



# Sri Lanka at The Crossroads

by Razeen Sally



**T**O MOST OUTSIDERS Sri Lanka is a far-away tourist destination, a tropical paradise that has fallen into a vicious cycle of ethnic conflict. To me it is closer to home. It is where I grew up; and Colombo, the capital city, is my hometown. I think of Sri Lanka as a heaven-and-hell country, consumed by its own extremes and contradictions. These play out at today's crossroads, with the seeming end of a 26-year military conflict.

Sri Lanka is one of the loveliest places on the planet, full of exuberant multicultural colour and with warm, welcoming people. It is green and fertile almost beyond imagination, and its natural endowments support an average standard of living that has long been the highest in South Asia (the Maldives aside). It has serendipitously beguiled visitors from Marco Polo and Ibn Battuta to Arthur C. Clarke. Flying into Colombo airport, the deep-dark green of the island, framed by the Indian Ocean, forms a soft, refreshing contrast with the harsh, parched landscapes of much of India. Once on the ground, the contrast is heightened—the

streets are not as filthy; people look better fed, clothed and housed; they have better manners; and they are friendlier.

Yet this is also a country that has descended into an inferno. A gathering of seemingly pacific Sinhalese Buddhists can sometimes flip into a frenzied mob. Sri Lanka's hardy Tamil minority has produced one of the most murderous terrorist movements in the world. Ethnic conflict has consumed 100,000 lives. Two student-peasant uprisings in the Sinhalese south, one in the early 1970s and the other in the late 1980s, were brutally prosecuted and brutally crushed. Several governments have used paramilitaries and vigilantes to achieve military and other objectives, in flagrant disregard of the law. Sri Lanka's politics are infested with assassinations, thuggery, mob violence and mafia connections.

The Sri Lankan government has completed an emphatic military victory over Tamil Tiger rebels. No one with an ounce

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of humanity will shed a tear at the death of the Tigers' monstrous leader, Velupillai Prabhakaran, and his chief lieutenants. But victory has come at great cost in terms of combatant and, above all, civilian casualties. It has been met by a wave of nationalist euphoria in the Sinhalese heartland, despair in the Tamil diaspora, and criticism of human-rights abuses by Western governments. All moderate, sensible commentators agree that Sri Lanka's president, Mahinda Rajapakse, must follow up his military victory with a just settlement for the Tamil minority. If not, terrorism will go underground and ethnic conflict will continue to fester. But, as important, Sri Lanka's economy needs radical change. Without that there will be no development take-off and broad-based prosperity. A political initiative to end ethnic conflict and economic-reform initiatives are intimately related; peace and development go together. But will it happen? Or will Sri Lanka miss yet another chance to drag itself out of the quagmire?

### The Post-Independence Record

FIRST SOME HISTORICAL background. Ceylon (the former name for Sri Lanka) was a model British colony, well prepared for independence in 1948, six months after India. Unlike India, not a drop of blood was shed in the transition to independence. Ceylon was at peace, had a stable parliamentary democracy and was Asia's second-wealthiest nation. Per-capita income was a fifth higher than the South-Asian average. Ceylon had a prospering plantation economy and, by developing-country standards, a well-developed infrastructure, an efficient public administration and judiciary, and significant achievements in health and education. Its prospects were golden. Visitors, including the economists Joan Robinson and Sir John Hicks, as well as the young Lee Kuan Yew,

waxed lyrically about Ceylon's conditions in the first decade after independence.

Decline ever since has its source in a disastrous Sinhalese political elite pandering to the worst instincts of the Sinhalese ethnic majority and egged on by a xenophobic Buddhist clergy. The elite came from a handful of aristocratic landholding families. Many of these "brown sahibs" were educated in Britain and imbued with Fabian or Marxist ideals. They had the gift of the gab, but little inkling of real life outside their charmed circles. Sir Ivor Jennings, distinguished constitutional lawyer, first vice-chancellor of the University of Ceylon and key adviser in the run-up to independence, worried presciently that these "schoolboy politicians" would play cheap populist politics and ruin the country. So it came to pass.

Sinhalese politicians appealed of course to the Sinhalese majority, an agrarian-based society with great laid-back charm, but one which had not created Ceylon's plantation-based wealth. That was mainly the creation of colonial administrators and planters, Tamil laborers, and a wider penumbra of Tamil and Muslim traders. Like Malaysia, the Ceylonese economy relied on its productive minorities with a work and education ethic, not on its majority ethnic group. But the latter inevitably took control of postindependence politics.

Successive Sinhalese-dominated governments played the populist ethnic card, especially after 1956 when Sinhalese became the official language at the expense of Tamil and English. Affirmative-action policies for the Sinhalese were rolled out, and discrimination against the Tamil minority increased. Opportunities for advancement were closed off, petty discrimination increased and human-rights abuses (especially by the police) proliferated. This sowed the seeds of the Tamil Tiger terrorist movement, culminating in an all-out violent conflict in 1983.

But disastrous economic policies played their part as well. Benign postindependence conditions bred a redistributive rather than growth-maximizing mentality, directed to expanding the welfare state for the Sinhalese majority. Especially after 1956, Ceylon followed the Indian path of rampant government intervention and trade protectionism, in addition to chronic macroeconomic profligacy. This became extreme after 1970, when Sri Lanka had its version of India's "license raj."

By the mid-1970s, the economy was close to ruin. Growth had come to a halt, real incomes were stagnant, public-sector subsidies were out of control, welfare expenditures were still increasing, unemployment rose to 25% of the labor force, there were balance-of-payments crises and acute shortages and rationing of consumer goods. Crucially, welfarist policies churned out educated youth from a fast-increasing population, but they had no job prospects in a stagnant economy. Disaffection led many to extremism and violence, not just in the Tamil north but also in the Sinhalese south.

The one bright spot was the major liberalization of the economy in the late 1970s, followed by liberalization bursts in later decades. Sri Lanka led the way in South Asia in switching from "import substitution" to "export-orientation," and more generally in market reforms that (re)opened the economy to the world. But reform has proceeded in stop-go fashion. Its glaring weakness has been macroeconomic incontinence. Public spending, budget deficits and inflation have not been brought under control. Nevertheless, despite civil war, macroeconomic instability and misgovernment, Sri Lanka has grown at about 6% annually. Average real incomes (\$1,540 at market prices and \$4,200 at purchasing power parity) are 50% higher than they are in India. Outside the fighting zones, ordinary people are significantly

better off than they were a generation ago. Key to this success has been industrialisation and a more diversified services economy. Employment in the formal manufacturing sector has more than doubled since 1980 and the share of manufacturing in total merchandise trade has increased from 5% to close to 70% of GDP. The star in the firmament is a strong, labor-intensive garments industry—a direct product of liberalization. The industry emerged in the early 1980s, now accounts for about 50% of total export earnings and employs about one million people.

Still, Sri Lanka is a sad tale of what-might-have-been. As of 1960, Ceylon's living standards were higher than those of South Korea and Thailand. As of 1970, Ceylon and Malaysia had similar living standards. With peace and East-Asian-style policies of macroeconomic prudence, openness to the world economy and better government at home, Sri Lanka would be where Malaysia is today (with an average real income of over \$15,000 at purchasing power parity). Absolute poverty would have been eradicated, average living standards would be four times what they are now, clusters of multinational enterprises would link the economy to global supply chains, tourism would be flourishing, services would be hitched to the Indian outsourcing juggernaut, and infrastructure would be much better, as would education and health care. Above all, Sri Lankans outside the elites would have life-chances they can only dream about today.

## The State of Play

FAST-FORWARD TO THE present. Start with politics. Power has been centralized in the presidency since 1978. The present incumbent, Mahinda Rajapakse, is riding the crest of popular support for his single-minded prosecution of the war in the north. He and his three brothers—one is

the defense secretary and another is a presidential adviser on the economy—control the levers of power. Mr. Rajapakse leads a governing coalition of leftist parties, centered on his own Sri Lanka Freedom Party. He has proved a brilliantly successful politician. The war effort has dominated his agenda—more so than under any previous government. His strengths lie in his ability to connect with the Sinhalese small-town bourgeoisie, of which he is a product, as well as the rural electorate. On the other hand, he is not a policy thinker—least of all on the economy—and has scant knowledge of the world outside Sri Lanka.

The opposition, on the other hand, led by the previously-governing United National Party, is weak, divided and demoralized. Its leadership comes from the Colombo upper-class elite, which seems utterly cut off from, and unable to communicate with, ordinary Sri Lankans, especially outside Colombo and the Western Province. Most likely, Mr. Rajapakse will call parliamentary and presidential elections later this year, with every prospect of winning handsomely. The danger is that Sri Lanka, shorn of institutional checks and balances, will veer—not for the first time—in the direction of a Caesarist elective dictatorship.

Other political features, visible periodically in previous decades, have also become more pronounced. Sinhalese chauvinism finds expression at the heart of government. It reinforces the worst aspects of Sinhalese pseudointellectualism—a highly mythologized historiography that emphasizes Sinhala superiority and xenophobia toward minorities and near-neighbors; a stark politicization of Buddhism; and a parochial, inward-looking attitude toward the present and future. Intolerance

of dissent and a culture of fear backed by violence, are, at the very least, not discouraged. The armed forces are more powerful than ever. Journalists have been intimidated and several assassinated. Businesspeople and activists from nongovernmental organizations are scared of criticizing the government—on economic and social issues as well as military issues. Self-censorship abounds. Rumors swirl of government-sanctioned vigilante operations against opponents (“white vans in the middle of the night”).

What passes for political debate is black-or-white, hectoring and puerile. Journalistic standards are low and shoddy. Ceylon was renowned throughout Asia for its liberal culture and high standards of journalism, with space enough for reasoned, nuanced and

*Sri Lanka is a sad tale of what might have been. With better governance, it would be where Malaysia is now.*

critical debate. That has been almost extinguished—a symptom of extreme degeneration in public life and an emasculated civil society. Liberal institutions and the rule of law are the inevitable losers. Not least, Sri Lanka has become a balkanized society, with deep splits, usually boiling down to poisonous personality clashes, at every level of politics, business and society.

Economic policy has also deteriorated. The government has spent like there was no tomorrow. Defense spending has more than tripled in the last four years. Other subsidies have also increased, especially to agriculture to shore up vote banks in the countryside. A bloated public sector, employing around one million people in a labor force of under seven million, has swelled even further. It is dominated by patronage politics and packed full of ill-qualified or unqualified political appointees. Monetary policy has resorted to the printing press to plug the yawning gap in

government revenues, predictably stoking inflation, which peaked at close to 30% last year. Official reserves were blown away defending an untenable rupee exchange rate. Yet again, Sri Lanka faces a home-brewed balance-of-payments crisis. Borrowing on international capital markets has dried up in the wake of the global financial crisis, forcing the government to negotiate a \$1.9 billion loan from the International Monetary Fund. Debt-servicing and unsustainable current expenditure have driven up real interest rates and crowded out private investment, as well as long-term investments in education.

State intervention in the banking sector has gone deeper. State-owned monopolies in oil and electricity have been reinforced. Hence energy and power costs remain artificially high, with inefficient delivery. Trade protectionism has increased, with a paraphernalia of additional import taxes. Discretionary powers have also been used more frequently and selectively to restrict imports, e.g., through customs delays and extra charges. The domestic private sector has been repressed with additional taxes and regulatory burdens. The government has even set up its own—predictably loss-making—low-cost airline. And oil, arms and infrastructure deals with China, Pakistan, Iran and Libya lack transparency, to say the least. The government's enthusiasm for these "new friends" has increased commensurately with its cooling of relations with Western governments—"old friends" who have criticized alleged human-rights abuses by the armed forces. But new friends cannot substitute for old friends: Sri Lanka trades overwhelmingly with the West; the U.S. and the European Union alone account for over 60% of its exports.

Over-regulation, regulatory opacity, frequent and unpredictable regulatory changes, and corruption keep the costs of doing business high. Sri Lanka is ranked

102nd in the World Bank's Doing Business 2009 report. It scores particularly badly in dealing with construction permits (which involve an average of 21 procedures, take 214 days to process and cost 1,500% of income per capita); employing workers (firing costs are equivalent to 169 weeks of salary); registering property (with 8 procedures taking 83 days and costing 5% of property value); paying taxes (with 62 payments per year taking 256 hours to process and with a tax rate equivalent to 64% of profits); and enforcing contracts (with 40 procedures taking 1,318 days and costing 23% of the claim). Sri Lanka is ranked not that much better than India (ranked 122nd) and is light-years behind Malaysia (ranked 20th). Sri Lanka does better in the rankings for trade procedures, but that is still nothing to write home about. It ranks 66th in the Doing Business "trading across borders" category (India being in 71st and Malaysia in 29th place).

Policy regression has occurred in a worsening policy-making climate. Academics and other government advisers advocate a state-directed economy, infant-industry promotion and agricultural self-sufficiency—all old ideologies that are back in fashion. Policy making is more populist, opaque and unpredictable, favoring the politically-connected and sidelining technocratic advice. This makes for knee-jerk microeconomic interventionism. Corruption and institutional rot set in long ago, but they have sunk to new depths. Today they pervade and poison all aspects of public life.

## What Next?

A WIDELY-SHARED SENTIMENT in Sri Lanka is that military victory will translate into peace and fast development. This fits a pattern: too many Sri Lankans, and certainly their governing elite, perennially expect a quick fix or manna from heaven. The real-

ization has never dawned that the world does not owe Sri Lanka a living. An East-Asian-type culture of working hard, planning for the future and earning one's success has never taken root. That is why Sri Lanka's blessings—its breathtaking beauty and bountiful natural endowments—are overwhelmed by its curse of lackadaisicalness and complacency. That is true of the world of everyday work, as well as the world of policy thinking and execution. A Sri Lankan acquaintance calls it the "broken window-pane society." The general attitude is that if a window-pane is broken, just leave it; don't bother to fix it.

Without a serious attempt to address the grievances of the Tamil minority—from real devolution of power to the northern and eastern provinces to enforcing legal rights and removing petty discrimination—there will be no peace. The preferred alternative in some government circles—co-opting ex-rebels in the north and east and giving them Chechenya-style warlord operations to run—is clearly not viable in the long-term.

On the economic front, the danger is of creeping Russification. A parastatal network of politicians, Mafiosi and the military could extend its tentacles into business life. That is not yet the widespread reality, but it is a risk. In any event, without an economic-policy overhaul, Sri Lanka faces either slow material decline or something worse, especially with a bleak medium-term global economic outlook.

The short-term imperative is to clean up macroeconomic policy: allow the exchange rate to devalue to a market-determined level, cut public subsidies, and impose order and transparency to the pro-

cedures of the central bank and the treasury. Beyond that, trade protection should be reversed, with accompanying simplification of trade and foreign-investment measures. (The latter are caught in a dense thicket of laws, regulations and government agencies.) Property rights to farmland need to be clarified and strict controls on land ownership lifted in order to raise agricultural productivity. Labor laws need to be more flexible. There needs to be deep public-sector reform; a move to market pricing for oil and electricity; and, not least, big cuts in the defense budget. Drastic domestic deregulation is also imperative to cut the high cost of doing business. In the longer term, Sri Lanka needs a revamp of its rotten political culture and public institutions. Sri Lanka's basic problem is that it has far too

much politics at all levels of society. This cramps individual freedom, particularly for the poor citizen without good political connections and it stymies wealth-creating enterprise.

Military victory gives the government a historic opportunity to engineer the political and economic turnaround necessary for economic take-off. Given the government's record, the chances of an enduring political settlement are not great. The odds are also against an economic-policy overhaul. But the political opposition does not provide a credible alternative. It is safe to say that without a change of political and economic direction, Sri Lanka will continue to be the broken window-pane society, and will fail to achieve its golden potential. Heaven will always be promised and just around the corner, but hell more often the reality—at least for some. ■

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