Six lessons in policy reform

THIS year Sri Lanka has its best opportunity for market reforms since 1977. The presidential and parliamentary election results give the Government a mandate for it, alongside constitutional reforms and reforms to repair ethnic relations. In a previous Daily FT column ('A new global economic strategy for Sri Lanka,' 17 September 2015), I set out my views on what needs to be done. Priorities should be macroeconomic stabilisation, domestic liberalisation, and liberalisation of foreign trade and investment. Medium-term reforms of education and state-owned enterprises are also important.

This is what should be done. But what can be done given Sri Lanka's Byzantine political realities? This takes us into the politics of economic reforms – political economy, in other words. For those who live in the real world, this is at least as important as economics. It is the art of the possible, not the science of the perfect.

In many ways Sri Lanka has become a more parochial, inward-looking country. At independence the outlook was different. But S.W.R.D. Bandaranaike, and then Sirimavo Bandaranaike, took the country on a navel-gazing course with their Sinhala-Buddhist nationalism and command-economy policies. And many UNP leaders followed suit. Argentina is another navel-gazing country; it was full of initial promise, but itruined itself over the course of the twentieth century. "Argentines,"so the saying goes, "like to compare themselves with themselves." So it is with Sri Lankans.

Prime Minister Ranil Wickremesinghe

But now Sri Lanka has a chance to look outwards again. It should scout better practice abroad and see what can be applied at home, tailored to the local context. Intelligent emulation is what a small multi-ethnic island, right along an ancient maritime trade route, should be doing. In this spirit, I will highlightsuccessful policy reforms abroad and extract lessons for Sri Lanka today. I have six lessons in mind.

My View

Global Economics

By **Razeen Sally**

Lesson 1: Leadership

"Cometh the hour, cometh the man." Individuals matter. A good leader has a clear vision of where to head, a roadmap of how to get there, and an iron will to succeed. He or she must also have a good team, a clear division of labour among them, and a practical sense of getting policies implemented.

Singapore's Lee Kuan Yew was such a leader. He was a political superman – one who appears rarely anywhere in the world. Among his qualities was excellent team-building. Singapore would not have soared if not for Lee's team of first-generation leaders. A veteran Singapore elite insider told me it was down to five individuals in key positions, working well as a team, with practical implementation skills, and with Lee as their coordinator and political frontman. Other examples come to mind: Margaret Thatcher's premiership in the UK in the 1980s; the Reagan presidency in the USA at the same time; the PM-Finance Minister duos of Hawke-Keating and Howard-Costello in Australia from the 1980s to the 2000s, and Lange-Douglas in New Zealand in the 1980s.

Sri Lanka, in stark contrast, has mostly examples of piss-poor leadership. Now Sri Lanka has a Prime Minister who is instinctively more pro-market than any of his predecessors. But that is neither true of the President nor most cabinet ministers. Are there five or six really competent individuals in key positions who can drive critical reforms? No – or at least not yet. Most appointments seem to have been made on political grounds, not on merit.

Lesson 2: Timing

"Events, dear boy, events." So said Harold Macmillan, a former British Prime Minister. The practical politician, official or businessman knows that choices are dictated by responses to often unanticipated events.

Major episodes of economic-policy reform have occurred mostly in response to crises. As Dr. Johnson said, "When a man knows he is going to be hanged in a fortnight, it concentrates the mind wonderfully." A macroeconomic crisis, with symptoms such as extreme external debt, hyper-inflation, a severe payments imbalance, capital flight and a plummeting currency, provides the classic backdrop. This is when "normal politics" is suspended, and when a period of "extraordinary politics" can provide a window of opportunity for market reforms. Examples are legion: Britain in 1979; Chile in 1973/4; Mexico in 1986; Brazil and Argentina in the early 1990s; India in 1991; Central Europe and the Baltic states in the early 1990s; Australia and New Zealand in 1983/4; and Sri Lanka in 1977.

But a crisis is no guarantee of successful reform; it simply provides a political opening. Crisis opportunities have often been squandered, as Russia, Ukraine and other parts of the ex-Soviet Union show. And while a crisis might trigger some reforms, it is no guarantee of further reforms down the line. Sri Lanka is a maestro in squandering reform opportunities. Macroeconomic incontinence – populist welfare spending, foreign aid-fuelled corruption and inflation – overwhelmed J.R. Jayewardene's market reforms. So did his contribution to ethnic conflict. This toxic cocktail poisoned subsequent opportunities right up to and after the end of the war.

Now Sri Lanka has a combination of golden opportunity and looming crisis. The defeat of the Rajapaksas and a new mandate provide the opening. And minds should be concentrated by a brewing balance-of-payments crisis – unsustainable foreign borrowing, capital flight from emerging markets, higher global interest rates around the corner, alarmingly depleted foreign-exchange reserves, pressure on the exchange rate, and widening fiscal and current-account deficits.

So now is the time to act. Monetary policy should be tightened, the rupee allowed to devalue further, and tough decisions made on taxation and public expenditure. The tax system needs to be radically simplified and public expenditure reined in. Microeconomic reforms to free up markets should complement macroeconomic reforms. Red tape should be cut, starting with licenses and permits; so should protectionism against imports and foreign investment. Not least, a "do no further harm" injunction should apply: the government should desist from monumental blunders such as ad hoc taxes on businesses, subsidies to the tea industry, price controls on tea and hoppers, and legislating wage increases in the private sector. All are examples of Sri Lanka's never-ending "auction of non-existent resources," as Lee Kuan Yew put it. It is extreme economic illiteracy – political meddling gone mad.

Of course not all necessary reforms can be done at once, or even in the first year or two. All market reforms are difficult. But some are more pressing than others. These I have just listed. They make up a critical mass of reforms for the next two years. If implemented, they will establish a bridgehead to harder, politically more costly reforms – none more so than in the public sector -- later in this parliamentary term and beyond. But without them all else fails. And the window of opportunity is narrow – two years at most. Reform's deadliest enemy is Sri Lanka's perennial complacency. "Happy is he to whom Nature has given a sparing hand," said the poet Horace. Sri Lanka's stupendous bounty – its luxuriant natural endowments – is also its biggest curse.

Lesson 3: Interests

John Stuart Mill, Britain's pre-eminent nineteenth-century political economist, said "a good cause seldom triumphs without someone's interest behind it." Economists from Adam Smith to James Buchanan tell us that interest groups drive policy choices. Minorities of well-organised producer interests, not the majority of unorganised consumers, lobby governments for their preferences.

For decades, politicians, bureaucrats, employers and unions imposed a straight-jacket of protectionism in developing countries. Mostly this benefited unionised urban manufacturing industries, employing a tiny minority of workers and producing shoddy goods for the domestic market. Agriculture and tradable sectors suffered. India's license raj was its most notorious incarnation. But Mrs Bandaranaike's license raj in the 1970s came close.

In many countries, a crisis was used to overcome interest-group opposition and push through liberalising reforms (as in India in 1991 and Sri Lanka in 1977). In some countries, protectionist coalitions slowed down, halted or even reversed liberalisation. Russia is but one example. Elsewhere, radical opening shifted economies in favour of tradable sectors. That we see especially in Eastern Europe and East Asia. Traditional protectionist interests were weakened, and countervailing coalitions – exporters, users of imported inputs, multinationals with global production networks, cities and regions acting as magnets for international business – emerged. These new interests lobby for further market reforms.

Sixty years of government intervention in Sri Lanka has bred a monstrous army of crony interests, all lobbying and bribing for favours and protection against their local and foreign competitors. And all defrauding the consumer with inferior goods and services at artificially high prices. They speak of the national interest and invoke patriotism. But, as J.S. Mill also said, this is "the last resort of the scoundrel." Now is the chance for pro-competition reforms – to weaken these interests and allow new open-economy interests to emerge. But does the Government have the will and courage to do it?

Lesson 4: Ideas

Ideas matter. To quote Mill again, "it is the word in season that does much to decide the result." Prevailing ideas, interacting with interests and events, can sway policies one way or the other. A consensus on import substitution, state planning and foreign aid was entrenched in developing-country governments and international organisations up to the 1970s. The pro-market Washington Consensus overturned it between the 1970s and '90s. The pendulum has swung the other way again, especially after the global financial crisis. Now Keynesian macroeconomics and government intervention to rectify alleged "market failures" are back in fashion.

Under the Rajapaksas, idiot economics – or caveman economics – was the governing ideology. It harked back to the dark days of the 1970s, when the Finance Minister had to approve every permit for an imported vehicle. Much of that idiot-caveman economics survives in Government today. Now those who know better must argue vigorously for sensible economics. And it is as important for at least a few senior politicians, from the PM downwards, to make a simple case for markets, economic freedom and limited Government to ordinary people, beyond Colombo's elites.

Lesson 5: Institutions

Institutions are the economy's decision-making framework, the arena for policy choice and implementation. Generally, the more prosperous a country, the better its institutional quality: a better rule of law (in terms of enforcement of property rights and contracts), a better legal system, public administration and corporate governance, better regulatory agencies, less corruption, and so on. Institutions always matter, but a poor country with weak institutions can still enjoy strong catch-up growth by getting some policy basics right (such as prudent monetary and fiscal policies, liberalising the domestic market, opening to the world economy, and investing in education and infrastructure). But institutions need strengthening as real incomes rise and growth depends more on efficiency and productivity gains. Otherwise countries get stuck in a middle-income trap. Only stronger institutions can foster trust, lower business costs and support more sophisticated, value-adding transactions.

Weak public institutions are Sri Lanka's Achilles Heel. Politicisation has degraded them for decades, but it got so much worse under the Rajapaksas. The State is massively overstaffed; there are far too many ministries and regulatory agencies; and, through blatant political favouritism, the wrong people have risen to the top. The Sri Lankan State is a hugely magnified version of many politicians: disgustingly obese, severely diabetic, alcoholic, wracked with venereal disease, with clogged arteries and running sores.

How an earth are even good policies going to be implemented by such a beast? Slimming it down and restoring it to health will take time, but it must be done, for if not it will block economic regeneration. In the meantime the beast should be denied extra supplies of sugar, fat and alcohol. I would highly recommend an Ayurvedic diet, but that is too much to expect politically.

FT Quote

> Leadership, timing, interests, ideas and institutions are all indispensable ingredients of policy reform. All need direction from Colombo – from the PM and his key ministers and officials. But Colombo politics will always obstruct doing the right thing. Which is why decentralisation and reforms "from below" – from cities and SEZs – are so important. But they will only succeed with market-friendly rules and institutions. If done right, they could be Sri Lanka's silver lining – its answer to Shenzhen and Dubai's IFC. If done wrong, they will add to Sri Lanka's long list of policy failures

Lesson 6: Decentralisation and reform "from below"

Policy reform gets more difficult the farther removed it is from the citizen. It is most difficult in countries with very large populations; political and administrative obstacles are greatest in the national capitals of big countries. Just think of Washington gridlock, constricting Delhi bureaucracy and Kremlin skulduggery. Even in authoritarian, politically centralised China, the central government in Beijing always has problems implementing its edicts in the provinces. Not surprisingly, small countries tend to be the most successful policy reformers. But reforms also get stuck in the national capitals of small countries. Singapore is an outstanding exception – but it is the world's last surviving city-state of any significance, whose government combines national and municipal functions.

Policy reform has a better chance of success when it is decentralised, closer to the citizen and with smaller populations to work with. Think of city-states in medieval Europe, whose competition for merchants, skilled artisans, goods, services and ideas generated a commercial revolution and a "European miracle". Hence the old adage Stadtluftmachtfrei – "city air makes you free". And think of coastal city-states – Calicut, Cambay, Malacca, Macassar and many others --- that were hubs of Indian Ocean and Southeast Asian archipelago trade before Western colonisation.

Today, successful policy innovation happens much more in cities and sub-national regions than it does in national capitals, let alone in faraway regional and international organisations. Policy-making is more practical, flexible and adaptable to changing external conditions the closer it is to the citizen. This is the real secret of Switzerland's success. It is a small country, but it still has the world's most decentralised political system. Most policy competence resides in its cantons and municipalities; they compete vigorously with each other, not least on taxation.

Cities in particular learn from each other and adopt best international practice better than nations do. What makes cities even more important is urbanisation – mass movement from the countryside to urban areas. This is happening at an unprecedented speed and scale. Over half the world's population is now urban; it accounts for over 80% of world GDP. About 2.5 billion people will urbanise by 2050, almost all of them in developing countries. Moreover, cities are nodal points of global value chains – vast production networks centred on multinational companies. Their value-adding activities cluster in and around cities. This is one reason, among many, why cities attract smart people who congregate to exchange ideas and innovate.

Cities, sub-national regions and even Special Economic Zones are the best places to experiment with rules and institutions. Deng Xiaoping started China's industrial reforms not in Beijing but in Shenzhen, bordering Hong Kong. It was a sleepy fishing village until the late 1970s; now it is a metropolis of seven million people. It was China's first SEZ; its success spawned many more SEZs, before reforms were rolled out nationally.

Successful SEZs succeed import market-friendly rules from outside the country. So do many successful cities. One example: Dubai's International Financial Centre operates under English common law with British judges – separate from the jurisdictions of Dubai and the UAE. These imported rules have attracted scores of international banks, private-equity groups and hedge funds, helping to make Dubai the Middle East's financial hub.

What does this mean for Sri Lanka? The Sri Lankan state is far too Colombo-centric; Provincial Councils and municipalities have little power. Devolution of power to Provincial Councils is a long-standing, highly charged political issue. But cities and SEZs as growth poles are more promising for economic progress.

Ranil Wickremesinghe's pet project is the Colombo Megapolis. He has announced plans to develop second-tier cities and new SEZs as well. So far so good. But it is easy to see how these ideas could go wrong. The Colombo Megapolis could grab most of the attention and resources, sucking oxygen from Kandy, Galle, Jaffna and Trinco. All these projects, starting with Colombo, could easily be ruined by political interference – Sri Lankan "politics as usual".

Hence urban policy and decentralisation should have three guiding principles. First, don't let Colombo divert attention and resources from second-tier cities. They might well be more promising venues for policy experimentation – precisely because they are at a distance from Colombo politicians. Second, SEZs should be small in number and large in size – the lesson from Chinese and other SEZs in East Asia. A large number of small SEZs will end up as tax boondoggles – the lesson from India. Third – and most important – think hard about importing good rules and institutions for cities and SEZs. Staff new administrations with clean and competent people. Depoliticise governance as much as possible: insulate administrations from grabbing politicians. Rules and institutions are where thinking should start; detailed masterplans for urban planning should follow, not the other way round.

Conclusion

Leadership, timing, interests, ideas and institutions are all indispensable ingredients of policy reform. All need direction from Colombo – from the PM and his key ministers and officials. But Colombo politics will always obstruct doing the right thing. Which is why decentralisation and reforms "from below" – from cities and SEZs – are so important. But they will only succeed with market-friendly rules and institutions. If done right, they could be Sri Lanka's silver lining – its answer to Shenzhen and Dubai's IFC. If done wrong, they will add to Sri Lanka's long list of policy failures.