Asian Studies Center

Backgrounder

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DISILLUSIONED WITH SOCIALISM, SOUTH ASIA EXPERIMENTS WITH FREE ENTERPRISE

INTRODUCTION

There is a new sense of economic realism percolating into the official economic policies of South Asian states. Sri Lanka, India, Pakistan, and Bangladesh--countries that inherited to various extents a legacy of Fabian socialism upon gaining independence from the British Empire--increasingly are looking to the free enterprise system to revitalize their moribund centrally administered economies. After decades of reliance on sluggish bureaucracies that have stifled economic growth, they are experimenting gingerly with free market approaches to economic development. Because the public sector failed to generate the resources necessary for development, South Asian governments now look to the private sector to spearhead economic growth.

India's Rajiv Gandhi is breathing life into the private sector to modernize the Indian economy, increase productivity, and raise investment capital. Sri Lanka has launched bold economic reforms that may transform that island nation into the "next Taiwan." Pakistan and Bangladesh, not to be left behind, also are unshackling their own economies from rigid bureaucratic controls.

Each state is enhancing the role of the private sector by deregulating or decentralizing administrative procedures, reducing trade barriers, loosening credit controls, trimming subsidies, and experimenting with privatization.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

PRIVATIZATION PROGRAMS

To Be or Already Privatized in Whole or in Part	India	Pakistan	Sri Lanka	Bangladesh
Telecommunications			x	x
Airlines		x		x
Shipping and/or Shipbuilding			x	x
Transportation			x	
Highways	x			
Oil and Petro-chemicals	x	x		
General Industrial	x	x	x	x

If these free market economic reforms successfully invigorate South Asian economies, they could be adopted elsewhere in the developing world, particularly in African states hamstrung by Soviet-style planned economies. A free market triumph could create the Sri Lankan model or Indian model or Pakistan model of economic growth that could inspire and give hope to even the most stunted Third World economies.

INDIA

India's mixed economy has grown at a lethargic pace since independence in 1947. Annual economic growth has averaged 3.6 percent over the past 34 years, ranking it 56th among developing countries.[1] Heavy taxes and pervasive bureaucratic controls have hampered growth by distorting resource allocation, rewarding inefficiency, and delaying technological modernization. A Fabian-cum-Soviet disdain for private enterprise spawned a swollen public sector dominated by an elephantine bureaucracy whose interlocking administrative controls throttled initiative, flexibility, and growth.

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1. Basil Caplan, "India's Quickening Pace of Reform," The Banker, May 1985, p. 63.

Indian industry is dominated by state-owned companies that have been insulated from foreign competition by a high wall of tariffs and from domestic competition by an extensive licensing system. Safe in their state-provided cocoons, public sector companies inefficiently churned out shoddy goods for a captive market. State firms control three-quarters of India's industrial assets yet produced only one-third of industrial output.[2] In 1983-1984, some 201 state companies with a capital investment of $24.3 billion earned a mere 0.8 percent as a percentage of capital employed. In contrast, large and medium nongovernment Indian firms showed a return to capital of 6 percent.[3]

A major drag on the Indian economy is the vast army of 16 million bureaucrats that run the public sector and regulate the private sector. Ironically, such a centralized bureaucratic system was anathema to Mohandas Gandhi who warned that the centralization of power always led to the people "becoming a herd of sheep, always relying on a shepherd to drive them to good pastures. The shepherd's staff soon turns to iron and the shepherds turn to wolves."[4]

Many Indian bureaucrats have become leeches, parlaying their arbitrary control over red tape into lucrative sources of illegal income. In addition to corruption, socialist redistributive policies have contributed to endemic tax evasion. The size of the underground economy is estimated to be up to 50 percent of the Gross National Product (GNP) and the smuggling industry alone is reported to employ one million Indians and be worth $11 billion per year.[5]

To harness Indian entrepreneurial energies better, Prime Minister Rajiv Gandhi, who succeeded his assassinated mother in 1984, has eased government regulations and reduced the blocking power of the bureaucracy. Industrial licensing requirements have been pared back for 25 industries including machine tools, industrial machinery, electrical equipment, and electronic components. The liberalization of business licensing has reduced procedural delays, streamlined investment procedures and removed constraints on production capacity.

Gandhi has accelerated the liberalization of trade begun during his mother's stewardship. Import rules are now set for three-year

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2. The Economist, December 21, 1985, p. 68.

3. Far Eastern Economic Review, July 25, 1985, p. 67.

4. Gandhi quoted in Larry Collins and Dominique Lapierre, Freedom at Midnight (New Delhi: Viskas Publishing, 1976), p. 370.

5. Caplan, op. cit., p. 63.

periods rather than for six-month periods, thus allowing companies to plan ahead. He has reduced import duties and other trade barriers to open selected areas of industry to some degree of international competition. He is nudging India away from the now discredited import substitution strategy that has isolated the Indian economy from foreign technology by encouraging the formation of "hothouse" domestic industries incapable of competing on world markets. By easing restrictions on capital goods imports New Delhi hopes to modernize its economy, improve productivity, and reverse the steady decline in India's share of world exports.

An important part of Gandhi's program was the March 1985 comprehensive tax reform package. It is designed to lure money out of the underground economy and put it to work furthering India's economic development. Income taxes were cut from a top rate of 62 percent to 50 percent, the wealth tax from 5 percent to 2 percent, and the corporation tax from 55 percent to 50 percent. In the first six months of the current fiscal year, revenue from income taxes nonetheless rose 27 percent--despite the rate reduction (in fact, because of it). This makes India one of the biggest beneficiaries of supply side economics in the Third World. Entrepreneurs have been encouraged to invest in productive activities rather than speculate in real estate or commodities. Predictably, Indian stock markets are booming.

About $2 billion of new capital was raised in 1985, almost twice that raised in 1984. Overseas Indians are participating in the boom, sending money back home for investment and improving India's balance of payments postion. Foreign capital has also been attracted by the economic liberalization. In the first nine months of 1985 there were 27 percent more foreign tieups or investments than in the same period of the previous year.[6]

The government is considering reducing its equity in some state enterprises and privatizing toll express roads. Although wholesale privatization is unlikely, there seems to be a growing reluctance to continue bowing to political pressures to save jobs through government takeovers of failing businesses. Expanding the public sector in this manner merely preserves noneconomic companies at the expense of their more efficient competitors. In the long run, this destroys many more jobs that it saves. To increase the efficiency of the public sector, the government is inviting experts from the private sector to serve as directors on the boards of major public sector undertakings.

Though India at last is moving in the right direction, it is doing so in a piecemeal manner. The well-entrenched Indian bureaucracy, established businesses with a vested interest in

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6. The Wall Street Journal, January 21, 1986, p. 28.

government protection, and the radical left of the Congress Party remain formidable obstacles to continued reform. Gandhi has focused his efforts on sectors of the economy that stand to benefit most from imported technology and has designated the computer industry as a showcase for his reforms. The outcome of his efforts to modernize India's computer industry therefore may determine the future viability of his program as a whole.

PAKISTAN

Though it enjoyed rapid growth in the 1960s, Pakistan suffered virtual economic stagnation from 1972 to 1977 under the populist socialist rule of Prime Minister Ali Bhutto. Nationalization of manufacturing, commercial banking, and insurance companies drove some private capital out of the country, reduced productivity and slowed industrial output. After the government imposed direct state management of industry, the private sector's share of industrial output fell from 90 percent in Pakistani fiscal year 1973 to 26 percent five years later.

Inadequate infrastructure, excessive bureaucratic controls, insufficient savings and investment incentives, and fears of further nationalizations crippled the private sector as government-controlled economic activity inexorably expanded. By the time the Pakistani Army deposed the increasingly unpopular Bhutto in 1977, the government fully controlled commercial banking, insurance, telephone and telegraph facilities, railways, electrical power, and the electronic media, while dominating shipping, airlines, mining, petroleum, natural gas, and agricultural storage. Bhutto's successor, General Zia al-Haq, quickly reversed the nationalization of cotton ginning, rice husking, and flour milling enterprises. Further privatization, however, met opposition from organized labor, concerned about jobs that would be trimmed from bloated public corporations.

The Pakistani economy expanded sharply from 1977 to 1983, with real gross domestic product growth averaging 6.3 percent. This was thanks primarily to good harvests, a growing stream of remittances from Pakistanis working in the Persian Gulf, the encouragement of private investment by the promulgation of safeguards against further nationalization, and improvements in the efficiency of state-owned enterprises. Public sector managers were given annual bonuses for improved performances and administrative procedures were streamlined.

In July 1984, the Zia government issued a new Industrial Policy statement that confirmed Islamabad's commitment to a mixed economy with the private sector functioning as the catalyst for growth and the public sector acting as the investor of last resort. New public sector investment was limited to modernizing existing undertakings. Some public sector firms were returned to their previous owners.

Investment limits were raised and business confidence partially was restored. The improved climate for private enterprise spurred record growth in private investment--21.2 percent in real terms during Pakistani fiscal year 1984.[7] The liberalization of import restrictions boosted productivity by improving access to imported capital goods and raw materials.

The early 1985 appointment to Finance Minister of Mahbubul al-Haq, a former director of policy planning at the World Bank, ironically was a promising development for Pakistani free enterprise. Haq long had been a champion of Third World economics and a vociferous critic of the free enteprise system. By last year, however, he apparently recognized the flaws of the policies he had been advocating and became an enthusiastic booster of privatization. He proposed a development strategy designed to "unshackle the national economy from the tyranny of economic controls"[8] He pushed for the liberation of the private sector and the decentralization of decision-making in the public sector. He advocated relaxing price and import controls, reforming the tax system, encouraging foreign investment, creating private banking to compete with nationalized banks, disinvestment of shares in public enterprises, and privatization of the electricity distribution system. Unfortunately, Mahbubul al-Haq, a technocrat with no political base, was removed as Finance Minister this January and demoted to the Planning Ministry. His quick exit throws into question Pakistan's commitment to continued reform.

BANGLADESH

Since coming to power in early 1982, President Hussain Mohammed Ershad's military government has accelerated movement away from statist economic policies established at independence. The government's New Industrial Policy of June 1982 opened up many economic sectors to private investment by domestic and foreign firms. Since then, the state has disinvested large parts of the vital jute and textile industries and may sell up to 49 percent of its equity in Biman Bangladesh (the national airline), shipping lines, and the telephone system.[9] Denationalization of banking and more liberal banking rules have permitted the establishment of six new private banks that have offered stiff competition to state banks in some areas. Ershad has announced that all government-owned banks except one will be privatized.

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7. U.S. Department of Commerce, Pakistan: Foreign Economic Trends, July 1985.

8. The Muslim, Islamabad, April 17, 1985, p. 1.

9. Far Eastern Economic Review, July 25, 1985, p. 69.

The public sector, which accounts for 75 percent of industrial production, has been reorganized to improve its performance. Reforms have given public enterprises more autonomy, increased flexibility in pricing, improved performance monitoring and financial management. The New Industrial Policy has yielded 3.7 percent GDP growth in Fiscal Year 1982-1983 and 4.5 percent GDP growth in Fiscal Year 1983-1984.

Although Bangladesh has set up its first Free Enterprise Zone for textile production, the pace of reform actually is slowing. Uncertainties about political stability cloud the willingness of businessmen to invest in the private sector. And although the Dhaka stock exchange is becoming responsive to privatization offerings, its capital base is still relatively narrow.

SRI LANKA

Sri Lanka's public sector expanded rapidly in the 1950s and 1960s due to the establishment of state-owned industries with Soviet bloc aid and the nationalization of ports, bus transport, insurance, and petroleum. The high water mark of socialist economic development came during the 1970-1977 period of rule by the left-of-center Sri Lanka Freedom Party (SFLP) in coalition with the Communist Party and the Trotskyite Party. Export and import controls were introduced along with foreign exchange restrictions that constrained the availability of imports needed for production and reduced incentives to export. State-owned trading companies were established with a near monopoly over international trade. Shortages, rising prices, and corruption resulted as black markets formed for government-issued permits.

The SFLP deepened and broadened state involvement in the production and distribution of goods and services. The government set price levels and subsidies that depressed agriculture, particularly food production. By 1977, 10 percent of GDP was spent on subsidies and the public sector accounted for 70 percent of GDP. Private sector firms were nationalized and business opportunities were reserved for politically privileged individuals and economic groups. Taxes were increased; the top bracket, in fact, was a dizzying 80 percent. This destroyed incentives to work, save, and invest. Annual economic growth averaged less than 3 percent while agriculture grew at less than 2 percent, forcing large increases in food imports.

When the opposition United National Party, led by J. R. Jayewardene, came to power in the 1977 elections, it launched growth-oriented economic reforms.[10] District Councils were formed to decentralize the government. The UNP moved toward a free trade policy by lowering tariffs, reducing export taxes, and ending import and export licensing. A floating exchange rate was adopted and the state's monopoly on importing and exporting goods was terminated. The longstanding import substitution strategy was scrapped to promote efficient and competitive domestic production. By suspending protective trade and foreign exchange policies the UNP, in effect, aided consumers by reducing what had been a de facto tax on imports and ending subsidies to domestic producers of higher priced import substitutes.

Price controls were lifted, allowing prices to rise to market levels where they enhanced the incentives for industrial and agricultural production. The UNP slashed subsidies for food, ports, public transport, and telecommunications. A food stamp program based on income levels was introduced to cushion the impact of these reforms on the poor. The banking sector was allowed to expand as private banks and foreign banks competed with the state banks. Controls on interest rates were relaxed, providing additional incentives for saving and investment. Taxes were reduced on personal income, corporate income, and capital gains.

A free trade zone was established near Colombo for modern export industries. Within the free trade zone firms were eligible for tax exemptions of up to ten years, production imports were allowed duty free, and no limits were placed on foreign equity holdings. Outside the free trade zone, foreign ownership in firms was allowed up to 49 percent.

The public sector was forced to compete with the private sector in many areas. Several nationalized companies were returned to their former owners and others were closed or sold. The government decided to privatize the telecommunications system and private bus companies, insurance companies, hospitals, and schools flourished in competition with the state-run enterprise.

As a result of these reforms GDP rose from 4.2 percent in 1977 to 8.2 percent in 1978, averaged 5.5 percent annually to 1983, and was 5 percent in 1984. The government's share of the economy fell from 70 percent in 1976 to less than 35 percent in 1985. Unemployment fell from 25 percent in 1976-1977 to less than half that in 1985. The

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10. For further information on Sri Lanka's reforms see Devinda Subasinghe, "Now, a Sri Lanka Free Market Economic Miracle," Heritage Foundation Asian Studies Center Backgrounder No. 27, May 7, 1985.

investment rate doubled from about 14 percent in 1977 to almost 29 percent in 1983. Exports climbed an average of 3 percent a year while the free trade zone created 35,000 jobs and attracted $150 million in foreign investments. A second free trade zone is now open and a third is planned. A final measure of success for the reforms of the Jayewardene government was the fact that it was returned to power in the 1982 elections, the first time in Sri Lanka's political history that this had been accomplished.

CONCLUSION

South Asian states, disappointed with the lethargic economic growth rates that afflict their public sectors, increasingly have looked to the private sector to catalyze economic development. To varying degrees they have lowered taxes, deregulated industries, privatized state companies, reduced trade barriers, and encouraged private enterprise. The results have been mixed: Sri Lanka has made major gains, India seems poised for a significant leap ahead, Bangladesh has made moderate progress, but Pakistan appears to be backpedaling away from the bold free market reforms outlined by Mahbubul al-Haq.

Despite the great promise of free enterprise, the state bureaucracies and protected firms that have profited from government regulation of the economy continue to resist reform. Yet these countries at last have admitted that the socialist formula of development has failed them. In its place, they recognize that free enterprise can provide the growth to give their citizens higher living standards.

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