the state to provide cheap food for urban consumers at the expense of rural farmers, the government no longer acted as the monopoly purchaser and distributor in the food market and in other areas of internal trade. Rationing of food and other commodities was ended. Subsidies for public transport, food, ports, and telecommunications were reduced. To cushion the impact on the needy, a food stamp program based on the level of income was introduced.

Many warned that the elimination of food subsidies and free rations would result in the kind of political turmoil triggered by an attempt in the 1950s to reduce the state's role in the economy. Yet Sri Lanka remained calm, probably because the electorate had provided a clear mandate for substantial changes.

Interest rate controls were ended and increasingly market oriented rates were permitted, ending negative interest rates and providing incentives to save. Credit controls which had diverted funds to the public sector at the expense of the private sector were ended. The banking sector long had been dominated by two state-owned banks, government controls and repeated threats of nationalization. Banking now was allowed to expand. State banks had to compete with domestic private banks; foreign banks were permitted to open. Offshore banking and other financial services were encouraged through legislative and tax incentives with a view to entering the international banking system.

A major tax reform introduced a supply-side policy. Declared Minister of Finance Ronnie de Mel: "High marginal tax rates can exert an adverse effect on the incentives to work, save and invest." The highest tax rates were reduced from over 70 percent to 55 percent for individuals. Corporate taxes fell from over 60 percent to 40 percent, while capital gains taxes on sale of public shares were abolished to provide for broadbased ownership and participation in the private sector. Other forms of capital gains were taxed at a 25 percent maximum. The category of small business was expanded, corporate taxes ended for all small businesses, and the definition of "small business" was broadened. A new depreciation scheme permitted faster write-offs and encouraged adoption of new technologies to foster increases in labor productivity. Tax holidays and targeted incentives were offered to foreign and domestic entrepreneurs. Indirect taxes, too, were reduced.

TRIMMING THE PUBLIC SECTOR

Controls on the private sector were ended and attempts begun to cut back on the public sector. A free trade zone (FTZ) was established near Colombo's international airport for modern, export industries. A range of foreign ownership, including 100 percent foreign-owned industries were permitted. This followed many years of hostility to foreign investment. Within the free trade zone no limits were placed on foreign equity holdings or on the transfer of shares and profits while inputs for production were allowed duty free. Tax exemptions ranging from two to ten years and further tax holidays were provided dependent on employment creation, transfer of technology and skills, size of the investment, and level of exports. Outside the free trade zone, foreign ownership in enterprises was allowed at up to 49 percent.

State enterprises were forced to compete with the private sector in the market economy and some of the state enterprises were closed or sold. Others were converted into private companies. Some nationalized companies, moreover, were returned to their previous owners. Bus transportation and insurance have been opened to the private firms, while private post offices, telecommunications systems, and a power distribution company were encouraged. The government has decided to privatize the inefficient and creaky telecommunications system. Private health care and hospitals have been encouraged to compete with the government run free health system. The free education system has been supplemented by allowing the establishment of private schools and private universities. Many other services provided by the government and local governments have been privatized.

Instead of subsidies and transfer payments, government funding has been focusing on providing the infrastructure needed by the now growing economy. The most impressive example of this is the Mahaweli River irrigation and hydropower project. It required investments in dams, irrigation systems, and such village infrastructure as schools, housing, and hospitals. State funds also have been increasingly directed at scientific research and development in areas ranging from agriculture to communications.

FREE MARKET SUCCESSES

These ambitious free market reforms have had a dramatic impact. Economic growth as measured by real increases in the gross domestic product (GDP) rose from 3 percent in 1976 to 4.2 percent in 1977 and then jumped to 8.2 percent in 1978, the first full year of the free market strategy. Growth averaged 5.5 percent annually to 1983 and grew by about 5 percent last year. This compares with an annual growth rate of less than 3 percent from 1970 to 1976.

Economic growth has spread through all sectors of the economy. Agriculture averaged 5 percent growth as rice production doubled

and has brought the country to near self-sufficiency in this basic crop. Industry (manufacturing, mining, construction, and utilities) growth averaged about 6 percent with over 70 percent capacity utilization. The services sector grew at a 7 percent per year average. In contrast, during the 1970-1976 period of socialist development, growth in these sectors barely averaged 4 percent, with many years of negative growth.

On a per capita basis GNP has grown over 4 percent in real terms compared to the previous average of 1 percent. Per capita income doubled from $190 to $380 by 1984. Real income has risen throughout the population at all income levels due to evenly distributed growth. Real per capita consumption has increased about 20 percent. Real wages for workers in agriculture increased 15 percent in 1979 and for industrial and commercial workers by 5 percent.

The government sector share of the economy fell from 70 percent in 1976 to less than 35 percent now. Unemployment in 1976-1977 was about 25 percent of the work force and has been cut to half that, with the private sector generating nearly three-quarters of the new jobs. Foreign employment opportunities have opened up to Sri Lankan professional, skilled, and semi-skilled workers, especially in the Middle East. This generates many jobs and a large flow of remittances back home.

Economic growth and job formation has enabled the government to cut its subsidies for food and other transfer payments from 11 percent of GDP in 1978 to 4.9 percent by 1982. The investment rate has doubled from about 14 percent in 1977 to about 29 percent by 1983. Private investment doubled from 7 percent of GDP in 1977 to about 15 percent in 1983.

As a result of economic growth, tax revenues from incomes and profits increased five-fold between 1977 and 1984, demonstrating that supply-side tax policies work in the Third World, as well as in the U.S., in providing incentives and increasing government revenues. Though tariffs have been cut, import tax revenues have more than doubled. The reason: lower tariffs encourage more imports. This in turn fuels growth and exports. Indeed, exports have climbed an average of about 4 percent a year. The free trade zone created 35,000 jobs and attracted about $150 million in foreign investments. A second zone has been opened, and a third is being planned around the strategic port of Tincomalee, proving the viability of free trade zones for attracting foreign investments. Foreign private investment has totalled about $300 million between 1977 and 1984. New technologies have been attracted as the economy entered the computer age almost overnight. New skills and management have revitalized the entire economy through their links to the international economy.

The free market policies have not been without mistakes. Government expenditures on infrastructure to support the growing economy required a huge public investment which pushed the state's

share of total investment from 37 percent in 1974-78 to nearly 50 percent by 1979. By last year, however, this share had fallen to about 4 percent. Budget deficits reached 53 percent of government expenditures and 26 percent of GDP in 1980. Inflation peaked at 35 percent in 1980, while the average annual inflation since 1977 has been about 17 percent.

Budget cuts of 35 percent, a restrictive monetary policy in 1981, and further budget cuts have reduced the budget deficit from 20 percent of GDP in 1980 to 10 percent in 1984. Inflation fell to 10 percent by 1984. This is a clear demonstration that government fiscal and monetary policy can be used effectively in a developing country.

A POPULAR MANDATE FOR THE NEW POLICIES

The final verdict on policies in a democracy is rendered by the electorate. In Sri Lanka's political history no government had ever been given two consectutive terms. This changed in October 1982 when the architect of the free market strategy, J. R. Jayewardene, won re-election by 53 percent of the vote. Two months later, 55 percent of the voters supported extending for a second six-year term the existing Parliament where Jayewardene's UNP had a five-sixths majority. In district and local government elections and individual parliamentary elections since, the UNP has maintained or increased its dominance. Economic growth has led to stronger democratic institutions and a stronger democracy while the democratic political process has enabled a continuation of the free market development strategy.

To build on its success, the UNP should reduce the government sector further by privatizing remaining state enterprises and services such as the national airline, telecommunications, plantations, a wide range of manufacturing industries, state trading corporations, and insurance. The size of government should be cut through further decentralization. In addition, the tax system should be simplified to reduce rates and indexed for inflation. Also needed are additional measures to reduce tariffs and provide incentives for exports, including maintaining a realistic exchange rate. Budgetary measures to reduce inflation and regulatory reforms all are pending.

These additional reforms are required as economic growth and the growing private sector are pushing against the limits of the remaining government sector and the structure of incentives. This could lead to increasing corruption, income disparities, and a lack of support for the free market strategy. The government is faced with a Marxist insurgency and terrorism supported by the Palestine Liberation Organization, Libya, North Korea, and other Soviet-bloc countries. Expenditures on national security are being increased. To fund these resources the government must reduce expenditures by reducing the size of the government.

In the context of the ethnic tensions in Sri Lanka, increasing the private economy is an even more powerful option than political agreements among politicians, as this would enable a greater role for all ethnic groups and prevent the recurrence of governmental policies discriminating against the minority. A free economy and private enterprise do not discriminate. In this respect, privatization is vital in restoring the lost economic bases of the majority ethnic group. Reducing the role of the government in the economy is also vital in de-politicizing the economy which is essential to the long-term viability of democratic capitalism.

CONCLUSION

The adoption of a free market strategy for economic development in Sri Lanka has yielded great benefits politically, economically, and socially. They are in stark contrast to the pre-1977 period.

The U.S. has a great deal at stake in Sri Lanka and its political and economic development. Along with Jamaica, Sri Lanka's experiment in free market development is an example of the Reagan Administration's stress on democracy and economic development in the Third World. Sri Lanka's success will boost greatly U.S. policy in South Asia. As such, Washington should provide political and security support for the democratically elected government in the form of assistance to defend the political and economic system. This could include the introduction of economic support funds (ESF) and foreign military sales credits (FMS).

Economically, such a policy would support the development strategy through (1) U.S. and multilateral foreign aid to build up the private sector; (2) promotion of American investment; (3) keeping U.S. markets open to Sri Lankan exports; and, (4) better focus and direct bilateral economic policy advice promoting policy reforms to continue the momentum of the free enterprise development strategy.

A Reagan Administration-sponsored private sector group should be established in the U.S. to promote investments in Sri Lanka. The group should include economists and academics who can export American economic ideas and policy advice directly without going through inflexible government channels. Such channels of communication would provide non-governmental channels in influencing developments in the Third World by helping implement the report of the President's Task Force on International Private Enterprise. Institutions such as the U.S. Chamber of Commerce, private corporations, research organizations committed to market economics, and groups affiliated with the International Democratic Union (IDU) could provide advice and help to Sri Lanka.

The Sri Lankan economic miracle has important implications for the development debate. It proves the merits of a free

market development strategy. It also underscores the centrality of democracy to development and belies the thesis that authoritarian regimes are better able to manage the challenge of development than democratic governments. It clearly demonstrates that the successes of Hong Kong, Singapore, South Korea, and the Republic of China are not due to special circumstances but to sound policies. Sri Lanka since 1977 demonstrates that democratic capitalism can reverse the economic catastrophes that plague most developing states. It is a lesson that should be learned by the Third World and advocated by the U.S.

Prepared for The Heritage Foundation
by Devinda R. Subasinghe*

*Devinda R. Subasinghe, a Sri Lankan, is completing his Ph.D. dissertation on development strategies at the School of Advanced International Studies, Johns Hopkins University, and an expert on the economics of developing countries.