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Political Economy of Growth and Reforms in South Asia

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1.Introduction

Even when there is a large measure of consensus among policy makers, policy reforms often are not carried out. This is often ascribed to lack of "political will". But what is this "political will"? Is this just a difference between the psychological make up of one politician and other? Or is it an outcome of objective reality such that no matter which politician is in power, the same reluctance to reform would be displayed? If one believed in the former there is not much scope for analysis. If in the latter, then analysis can throw some light and perhaps guide in the design of reform packages which have a better chance of acceptance. Thus, the literature of neo-classical political economy has sought to explain political behaviour as an outcome of rational behaviour by politicians and economic agents pursuing their own objectives singly or in coalitions with others.

The new political economy is, to paraphrase Srinivasan (1991), the application of the tools of neoclassical economics to the analysis of political decisions. In contrast to the classical version, which emphasized outcomes regarding the distribution of income, the new version is concerned with the processes by which different groups in an economy seek to influence policymaking in order to maximize their own objective functions. The early work in this area, emerging from the public choice analysis of Buchanan (1987) and refined into a specific terminology by Olson (1965) applied almost exclusively to the liberal democracies among the developed countries. The approach gradually worked its way into the analysis of policy decisions in LDCs, most of which were not liberal democracies, in work by, for example, Bhagwati and Srinivasan (1980), Jones and Sakong (1980) and Bardhan (1984). Subsequently, there have been several efforts to document and analyze the nature of the relationship between political economy and policy reforms in LDCs, notably, Nelson (1990), Mosley et. al.(1991), Cornia et al. (1992), Mosley (1992) and Agrawal et al, (1995).

The basic framework is that of economic agents who given their preferences, constitute different interest groups, pressure groups and political parties. How effectively they are able to organize themselves for effective action depends on the strength of their interests in a particular set of policies and how much it costs to organize (Olson 1965). “The benefits, of course, have to be traded off against the costs of organization; it is therefore likely that small homogenous, cohesive groups, finding it easier to organize, will be able to tilt policy decisions in their favour, as opposed to large, diffuse groups, even through the latter are given relatively more importance in the government’s stated agenda” (Agrawal et al, 1995).

The effectiveness of these groups affect the policy outcomes. Politicians on the other hand weigh the political costs and benefits in the short term and for the next election and find or do not find the “political will” for policy reforms. Bates and Devarajan (1999) show this schematically as in Figure 1.

Figure 1: Framework

Preferences → Methods of Aggregation → Domestic Political → Policy Outcomes

Interest groups

Institutions

Political Parties

Source: Bates and Devarajan (1999) “Framework Paper on the Political Economy of African Growth”

With this framework, one can understand why policies get distorted, why over time distortions get entrenched and become pervasive, and why countries get into situations which call for drastic reforms. It does not explain why reforms take place at all. To do this, the simple schematic framework needs to be extended. It needs to be closed. Policy outcomes in turn create interest groups who over time may become stronger than the original pressure groups. This dynamic nature can explain how the same set of policies but sequenced differently can lead to different outcomes. Figure 2 shows this framework.

Figure 2: Dynamics of Political Economy

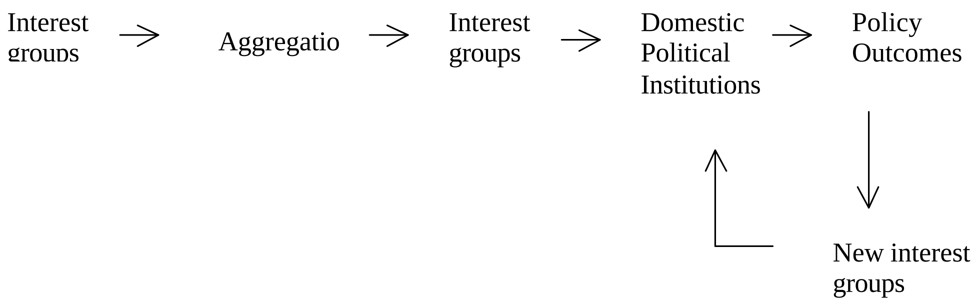
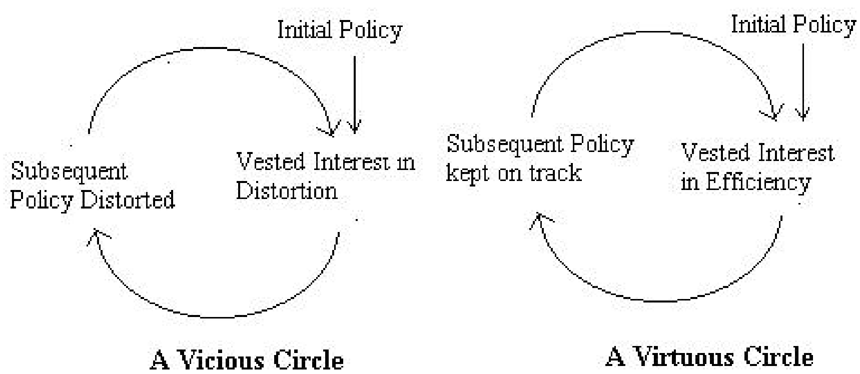


Figure 3: Policy Sequencing, Virtuous and Vicious Circles



This if the initial policy creates vested interest in distortions we can get into a vicious circle of distortions piling on top of distortions. On the other hand, if the initial policies create vested interest in efficiency and competitiveness, we get a virtuous circle in which the same policies can give different results. Schematically, Figure 3 shows this.

One should also recognize that rule-making and policy-making are two stages of the policy process (Buchanan 1987, Dixit A. 1999). The vested interest groups may not permit a change in policy but might agree to changes in rules, which may later on facilitate a policy change.

How does initial policy decision get taken? One has to recognize here that the neo-classical political economy framework is not complete and cannot explain all policy decisions. While it can help in understanding evolution of economic policies over much of the time, other exogenous influences play important roles. Thus, for example, the initial policy may be an outcome of historical experience (e.g., colonial experience of South Asia) or accident of a charismatic leader's learnings (Nehru's exposure to Fabian socialism).

The important role played by political set up in which the relative power of different groups change has to be recognized. Thus, coups that replace a democratic government by a militancy dictatorship, revolutions that establish a democratic government and elections that lead to change in governments, can alter economic policy.

One should also recognize that in a large country with diversity, there may be many small interest groups. Also an individual may have many interests they want the political process to fulfil and thus, one may be part of more than one interest groups. How these groups form coalition for political action can affect the policy outcome. Elections can change these coalitions. Moreover, not all the objectives of individual are economic. In fact, as Varshney (1999) has pointed out, ethnic objectives may so dominate concern of many political parties that they might not oppose economic policy changes even when they hurt the economic interests of their supporters.

Our purpose in this paper is to examine the political economy behind the economic policies in South Asia and to draw lessons from them. We will also look at some specific reform measures that India and Sri Lanka undertook and examine the political economy rationale of such policies. The paper is organized as follows: In Section 2, we briefly describe the political history and economic performance of South Asian countries. Section 3 describes the failure of political governance and its consequences and poses the main question of political economy that emerge. Sections 4 and 5 look in detail at the Indian and Sri Lankan experiences, respectively. Section 6 concludes.

2. South Asian Economic History and Performance

2.1 The Influence of British Colonial Rule

Bangladesh, India, Pakistan and Sri Lanka all share the common characteristic of being a former British colony and all inherited the infrastructure, political and administrative structures left behind by them after gaining independence. Some argue that these structures could not accommodate the elaborate goals of achieving socio-economic development and were only equipped for simpler legal, financial and administrative duties. As a result of the entrenchment of these systems, the newly independent states could not extend and adjust them to suit the growing needs of the modern country (Hossain et al., 1999).

Also, during the British rule, India, Pakistan and Bangladesh made remarkable headway in terms of industrialization. In particular, India's first industrialization experience was in the 1860s when India demonstrated record levels of growth. By the early 1900s India had large textile and jute manufacturing industries and, its total exports accounted for 11 per cent of national income. This is in contrast to South Korea, which began its industrialization process almost half a century after India, and did not particularly produce goods based on the principle of comparative advantage, but more-so to meet the requirements of their Japanese rulers at the time.

2.2 Post-colonial Approach

While the colonial era did leave South Asia in an advantageous position with respect to administrative structures and industrialization, there were also negative impacts on the colonies, which warrant recognition. The most significant effect was the "denial of self-esteem" and also the aggravation of ethnic conflicts amongst different ethnic groups by the 'divide and rule' policy. Still suffering from these effects at the time of gaining independence, these South Asian nations, subconsciously or consciously acted to repudiate the policies of the British rule in order to seek out their own identities and rebuild their cultures.

As such, these nations embodied aspects of import substituting industrialization, turned to extensive state intervention in financial and labour markets, promoted state-owned enterprises and were partial to regulation and planning. Each of the nations implemented these policies at various stages of their development. India was the first to implement these policies – soon after independence and Sri Lanka followed suit in the mid 1950s. In the case of Bangladesh however, after the civil war to pull away from Pakistan, the new government found themselves having to take ownership of abandoned assets and unplannedly followed these policies. Some argue that Bangladesh was obliged to follow these policies which are the very same ones followed by the USSR and India, who supported them in their efforts to break away from Pakistan (Hossain, et al., 1999).

Some of these policies were embraced because empirical evidence of the experience of the 1930s and 1940s supported them and there was an almost universal consensus among development economists around the world. It helped in their widespread acceptance that they seemed to strike out an independent path from 'western' economics. Consequently, these nations turned towards, 'state-led ventures that relied on domestic markets.'

When reviewing the post-colonial political histories of the South Asian nations, some obvious commonalities are immediately visible. In particular, the South Asian nations demonstrate a strong culture of political violence, with the assassinations of political leaders occurring all throughout their post-independence histories. In addition there has been a clear military presence in government, especially in Bangladesh and Pakistan, where the military has had a favored position in society and has carried significant political clout (see Appendix). Furthermore, South Asian politics appears to have been dominated by successive family members in each of the South Asian countries and such monopolistic trends have also been evident in the centralized nature of the economies through out the post-independence era.

2.3 Performance

During the 1950s and 1960s some South Asian countries such as India and Sri Lanka, were predicted to be the most rapidly growing economies of the future. These nations were comparable to and in some cases, exceeded their East Asian counterparts in terms of per capita GDP and the advent of industrialization. The South Asian nations also had a significant advantage over East Asia in inheriting the modern legal, administrative and political structures left over from British Colonial rule. However, fifty years hence these South Asian economies have not been able to live up to popular expectation and are now burdened with low rates of growth, political instability, poverty and indebtedness, amongst other stifling attributes.

Table 1 elucidates the rapid growth (in terms of per capita GDP) of the model East Asian economy, South Korea, as well as the four main South Asian nations which have lagged behind considerably, in comparison. It is particularly interesting to note that during the 1950's Sri Lanka's average income was double that of Korea. However, by 1995 South Korea had reached the status of a 'high-income' economy and subsequently became a member the OECD in 1996.

Table 1: Per capita GDP of South Asian economies and Korea as a percentage of US GDP (PPP:USD) 1950 - 1995

Country	*1950*	*1960*	*1970*	*1980*	*1995*
Bangladesh	-	8.3	7.0	6.5	5.1
India	7.1	7.5	6.5	5.7	5.2
Pakistan	9.0	7.8	8.4	7.6	8.3
Sri Lanka	11.4	10.2	9.4	9.4	12.1
South Korea	7.6	11.8	11.8	24.8	42.4

Source: Hossain et al., 1999

Growth in the South Asian region has been significantly influenced by the specific policy decisions taken by each government. A few key factors characterized South Asia policies in the post-colonial era. In particular, these economies entered an import-substitution phase and were characterized by significant state intervention in both financial and labour markets. In addition, these nations relied heavily on State owned enterprises and favoured regulation. The entrenchment of some of these policy decisions over time have resulted in delayed or stagnant levels of growth, which have been difficult to amend due to various political pressures.

The ADB (1997:8) notes "Much of East Asia's success can be ascribed to the fact that East Asian countries used market institutions and openness earlier and much more than other developing economies. ...they adopted a strategy of export-led growth and stuck to the discipline that this imposed. Governments generally struck an appropriate balance between private and public action. They relied heavily on the private sector as the engine of industrial growth, especially in the crucial area of export-oriented manufacturing, but they also provided selective support through direct credit and other mechanisms. A common error in South Asia and elsewhere was trying to do too much, not only providing public goods, but also run bakeries, mines, steel mills, hotels, and banks".

3. The Failure of Political Governance in South Asia and its Outcome

One of the most significant impediments to growth in South Asia throughout its post-independent years, has been the failure of governments to effectively govern in terms of both politics and economics. In particular, state powers have been highly concentrated in centralized regimes and corruption both in public and private sectors has become the rule rather than the exception. In addition, there is an apparent lack of accountability amongst administrators and elected members of parliament, and a widening channel of communication between them and their constituencies (HDR 1999).

South Asian countries have had varying political systems since independence – while Sri Lanka and India have had democratic systems throughout, Bangladesh and Pakistan have had some form of military government. Despite this, South Asian political systems are rife with signs of poor political governance and some of these factors have had significant impacts on growth in the region. In particular, political power since independence, has been concentrated amongst a small group from the more privileged segments of South Asian society. In a region constituting a diverse range of ethnic groups, religions and languages such centralized political governance resulted in the discounting of the vast majority of South Asia's population. As a result, these disregarded segments of society responded by asserting their ethnic and religious identities, and forming themselves into powerful and often militant political groups. Instead of reacting to decentralize economic and political power, these ruling elitist groups reinforced their power through those of the State to secure their interests in the face of such opposition. The result has been a number of internal ethnic and religious based crises, which had significant adverse effects on each of these economies (Bardhan 1998).

Looking at Bangladesh and Pakistan there has been an alternation of leadership between the same political leaders, and generally throughout their post-independence history, these leaders hailed from the landowning elite of each nation. Such a system perpetuated a large gap between the voters and the leaders and resulted in a significant lack of transparency in policy decisions. Political instability has its roots in fraudulent electoral practices and other forms of financial corruption. While these signs are evident in all of the South Asian nations, in Pakistan in particular, corruption has been the downfall of every democratically elected government (HDR 1999).

Signs of excessive bureaucracy in South Asia originate from the administrative structures left behind by the British. Within this colonial structure, policies were formulated by the colonial leaders and subsequently implemented by the civil servants. However, after independence the bureaucrats performed both roles, despite their relative inexperience in leadership. This has carried on to the present day, and as a result the roles of policy makers and leaders are not distinct in South Asia but fulfilled by inexperienced bureaucrats (Bardhan 1998). The bureacracy and the tendency to centralize political power led to rapid growth of the state in South Asia (see Table 2).

Table 2: The growth of the South Asian trade

Country	Total public expenditures (As a % of GDP)			Governmentconsumption (Avg. annual % growth)		Government consumption (As a % of GDP)	
	1980	1995	1998	1980-90	1990-7	1980	1997
Bangladesh	10	14.2	14	5.2	6.3	2.	4
Bhutan	34	42	N/a	0.27	0.13	25	17
India	24.5	29	33	7.7	3.5	10	10
Maldives	44	48	51	0.28	N/a	12	N/a
Nepal	15	18	19	7.2	6.0	7	9
Pakistan	18	23	21	10.3	0.8	10	12
Sri Lanka	41	29	26	7.3	7.2	9	10
South Asia	**22.5**	**26**	**29.4**	**8.0**	**3.6**	**9**	**10**

Source: HRD (1999).

Many have wondered why India did not grow more rapidly than it did. It had natural resources, political stability, the steal frame of administrative civil services and a large body of science and technology (S&T) personnel. In short, it had all the ingredients needed for rapid economic growth. The irony may be that it is precisely because of these that India could not grow faster. The abundance of natural resources permitted the government to avoid taking hard decisions. The one party dominated polity made successive Congress governments complacent, the steel frame of the bureaucracy turned into a rigid cast iron straight jacket and the large body of S&T people constituted a strong lobby for self-reliance, wasteful R&D much of it directed to reinventing the wheel, and many non-competitive industries.

Another key feature of South Asian systems of governance is the high level of corruption, has served to undermine economic growth, by reducing efficiency, and by acting as a disincentive to potential investors. In particular, government bureaucrats have control over most of the state resources and the rents generated from them. The result is not only a welfare loss to the state but there is also loss in tangible resources resulting from the rent-seeking activities of government officials. In addition, studies have shown that countries with high levels of corruption are likely to reduce aggregate investment by approximately five percentage points and per capita growth rates by half a percentage point (Paolo Mauro 1998 as cited in HDR 1999). Studies on the South Asian experience have shown that in India, if corruption levels became comparable to those in Scandinavian countries, investment could be increased by 12 per cent and the GDP growth rate by 1.5 per cent per annum (Gandhi 1997 as cited in HDR 1999). Similarly, Bangladesh could increase its GDP growth rate by half a per cent (Wei 1998 as cited in HDR 1999) if profiteering practices were reduced to the level of that in Uruguay. Likewise, if Pakistan were to reduce its level of corruption to be on par with Singapore, GDP growth rates could increase by two percentage points. Corruption also creates uncertainty in the decision making process which is reflected in the higher degree of risk that is associated with investing in South Asia.

Kaufman 1997 and Klitgaard 1998 (as cited in HDR, 1999) argue that investing in corrupt country (as opposed to a relatively non-corrupt one) results in equivalent to an extra tax of approximately 15 per cent. Wei 1998 (as cited in HDR, 1999) extends this argument in showing that if corruption levels were lower in Pakistan, this implicit tax on foreign investment would have been 28 per cent lower. Similarly, Gandhi 1997 (as cited in HDR, 1999) claims that at the current levels of corruption in India, this implicit private tax amounts to approximately 20 per cent.

One can argue that all societies are corrupt to some degree and that all that the degree of corruption changes is the expected return and who shares it. Once that is accounted for, the neoclassical framework of optimizing agents and collective action should apply. The political economy analysis of a corruption infested economy becomes much more complex. Policy distortions result not only from collective action but also individual actions. Even when a façade of a rule of law is maintained and even when the law is ideal and non-distortionary. Thus many more possibilities of distorting outcomes need to be recognized.

The similarity of background, motivations and compulsions of economic policy making in South Asia led to somewhat similar outcomes in terms of neglect of the social sector, rigid macroeconomic strategy, fiscal profligacy, trade distortions, centralization, investment inefficiency, and so on. Slow growth and potential for crisis were the outcome. We look at some of these issues below.

3.1 Rigid Macroeconomic Strategy

As discussed earlier, after gaining independence from the British, as an indirect backlash against their Colonial rulers the South Asian economies followed a set of common policies, which were essentially nationalistic and 'inward looking'. These policies involved the key elements of import substitution industrialization, state intervention in both labour and financial markets, dependence on State owned enterprises and a bias towards regulation and central planning. While the onset of these policies varied between the states, they remained entrenched within the economies of South Asia, far longer than in those of their East Asian counterparts.

In keeping in line with this, during the 1950s many of the South Asian economies devised large Planning Ministries to establish long term development plans for the economy. The resulting five-year plans in all four economies had comprised of import substituting policies in both the agricultural and industrial sectors. With the macroeconomic view of promoting self-sufficiency, any form of foreign participation in these economies was discouraged in these development plans. In addition, South Asian policy makers, being reluctant to share power with those outside their privileged group, went ahead in assuming state control of industries and infrastructural assets. The private sector was marginalised during this time and was confined to small industries (see, for instance, Hossain et al., 1999).

3.2 Fiscal Profligacy

One of the greatest threats to macroeconomic stability is the presence of large fiscal deficits which can lead to increased inflationary pressure. As well known, a stable macroeconomic environment is essential for economic growth and also has subsequent effects on human development. Poor fiscal management has been a key feature of South Asian economies in the post-independence period and has been a significant constraint on the growth. The effects of this, have become visible through increasing inflation, which in turn has deterred investment efforts in the region and increased tax rates on the already narrow tax base (Shand 1997).

In India, for instance, during the mid 1980's this phenomenon arose when the Reserve Bank of India lent increased amounts of net credit to the government, which subsequently increased the supply of money and also inflation. B 1994, India's fiscal deficit was around 7.5 per cent. Similarly, in Sri Lanka, high fiscal deficits have been prevalent since the late 1970s, and in 1980 the fiscal deficit stood at 17 per cent of GDP. As a result of these high fiscal imbalances, high rates of inflation and difficulties in the management of monetary policies have resulted in Sri Lanka (Dunham and Kelegama, 1997). These high fiscal deficits have been primarily attributed to difficulties associated with the management of government spending, as well as to the large inflows of concessional foreign aid during that period. In addition, attempts to increase the collection of non-tax revenues in these countries have been hampered by poor cost recovery policies for public services. While Bangladesh, India and Pakistan have been able to reduce their fiscal deficits to approximately 6 per cent, Sri Lanka's deficit still fluctuates between 8 and 12 per cent (HDR 1999).

In addition, these deficits have been the financed by borrowing domestically and from overseas, which led to increasing debt burdens in South Asian economies. Countries such as Sri Lanka and Pakistan already have public debt to GDP ratios in excess of 60 per cent. In general, more than half of the South Asian region's deficits are financed by foreign borrowing. In addition, the banking sectors in most South Asian countries, have had to resort to the printing of large sums of money to finance these deficits. Similarly, domestic debt is in excess of 40 per cent of GDP in India, Pakistan and Sri Lanka.

Table 3: Public debt in South Asia, 1997

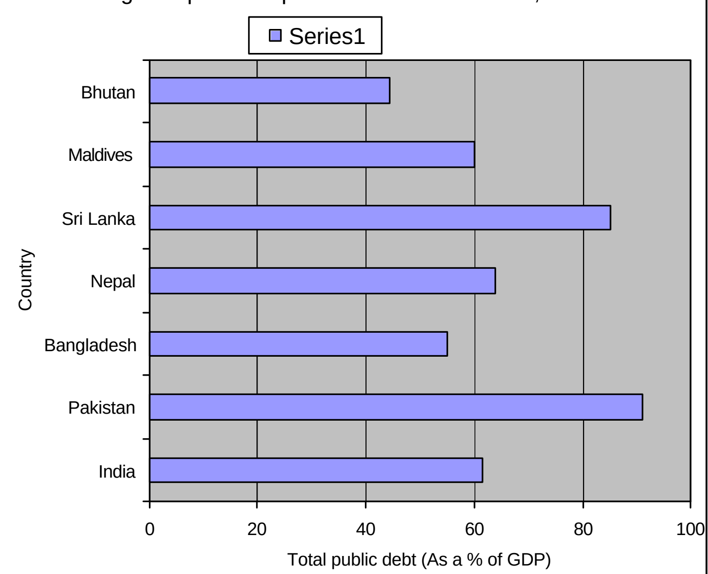
Country	Total public debt (As a % of GDP)
India	61.5

Pakistan	91.2
Bangladesh	55
Nepal	64
Sri Lanka	85
Maldives	60
Bhutan	44.5

Source: HDR (1999).

Clearly, South Asian governments have not been prudent in their fiscal management throughout the post-independence period. In particular, the fiscal deterioration in India during the 1970s can be directly attributed to government mismanagement in the wake of the increasing political participation by up and coming pressure groups. These new interest groups arose from the middle rungs of the social ladder, as opposed to the industrialists and bureaucrats who retain the controlling share of the economy. By the sheer magnitude, these groups became more important over time. At the same time, there was a notable deterioration in the capabilities of government institutions to support the growing pressures from these interest groups, which was primarily the result of political

Fig.4: A profile of public debt in South Asia, 1997



leaders looking after their own interests at the expense of the State. During Mrs. Gandhi's reign after 1971, she discarded democratic practices and appointed only her loyal supporters within the bureaucracy and government institutions. This weakened the organizational structure of the government, and led to band-aid handout measures to cater to the demands of the growing pressure groups and only served to increase government expenditure and further erode the nation's fiscal position (Joshi 1994).

Similar patterns of fiscal mismanagement are common to other South Asian countries. In Sri Lanka, like many of the other South Asian nations, large transfers have been made to languishing public enterprises which have been a huge burden on the government and have placed severe constraints on other government expenditure (Dunham and Kelegama, 1997).

Another significant flaw is the inadequate taxation structure in most South Asian countries which lacks transparency and is inefficient in its execution. Both the collection and re-distribution of taxation revenue has been inefficiently performed by government institutions. In general, South Asian governments collect a relatively small quantum of tax, approximately 10.4 per cent of GDP, and more worrying is that these tax ratios are not increasing. In Pakistan and Sri Lanka, the tax to GDP ratios decreased by 3 per cent while they remained sluggish in other South Asian nations. The South Asian tax base is also limited and only 1 per cent of the population pays income tax. This can be attributed to a system in which tax evasion is the norm, and the penalties for tax evasion are not implemented with severity.

One of the main functions of the taxation system should be to ensure efficient allocation of revenue in order to promote investment and growth. In the case of South Asia, there have been a number of factors that have hindered this process. The governments have primarily targeted trade taxes as a source of taxation revenue, and devised a complex system of taxation in which there was a significant number of tax concessions. Also, in both India and Pakistan there was a tendency to heavily tax production inputs, which were commonly used in the industrial and agricultural sectors. In addition, incomes have not been considered equally, and in the case of agricultural incomes in particular, there have been significant tax exemptions in South Asian countries as a result of the political power that the land-owning elite have traditionally yielded.

The large black market economies (approximately equivalent to a quarter of the economy, in India) that exist in South Asia remain outside the tax net , and in addition other informal industries and small enterprises have also managed to evade taxation successfully. The South Asian tax system is generally not transparent and is plagued with tax evasion due to the weak administration amongst tax collecting institutions. The rationale for the anomalies in the system, lies mainly in the relationships between the tax administrators and the tax evaders. Corruption is rife in this sphere of government and taxation policies are largely influenced by the ruling elite of South Asia, for self-seeking reasons. While tax departments throughout the region have the common features of low pay and flexible regulations, bribery and corruption are common. These practices are commonplace, not just amongst the rich industrialists but also amongst the politicians themselves. As a result, there is no incentive to restructure taxation in most South Asian economies. The fiscal costs of the tax concessions are estimated at approximately 2 per cent of GDP in South Asia (HDR 1999).

3.3 Trade Distortion

A notable characteristic of early post-colonial South Asia was the region’s intense suspicion of liberalized trade measures. This aversion to free trade can be traced back to the Colonial era itself during which the exploitation of the regional colonies was closely associated with the policy of free trade. The Congress Party which led the independence movement in India strongly advocated national self-reliance, and other fundamentalist Hindu parties and Communist parties shared this view. During the nationalist independence movements in India, a campaign of destroying all foreign-made goods was also embarked upon over a long period with vehemence. In addition, the tendency amongst politicians and bureaucrats in this region has been to lean towards central control in order to exercise their own power more visibly (Joshi 1994).

During the 1980s, South Asian governments showed some signs of commitment to the Structural Adjustment Programs (SAPs) of the World Bank and IMF, but approximately 10 years after their East Asian counterparts. Even after undertaking the SAPs, the rate at which reform has occurred has been slow. This has been primarily attributed to electoral changes in governments during this period in all of the South Asian countries concerned. There also seems to be an inverse relationship between good governance and rapid implementation of reform.

Sri Lanka however, has shown more commitment to the reform process and was the first country to initiate liberalization of its economy (Section 5). Despite this early attempt at liberalization, the reform process did not deliver the expected results and soon inflation increased, budget deficits and balance of payments problems arose. The government took on a far more authoritarian role after the initial years, and macroeconomic mismanagement and *ad hoc* policy making became the standard (Dunham and Kelegama 1997, Athukorala Jayasuriya 1994).

In keeping with the India’s post-independence ideologies, India’s trade policy during the period has been consistently characterized by a number of stringent controls. Due to the sizeable rents that could be generated from the maneuvering of these controls, their was popular support for their retention for a long period. While India’s early liberalization attempts began in the early 1970s the process at that time was a token effort by a minority of bureaucrats. The next real attempt at liberalizing Indian trade occurred in 1986/87, in a determined effort to wipe clean the ideological slate and to adopt a more modern approach. The liberalization momentum was greatest during the early years, and thereafter the effort slackened as the administration faced the issues of large fiscal deficits, the emergence of ethnic struggles in Punjab, and allegations of corruption against the Prime Minister himself. Overall this liberalization attempt was hampered by other political factors and vested interests, and India’s industrial sector was not exposed to foreign competition and liberalization was confined mainly to inputs which resulted in higher levels of effective protection on end products (Joshi 1994).

Both Bangladesh and Pakistan liberalized their economies in the early 1980s under the IMF and World Bank SAPs. In Bangladesh, until that time, the country pursued a policy of intensely protecting local industries and enforcing rigorous import controls. Similarly, Pakistan also placed significant emphasis on protecting domestic industries and these policies were particularly supported by Bhutto's socialist ideologies in the late 1970s. The economy was liberalized under General Zia's martial law in the early 1980s during a time when the government was seeking political and economic support from the United States (Jahan et al 1995, Khatkhate, 1999).

3.4 Investment and Inefficiency

As investment is seen as significant determinant of growth, the level of both public and private investment in South Asia has had a significant impact on the development of the region.

When considering public investment in South Asia, the evidence indicates that there have been a number of inefficiencies that have hindered the effective implementation of public sector investment projects. In particular, management failure on the part of governments is one of the most notable factors. As a result, delays in project completion and project costs exceeding budgetary allocations were very common features of South Asian public investment programs. These delays generally arose as a result of inefficient planning, and limitations with regard to finances, and infrastructure facilities. In addition, the choice of projects was determined by political influence, rather than principles of comparative advantage and regardless of economic viability in some countries. Furthermore, even until recently many of the public sector enterprises were incurring large losses, and in light of this the efficiency of investment in this sector is difficult to ascertain accurately (Joshi 1994).

In the case of private investment in South Asia, practical delays in implementation also exist, and to a large extent project completion is still subject to government regulation. In India, the choice of technology used by private investors is limited and regulations governing the expansion of large private firms are said to have hindered industry development in some cases (Joshi 1994).

South Asia's achievements with regard to attracting Foreign Direct Investment (FDI) during the post-independence period has been relatively ordinary. Political and economic instability, poor infrastructure, inadequate labour legislation and bureaucratic procedures have all been disincentives in this regard. While most of the South Asian nations have recently diverted their attention towards setting up export processing zones and creating other incentives, the bureaucratic hurdles are still a weighty impediment to FDI and related growth in South Asia.

In the case of Sri Lanka, though FDI increased significantly after 1977, this trend did not continue as a result of inefficient macroeconomic management. In addition, the increase in ethnic violence has had a significant impact on FDI to Sri Lanka and is likely to continue to do so in the future.

3.5 Agricultural Development and Land Reforms

South Asian governments did, after an initial neglect, push agricultural development. They have encouraged state research, extension and development of agricultural infrastructure of irrigation, electrification and rural roads to varying degrees. The policy has been to keep food prices low to keep happy urban consumers. At the same time, to encourage production, input subsidies were provided to farmers. These subsidies have grown over the years, to the extent of straining government budgets and becoming unsustainable. The vested interests created in these subsidies make it very difficult for governments to reform them.

While much lip service to land reforms was paid and land ceilings legislation were enacted, their effectiveness leaves much to be desired. Effective land reforms could have been a potent instrument for poverty alleviation, as well as for agricultural development.

3.6. Human Development and Social Sector

While Sri Lanka's achievements in human development are widely lauded, other South Asian countries have done poorly. Table 4 gives poverty profile in South Asia under three indices. The first one is the [$1/day] measure – which is now internationally fashionable. The second one is human poverty index (HPI) as developed by UNDP (1997) which includes shorter life span, illiteracy and lack of access to safe water, health and nutrition. The third is poverty of opportunity index (POPI) developed by Mahbub ul Haq by adding an income component to HPI.

Table 4: Poverty profile in South Asia

	$ 1 a day (1989-94)	HPI (1995)	POPI (1995)
Pakistan	12	46	44
Nepal	53	-	52
Bangladesh	29	47	46
India	53	36	38
Sri Lanka	4	21	27
South Asia	**45**	**38**	**39.5**

Source: HDR (1999).

The neglect of social sector is reflected in Table 5.

Table 5: Social Sector Expenditures

	India	Pakistan	Bangla-Desh	Nepal	Sri Lanka	Bhutan	Maldives	South Asia (weighted Average)
Expenditure on Social Security: Poverty alleviation programmes (as % of public expenditure) 1997	3.5	5.8	…	…	3.4	…	…	3
Education: Expenditure on education (% of GNP) • 1985 • 1995	3.4 3.5	2.5 2.1	1.9 2.3	2.6 2.9	2.6 3.1	… 5.2	4.4 8.4	3.13 3.21
Priority in education budget(%) Primary Secondary Tertiary Technical and scientific	46 31 12 4.4	48 24 14 2.6	52 19 17 8.4	49 16 22 4.4	82 … 14 2	… … … …	67 32 5 …	47 29 13 4.4
Pupil-teacher ratio (1989-94) Primary Secondary	63 26	41 19	45 43	42 32	29 20	33 24	… …	57.86 26.86
Health Public Expenditure on health (as % of GDP) 1990-97 Doctors (per 100,000 people) 1993	0.7 48	0.8 52	1.2 18	1.2 5	1.4 23	4.0 20	5.3 19	0.78 44.34
Population with access to Health services % 1995 Safe water % 1995 Sanitation % 1995	85 81 29	55 60 30	45 79 35	… 48 20	93 57 63	65 58 70	75 96 66	76.30 77.46 30.09

Source: HDR (1999).

Even the relatively modest expenditure on education and health has not been effectively utilized and the outcome is worse than what could have been obtained. Absent teachers are a common feature in rural schools. Lack of facilities handicap even the willing teachers. Similarly, lack of medicines has greatly reduced the effectiveness of primary health care centres. Decentralization and devolution of powers to local bodies were neglected.

3.7 Sluggish Decentralization

The South Asian region has been characterized by centrally controlled regimes which have in turn, been influenced significantly by Socialist and Marxist ideologies since independence from Britain. While such regimes have resulted in the isolation of those in power from the populous majority it has also created loopholes to promote corrupt practices and retain power in the hands of an elite minority (HDR 1999).

With the advent of liberalization and pressure for reform from multilateral institutions, there has been a gradual shift towards decentralization in South Asia in the recent past. In India however, the move towards decentralization is said to have arisen as a result of sentiments that such strictly centralized regimes in the face of such huge ethnic diversity, have been responsible for heightening ethnic hostilities.

Despite this shift in direction throughout South Asia, the authority granted to local governing bodies seems to have been somewhat tokenistic as financial and other policy related powers are still primarily vested with the central government. Unfortunately in South Asia, much of the devolved powers at the local levels are dominated by wealthy or influential people based on contacts rather than democratic positioning.

In principle, India and Pakistan have federalized governments, but in reality a concentration of central power is more visible than the accepted devolution of power. The reason for this lies with the Constitutions of each country which clearly favour the central government and give them the right to dissolve state assemblies under special circumstances. In addition, the states rely on central authorities for financial provisions, and are subject to central legislature.

In Sri Lanka, there is pressure to devolve power in a federal set-up to ease ethnic hostilities. There is already some degree of local autonomy in the Sri Lankan power structure. While Bangladesh does have a local government system, these units are controlled by central government. It appears throughout South Asia that the centralization of power has been a key factor in fuelling ethnic tensions and the calls for autonomy amongst the diverse communities of the region (Athukorala and Jayauriya 1994).

3.8 Internal Conflicts

Throughout South Asia's independent history there has been a long record of internal and external conflict. As a result, many South Asian governments have been forced to make large budgetary allocations to defense spending at the expense of other sectors, national development and ultimately growth. Internal and external conflicts have continuously hampered any efforts at long term development, have added to increased political instability and have consequently deterred more significant investment in the region.

India has been plagued with civil hostilities since the early post-independence period with protests in Kashmir and discord as well as calls for autonomy from numerous other states within India. Similarly, Bangladesh suffered heavy losses during the process of seceding from Pakistan in the early 1970s. Within Pakistan itself ethnic and religious hostilities are rife amongst extremists and minority groups. Sri Lanka has been suffering at the hands of a violent war for over 15 years, in which the Liberation Tigers of Tamil Eelam are demanding a separate state. Sri Lanka's militant war is said to have adversely affected growth by 3 per cent (HDR 1999).

The continuance of these uprisings has been blamed directly on South Asian governments in their failure to manage the ethnic conflicts successfully within a long-term growth framework. The conflicts that rage throughout South Asia can be attributed to the reasons of failed governance discussed earlier. While leadership remains only democratic in principle, states are still predominantly centrally controlled.

3.9 Institutional Failure

A sound framework for economic growth depends heavily on the strength of institutions and their ability to adapt to policy changes as well as provide some degree of political and economic stability. In addition, efficient institutions allow for the smoother functioning of markets and promote growth. These end results can be achieved when institutions have a well defined and well implemented rules which reduce the political clout of large lobby groups and reduce any transaction costs associated therewith. In addition, a sound institutional framework encourages investments and acquiring new technologies required for economic growth. Most importantly competent institutions establish the channels by which policies are formulated and implemented.

In South Asia, the above mentioned factors are sadly lacking, and numerous deficiencies in the functioning of institutions have had a significant effect on growth. Some of the key institutions in South Asian countries were inherited from the colonial era, while others emerged to support the Socialist agenda's of the post-independence time. Despite the recent attempts at liberalization, these institutions have not always been upgraded in line with the corresponding changes in policies. This was visible in Sri Lanka when trade liberalization took place before the parallel institutional changes, to promote exports (Section 5).

Institutions in South Asia, mostly thrive on informal networks of political and family connections. Institutional regulations are subject to a high degree of corruption and are implemented more on an *ad hoc* basis. There is a certain lack of transparency and accountability in the operation of government institutions in South Asia. As a result, discretionary measures taken by key individuals within institutions have become widespread. This type of institutional operation has not only resulted in large transaction costs but has also created political and economic uncertainty in the region.

While exceptions to this perceived rule do exist, the trend in South Asia, is a gradual deterioration of institutions despite the moves to further liberalization. South Asian governments seem to be unable to bear the political costs of institutional reform within the short term (Sections 4 and 5).

3.10 The Issues to Probe

This brief overview of policies and outcomes raises a number of questions, why did the governments pursue the policies they did? Why didn't they change them even when need became obvious? To what extent policies pursued, options shunned and reluctance to reforms can be explained by the political economy framework given in Section 1? We expect the country case studies to answer these questions. Here we list the major issues.

- ❖ Why did the country select the particular development strategy of planning, import substituting industrialization and public sector dominance?
- ❖ When did the problems of government failure became apparent? Why did the policies persist? What forces oppose or support reforms of these policies?
- ❖ Why were trade distorting policies pursued? Why did they persist ? Who supports trade liberalization? Who blocks it?
- ❖ Why were land reforms not successfully carried out? What is the political economy of the performance here?
- ❖ Why was the agricultural policy of low output prices and low input prices followed? When was the need for reforms realized? What is the political economy of it? Who blocks it? Who supports it?
- ❖ Why was social sector not given adequate attention?
- ❖ Why were anti-poverty programmes permitted to be highjacked by the not-so-poor? Why do they persist in spite of their ineffectiveness?
- ❖ What forces oppose fiscal policy reforms? What are the non-merit subsidies? How can these be reformed, given the political economy?
- ❖ How have public sector entreprizes performed? What blocks reforms including privatization?

We analyze these issues using the neo-classical political economy framework of Section 1 for the two countries we have selected in turn.

4. India: Political Economy of its Development Strategy and Reforms

India's slow growth economy was the result of the strategy of development that it followed, which was, for most part, an import substitution-industrialization (ISI) strategy. In the early years after independence, there were many opportunities for economically efficient import-substitution. Moreover, from the vantage point of the late 40s, export pessimism may have seemed justified. World trade during the 30s and 40s had not grown much. The war ravaged economies of America and Europe were not expected to recover and grow in the way they did. Import substitution seemed a sensible policy and provided many opportunities. For the newly independent country that imported all kinds of manufactured goods, however, import substitution soon got coupled with self-reliance. To further self-reliance, technology imports were restricted to only one time, followed by assimilation of the imported technology. Thus, reduction in import content rather than the domestic resource cost of production became the guiding parameter in the drive towards self-reliance. Even when world trade in the 50s and 60s grew at an unprecedented rate, export pessimism was not given up by India's policy-makers and import substitution continued.

In addition, the strategy for industrialization was based on a heavy industries first strategy. (It is not generally known but worth noting that the initial emphasis on heavy industry in the second five year plan was argued on the ground that India has comparative advantage in them). This led to a number of problems - which were obvious to some then and which are now obvious to all. Heavy industries involved lumpy investment with high capital output ratios and long gestation lags. They also required large imports of capital goods. Inadequate infrastructure, lack of experience, and the necessity of learning by doing further stretched the period of gestation. The costs increased and cascaded into all industries using these inputs. To protect the high cost domestic industry against foreign imports, trade was restricted and protection through tariffs and quotas was provided. To stimulate investment in spite of the high costs of domestically produced capital goods, capital was subsidized through cheap credit and factor prices got distorted. This resulted in the choice of more capital intensive techniques than would have been appropriate, given the abundance of labour in the country.

The plethora of controls, procedures, permits and bureaucratic restrictions created such a maze that the net effects of these policies were not at all obvious. While the nominal tariffs remained extremely high averaging 117% in 1989/90, a World Bank (1989) study in a review of 16 sub-sectors, found that effective protection rates ranged from -16% to 162%. In another study, a detailed review of 60 projects showed that half the firms studied received negative protection. It was here not a case of the right hand not knowing what the left hand does but of the right hand not knowing what the right hand does!

In addition, India’s strategy had one important characteristics. It protected organized labour which has become a labour aristocracy. The real cost of organized labour has been way above the costs of unorganized labour. A labour policy which protects employment operates in many ways. Labour laws make it extremely difficult to retrench any worker. Even economically unviable units are not permitted to close down. In fact such units are often taken over by the government. Along with this job security a number of other benefits are provided to workers. Among these is one month's pay as annual bonus which is considered as deferred pay and is not linked to productivity or even profitability of the enterprise.

As a consequence entrepreneurs have all the incentives to restrict regular employment. One can expect that recourse will be taken to subcontracting and ancilliarization.

The location of public sector enterprises to promote regionally balanced industrialization has also not been very successful. Politically determined locations involve some economic costs. While these may be considered acceptable from the view point of regional equity, location of large public sector enterprises do not seem to have stimulated development of other industries in the area. Thus Bihar continues to remain industrially underdeveloped inspite of having many public sector heavy industry units and inspite of its large mineral resource base. Perhaps a labour force spoiled by public sector indulgence does not attract other entrepreneurs. We now explore some political economy questions that arise from this description.

4.1 What made India select a mixed economy based heavy industry first import substitution strategy of industrialization; and why did India continue on that path for so long?

India's choice of its development strategy in early 50's was logical. The political economy posed no problem either. The bulk of the population didn't quite understand the consequences. They trusted their leaders who had selflessly sacrificed so much in the freedom struggle. A poverty-free world in 15 years was promised and people believed it.

The only opposition that could have come was from Gandhi who had an innate distrust of large governments. He was, however, assassinated in 1948 and other supporters of Gandhi's economic ideas had little mass appeal compared to Nehru. However, the government did support khadi and village industries. This satisfied, or at least, occupied some of them. Moreover, Gandhi's distrust of big government and socialist distrust of big business combined to give small scale industries an important place in India's development strategy. Once begun, the dynamics of the situation led to its entrenchment and continuation. The policy created its own vested interests and in fact, the three dominant groups, the industrialists, the bureaucrats and the politician all benefitted from it. The pervasive controls provided tremendous scope for affecting what economists call rent seeking activities (influencing government policies or bureaucratic decisions in one's favour to make gains) and industrialists, traders, bureaucrats and politicians found it much more profitable to seek these rents rather than increase the efficiency of domestic production or improve the functioning of the domestic economy. Domestic industry, which was already protected from foreign competition through import restrictions against any domestically available product, and from domestic competition through industrial licensing, had thus no incentive to be efficient. The only group that suffered were the consumers who got poor quality products at high prices. However, till the `80s, when the East Asian miracle brought about by Asians like themselves became visible, most of them didn't know about the possibilities. Thus, the policies continued till 1991.

The educated classes were co-opted and developed a vested interest in the system. The open recruitment for the adminsitrative services provided a scope for the brightest, many of them idealists, to improve their social status. (The IAS has become a high caste). The socialistic slogans and the public sector which ostensibly protected them against the predatory capitalists and a state that promised to eliminate poverty in fifteen years was able to win the loyalty of many educated Indians. The emphasis on self-reliance, creation of large domestic R&D establishments and preference for domestic technology (no import license if someone produces it domestically – no matter at what cost) excited the engineers and scientists and created over time a large and powerful lobby for self-reliance.

4.2 How did public sector gain its dominant role?

The initial emphasis on public sector was logical. The public sector was developed for a variety of reasons - to reduce concentration of economic power, to control the commanding heights of the economy and to provide a means to balance industrial development across regions. In the initial phase of development, it was seen as the only way to start large projects requiring heavy investments which private entrepreneurs in India were unwilling or were considered incapable of making. It was to generate increasing surpluses and profits all of which would be available to the state for reinvestment so that investment rates can go on increasing without raising tax rates on private incomes. It was also to be a model employer.

Roughly 50% of the capital formation in the Indian economy since 1965-66 has been in the public sector. It has reached the "commanding heights" in the sense that more than 2/3rds of the employment in the organized sector is in the public sector (see table 5.2.1) and it generates around 55% of the value added in the organized sector. Unfortunately, public sector has failed miserably in generating surpluses and its gross savings have been less than 40% of the investment in public sector over 1950 to 1985. Thus, instead of accelerating investment it drew substantially from private savings. All commercial public sector enterprises together showed an after tax net profit of 2.2% on capital employed in 1990-91. While this increqsed to 6.2% in 1997-98, if we exclude petroleum related public sector units (as their profitability is largely a matter of government's pricing policy) then the net profit even in 1997-98 was only 3.4%. Given the generally high capital/output ratio of these enterprises, this indicates a very poor return on investment. The gravity of this failure of public sector enterprises to generate adequate surplus can be appreciated when we note that in 1983-84 the non-financial commercial public sector had a total net savings of Rs. 295 crores while its net capital formation that year was Rs. 12,766 crores. For 1996-97 these figures are Rs.9930 crores and Rs.21550 crores.

One objective that the public sector has fulfilled is that of being a "model" employer. This is true atleast from the view point of those employed by it but not from the view point of economic efficiency. The public sector has become a high wage island in the economy. In 1980-81 public sector employees accounted for 6.8% of labour force who got as much as 39.8% of the wages and salaries in the entire economy. The situation must have become even more skewed now after the revision in government pay scales in late 80's. The poor performance of the public sector has had serious consequences for the poor as it has significantly lowered the growth rate of the economy and has pushed wages higher in the organized sector as a whole. This has led to choice of relatively more capital intensive techniques and further constrained the growth of employment.

The public sector managers were not given a clear mandate as to what they were supposed to do. The objectives of self-reliance, and being a model employer seemed to dominate their concerns. The objective of generating surpluses was of little concern to most of them. Producing, at whatever cost, was the objective. Since the managers operated without a hard budget constraint, they took the easy way out and workers were given emoluments which were not related to either productivity or profitability. The public sector employees became a large powerful group of vested interest. Its power comes from its numbers (more than 70 percent of the employees in the organized sector) and its control of critical infrastructure (ports, airlines, railways, passenger buses, electricity supply, banks and municipal services).

Trade union movement brought similar employment benefits to workers in the organised sector. They were able to extract job security. In January 2000, it is not possible even for privately owned organised sector industries to retrench a worker without a written permission from the state industries minister, a permission that is almost never given. The public sector also grew in two other ways, when government nationalized insurance, banking and coal industries and when government took over sick private industries who could not close down as they cannot retrench workers.

There were no groups who opposed this growth of public sector. In the process of its growth, it has created a large vested interest group of employees as well as of bureaucrats and politicins who enjoy the power and privileges of running large enterprises. These groups are formidable opponents to privatization.

4.3 What explains the emphasis on village and small industries? Why do small scale sector reservations continue?

Development of village and small industries (VSIs) was an important element of India's development strategy. They contribute significantly to income, employment and exports. Thus, in 1996-97, not counting traditional village industries, there were 2.86 million units of small scale industries (SSIs), which produced Rs.4126 billion worth of output of which Rs.392 billion of output was exported, (nearly 45% of industrial export) and employed 16 million persons compared with the total employment in the private organized and industrial sector of 7 million and in public sector of 20 million.

The VSIs were promoted to encourage small entrepreneurs to create broad-based employment opportunities in dispersed manner across states and in rural areas (which could slow down rural-urban migration), to promote regionally balanced industrialization and thereby to promote equity.

There was widespread political support for such a strategy. It seemed to restore the set-back suffered by craftsmen and rural artisans during the British colonial rule and who were being driven out of their traditional occupations because of new tastes and products (Bhawani, 1980 and Gadgil, 1973 cited by Tendulkar and Bhawani, 1997). It also satisfied the large number of Gandhians who were not persuaded by the heavy industry first central planning based development pushed by Nehru and his supporters. It constituted a middle path betgween the Gandhian and Nehruvian approaches.

VSIs were promoted in a number of ways. Excise exemptions and concessions were given. Industrial licence was not required of them. They were protected from competition by large scale producers by reserving certain products for them. They were provided concessional credit. Credit concession could be justified as small entrepreneurs typically find it difficult to get credit and pay higher interest rates. (Banks justify the higher interest on the ground of higher transaction cost and percieved risk).

These concessions certainly led to growth of VSIs but also created some problems. The excise concessions encouraged many to fake smallness. For example, one can own 120 powerlooms registered under 20 different firms, each firm owning no more than 6 looms. The concessions also created a vested interest in remaining small and firms did not grow even when there were economies of scale to be exploited. Time has come to change all these. Thus, the Abid Hussain Committee (1997) has recommended complete abolition of product reservation and other protective policies and suggested concentration only on promotional policies. These include concessional credit, technology support, training support, marketing assistance and infrastructure development.

The protection provided to VSIs was also justified on the ground of infant industry protection. The problems with infant industry protection is that the infants lose all incentives to grow. India has many senile infants among its industries. Such protection must be time-bound. Political pressures, however, manage to keep on getting the time limit extended.

Reforms have become difficult simply because the VSIs have grown in numbers and command some political clout. Yet reforms have whittled away quite a bit of VSI advantage. Now, industrial licensing is not required even of large producers. The excise rates have been lowered and are being simplified. Imports as already mentioned, are freely permitted of many of the products of VSIs. Thus, VSIs already face increasing competition. At the same time, some of them have benefitted from the reforms that have favoured exporters by devaluation of the Rupee. Bulk of India's manufacturing exports come from small firms. These firms would welcome the opportunity to grow and have modern technology. The political climate for VSI reforms is now much better and one hopes that they will be carried out in not too distant a future.

4.4 What led to progressive increase of subsidies and deterioration of quality of infrastructure services and why did India continue on the path for so long?

Goyal (1999) has questioned the dominant explanation for the decay in Indian government finances provided by Bardhan's (1984) thesis of powerful vested interests, each getting concessions such as employment, subsidies, free loans, and cheap public goods. If this were the whole story, she argues, government consumption would be rising as a ratio of the GDP.

However, Goyal examines the budget data rom 1970 onwards and finds a small decline since 1987-88 in compensation of employees of public sector, in compensation of employees of non-departmental undertakings, in expenditure on general expenditure and in consumption expenditure of administrative departments, all as percentages of GDP.

Goyal advances an alternative hypothesis. The various subsidies on user prices for economic services such as electricity, water, fertilizer, kerosene and diesel and food subsidies were well motivated. Subsidies on electricity to farmers were to promote water for irrigation or fertilizers agricultural development and diffusion of new technology of green revolution. Fuel subsidies were introduced to protect the poor against oil shocks of the 70s and food subsidies were initiated during poor agricultural years. In a regime of administered prices of these products and services, subsidies, once introduced, kept growing. Now they have reached levels which stress government finance severely, but by the same token, have generated its own vested interest groups which resist reforms.

These subsidies have seriously affected the ability of public sector to expand capacity to provide quality service for a growing population. Thus, power shortages are endemic and road, railways and public irrigation systems are poorly maintained and cannot be expanded rapidly. Quality of health services and education leave a lot to be desired.

Goyal summarizes this well. “In Greek plays tragedy was never purely the outcome of fate; human motivations entered richly and often fatally. There was no villainy, however, only frailty. In an analogous way, the means used to achieve valid objectives amplify the exogenous shocks of the 1970s. It was doubly unfotunate because there were no villains; players often had the best of intentions.”

4.5 What caused the crisis of 1991?

India faced a crisis in the middle of 1991. When a new government took over in June 1991, India faced a serious balance of payments crisis. The foreign exchange reserves had rapidly dwindled to a level barely adequate to meet bare essential imports for only a few weeks. The non-resident Indians (NRIs) were withdrawing their dollar deposits from Indian banks at alarming rates. The confidence of international financial community in India's ability to meet its obligation was shaky. India's credit-worthiness ratings had fallen in about a year from AAA to BB+(put on Credit Watch). These problems required immediate action if India was to avoid defaulting on its international obligation or a collapse of its economy for want of critical imports.

India had faced foreign exchange crises in the past: in 1965-66, in 1975-76 and in 1979-80. The crisis in 1991 was in a sense less serious. Exports in the 80's had picked up and grown at an average annual rate of 6.5%, up from the growth rate of 3.0% over 1965-80. In fact merchandise exports grew at more than 15% per annum over 1987-1990. The loss of confidence of international financial community was due more to the political instability in India, where three governments had changed in less than two years, than due to economic fundamentals. Nonetheless, given this loss of confidence, the government had to act and act fast. Since commercial borrowing on reasonable terms was not possible, there was no choice but to seek the help of IMF and the World Bank.

Though the BOP crisis was precipitated by the loss of confidence of international financial institutions, the seeds of the crisis were sown by the fiscal profligacy of successive governments in the 80's. The government deficit on revenue account went on increasing and was financed by borrowing from both domestic and external sources. This is seen in Table 6 below.

Even then, the inflation rate during the 80s was around 9 percent per annum. It was only in 1989-90 and 90-91 that the inflation accelerated. The Gulf war put a severe strain on the Indian economy. The increase in petroleum price, fall in the remittances of Indian workers in Kuwait and Iraq and the added expenditure of airlifting Indian citizens from middle east (a feat that has got Air India in the Guiness Book of Records) all stressed the Indian economy. Wholesale prices increased during 1989-90 at 8% and at 13.5% during 1990-91. The price increase in 1990-91 was aggravated by government policy. In October 1990 the WPI was consistent with an annual inflation rate of 9% provided prices slowed down as they normally do over October to March. However, under the powerful influence of the then Deputy Prime Ministry, Chaudhury Devi Lal, food prices were pushed up by putting into government stocks 5 Mt of cereals when the government should have off-loaded 2 Mt on the market. The result was an inflation of 13.6% in CPI, a further loss of faith in the ability of the Indian political system to manage the economy and creation of inflationary expectations.

Table 6 : India: Budget Deficits and Interest Payments

	1988-89	1989-90	1990-91
Inflation			
WPI(81-82 = 100)	6.3%	8.1%	13.5%
CPI(1982 = 100)	8.5%	5.4%	13.7%
Percentage of GDP			
Total Government Deficit	-11.2%	-12.2%	-12.7%
Deficit on the revenue account	-2.7%	-2.6%	-3.3%
Financing of Deficit	82.6%	74.2%	75.2%
Domestic capital receipts	7%	6.5%	7.5%
Net external assistance	10.4%	19.3%	17.3%
Monetization			
External Debt / GNP (%)	21.7%	24.5%	25.0%
Government Expenditure			
Interest Payment	25.7%	26.9%	28.5%
Subsidies	14.1%	16.5%	14%

Thus, even the fiscal crisis appeared to be worse than the policies followed over the 80s by themselves would have led to.

Yet, while the crisis seemed to be an outcome of political difficulties and cried out for action, there are indeed more fundamental problems that had resulted from the development strategy followed since independence by India which also called for re-orientation in our strategy and reforms in our policy.

The crisis provided an opportunity for a major reorientation of Indian economic policy. To the credit of the Government of Prime Minister Narasimha Rao and his Finance Minister Manmohan Singh, the opportunity was seized and major reforms were initiated.

4.6. The First Flush of Reform Measures and why were they permitted?

The reforms initiated in June 1991 and followed up since, can be classified under some broad headings, domestic de-regulation, trade liberalization, fiscal stabilization, financial sector reforms and privatization.

The very first set of measures in June 1991, deregulated all but eight Indian industries by virtually eliminating licensing requirement and permitting Indian industries to decide what, how much, where and how to produce anything. These choices had to be earlier approved by government. Also private sector was permitted to enter into areas hitherto reserved for public sector. However, reservation of manufacture of certain products for the small scale sector continues till this day.

Trade liberalization was pursued by drastically slashing import tariffs, accompanied by devaluation of the Indian Rupee, which was made convertible on trade account shortly thereafter. The need to obtain import licenses was more or less scrapped by putting increasing number of importables under open general license (OGL) – (The bureaucratic mindset cannot get rid of the term "license"!) still consumer durables' imports are not free and agricultural trade is state dominated.

For fiscal stabilization, the regime of administered prices is being dismantled slowly. Subsidies for various products such as fertilizer, food etc. are being restrained but not with much success. Much more progress is made in income tax reforms. Rates have been lowered and collection improved, yet many who should, do not pay taxes. The excise tax structure was simplified and rationalized but leakages abound. The worst step was upward revision of salaries of government employees, which went beyond the recommendations of the Pay Commission.

Privatization of public sector enterprises (PSEs) has not got beyond selling part of the equity of PSE to public and significantly curtailing fresh government investment in PSEs.

Much progress has been made in financial sector. Interest rates are freed, private banks are permitted, stock markets have been made much more transparent with open electronic trading and establishment of a regulatory authority, securities and exchange board of India (SEBI). Yet a debt market is yet to be developed. Futures and options trading are not yet permitted. However, in late 1999 the new government got the legislative amendment passed, which will permit such trading. The public sector banks constituting the bulk of the banking sector have large non-performing assets (NPAs), are overstaffed and generally not in good health.

What remains to be done face much stronger opposition from interest groups. Before turning to them, we look at the political economy of what has been done so far. Why were the reforms allowed to be initiated in the first place?

The New Political Economy approach to India came into general use with the arguments of Bardhan (1984). These sought to explain India's relative stagnation in terms of 'heterogeneity' of the 'dominant coalition', consisting of industrialists, large farmers and the professional class, primarily bureaucrats and other white-collar workers. The conflicting interests of these three groups, in Bardhan's view, led to regulatory and public expenditure patterns that were mainly political compromises and failed to deliver rapid and sustained growth. Given this, the question is (Kohli,1991).why did the reforms happen? Why were not the interest groups able to stall it as they had done earlier in 1980s?

The first set of reforms was a response to a crisis. There was no other option. If default was to be avoided, external help was inescapable. IMF help would not have come without the reforms. Of course, there were economists in India who argued that India needed IMF conditionalities more than IMF money. The government of Prime Minister Narasimha Rao which took the initial step was a weak government, a minority government. Even though some inside observers have claimed that Prime Minister was personally a believer in reforms, he must have been concerned about the political price he might have to pay.

Politicians are supposed to have short time horizons, upto the next election. A crisis, however, if unattended, might not only bring the next election much closer, but also ensure certain defeat in it. When death is imminent the mind becomes clear and focussed. Thus a crisis can push even a weak government to reforms.

The minority government was able to push reforms for another reason. Varshney (1999) argues that political parties have multiple objectives, economic and ethnic. In 1991, the various secular parties were more concerned about keeping out the Bhartiya Janata Party (BJP) with its emphasis on “Hindutva” than about guarding the economic interests of their various supporters. The BJP had won 120 seats in the Parliament in the election of July, 1991, following the movement led by BJP in 1990 to demolish the Babri Mosque, touching off ghastly communal riots and polarizing the electorate. The demolition of Babri Mosque in December 1992 had created a climate in which, were elections to be held, BJP could come to power. Thus, even when all the non-Congress, non-BJP opposition parties voiced strong opposition to reforms in the Parliament, they voted with the government for the first three budgets which carried out bulk of the reforms so that the government does not fall and fresh elections don’t have to be held.

(a) Deregulation

Earlier, industries needed approval from the Ministry of Industries to set up any manufacturing capacity, to change product mix, to expand capacity, to decide what technology to use and where to locate the plant. The proposals were vetted by the officers of Directorate General of Technical Development (DGTD). The reforms eliminated all these in one go for all except eight industries of strategic or environmental importance.

Before the reforms, large houses were defined as those having total assets of the company either by itself, or together with assets of related group of companies equalled or exceeded a certain limit (Rs.1 billion in 1991), required a special permission to expand their industrial activities. The special permit was required to prevent concentration of economic power. It was an additional barrier that needed to be overcome. The reforms also abolished this restriction on large houses.

The gainers from deregulation were entrepreneurs who could not expand their activities in a competitive set up. The resulting efficiency of industries would also benefit the consumers, the people. The main losers were the bureaucrats, the officers of DGTD and politicians who dispensed quotas and licenses. They were however a small group.

What may seem surprising is that industries welcomed it. Industries had thrived in the old regime with protection from both domestic and foreign competition. They had a cushy life and the rents they obtained from scarce licenses gave years of painless profits. Yet, further expansion had become difficult.

Over the years, bureaucrats and politicians' greed had increased and had become widespread. They were demanding increasing shares of "rents" and repeatedly. The gains to industrialists had become ephemeral – the cost of rent seeking absorbed much of the rents.

Also the number of potential entrepreneurs had increased over the years, with education and growth. With entry restrictions they felt thwarted. Even among the established industrial houses – new generation had come up – with aspirations to show that they can be even better than the old generation. They felt frustrated when they couldn't diversify. Also, the rent-seeking supplication was anathema to them. This second generation entrepreneurs were very enthusiastic about reforms.

Domestic deregulation, however, is not complete. Production for more than 800 products is still reserved for small scale sector (SSS). Small scale sector is defined as one in which the value of investment in plant and equipment does not exceed a prescribed limit. When first introduced in 1967, 47 items were reserved. By 1997 the list was expanded to 800 items (quite a few of these were elaborations of sub-items of the original 47).

The reforms in 1991 did not touch the SSS reservation. The United Front (UF) government in 1997 raised the investment limit from Rs.6 million to Rs.30 million and dereserved 15 items. The BJP government has dereserved farm implements.

SSS reservation of low-tech items with large export potential such as garments, toys, shoes and leather products have cost India enormously in terms of lost exports.

India and China exported comparable amounts of toys, shoes, garments etc. in 1975. If India had shared the global market with China, India should have been exporting today $55 billion worth of toys, shoes, garments etc. instead of $15 billion. It needs to remove small sector reservations and introduce labour flexibility.

If Indian economy were exporting $40 billion more today, its shape would have been very different. The government did permit larger units in 1997 to get into these sectors provided they exported more than 50 percent of their output. The SSS employs many, is spread all over the country and would be apprehensive about dereservation. However, SSS is most likely to gain substantially from reforms. So if, politicans feel differently, they need to be better informed.

The SSS reservation has become inconsistent. Many reserved products can be freely improted. Thus, the SSS in India has to compete with foreign large scale manufacturers but not domestic ones. SSS reservation should go. The political economy question is why successive governments have been reluctant to proceed with these reforms?

(b) Trade Liberalization

Trade liberalization by simultaneously devaluing the rupee and lowering tariff rates, did not lower significantly the protection rates on import competing industries. On the other hand, it gave exporters a better deal. Thus, the exporters welcomed it and the importers did not oppose it.

The abolition of various subsidy schemes and duty drawbacks and its replacement by a devalued rupee was also welcome to exporters as they were freed from dealing with greedy bureaucrats. The bureaucrats would have been expected to oppose these reforms but since their own minister, Mr. Chidambaram led this reforms and reduced the power of patronage of his own ministry, they could not oppose. In any case, all these happened so suddenly that they had little chance to organize any opposition.

(c) Fiscal reforms

What has taken place are the politically easy reforms of lowering tax rates and rationalizing them. Naturally, there has not been much opposition.

Subsidy reductions, such as from fertilizers, however have been partially retracted and progress is little and slow. In fact, a major regress took place when the government of I.K. Gujral went beyond the recommendations of the Pay Commission (required to be set up periodically to review salaries of government employees) and raised their emoluments generously. Moreover, it did not even accept the conditions of trimming the bureaucracry attached to these recommendations by the Pay Commission. This is an indication of the political power of government employees' union. During the period 1996 to 1999, four different coalition governments ruled and one of them sucumbed to its pressures; In February 2000, the second BJP government promises to implement some of these conditions.

(d) Privatization

Privatization is promoted in a number of ways. Firstly, sectors which were reserved for public sector were opened up for private sector. The hope was that over the years, the role of public sector would be reduced. Second, part of the equity of public sector owned by the state was offered to the public. Third, outright sale of the unit.

The first method was used for power sector generation which was opened up to both domestic and foreign firms. It generated virtually no political resistance. In fact, the politicians welcomed it, as it opened up possibilities of "negotiated contracts" with firms. Unfortunately, very little progress has been made here, even though by 1993 some 240 memoranda of understanding were signed by various states with private parties willing to set up generating plants. The real reason for this relates to the political economy of electricity pricin. The state electricity boards (SEBs) are financially sick and make losses. The private generators are required to sell electricity only to the SEBs and since their only customer is bankrupt, they are reluctant to go into the business. Thus, the most critical power sector reform is of making the state electricity boards (SEBs) financially viable. What is needed is to remove subsidies from agricultural consumers and reduce the large scale theft and pilferage encouraged and abetted by the staff of SEBs. (In Delhi city itself, less than 50 percent of the power sent out is billed). These run into obvious political resistance from farmers and unions. Most state governments don't want to bite the bullet of raising electricity price for farmers. They are not willing to play the game but are willing to change the rules of game (Buchanan 1987, Dixit, 1999) and have therefore, set up State Electricity Regulatory Commissions (SERCs) with statutory authority to set prices. It is hoped that they will set the prices right and farmers will accept it!.

Private entry is also liberalized for banking but their spread is still regulated. The second method has been followed and government has offered 10% or 20% of equity of some public sector firms. This has had little organised opposition. Yet, it is generally criticized. Since the firms remain public, the stock fetches a low price. It is now strongly argued that government should sell at least 51% of the equity and thus, follow only the third option. Till February 2000, only one from Modern Food has been so sold. The progress of outright sale has been minimal. Even when the cabinet has decided to sell a unit, the concerned ministry sits on it. Neither the Minister, nor the bureaucrats want to loosen their control over the unit. Moreover, the political clout of unions is strong here.

(d) Financial Sector

The reforms so far have been somewhat easy. (They always look easy after the fact). The harder part of restoring the financial health of public sector banks and rationalizing their operations in the context of overstaffing and strong bank employees' union remains.

(e) Regulatory Capture in Capital Market

How the process of reforms can be slowed down by regulatory capture can be seen in the case of capital markets in India. Capital markets require an appropriate regulatory framework. Indian capital markets have seen a dramatic improvement over the years. Anonymous electronic trading was started in 1994. A clearing corporation was set up in 1995 which eliminated counterparty risk. A depository system was started in 1996. What needs to be done is rolling settlement and a liquid debt market.

A regulatory body, Securities and Exchange Board of India (SEBI) was set up in 1992. Shah and Thomas (2000) have studied the political economy of SEBI.

"In its early years, SEBI was remarkably distant from stock brokers and formulated policies based on an independent vision about where India's capital markets should be headed. A reforms program which focuses on markets and not intermediaries is inevitably unkind to intermediaries. The early success of reforms in the stock market led to a halving of the price of a BSE card, a Rs.2 crore reduction of the net worth of each BSE broker.

From a political economy perspective, these early years of SEBI were not an equilibrium, since the reform program was under attack from a constituency (market intermediaries) that had clear self--interest to engage in political actions. In this case, we can accurately compute the impact of the reforms: a drop in the BSE card price of Rs.2 crore, multiplied over 600 members, is a loss of wealth of Rs.1200 crore.

This is a sharp incentive for intermediaries to mobilise politically.

The reforms program did not derive a counterbalancing political support from the constituency for market reforms: the diffused mass of market users in India who obtained a credible stock market for the first time in India's history. Policy makers in the finance ministry, who might have been a voice which supported the goals of the economy as opposed to the goals of intermediaries, did not clearly support the reforms program.

Hence, from this political economy perspective, it is not surprising to see that in recent years, SEBI has been substantially co-opted into the interests of the brokerage community. SEBI's policies on prudential regulation, rolling settlement, derivatives, etc. have reflected the goals of special interest groups.

Reforms in the equity market are widely extolled as an outstanding achievement of radical reforms. However, it is useful to note that after the components of the radical reforms were in place (electronic trading in 1994, clearing corporation in late 1995, depository in 1996), SEBI's policies have been largely conservative.

A simple litmus test that is very revealing is the fraction of members of SEBI committees who are market intermediaries in general, or stock brokers in particular. A committee that is dominated by stock brokers is likely to work in the interests of stock brokers, and not the economy. Most SEBI committees have over 75% of the members who are market intermediaries.

4.7 The Reforms over the '90s and the Tasks Ahead

The reforms progressed rapidly in the first two years and accomplished a lot. Then it slowed down. After the first two/three years, further reforms faced the resistance of the groups that had coalesced around the earlier process, as well as the potential resisters of the reform process, in essence, some domestic industrialists and organized labour in the private and public sectors. There was also criticism of the reform among some Left academicians who were concerned about the adverse effects of some elements of the reform package (such as cuts in public expenditure on the social sector and agriculture) on the poor in India [for a reflection of these views, see the Alternative Economic Survey 1992-93 (1993) and the Alternative Economic Survey 1993-94 (1994)]. Both industrialists and organized labour were against changes in industrial and trade policies that aimed at significantly increasing the competitiveness of domestic markets and went much deeper and were more widespread than the changes attempted during the 1980s. In addition, public sector employees, both blue-collar and white-collar, faced the threat of redundancy as budgetary support to public sector enterprises was slated to be reduced as part of the overall stabilization package.

The industrialists group resisting liberalization, or at least some aspects of the package, which had been highly vocal and visible during 1993, did not appear to be speaking for industrialists as a whole. There were, clearly, several large industrial interests that, even as they had, benefited from the favour bestowed by the previous regime, were technologically and organizationally well positioned to take advantage of the new regime, be it by expanding core capacities, diversifying or entering into joint ventures with foreign firms. These interests stand to gain from new opportunities even as they stand to lose from the competitive weaknesses of some of their old businesses. The overall position of the industrialists is that they have no problems with internal liberalization, i.e., removal of pricing and distribution controls and entry barriers to domestic investors, but are concerned that a rush of foreign entry, either through imports or investment, may not give them time to upgrade their competitive resources.

Organized labour has so far been generally successful in blocking the implementation of a meaningful exit policy, which was earlier viewed by the government as being an integral part of the reform package. Public sector unions have also effectively impeded the progress of privatization measures in the manufacturing as well as the services sectors.

Even then, the reforms have continued in small steps and quite a lot has been done over the 90s. What is most remarkable is that the two United Front governments and the two BJP led coalition governments that followed the Congress government of Narasimha Rao, have all contributed to these reforms. No party today talks of rolling back the reforms. The political mindset has changed. Over the years, tax rates are rationalised. Import tariffs have been brought down, consumer goods imports have been relaxed. The process of tariffication of quotas has begun. Much progress has been made in financial market liberalization.

In February 2000, there is however, more hope of progress in the areqs of subsidy reduction and privatization. The general public has by and large realized that loss-making or inefficient public sector is not in its interest and that it is not ready to put up with poor service from public sector. The political power of the unions has waned. This was evident in the power engineers strike in US where the engineers' union had to back down and importantly, it did not find much public support.

Still, the Indian economy has many handicaps. The infrastructure is poor. There is no exit policy. Subsidies and loss-making PSEs continue to strain government budget. While inflation has been brought down to less than 3% per annum in 1999-2000, fiscal deficit is the most important problem facing the government. Procedural hurdles delay decisions. Corruption opportunities are still many and are exploited. How could the needed reforms be carried out in the face of opposition by organized vested interest is a challenge India has to face.

5. Political Economy of Growth in Sri Lanka

5.1 Background

Before 1977, the Sri Lankan economy was inward-looking and high regulated. Exports were dominated by tree crops. State corporations were ubiquitous. The country had an entrenched welfare tradition, and almost half a century of universal franchise, together with high rates of literacy, had nurtured strong political consciousness among the population. There was widespread politicization of administrative processes (and of public life generally), an established culture of political patronage and an acute awareness of ethnicity (Lal and Rajapatirana, 1989; Moore, 1990). Liberalization meant a major reorientation of the Sri Lankan economy, but one that was bound at some point to encounter problems of institutional change and governance.

Nevertheless, managing the process of reform was not initially an issue. The United National Party (UNP) that came to power in 1977 had a four-fifths majority in the Sri Lankan parliament; it had a strong political mandate for economic reform, and executive power was centralized in the Presidency under a new (1978) constitution. Liberalization measures were mainly concentrated in the first three years when the economy grew strongly (on average 6.6% a year during 1978-81), and when the population (and the urban middle class in particular) were buoyed up by the material gains from deregulation. A massive influx of foreign aid then detracted from questions of governance. Liberalization was overtaken by a commitment to major infrastrucutural projects and to the Accelerated Mahaweli Development Programme (AMDP) in particular – a billion dollar land settlement-*cum*-hydroelectric project that swamped all other endeavours. The AMDP was largely donor-funded and involved such an extraordinary inflow of concessionary aid that accountability and efficiency became low priority. It offered the political important vision of a renewed (Sinhala) society – and it meant that the government was never forced to choose between economic reform and political patronage because it could afford to continue its commitment to loss-making state enterprises and because aid provided a bonanza of state employment and influence (Moore, 1990).

The AMDP however, had serious deleterious effects on the macroeconomy. The sheer scale of the project was such that it fueled the budget deficit, generated inflationary pressures and created “Dutch disease” type effects, undermining incentives to exporters from the initial liberalization (Lal and Rajapatirana, 1989; Athukorala and Jayasuriya, 1994). Sri Lanka’s external terms of trade declined sharply, by 44% between 1977-82. External debt quadrupled in the early 1980s, official reserves were run down to plug the current account deficit and the government resorted to commercial borrowing to finance the budget deficit. The decade 1977-88 was one of mounting macroeconomic instability, exacerbated on the political front by manipulation of the law and by a growing atmosphere of violence after the July 1983 riots. By that time, the government’s honeymoon was over. A major conflict was developing in the north and east, there was increasing use of force and the government’s popularity was waning. Terrorism and insurgency then permeated the south during 1987-89.

5.2 The First Wave of Liberalization

Sri Lanka is one of very few countries that have had more than two decades of reform experience. The first wave of liberalization took place during the 1977-81 period and continued till 1988. It was three years before the World Bank embarked on its first structural adjustment loan in 1980. What was achieved has been extensively documented to the end of the 1980s (Herring 1987; Lal and Rajapatirana 1989; Cuthbertson and Athukorala 1991; Athukorala and Jayasuriya 1994). The discussion has been detailed and it has been very wide-ranging, but why the Sri Lankan reform effort faltered in the second half of the decade has still not been adequately explained.

Part of the reason lies with the theoretical starting point. The contention of mainstream economists has been that the first wave of liberalization in Sri Lanka (as in so many developing counties) was not sufficiently far-reaching (Lal and Rajapatirana 1989). The initial reforms are acknowledged to have been immensely important, but macroeconomic mismanagement is said to have left an “unfinished agenda” (Lal and Rajapatirana 1989, p.29). It has been argued that this explanation is insufficient; that initial conditions, economic circumstances, and the nature of the political system reduced the government’s room to maneuver; and that tensions between the differing needs of stabilization and adjustment hindered the reform process (Dunham & Kelegama, 1997). A crucial explanatory factor in all these elements is seen to lie in the political sustainability of the reform process and the need for the government to respond promptly to domestic social pressures. This argument is summerised below.

The argument is not that the Sri Lankan reform process was adequately managed. There is sufficient evidence to the contrary. The AMDP was a digression from the liberalization exercise that the county had embarked upon, and it raised very serious questions about its management capacity at the speed and scale at which resources were made available. There was a tendency to believe that resource constraints no longer mattered (Athukorala and Jayasuriya 1994, p. 83) and that the allocations of funds or contracts on the grounds of political expediency was ultimately justified. Throughout the period of 1977-88 there were serious problems of accountability and administrative propriety. The issue here, however, is rather different. It is the way the process of economic reform is understood and the assessment of policy performance.

The Sri Lankan experience (or any other) can be assessed from at least two different standpoints. From a textbook perspective, it is clear that the reform process it embarked on was incomplete. The initial liberalization in 1977 was not followed up by a sufficiently rapid reductions in tariffs to ensure trade neutrality, and trade and financial reforms should have been completed before embarking on such a massive foreign-funded public sector investment as the AMDP. From this point of view, the Sri Lankan liberalization process in the early 1980s was undone by "revisionist thinking" that reversed some of the initial gains and by the creation of new and increasingly more serious imbalances in the macro economy (Lal and Rajapatirana 1989). Similarly, it could be argued that inadequate liberalization of domestic financial markets, the external capital account, and domestic labor markets were a further indication of mismanaged reform. Policy performance on this criterion is assessed against some stylized notion of a sound reform exercise.

The alternative is to view the Sri Lankan reform experience in relation to economic and political circumstances and the economic and political objectives of the incumbent government. The focus is then not so much on the government's resolve to liberalize the economy, as on the reasons why particular policy decisions were made or took the form that they did. In this perspective, economic and political concerns have to be seen together. External events and political imperatives (ethnic conflict, insurgency, the social costs of adjustment, and existing political commitments) assume a more critical role in the explanation, and the political viability and sustainability of reform becomes the crucial issue. As Krueger (1981) has argued, it seems senseless "to incur the costs of adjustment only to reverse policies before they have had any chance to affect resource allocation and growth. Yet the evidence is that a significant number of stabilization programs have foundered precisely because the authorities have been unwilling or unable politically to survive political pressure during the adjustment period" (pp. 100-101).

The Dunham & Kelegama (1997) paper tried to illustrate the relevance of such an approach in understanding the Sri Lanka policy agenda. It suggests that, in the inevitably politicized process of trade-offs incorporating political responses, there is bound to be tension between stabilization and adjustment, it is stabilization that was given lower priority. Domestic political needs may have seriously weakened the economic reform process, but continuing political support was crucial for its sustainability. In that sense ad hoc piecemeal reform had a rationale of its own.

5.3 Second Wave of Liberalization

The second wave of liberalization started in 1989 and lasted till 1993.. From the political economy point of view two factors are important during this period, i.e., institutional support and governance. We deal with them below.

(a) Institutional Support—A Brake on Growth ?

The liberalization process after 1989 gave relatively low priority to institutional structures and to the way markets functioned. It was therefore hard for the government to implement many of its policies effectively. It lacked the capacity to monitor and regulate developments in the public interest. There were several problems: with institutions themselves, coordination, and the legal support structure.

Discussions on the need for institutional reform were focussed to a large extent on the public service. In theory, as market mechanisms gained strength, the withdrawal of government from direct involvement in the Sri Lankan economy should have meant that many old tasks became redundant and that new and more relevant tasks, attitudes and training were taken on (PIP 1990:31). These were themes that had been taken up at length by an Administrative Reforms Committee (ARC), set up in 1986 and reporting two years later. The Committee set out to simplify government (reduce the number of ministries, eliminate duplication and close defunct agencies), to rationalize systems and procedures, streamline the civil service cadre, and up-grade management skills in line with the needs of a liberalized and industrialized economy. It had attempted to give direction to the civil service, urging that reform of the administrative system be considered holistically (ARC 1988).

The government therefore embarked on the second wave of liberalization with a fairly comprehensive agenda for reform at hand. However, it faced pressures from two sides. The government placed importance on decentralization -- as a response to ethnic conflict in the north and east, to improve the implementation of policy and "to bring government to the people".[1] Public service employment also continued to be important as a source of political patronage. As a result, decentralization was carried out with no contraction at the centre. On the other side, there were external pressures, from the World Bank in particular, to reduce the number of people employed in the civil service as part of a broader programme of cost containment and reforms to improve performance. A voluntary retirement scheme was introduced; generous severance packages doubled the civil service pension bill, but new appointments continued. Competent managers, who could find other employment, took up the offer of retirement, with a resultant loss in management capacity -- and many were subsequently rehired as "consultants" to fill the gap that they had left.

What emerges is that government employment actually rose by almost 9 per cent between 1989 and 1992, with substantial increases at the management and executive levels.[2] However, there does not appear to have been any marked improvement in cadre quality. Wanasinghe has been especially hard-hitting on this point: " the continuance of pre-ARC practices, based on a concept of partisan political control over public officers at all levels has, in the intervening years, reduced the public service to a state of supine passivity -- an unsuitable partner for an active role in development management" (1994:18). As the ARC had earlier anticipated, it nurtured low morale, low levels of accountability and a lack of transparency and quality. It also made it more disposed to corruption at higher levels. Weak implementational capacity was partly responsible for the low levels of disbursement of donor aid -- as low as 15-20 per cent during 1989-93 (Kuruppu 1994). Administrative reform was downgraded to little more than matters of staffing and a new structure of emoluments.[3]

Similar difficulties were experienced in other areas of public management. Some bodies grew stronger (such as the Securities and Exchange Commission), others weakened over time (such as the Plantation Restructuring Unit) and others (such as the Public Investment Management Board -- the apex body for the privatization exercise), from the outset, never

1 The Presidential Mobile Service was one such example.

2 There are no figures available for 1993. The corresponding figures for 1994 (for which there is no comparable breakdown) was 520,000 -- a rise of almost 20% over 1989 (Cadre and Salaries Committee).

3 The extent of the problem is captured by Wanasinghe (1994:7). Referring to the end of the second wave period he found that "in addition to the total of 40 ministries at the provincial level, there are today 35 Cabinet Ministries, 31 State Ministries - making a total of 89 ministries in all. Given that each of these positions entails a bureaucratic retinue of Secretaries, Co-ordinating Secretaries, Private Secretaries, security staff etc. etc. as well as an infrastructure of transport, office accommodation etc. the enormous burden to the tax revenue of this irrational structure can easily be understood".

functioned effectively. The picture was therefore a mixed one. But a common ingredient in many of their failures was political influence. Pressures on individual bodies pulled in different directions, and this made the overall coordination of policy extremely difficult. By 1993 there was no agreed, overarching vision of what was needed or of the role that different institutions were expected to play in the overall design. Low-result, supply-oriented training programmes exacerbated the shortage of managerial and technical skills in the Sri Lankan economy (Kelly 1992; World Bank 1994a). Public sector R&D never became an integral part of the overall growth effort. It remained wary of what it saw as the "commercial interests" of the private sector (IPS 1993).

Regulatory frameworks were also found wanting and to be a barrier to increased efficiency. With liberalization of the economy after 1977, *ad hoc* efforts had been made to up-date the legal system. The Code of Intellectual Property Law of 1979, the Companies Act of 1987, the Securities Commission Act of 1987 and the Banking Act of 1988 were important examples. But no systematic legal review had taken place to consider the changing needs of a market-oriented economy. Some of the problems that arose are easily illustrated. Because debt recovery laws were weak (a backlog of 15,000 debt recovery cases are pending in Sri Lankan courts), small and medium industrialists found it difficult to obtain bank loans without substantial collateral. Bankruptcy laws were weak (no bankruptcies were declared during the second wave period),[4] and labour legislation was a source of perennial complaint by the private sector (Godfrey 1990).[5] There were 46 labour laws in operation. As a totality, they tended to create confusion and uncertainty, to increase the cost of labour and to reduce labour mobility. And, equally importantly, they provided no clear way out in many key situations -- they did not, for example, contain an agreed framework for the determination of redundancy compensation (Fizbein 1992). The development of a rural land market was also heavily constrained by the fact that 80 per cent of the land was owned by the government, and by the fact that the Land Reform Law of 1971 placed a ceiling on private holdings. Land laws were felt to be a constraint on agricultural growth in a free market setting.

However, this was a difficult area of policy. The government had intended to codify labour laws, and to repeal (or amend) the Termination of Employment of Workers Act of 1971 had

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[4] The orderly closure of enterprises that are unable to continue is especially difficult in Sri Lanka. Companies that file for bankruptcy are liable to the Termination of Employment for Workers Act (see footnote 5), and even when firms are allowed to close operations procedural barriers to creditor filing and prosecution make it unusually difficult.

[5] The Termination of Employment of Workers Act of 1971 is the particular *bete noire* of the private sector, prohibiting the dismissal of a worker with more than one year's service on non-disciplinary grounds in a firm of 15 employees or more without the written consent of the worker or approval of the Labour Commissioner.

been an element of its *Strategy for Industrialization* of 1989. But such moves were seen to threaten rights that people had fought for, and any attempts at reform were therefore bitterly resented. Privatization, for example, was vigorously promoted in 1990-91 but ran into difficulties.[6] Opposition of strong trade unions to labour retrenchment (at a time of opposition allegations of corruption and "cronyism") made the government more cautious (Kelegama 1993). It found it increasingly difficult to broach the dismantling of labour legislation which the unions saw as a part of a tradition of labour protection. On the question of land ownership, the government was similarly sensitive to any suggestion that they were riding roughshod over rights of the peasantry to land and water (Dunham 1993). Basically, institutional change could not be divorced from confrontational politics.

(b) Style of Governance – A Brake on Growth ?

This section looks at the second wave of liberalization in Sri Lanka from the standpoint of governance. The years of the second wave of liberalization have been characterised as a period of highly centralized, authoritarian government, accentuating a trend that had been observed earlier (Moore 1990; de Silva 1993). However, this trend does not explain the programme that emerged nor the eventual policy outcome. The government was never monolithic, and policy formulation revealed competing forces. Throughout the 1989-93 period, there was tension between efforts (principally on the part of the Ministry of Finance and the Ministry of Industries) to pursue a fairly conventional stabilization-cum-liberalization/industrialization programme, and the politicians' (especially the President's) perception of what liberalization should provide in terms of government support and distributional gains.[7] The relative weight of the two inputs fluctuated, and they can be said, in some senses, to have resulted in two sets of policies (Lakshman 1993). However, political imperatives came increasingly to fore over the course of the period, with a corresponding deterioration in the quality of governance. It is this we attempt to explain in the following paragraphs.

The new government that came to power in 1988/89 faced two forceful realities. First, there was a macroeconomic crisis, and it was under severe political pressure with insurgency and with opposition challenges to the validity of the Presidential elections (de Silva 1993). With defeat of the insurgency, the President began to exert his authority and to expand the support

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6 There was also an element of manipulation of trade unions by opposing political parties and by factions in the ruling party, and by managers of state enterprises who stood to lose from the process of privatization.

7 The Secretary to the Ministry of Finance, a political appointment, played a crucial role as a broker on matters of economic policy.

base of his government. The macroeconomic situation had to be dealt with because the government was desperate for balance of payments support and for further concessional loans to rehabilitate the economy. Official reserves were down to as low as one week of imports in June 1989, and it was clear that large-scale aid would be contingent on stabilization of the economy and further liberalization (Dunham & Kelegama 1997). The programme of reform that emerged was fairly coherent, because it built on preparatory work during the earlier period of disruption,[8] and most of it was allowed to proceed uninterrupted with strong support from the World Bank and the IMF.

The second element, however, was problematic. The new President came from a modest background, and there was mutual antagonism between him and the English-speaking, professional and urban-based landed elite that had in the past dominated his party. Being in many ways an outsider, he looked to non-elite groups for political support, and he was intent on changing the social base of the UNP and of the machinery of government (Uyangoda 1993). He was increasingly preoccupied with what Westerbury (1989) had referred to as "coalition building", incorporating the rural poor, an urban underclass, and a new politically-created, Sinhalese business class (that was strongly pro-President, and which might have felt it had the most to lose if he fell from power). Many of the latter were not committed to a market economy and preferred a state of affairs they could exploit for their personal advantage by establishing *pro tem* alliances with members of the polity and bureaucracy. There was also a price to be paid for the more professional party structure that had emerged in the 1980s. Referring to the early 1980s Moore has argued that "unless it were to jeopardise its party machine in the electorates, the UNP could not have ignored the patronage demands in favour of sound economic policy" (Moore 1990:351). This would seem to have applied during the years 1989-93.

For the programme to work, patronage was important and it was crucial that the government's economic policies should be seen to yield benefits. The 60-70,000 new jobs created each year (plus retirements) were not enough for the 120,000 new entrants to the job market, let alone to reduce the backlog of unemployed. The President was also aware that unemployment and marginalisation of the poor had fed extremist agitation. The ruling party manifesto for the 1989 parliamentary election therefore gave "the highest priority" to job creation and to increasing the access to assets of poor groups in society. The time horizon for achieving results had, however, to be short, and if liberalization failed to generate the desired

[8] The 1988 PFP and A Strategy for Industrialisation (MoI 1989) are the best examples.

investment, employment and incomes, it was felt justified to force the pace using less conventional means.

These attitudes had weighty implications for the formulation of policy. The government's "high profile" projects were frequently non-technocratic. They had to be visible and to yield results rapidly. State power lay in the hands of the President, assisted by the Presidential Secretariat and a small coterie of ministers and top civil servants who were not, in general, disposed to painstaking analysis. Their stand was more populist. There was, in principle, a growing reluctance to make any decisions that implied retrenchment of labour, and job creation seemed at times to be pursued regardless of the economic cost or of its ultimate effectiveness. (The growing number of ministries, the self-employment component of the Janasaviya Programme (JSP) and the block hiring of educated unemployed to be rural teachers present relevant examples). There was also what the ARC had described as a creeping tendency to set up funds outside the control of parliament (ARC 1988:3) and for heavy expenditure on prestige projects which entailed a considerable diversion of public funds (such as Gam Udawa -- village reawakening -- the up-grading of Air Lanka and rural housing development). The JSP and the Two Hundred Garment Factories Programme (THGFP) were examples of "shock therapy" -- attempts to get the quick results that could not have been obtained using more conventional measures. The THGFP pushed the high profile export drive and the Board of Investment to their limits in order to alleviate poverty and to provide employment. Both programmes were foisted on the Treasury and the Ministry of Policy Planning, which had to accommodate them regardless of their macroeconomic impact (though the JSP was later phased over eleven rounds as the massive economic implications of the project became gradually clearer).

This desire to accelerate results had budgetary consequences and it permeated the implementation of government policy. Politicians exerted pressures to accommodate supporters (and to neutralize opponents), a process that was heightened after the attempted impeachment of the President in August 1991. The latter was in many ways a watershed. By the middle of 1992, when the THGFP had become a "lead project" of the government, negotiation and lobbying for concessions had begun in earnest. Though little information is available, claims appear initially to have been considered on a case-by-case basis, with willingness to invest and employment creation (and to a much less extent party links) as the main criteria. But, over time, personal and party affiliation became more important. There was also an element of command, as investment and employment lagged behind expectations. Businessmen were coaxed to set up a garment factory and, though government banks offered ready finance, many "would not have participated in the programme if not for the 'persuasion' of the government" (CCC 1994:29). Those who complied gained access to tax concessions and off-shore borrowing facilities (and to export quotas that varied in amount with the difficulty of their location but which, in the aggregate, threatened to disrupt established firms because their quotas were cut to make way for the programme). Those who did not comply ran the risk of blacklisting or recrimination.

In such situations, the scope for independent technical assessment was also frequently limited. Officials were required to acquiesce to political preferences and some were expected to apply regulations on a discretionary basis. This was felt to be a particular problem in the allotment of financial incentives and the allocation of duty waivers, though only fragmentary evidence has emerged as to just how extensive direct political influence was in the implementation of these measures. One result was to depress the already low morale of the civil service, with even lower levels of accountability and a growing lack of transparency.[9] Lack of accountability had been highlighted by the ARC which pointed to ineffective audit controls and consideration of alternatives in particular and to scope for corruption, negligence and wastage in the business of government (ARC 1988).[10]

Lack of transparency was widely believed to have been particularly blatant in the privatisation exercise. One senior official had maintained in the mid-1980s (perhaps irresponsibly) that arrangements existed to hand over state enterprises to individuals and companies that were close to the government (Karunatilake 1986), and there was a view that similar considerations were present later (Kelegama 1993). This may have been the case. But in part the problem was also one of haste and inadequate institutional supports for the tasks at hand. The government wanted quick results from the privatization exercise -- with some justification in a number of instances. It was not prepared to lose time over an agreed legal framework for divestiture or, in some cases, over the comprehensive annual reports that were needed to float a new company. In part the process was also a learning exercise. The tendency, however, was to resort to *ad hoc* procedures which, whether justified or not, were certainly much quicker and also more vulnerable to any allegations of wrong-doing. Other regulatory institutions failed to provide adequate safeguards for similar reasons, and partly

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9 On the decline in public accountability since the 1970s see de Silva (1993) and Sanderatne and Hulme (1994).

10 It also exacerbated problems of consistency and coordination in the government policy. Wanasinghe has argued that "the holistic nature of policy formulation is, as yet, not fully understood in either the political sub-system or administrative sub-system of Sri Lanka. The process tends, therefore, to be *ad hoc* and sectorally compartmentalised. The result is that the economy and society, and consequently the polity, lurch from one crisis to another" (Wanasinghe 1994:20).

because they lacked adequate powers and/or expertise. The regulatory body for the privatization of bus transport (the National Transport Commission) failed, for example, to devise schemes to maintain services on uneconomic routes, to accommodate season ticket holders or to ensure that adequate services would be running at off-peak hours. Thus, while the privatization programme may have been successful, as far as it went, in macroeconomic terms, it was not always perceived by the public to be so efficient. There was loss of public support, and this slowed the process of privatization however aggressively it was marketed.

Thus increasingly after 1991, Sri Lanka revealed characteristics of what the World Bank was to define as "bad governance", despite a better macroeconomic situation, increasing liberalization of its economy and achieving an average annual growth rate of 5.5 per cent. Public resources appeared to have been diverted to private hands, there was arbitrary application of rules and procedures, rent-seeking was rife and there was a definite lack of transparency in many areas of government. There was also a climate of unpredictability. At different times and to different groups in Sri Lankan society, the 1989-93 government was intimidating, arbitrary, benevolent, even capricious. However, it is arguable that, particularly in the early years, strong (even authoritarian) leadership had in many ways facilitated difficult decisions on economic policy. There may also have been a case for thinking that -- within certain bounds (which that government had clearly exceeded) -- the electorate might be more likely to vote for a tainted regime that had achieved results, than for a saintly and democratic one that was indecisive and achieved nothing at all. But there was in practice little alternative. Whether better governance could have produced a higher rate of growth in the Sri Lankan case is reminiscent, in a sense, of the meeting of mice that considered belling the cat: it was a splendid idea, but inconducive to success given prevailing conditions.

Sri Lankan experience during the 1989-93 period would seem to confirm the view that the political regime cannot be meaningfully divorced from discussions of governance. The liberalization path that a country follows is always likely to be determined by initial conditions, external and internal shocks and, to very significant extent, by political economy. Conditions and events tend to be more relevant to the speed of reform, but it is politics that determines its form and just how much is feasible. Politics pushes the process from the path that the theorists advocate so that the reform package that emerges is often "not an application of economic principles, but rather an improvisation" (Mosley 1991:227). This may be almost inevitable in a developing country where democratic institutions are immature and the incidence of poverty is high.

But the significance of this political input is at the same time paradoxical. On the one hand, strong leadership is necessary to push through difficult decisions and give firm signals of the continuity of the government's open market policies -- a conclusion reinforced by the experience of the East Asian NICs. This was clearly present in the case of Sri Lanka where there was increasing macroeconomic stability, a steady process of liberalization and a fairly solid rate of growth. On the other hand, politicians adjust their time horizons to the electoral cycle and they need to build coalitions to support the process of reform. The result can then be a trade-off between "quick results" (which politicians are likely to see as a measure of the efficiency of policy) and "good governance" in the World Bank sense of managerial propriety. This would also appear to have occurred in the case of Sri Lanka with rent-seeking, patronage and populist measures undermining the predictability of policy. Those who argued that the growth rate could have been markedly higher with better governance were, to a large extent, the professional economists and the westernised urban intellectuals and businessmen who were anti-establishment. For basic political reasons, shifting the weight from "bad" to "good" governance was not a viable alternative.

Much of the domineering authority of the 1989-93 government has to be attributed to the Sri Lankan Constitution of 1978 and the excesses of an Executive Presidency. The President believed that visible benefits had to come rapidly to offset "adjustment fatigue" and to provide electoral benefits and not just over the long-term. Moreover, to achieve it, he felt that the government needed, not just political stability, but a form of administration that would permit "decisional mobility". Even with checks and balances in place, he believed that the Executive had to be in a position to make quick and effective decisions, and the Executive Presidency was an institutional instrument that permitted this type of behaviour. Sri Lankan experience has shown quite clearly that good governance is not a necessary, and may not be a sufficient condition for achieving high growth rates. It has also shown that economic growth can be at the cost of political accountability and political institutions.

(c) Post-1993 Political Economy of Growth

In 1994 there was a change of government and the economic philosophy of the incoming government was in line with the previous government. However, the emphasis was on a market-friendly economy with the added element of human face. The concept of an open economy model had two dimensions. First, a more comprehensive safety net to protect the poor and, second to reduce state-sponsored corruption and violence of the previous government. Even though the new government's economic philosophy was not very different from the previous government which made attempts to satisfy the society with short-term consumer-oriented welfare programmes. On the other hand, it also attempted to more away from the political illiberalism of the previous government and even promised to abolish the executive presidency. The decision-making power of the new government was far below that of the previous government. First, it did not have an adequate majority in the Parliament. Second, it suffered from a lack of political consensus as it was a coalition government comprising different political ideologies. Third, the war escalated during its time of government as all its efforts ended up in failure.

Given this background, the new government was unable to provide an adequate impetus to growth. Unlike the previous government, the new government did not come to office with a radical policy package to enhance the growth momentum. As part of a welfare orientation the government appears to be reluctant to implement growth-oriented measures if they were likely to affect short term welfare. Given the resurgence of political liberalism, the new government exposed itself to political resistance affecting its authority and decision-making power. Attempts made to be more labour-friendly than the previous government in fact facilitated the resurgence of labour unrest affecting the business environment of the country. The resurgence of political liberalization and welfare-orientation under the new government in fact constrained growth. Consequently, signs of slow growth momentum were evident after 1994.

6. Concluding Remarks

The Indian and Sri Lankan experience with reforms lead us to a number of insights.

The framework outlined in Section 1 did help explain India's policies and performance. We have seen how policies create their own vested interests and how they in turn resist reforms. We have also seen that good policies initiated by well-meaning people to deal with an external shock, get entrenched and become difficult to dislodge. The vicious circle of policy creating vested interest distorting future policies etc. is far too frequent. As Goyal (1999) has observed as in “Greek-plays, tragedy was never purely the outcome of fate; human motivations entered richly and often fatally. There was no villainy, however, only frailty.” In many cases, India’s choice of development strategy when made, was sound and justifiable. Yet the dynamics of the situations led to outcomes contrary to original objectives. One lesson that one learns is that one should design policies that liquidate themselves when the need for them no longer exists. The challenge for reformers is that they need to engineer policies which have a chance of acceptance and which create virtuous circles and which do not entrench themselves.

We have also seen an example of the importance of non-economic motivations in why the minority government of Narasimha Rao was able to push reforms successfully. The lesson here is that political economic analysis should go beyond purely economic motivations.

We have also seen that a gradualist approach allows resister groups the time to organize, mobilize resources and capture regulator or reform agencies. Thus, the slower the government proceeds (the Indian government has been liberalizing since the early 1980s and the Sri Lankan government since late 1970s) the more it finds its choices constrained by the resistance of various groups. Given fiscal constraints, the possibility of ‘buying out’ some or all of these groups is limited. From a political economy perspective, the success of a gradualist programme is therefore dependent on preventing the emergence of effective resister groups.

A second implication is the nexus between the legacy of the previous regime and the nature of the interests resisting its change. Four decades of import substituting industrialization have led to enormous sunk costs in products and processes inconsistent with comparative advantages. These sunk costs underlie the intensity of the resistance of the industrial and labour interests to reform. The longer the economy has strayed from the path of comparative advantage, the more resistance there seems to be to a reform package designed to bring it back in line.” (Agrawal et al., 1995).

From the Sri Lankan experience it is clear that all policy reform is determined by the five-year (or six-year) electoral cycle. If the reform would provide net benefit before the five-year cycle a government would implement it. If, however, the cost of the adjustment process related to reform is not offset before the five-year cycle such reform would be postponed. Thus the political trade-offs of the reform process is the key to further liberalization of the economy. This phenomenon was particularly visible during the post-liberalization period of 1977-1999.

Without taking this factor into account no amount of pressure for reforms, by International Financial Institutions, can push a regime to implement readily. Abrupt changes in broad strategy or in detailed components of a given strategy require considerable support and understanding by the population. This is not primarily because of the power of those who profit from possible rents, but rather because the community's history, institutions, and organizations create a milieu in which change that affects deeply rooted views and practices cannot be seen as either appropriate or necessary. It then takes some event of some magnitude to convince the population and the government that new directions are necessary and possible. This is by no means an easy exercise as short-term costs can be very heavy. As the Indian Finance Minister, Manmohan Singh once said: "Finance Ministers must look after the short term if they want to survive in the medium term" (IPS, 1993:4).

Despite all the problems mentioned above, Sri Lanka achieved an average growth rate of 5 per cent during 1977-1999 which was quite remarkable given the chaotic situations the country encountered during this period. Commitment to a liberal trade and investment regime was one obvious contributory factor to this achievement. In other words, the answer to this performance could be found in the dynamics of capitalism. For example, writing on Asia's Reemergence, Radlet and Sachs (1997:46) observed: "corruption is rife, judicial systems are weak, and local governments often lack authority and adequate finance. But global capitalism stirs powerful forces for economic growth even in face of serious limitations in law, economic structure, and politics."

Appendix

Chronology of post-independence political events in the region

In order to provide a background of the political events of each South Asian country, during the period in which regional growth languished, the following framework has been borrowed and adapted from *Hossain et al 1999.*

Bangladesh

Bangladesh obtained independence from Pakistan in 1971 after a ruthless civil war, which resulted in mass destruction throughout the country. Thereafter, the government took over abandoned enterprises and followed a regime of state control. In 1975, the first signs of political instability became visible when Bangladesh's post-independence leader, Sheik Mujibur Rahman was assassinated by members within the ranks of his own army. Consequently, a number of military coups threw the country into deeper instability. However, by the end of that year, General Ziaur Rahman took military leadership of the country until 1977, when a referendum was called and General Ziaur officially became President of the People's Republic of Bangladesh. Similarly, Ziaur's reign was curtailed when he too was assassinated by members of his own army in 1981. While a non-military president was subsequently instated, he too was ousted within months, as a result of another military coup, and the army chief, General H.M. Ershad, assumed 'de facto' leadership in 1982. He officially became President in 1983 and governed the nation until 1990, at which time he was overthrown by a public uprising and finally convicted and jailed. In 1991, former president's widow, Khaled Zia became Prime Minister following a general election, during which time the executive powers of the presidency were abolished, after 16 years. She governed until 1996, when the opposing Awami League were sworn in after a general election and Sheik Hassina, the daughter of Bangladesh's first ruler, assumed power.

India

Since independence from the British Monarchy in 1947, India adopted a Westminster type of government and was ruled by the Indian Congress Party for more than forty years. Having led the struggle for independence, Nehru assumed power as the leader of the Congress party and ruled for 17 years until his death in 1964. Subsequently, Lal Bahadur Shastri was elected to lead and had to fight an outright war against Pakistan. However, Shastri's term was short-lived and after his sudden death in 1965, Indira Gandhi, Nehru's daughter was instated as India's leader. Indira Ghandi maintained power until 1977 when she lost the general elections as a result of establishing emergency rule from 1975 to 1977. However, in 1980, Indira Gandhi assumed power once more until 1984, when she was assassinated by her Sikh bodyguard after a Sikh separatist struggle. After her death, Indira Gandhi's son, Rajiv Gandhi, replaced her in the general elections that year and he remained in office until 1989 when he lost to the anti-Congress coalition, Janata Dal. In 1991 this coalition collapsed, and just prior to the general elections, Rajiv Gandhi was assassinated by a Tamil terrorist during the campaign. This was in retaliation for Rajiv Gandhi's support for the Sri Lankan government during the peace process with the Tamil Separatists. The Congress was returned to office after the elections under the leadership of Narashimha Rao, though without a majority in parliament. Similarly, in the elections of 1996, no party won a majority in parliament and a coalition was formed between left and centre-left parties, which was led by Deve Gowda and then I.K. Gujral. Within a year, Gujral's government collapsed when the Congress Party withdrew their support in 1997. In 1998 another general election took place a new Hindu Nationalist Party Coalition was formed and led by Atal Behari Vajpayee, with the support of more than ten other parties. The Vajpayee government fell and was re-elected in 1999 and formed a new government in September 1999. Having had three general elections in the last six years, India's political environment may be considered rather unstable. However, in spite of the changes of government, the policy environment has remained stable.

Pakistan

Pakistan was created in 1947 out of India when it gained independence and the new state constituted two east and west sub-divisions, divided by Indian territory. Zaidi (1999) divides Pakistan's fifty years into five epochs: the first elevement years from 1947 to 1958, were a period when Pakistan tried to settle down after the turmoil of partiition which saw millions of refugees. Run mainly by bureaucracy, the economic performance was modest. In 1956 Pakistan was declared an Islamic Republic. Leading up to this time, while there were several attempts to have a non-military governments in both the east and west sections of Pakistan the unstable situation resulted in a military take over in 1958, led by General Ayub Khan, who governed until 1969. This was the second epoch and was the decade of development. At that time, General Yahya Khan ousted the former ruler and governed on the basis that a general election would be held thereafter. The promised election did not eventuate until 1970, when the Awami League won a technical majority of seats in the Parliament. As General Yahya refused to leave office despite civilian protests, a deadlock resulted and civil unrest broke out in early 1971. During that year, Bangladesh gained their independence after a civil war and Zulfikar Bhutto finally assumed power of West Pakistan as a democratically elected leader. Zulfikar Bhutto's rule ended in 1977 when General Zia-ul-Haq took over and later charged and hanged Bhutto in 1979 for instigating murder. General Zia-ul-Haq governed Pakistan until 1988 when he was killed in a suspicious air crash. During this second period of martial law, the Middle East was opened up to Pakistani migrants, Afghan was brought "the culture of drug and arms" (Zaidi, 1999) and Ismalization got a boost. In the elections that followed, the late Bhutto’s daughter, Benazir became Prime Minister in 1988 and marked the beginning of the fifth epoch. She was removed on corruption charges just two years later. Nawaz Sharif was then elected into office at the ensuing election and similarly dismissed on charges of fraud in 1993. Despite the fact that the Supreme Court ruled that the Nawaz government could be reinstated, Nawaz resigned and Benazir was again returned as Prime Minister until 1996, when she was dismissed on the basis of suspected corruption. Following a general election in 1997, Nawaz Shariff regained his position as Prime Minister, leading the Muslim League. In October 1999, General Musharaf led a coup, arrested Naz Shariff and re-established military rule once again.

Sri Lanka

Sri Lanka gained independence from the British in 1948 and initially inherited a stable political and economic environment. However many of the ethnic tensions that had been suppressed during the independence movement surfaced in the following years and Sri Lanka is to date plagued with a culture of ethnic violence. After independence, The United National Party (UNP) formed a government led by D.S. Senanayake who became the first Prime Minister of Ceylon (as it was then known). Senanayake governed the nation until 1953 when the Prime Minister was forced to resign in the face of massive opposition to cuts in consumer subsidies. Following an interim period, led by Sir John Kotelawala , Solomon Bandaranaike led the Sri Lanka Freedom Party (SLFP) to victory in the general elections of 1966. Bandaranaike's reign was to be short-lived however as he was assassinated in 1959 by a Bhuddist monk over a religious issue. Bandaranaike's wife, Sirimavo, then assumed power, becoming the world's first woman Prime Minister, and governed until 1956, when Dudley Senanayake, the first Prime Minister's son, was instated as the country's leader. Once again Sirimavo returned to power in 1970 leading a left-wing coalition. Within a year of assuming power, the government was faced with a powerful , armed youth uprising led by the Janatha Vimukthi Peramuna (JVP), which was eventually quelled. In 1972, the country was renamed the Republic of Sri Lanka and Sirimavo retained the leadership for 7 years until she lost the general election to J.R. Jayawardene of the UNP. Jayawardene immediately changed the previous constitution and became the President of the country, entitled to executive powers. During this period civil unrest heightened and in 1983 ethnic riots broke out in Colombo, leaving a painful scar in Sri Lanka's political history. Also, in 1988/89 the Sinhalese led JVP re-surfaced and another attempted insurrection was quashed. In 1988, Jayawardene's former Prime Minister, Ranasinghe Premadasa, was elected as President. During his reign, the Tamil separatist movement intensified further and in 1987, Indian peacekeeping troops were sent to the north of the island in an attempt to negotiate a peace settlement. However, the Indian forces were withdrawn in 1990 after the assassination of Rajiv Gandhi in India by a Tamil separatist. In 1993 President Premadasa was assassinated by a suicide bomber, and the then Prime Minister, D.B. Wijetunge became the President. Shortly afterwards, in the 1994 elections, Chandrika Bandaranaike Kumaratunga, daughter of Solomon Bandaranaike, was elected as Prime Minister.

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