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## **ECONOMIC REFORM AND GOVERNANCE: THE SECOND WAVE OF LIBERALISATION IN SRI LANKA 1989-93**

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# WORKING PAPERS

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# Economic Reform and Governance: the second wave of liberalisation in Sri Lanka 1989-93

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and  
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## 1. Introduction

Economic liberalisation has become the conventional policy line in most of the developing countries. But with the growing body of country studies and analysis of economic performance, policies are now cast in more nuanced terms than in the 1980s. The focus of the policy debate has shifted. It has moved away from the content of policy -- from problems of stabilisation, timing and sequencing, the social costs of adjustment and the need for safety nets (Cline & Weintraub 1981; Choksi & Papageorgiou 1986; Dornbusch & Helmers 1988) -- towards the broader context in which policies are made and implemented and the institutional capacity of a government to carry out reform (World Bank 1992; World Bank 1994; Ashiem 1994; Frishtak 1994). The role of the state has also, in the process, been reappraised and revalued. It is no longer enough that it is smaller and that it is non-interventionist, it has to be disciplined and professional -- performance-oriented, committed to reform, single-minded in its determination to create an environment conducive to private sector investment, more accountable, more transparent and of course much more efficient. The institutional capacity to implement reform and to monitor subsequent progress is identified as a major cause of economic policy failure (World Bank 1993).

The need for "good governance" has emerged as part of the new policy prescription. But what exactly does it entail? The World Bank, in two important papers *Governance and Development* and *Governance: the World Bank's experience*, sets out from a dictionary definition. It finds three elements to governance: (a) the form of political regime; (b) the way authority is exercised in managing economic and social resources; and (c) the institutional capacity of government to design and implement policy (World Bank 1992:3, footnote 1; World Bank 1994:xiv). The Bank sees the first of these elements to be outside its mandate -- funding decisions should not be determined by its views on

the political regime of a particular country. And this much would seem justified. The danger is that, in taking this step, political inputs are eliminated, and "good governance" comes to be treated as a largely technical affair.

The dilemma this poses can be usefully illustrated by looking at what the Bank means by "good" and "bad" governance. Main characteristics of bad governance are seen as the following:

- o failure to make a clear separation between what is public and what is private [and], hence, a tendency to divert public resources for private gain;
- o failure to establish a predictable framework of law and government behaviour conducive to development, or arbitrariness in the application of rules and laws;
- o excessive rules, regulations, licensing requirements and so forth, which impede the functioning of markets and encourage rent-seeking;
- o priorities inconsistent with development, resulting in a misallocation of resources; and
- o excessively narrow-based or non-transparent decision-making (World Bank 1992:9).

The common factor in these shortcomings is precisely what Frischtak's World Bank paper sees as the realm of politics (Frischtak 1994:12). Politics, in this constrained and essentially negative sense, has therefore to be eliminated. "Good governance" is then the opposite: it is non-political -- "predictable, open and enlightened policy-making; a bureaucracy imbued with a professional ethos; an executive arm of government accountable for its actions; and a strong civil society participating in public affairs" (World bank 1994:vii). It is a system of institutional checks and balances where rules and institutions "provide a predictable and transparent framework for the conduct of public and private business" (World Bank 1992:3).

All this is intuitively attractive, but how do you bring it about? Once politics is excluded, all that is really left to the notion of governance is a suggestion that better state institutions, better management and clearer rules will improve economic performance. It may be true, but some of the most profound problems of governance lie at a political level in realising the reform that is necessary -- not only with the interests of politicians and the political will to bring about meaningful changes, but in the area of political

accountability, democratisation and human rights. The experience of economic reform in developing countries has shown that political factors make inroads into programmes that are the most desirable technically. Economic reform is "contaminated" by political imperatives. The extent to which this constrains economic growth is an important question and Sri Lankan experience provides a useful case study of the issues.

This paper examines the second wave of economic liberalisation in Sri Lanka from 1989-93 (the Premadasa years) from both a traditional economic and from a governance perspective, looking at political and technical determinants of economic policy. We argue that the two dimensions are intertwined, that political will is an essential ingredient of economic reform, and that the suggestion that, by shifting its weight from "bad" to "good" governance, a government can improve economic performance may be misconceived. The paper is also a first attempt to fill a gap in the literature on Sri Lankan economic policy. A substantial body of analysis exists on the early years of liberalisation from 1977-88. Little has so far been written on the later period.

The structure of the paper is as follows. Section 2 sets the stage; 2.1 looks at the need for a second wave of liberalisation, 2.2 provides an overview of the policies that were implemented, and 2.3 assesses what was achieved. Section 3 then looks more closely at impediments to private sector-led growth. Section 4 analyses this experience from the standpoint of governance, and it is followed by a final section which contains concluding remarks.

## **2. The Background**

The discussion in this section is structured around three main questions: why a second wave of liberalisation was necessary; what policies were introduced; and why, in the light of the continuing economic liberalisation that was taking place, the level and pattern of growth were considered by some to have fallen well short of expectations.

### **2.1 The Need for a Second Round**

There is general consensus that a second wave of liberalisation was needed at the end of the 1980s. Mounting macroeconomic instability and violence had overtaken earlier efforts. The government had been heavily committed to massive, public infrastructural

projects in the early '80s, the largest of which (the Accelerated Mahaweli Development Programme) was mainly donor-funded. The sheer scale of the investment fueled the budget deficit, generated inflationary pressures in the economy and created "Dutch Disease" type effects that had undermined the incentives that had earlier been given to exporters (Athukorala & Jayasuriya 1994). The first period of liberalisation, from 1977-88, proved one of macroeconomic instability. External debt quadrupled in the early '80s, official reserves were run down to plug the current account deficit and the government resorted to commercial borrowing to finance the budget deficit. The situation was also exacerbated by a growing atmosphere of violence after 1983; civil war was taking shape in the north and east and there was insurgency in the south from 1987-89. The process of economic reform, which was at best incomplete, was then put on hold.

This left a great deal of unfinished business on the liberalisation and structural adjustment agenda (Lal & Rajapatirana 1989). The opening up of the economy in 1977 had seen a major reorientation of the country's development strategy, but most liberalization measures were concentrated in the initial years. In many areas, key reforms had still to be implemented a decade later -- in systems of taxation and tariffs, in the civil service, in public sector enterprise and in banking. High level commissions (the Administrative Reform Commission, the Taxation Commission, the Privatisation Commission) and a range of specialist task forces were to be appointed in the mid and late 1980s to formulate policies. Their recommendations, on the whole, were accepted by government, but at best they were only implemented half-heartedly.

One principal reason was that the deteriorating economic and political situation was less and less conducive to any rigorous reform. National policy-makers became increasingly preoccupied with the macroeconomic situation and with crisis management as the economy was hit by a succession of external and internal shocks (Dunham & Kelegama 1994). Their room for manoeuvre narrowed. The burgeoning public sector was acknowledged to be an anomaly, but it was also an important source of employment and patronage. Reform was difficult when elections were approaching in late 1988 and early 1989, and the Sri Lankan economy was in decline. The poor management record and low productivity of the public sector were not properly addressed for similar reasons, and the government was undecided about whether to stop at the restructuring of public sector enterprises or go for outright privatisation.



Action was therefore confined to a few limited sorties -- opening a state monopoly to private enterprise (as in public bus transport) and engaging consultants to manage enterprises on contract (as in the case of state textile mills). Restructuring the public sector was acknowledged to be essential but little real progress could be made.

Increasing preoccupation of national policy-makers with security and with crisis management meant in turn that there was little scope to extend reforms to a sectoral level. The reappraisal or restructuring of sectoral policy to buttress macroeconomic strategy never really took place, despite the high level committees that advised on policy.<sup>1</sup> The sectoral policies that were implemented were usually separate initiatives and they were *ad hoc* in nature. The government's sustained commitment to infrastructural projects and the enormous share of public expenditure that they commanded, were possible only at the expense of other investment. The latter was in consequence piecemeal. Sectoral strategies had to be postponed or laid in abeyance until priorities changed and the necessary resources could be realistically envisaged.

The level of private sector investment was therefore relatively low, despite substantial policy incentives to make it more attractive. The ethnic violence of 1983 and subsequent political instability created considerable uncertainty. But the low level of investment was also aggravated by the preference of Sri Lankan entrepreneurs for debt capital over equity. For various reasons, the Colombo Stock Exchange (CSE) never really became important as a means of mobilising capital. Sri Lankan investors were unfamiliar with equity, appropriate mechanisms to mobilise small savings were lacking, and most firms preferred to hold back on investment, to incur debts or contribute their own funds than to resort to share issues. A tight monetary policy and weak legislation reinforced the trend. High returns and the relatively risk-free nature of fixed deposits and Treasury Bills and a perception amongst borrowers that the costs of any failure to service debts would be comparatively low (because debt recovery laws were weak) worked against share market activity.

The need for a second wave of liberalisation was therefore quite unambiguous. Why policy had veered off course is a more contentious issue. Lal and Rajapathirana (1989)

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<sup>1</sup> In the mid-1980s high level committees were appointed to formulate a policy framework for industry, food and nutrition, forestry, and electricity supply and transport. A draft industrial strategy was first put forward in 1987, although it was subsequently to be revised.

attribute it largely to the government's mismanagement of domestic economic policy. This may have been partly true. But due allowance has also to be made for other factors -- for initial conditions, terms of trade and workings of the political system. It has led us to argue elsewhere (Dunham & Kelegama 1994) that internal and external shocks and the social costs of adjustment were important contributory factors. The government embarked on its investment programme for good political reasons. There was pressing need to generate employment quickly after reductions in food subsidies, and the new schemes offered invaluable sources of political patronage. That they ran counter to liberalisation objectives, that export-promotion was overshadowed in the government's priorities, or that policies of stabilisation and adjustment pulled in different directions, was understandably second to restoring political stability and reinforcing the government's power base. By 1987, the deteriorating security situation had become the overriding factor, but by then the die was already cast.

## **2.2 The Second Wave Policies**

By 1988, a stabilisation programme had been formulated and was agreed with the IMF under its Structural Adjustment Facility (SAF) and key reforms were planned, only to be stymied by the insurgency and by demand pressures that were unleashed by the oncoming elections (PIP 1989). With re-election of the ruling, United National Party and insurgency brought to heel in the South by the end of 1989, the stage was set for a second wave of liberalisation in the Sri Lankan economy. For analytical convenience, three broad areas of policy can be identified: the stabilisation programme, what we have chosen to call "bread-and-butter" reforms, and a few selected initiatives that were heavily publicised and which were to prove politically high-profile. Preparation of many of these measures had begun well before the elections and there was a considerable element of continuity with the earlier period, but as a whole "the new vision" was to prove much more a "wave" of reform than had been the case in the earlier period from 1977-88.<sup>2</sup>

### **2.2.1 The stabilisation programme**

In the middle of 1989, the Sri Lankan government embarked on a new stabilisation programme which was to open the door to substantial donor assistance (from the

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<sup>2</sup> Examples of earlier preparation can be found in the Strategy for Industrialisation, in the identification of state enterprises for privatization (PIP 1990:49) and in the 1988 SAF.

World Bank, ADB and Japan in particular).<sup>3</sup> Table 1 summarises targets set in the initial and in later Policy Framework Papers (PFPs). Sharp cuts were required in government expenditure (including cadre reductions through an early retirement scheme for public servants and a freeze on new recruitments), a tight monetary policy was to be pursued, and the current account deficit was to be brought down to levels that the country could expect to finance from foreign aid.

**Table 1**  
**Key Macroeconomic Targets of the PFP, 1989-93**

Indicator	By end 1989	By end 1993
Real GDP growth	2-3 %	Around 5 %
Budget deficit	12.5 % of GDP	8 % of GDP
Inflation	12% of GDP	6 % of GDP
External current account deficit	Around 10 % of GDP	Around 5 % of GDP

Source: PFP 1989-92 and PFP 1990-93 and PIPs.

### 2.2.2 Bread and butter reforms

The serious manner in which the new government approached crisis management and the subsequent up-turn in the economy paved the way for the second wave of economic liberalisation that was soon to follow. It comprised a number of technically important, but undramatic, low profile adjustments:

- o a reduction in the maximum nominal tariff on imports (to 45 per cent in 1993), introduction of a four band tariff and the progressive elimination of export duty on traditional exports;
- o devaluation of the rupee to renew the drive for export-led growth (the rupee was devalued from Rs.34/US\$ mid year to Rs.40 in September 1989 and was to rise to almost Rs.50 by the end of 1993);
- o tax system reform to lower income and corporate taxes (to 40 and 35 per cent respectively), to abolish wealth and capital gains taxes with a view to stimulating the capital market, and to improve tax compliance and increase administrative efficiency;

<sup>3</sup> SDR 156.2 million was made available under the Structural Adjustment Facility (SAF) for the period 1988-90, and US\$ 600-700 million was to be forthcoming each year in the form of concessional aid and grants from the donor community.

- o further liberalisation of commodity and financial markets (prices of wheat and fertiliser in particular were aligned with world market prices, sugar prices were reduced, controls on imports of raw materials were removed, and the Central Bank refinance scheme was abolished);<sup>4</sup> and
- o in 1993, liberalisation of exchange controls on the current account of the balance of payments and abolition of compulsory surrender requirements for exporters.<sup>5</sup>

None of these reforms was to prove contentious. They were designed to stimulate the economy and to create a macro environment that was conducive to higher levels of private sector investment.

### 2.2.3 High profile projects

A third group of measures that were highly publicised and, over time, to prove more contentious were the flagships of Premadasa's policy. They were "peoplisation", export promotion and the alleviation of poverty. The first two formed part of the 'New Strategy of Industrialisation' of 1989. They can be briefly summarised as follows:

#### Peoplisation

The privatisation process was presented in Sri Lanka as "peoplisation". It reflected the government's objective of broad-based share ownership wherever possible, although it was recognised that private corporate investors would have to take management control and that share issues to the public were not necessarily the most appropriate form of divestiture. By 1989, a list of priority enterprises had been prepared for peoplisation and there had been studies on their share structures (PIP 1990). A number of public enterprises (principally Thulhiriya and Pugoda textile mills) had been restructured with a view to subsequently converting them into public companies. The government embarked on an ambitious programme of privatisation, and new institutional arrangements were put in place to facilitate the process. The Public Investment Management Board (PIMB) absorbed the newly-created Privatisation Commission and, with the Ministry of Industries, was to oversee the restructuring and divestiture of public manufacturing enterprises. The Telecommunications Department (already a public company), public bus transport, shipping and plantation management were also in due course to be privatised.<sup>6</sup> By

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<sup>4</sup> By September 1990 only pharmaceuticals and a small number of items that were health or security sensitive items remained under controls.

<sup>5</sup> Full convertibility of currency in the current account was achieved in March 1994.

<sup>6</sup> Shipping operations were liberalised in January 1990 when the earlier system of allocating freight through the Freight Bureau was formally abolished and the Ceylon Shipping Lines privatised. In air transport the government took a decision to end Air Lanka's monopoly of air freight. These policies were accompanied by infrastructure development related to ports and to the international airport at Katunayake.

the end of 1993, the majority shareholdings of 35 state-owned enterprises had been divested, and another 30 were in various stages of divestiture. New measures were also introduced in the 1990 and 1991 budgets to lower taxes and thereby mobilise more savings.<sup>7</sup>

#### Export promotion

The New Strategy of Industrialisation was the culmination of work that stretched back to the mid-1980s and which had found expression in the Industrial Policy Statement of 1987 and *A Strategy for Industrialisation* in 1989. It laid strong emphasis on export-oriented industrialisation and a more liberalised trade regime to stimulate exports (PIP 1990). In November 1990, an Investment Policy Statement made several important changes to the foreign investment policy framework (Athukorala 1994).<sup>8</sup> An Export Development Plan was formulated and the 1990s were declared to be 'The Decade of Exports'. Tax holidays, which had previously been confined to Export Promotion Zones (EPZs) were extended to any exporter who could meet the government's export criteria -- making the whole island, in effect, a free trade zone.<sup>9</sup> The Foreign Investment Advisory Committee (FIAC), the approval body for foreign investment in non-EPZ areas was absorbed by the Greater Colombo Economic Commission (GCEC), that for EPZs, in January 1990 -- later renamed the Board of Investment (BOI) in November 1992 -- as a "one-stop shop" for assistance to investors and for the automatic approval of most foreign investments.<sup>10</sup> In 1992, the private sector was named the "engine of growth" and a goal was set to achieve NIC status by the year 2000.

#### The alleviation of poverty

Even prior to the elections, Mr. Premadasa had committed himself to a major programme for the alleviation of poverty and it was a prominent feature of the 1988 election manifesto of the UNP (*A Manifesto of Action for Investing in People*). He was quick to respond to perceptions among many of the rural poor and urban working class that the "middle class" dynamics of the early liberalisation phase had effectively by-passed them. The cash-value of foodstamps was doubled and a

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7 It was important for privatisation that the capital market could absorb the share issues that would be forthcoming and with this in mind, a number of constraints that had inhibited the stock market had to be removed. Foreign participants were permitted 100 per cent share-ownership in all but a narrow range of activities. Measures were introduced permitting venture capital funds, the establishment of unit trusts with State participation to attract small savers, more effective debt recovery and tax relief on profits from the sale of shares.

8 Foreign investment approvals were made more automatic; restrictions on ownership lifted; and foreigners were permitted to purchase up to 40 per cent of shares in existing quoted companies.

9 On these criteria see the Board of Investment, Package of Incentives for Investment Below Rs 10 Million, Colombo, (undated). Incentives varied by sector, but at least 70% of production had to be destined for export (over 90% in the case of industrial-based products), they had to be new businesses, and they were not to involve the transfer of assets from an existing business in Sri Lanka.

10 A third EPZ was also established at Koggala in mid 1991.

major poverty alleviation project (the Janasaviya Programme)<sup>11</sup> was launched in 1989 as the lead project of the new government under the personal supervision of the President (in his capacity as Minister of Policy and Plan Implementation). It was later supplemented by programmes for school uniforms and midday meals. He also launched a programme to establish 200 garment factories in rural areas to promote rural employment and to help reduce regional disparities that were becoming socially divisive (Dunham & Kelegama 1994). All these measures helped to strengthen the power base of the President, but they also reflected concern for the poor and for political reconciliation in the wake of the violence that had occurred in the south after 1987.<sup>12</sup>

### 2.3 The Achievements

Table 2 shows the performance of the Sri Lankan economy between 1989 and 1993 on selected macroeconomic indicators. Comparing them with the targets of the PFP (see Table 1), reveals that solid progress was recorded on almost every score -- with the notable exception of inflation. There was a steady increase in investment, and the contribution of domestic savings grew more than proportionally. Exports as a percentage of GDP rose steadily. The balance of payments had been in surplus since 1989 and official reserves had risen.

The period from 1989-93 demonstrated the remarkable resilience of the Sri Lankan economy as it bounced back from the traumas of the period of insurgency to record an average annual GDP growth rate of 5.5 per cent, despite bomb blasts in the South and on-going war in the North and East. Most of it was also generated in the private sector. The mainstay of the growth was the manufacturing sector (which grew at 7 per cent p.a.), and more particularly factory industry (8.7 per cent) and production of garments for export (12.2 per cent). Services grew steadily (at 4.5 per cent) -- especially external trade (at over 7 per cent), while agriculture lagged behind (at under 3 per cent). The share of the public sector in GDP saw a marked decline and the stock market surged in 1990 and 1991, with a growth of foreign portfolio investment. The Quarterly Labour

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<sup>11</sup> The Janasaviya Programme was initially designed as a massive income transfer (almost 20% of GDP) to 50% of the population over a two year period, during which the recipients were expected to develop the necessary skills for (self) employment. As fiscal, inflationary and the potentially divisive implications of the proposal became recognised it was subsequently reduced and staggered into 11 rounds with tight community screening and a stronger employment orientation that it had shown at first. Recipients were to receive Rs. 1,042 a month for consumption purposes with Rs. 458 a month placed in a bank account as forced savings to be available as starting capital at the end of the period.

<sup>12</sup> The scale and the political priority of these welfare programmes created shock-waves amongst economists when they were first announced.

Force and Employment Survey recorded a fall in unemployment (DCS 1994), and there were indications that poverty had declined (World Bank 1994b). On all these scores, the record seemed sound and to have been consistent with the government's overall policy objectives. So in what sense was it felt to have fallen short of people's expectations?

**Table 2**  
**Economic indicators, 1978-88 and 1989-93**

Criterion	1988	1989	1990	1991	1992	1993
GDP growth	2.7	2.3	6.2	4.6	4.3	6.9
Budget deficit*	15.6	11.2	9.9	11.6	7.4	8.1
Inflation	14.0	11.6	21.5	12.2	11.4	11.2
External current account deficit*	-5.6	-4.4	-3.2	-5.4	-4.5	-3.8
Investment*	22.5	21.5	21.9	22.6	23.5	24.0
Domestic savings*	12.0	12.2	14.3	12.7	15.3	15.5
Exports*	21.1	22.3	24.7	22.6	25.9	26.6

\* Expressed as a percentage of GDP.

Source: Central Bank of Sri Lanka, Annual Report (various years) and the Institute of Policy Studies Data Base

This can be answered in two ways. First, economic performance was lower than government projections. GDP growth was consistently well below that anticipated in annual Public Investment Programme (PIP), and foreign direct investment (at 1 per cent of GDP) was short of expectations. It became increasingly apparent that the much-publicised vision of Sri Lanka moving to NIC status by the year 2000 was in fact little more than a pipedream. The on-going war put a brake on the rate of foreign investment, but disincentives ran deeper. There was, second, a decreasing degree of coherence and consistency in government policy with a strong element of unpredictability and particularism in its implementation. The government hedged on key reforms (such as restructuring and possible privatisation of the two state banks which controlled nearly 60 per cent of the banking assets of the country) there was insufficient regulation of private sector activities, discriminate use of fiscal incentives and a growing victimisation of those linked to political opponents. These weaknesses combined to dent business confidence, and they created an air of reversibility about the country's economic achievements (IPS 1993). There was a feeling among some commentators that relaxation of the reform process or a new lavish welfare measure could at any moment spark off a reappearance of serious macroeconomic imbalances. For much of

the 1989-93 period, there was a group -- in both public and private sectors -- who were convinced that the Sri Lankan economy could, and should have been recording higher levels of growth. How did it come about, and how valid was the viewpoint that they expressed ?

### **3. Impediments to Growth**

The period from 1989-93 was characterised by mounting tension between the technical requirements of the stabilisation/liberalisation exercise and the populist policy priorities of the President. In this section we look at the outcome from a technical standpoint, focussing on two main areas: the stabilisation programme and institutional support for the liberalisation agenda.

#### **3.1 The stabilisation programme**

In contrast to the earlier period, there was a serious attempt to stabilise the economy after 1989 and this gave added momentum to further liberalisation. However, many demands of the stabilisation policy (in terms of monetary policy and cutbacks in government expenditure in particular), produced contradictions that discouraged investment and meant that the country's economic performance remained below potential.

High interest rates (one-year Treasury Bills secured over 20 per cent in some years and averaging around 18 per cent throughout the period) were a persistent feature of the Central Bank's monetary policy. The private sector (the so-called "engine of growth" of the Sri Lankan economy) continually complained that the cost of capital was high compared to other countries, such as Malaysia. World Bank studies found that Sri Lankan industrialists singled out the cost of capital and infrastructural inadequacies as the major impediments to growth (World Bank 1992a; 1994c). Private sector interest groups and individuals therefore felt justified to press for tax and tariff concessions and offshore borrowing facilities to offset these costs, and to enable them to fulfil the role that the government had assigned to them.

The government's reliance on tax concessions to attract investment led to distortions. It affected the relative profitability of different projects. It also eroded the tax base, and encouraged companies to shift their costs between tax-paying and tax holiday units -- a



move that was hard to combat with limited tax enforcement facilities. Revenue losses had to be overcome by means of *ad hoc* measures, such as the imposition of a 15 per cent Income Tax Surcharge (initially for two years to make up for low compliance and problems of administration during the years of insurgency, but in fact subsequently continued) and of a Defence Levy (1 per cent of turnover when it was introduced in 1992, and eventually 3 per cent in 1993). The Defense Levy alone yielded 6.7 per cent of total government revenue in 1993, up from 4.4 per cent in 1992 (CB 1993: table 69). The extra costs fell largely on the corporate sector, and they were passed on wherever possible to the consumer (increasing the rate of inflation). For small companies that had been successful in evading tax, it also meant that it was more costly for them to expand if, in doing so, they came under the scrutiny of the tax authorities.

One result of these measures was further pressure for concessions, and once they had been granted to industrialists who joined the Two Hundred Garments Programme (THGP),<sup>13</sup> it became increasingly difficult to deny them to others who made claims on the grounds of equity or of continuing loyalty through the difficult years of the insurgency. Time series data on the numbers of tax holidays reflect several developments (the increasing number of approvals, changing rules on entitlement as well as irregularities), and the extent of the problem that was created is difficult to interpret. However, BOI data (which capture only a part) reveal a sharp increase in the number of concessions it granted from 14 in 1989 to 325 in 1993, with a rising proportion of BOI approved projects being granted tax holidays (up from 40 per cent in 1989 to 70 per cent in 1993). Though equally difficult to evaluate in any quantitative sense, rationalisation of the tariff structure into a four-band system was accompanied by a sharp increase in the number of import duty waivers. It is claimed that the government lost nearly Rs.8 billion from duty waiving (Ministry of Finance 1995). There is no doubt that rent-seeking increased; interest-groups were created to press for concessions, and those who lacked an organised mouthpiece at national level (such as the peasantry) were left behind (IPS 1993). The focus of attention was increasingly drawn to manufacture and trade.

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<sup>13</sup> Tax concessions were granted under the TGFP to new enterprises or for the expansion of existing enterprises in 200 identified centres, providing they constructed a new building, employed at least 500 workers, paid a minimum wage of Rs 2,000 a month, provided free breakfast, two teas and medical care facilities on the premises, provided insurance cover, and made no reduction in levels of employment in the parent enterprise (BOI n.d.). The TGFP was initiated in late 1991.

Despite the surcharge, the Defense Levy and net proceeds to the government from its privatisation programme (roughly Rs. 8 billion by the end of 1993), the increased number of concessions was accompanied by a shortfall in revenue. This was made all the more serious by additional expenditures. The Janasaviya Programme proved an overambitious, poorly targeted and potentially costly election promise that was viewed contemptuously at the time by professional economists and by the Colombo urban elite. It was nevertheless politically important. It was given high priority, and welfare expenditure -- having fallen from 19.9 per cent of government expenditure in 1979 to 11.8 per cent in 1988 -- rose again to 16.9 per cent in 1993. Decentralisation (see Section 3.2) and on-going war were also added expenditures. Defence expenditure was over 4 per cent of GDP and, with the cost of rehabilitating refugees, it made enormous demands on the budget. The government had also awarded public servants an across-the-board wage increase of 30 per cent towards the end of 1992.

These were massive expenditures. The result was a continuing budget deficit that had to be lowered by capping capital expenditure and by correspondingly lower levels of infrastructural investment. The cutback in government expenditure, from 34.0 per cent of GDP in 1989 to 29.8 per cent in 1993, was achieved by holding down capital expenditure in real terms. Real capital expenditure rose by 1.5 per cent over the whole four year period, while recurrent expenditure grew by 10.7 per cent. Major investments in telecommunications, transport, irrigation and power that were essential for long-term growth of the Sri Lankan economy, were postponed in favour of recurrent expenditure that was politically much more sensitive and therefore harder to cut. From early 1993, the government looked for private sector involvement in infrastructure development, under "Build-Own and Operate" and "Build-Operate and Transfer" schemes, but the response was weak. Low investment and low organisation and management outlays on infrastructure increased costs of production and fueled the pressure for more and more concessions.

Liberalisation of exchange controls on current account transactions and the abolition of foreign exchange surrender requirements on export transactions (in March 1993) also served, towards the end of the period, to reinforce these trends. High real interest rates (over 7.5 per cent in every year except 1990, when high inflation and managed rates meant that it was actually negative, and 9.3 per cent in 1993) saw significant capital inflows into the Sri Lankan economy. Exporters preferred to repatriate earnings (even

after the lifting of surrender requirements) because of the attractive interest rates, portfolio investment increased and private remittances, which had averaged 5.9 per cent of GDP over the whole of the period, peaked at 6.7 per cent in 1993 at SDR 453.6 million (Central Bank 1993). There was inevitably some conversion of these funds into the local currency, adding to the money supply, fueling the rate of inflation and keeping the real cost of borrowing up.

### **3.2 Institutional support**

The liberalisation 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 rationalise systems and procedures, streamline the civil service cadre, and up-grade management skills in line with the needs of a liberalised and industrialised economy. It had attempted to give direction to the civil service, urging that reform of the administrative system be considered holistically (ARC 1988).

The Premadasa government therefore embarked on the second wave of liberalisation with a fairly comprehensive agenda for reform at hand. However, it faced pressures from two sides. The government placed importance on decentralisation -- as a response to ethnic conflict in the north and east, to improve the implementation of policy and "to bring government to the people".<sup>14</sup> Public service employment also continued to be important as a source of political patronage. As a result,

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<sup>14</sup> The Presidential Mobile Service was one such example.

decentralisation was carried out with no contraction at the centre. Similarly, a scheme was drawn up (on the express instructions of the President) to employ 15,000 educated non-graduates as teachers in local schools. Between 1989 and 1993, the number of teachers rose from nearly 147,000 to 176,000, and the World Bank complained that most of the new additions were in primary schools where, given the declining birth rate, they would be less and less needed (World Bank 1994a). 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.

The net result of the exercise can be seen from Table 3. These figures include teachers, health service cadres and police, but exclude armed forces. 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.<sup>15</sup> 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

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<sup>15</sup> 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).

**Table 3**  
**The Size of the Civil Service Cadre**  
**By Employment Category, 1989 and 1992**

Category	1989	1992
Senior, middle and upper management	11,948	17,065
Executive	12,337	19,267
Manual, middle office and technical	409,564	435,887
<b>Total</b>	<b>433,849</b>	<b>472,219</b>

Source: Cadre and Salaries Committee

(Kuruppu 1994). Administrative reform was downgraded to little more than matters of staffing and a new structure of emoluments.<sup>16</sup>

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 privatisation exercise), from the outset, never 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 liberalisation of the economy after 1977, *ad hoc* efforts had been made

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16 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".

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),<sup>17</sup> and labour legislation was a source of perennial complaint by the private sector (Godfrey 1990).<sup>18</sup> 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 been an element of its *Strategy for Industrialisation* of 1989. But such moves were seen to threaten rights that people had fought for, and any attempts at reform were therefore bitterly resented. Peoplistisation, for example, was vigorously promoted in 1990-91 but ran into difficulties.<sup>19</sup> Opposition of strong trade unions to labour retrenchment (at a time of opposition allegations of corruption and "cronism") made the government more cautious (Kelegama 1993). It found it increasingly difficult

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<sup>17</sup> 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 17), and even when firms are allowed to close operations procedural barriers to creditor filing and prosecution make it unusually difficult.

<sup>18</sup> 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.

<sup>19</sup> 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 privatisation.

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.

#### **4. Politics and Governance**

This section looks at the second wave of liberalisation in Sri Lanka from the standpoint of governance. The Premadasa years have been characterised as a period of highly centralised, 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 stabilisation-cum-liberalisation/industrialisation programme, and the politicians' (especially the President's) perception of what liberalisation should provide in terms of government support and distributional gains.<sup>20</sup> 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 UNP 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 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 stabilisation of the economy and

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<sup>20</sup> The Secretary to the Ministry of Finance, a political appointment, played a crucial role as a broker on matters of economic policy.

further liberalisation (Dunham & Kelegama 1994). The programme of reform that emerged was fairly coherent, because it built on preparatory work during the earlier period of disruption,<sup>21</sup> 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-Premadasa, 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 Premadasa years.

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 UNP 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 liberalisation failed to generate the desired investment, employment and incomes, it was felt justified to force the pace using less conventional means.

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<sup>21</sup> The 1988 PFE and A Strategy for Industrialisation (Mol 1989) are the best examples.



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 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 Janasaviya Programme (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 BOI 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 neutralise 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.<sup>22</sup> 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).<sup>23</sup>

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 privatisation 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

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<sup>22</sup> On the decline in public accountability since the 1970s see de Silva (1993) and Sanderatne and Hulme (1994).

<sup>23</sup> 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).

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 because they lacked adequate powers and/or expertise. The regulatory body for the privatisation 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 privatisation 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 privatisation 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 liberalisation 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 Premadasa 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.

## **5. Conclusions**

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 liberalisation 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 liberalisation 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-Premadasa. For basic political reasons, shifting the weight from "bad" to "good" governance was not a viable alternative.

Much of the domineering authority of the Premadasa government has to be attributed to the Sri Lankan Constitution of 1978 and the excesses of an Executive Presidency. President Premadasa 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.



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