Pathfinder Economic Flash

Limits of Statist Development or State Capitalism.

Countries have achieved sustained growth and development by adopting a range of approaches. Successful outcomes have come from policies varying from state capitalism to those based on market-driven private sector-oriented models. A high premium needs to be attached to the pursuit of pragmatic policies that are appropriate for country-specific conditions at a given point in history. It is in such a context that one needs to consider carefully the options available to Sri Lanka at this point in time.

The question that needs to be posed is: What is the right model for a country like Sri Lanka, which has had an endemic structural budget deficit for over three decades; and public debt which currently amounts to about 80% of GDP, with a rapid build up in foreign commercial debt, including short term foreign borrowing?

Such prior conditions make state capitalism an unviable option for Sri Lanka. A country like China has enjoyed unprecedented success using this model. However, the differences between China and Sri Lanka are stark and dramatic. China has had robust fiscal outcomes; very low levels of public debt; and extensive foreign reserves that have been earned through outstanding export performance rather than borrowed from fickle and volatile international capital markets. For decades, China has had low inflation, subdued interest rates, an undervalued currency and dynamic export performance on the back of a sound fiscal framework. Sri Lanka, by contrast has tended to have high inflation, high interest rates, an overvalued currency and poor export performance on the back of unsustainable budget deficits. One may conclude that it would be imprudent to opt for state capitalism when public finances are highly constrained. It would not be possible to achieve sustained accelerated growth and development through recourse to such policies in the current Sri Lankan context of high public debt and deficits. The consequences are likely to be elevated inflation, balance of payments instability or both. Furthermore, China has a large domestic market with a considerable potential to expand its natural resource base, this serves to act as a buffer against external and internal shocks. On the other hand Sri Lanka has a very small market due to its population size and the current level of per capita income. Our resource base is nowhere near that of many countries where the statist development model has enjoyed some success.

Arguably, the worst of all options is what may be termed "opportunistic state capitalism" where the state "cherry picks" attractive economic opportunities for itself. The problems are compounded if this is associated with high levels of rent-seeking behaviour. This model creates confusion regarding the respective roles of the public and private sectors.

The ensuing uncertainty undermines the investment climate. As result, private investors, both domestic and foreign, become reluctant to invest. At the same time, the state does not have sufficient resources to fill the gap. In Sri Lanka, a number of its major players have been investing much more money abroad than at home. Uncertainty regarding the overall development model, particularly the respective roles of the state and the private sector, is likely to be an important explanatory factor. Sri Lanka's major challenge is to increase private investment, domestic and foreign, by 7-8% of GDP (public investment has been capped at its current level of 5-6% of GDP). Evidence from around the world indicates that domestic investment picks up before FDI, unless a country has a large domestic market or a rich natural resource endowment. Sluggish private investment has arguably been the most disappointing aspect of the post-conflict recovery. Less uncertainty regarding the role of the private sector in the economy would be a major factor in reversing this.

The recent decision for the Sri Lanka Transport Board (SLTB) to import 3,000 new buses is a good example of a measure that gives mixed signals and discourages private investment and enterprise. The SLTB undoubtedly plays a crucial role in providing services on uneconomic routes, particularly in remote areas, as well as special services for groups, such as school children. However, de-regulation has also encouraged the growth of private enterprise in the bus transport sector. This has generated both investment and employment without imposing any burdens on the over-stretched budget. In such a context, the SLTB's recent decision is an example of opportunistic state capitalism and is likely to stifle future growth of the private bus transport sector.

An important question that needs to be posed is: "What is the opportunity cost of using budgetary resources to import 3,000 new buses?" By diverting public money to a sector where there is an active private sector, less money will be available for priority needs such as: assisting the 1.8 million Sri Lankans who live in abject poverty, supporting underfinanced schools and hospitals in less developed areas of the country; and many other competing priority claims for the government's resources in areas which are not commercially attractive enough to attract private financing.

In conclusion, one must emphasise that the state has a crucial role to play in a modern economy. It should maintain macro-economic stability; address market failure; design a well-targeted safety net to protect the poor and vulnerable; and provide important public goods, such as prudent economic governance, law and order and a conducive investment climate, including robust and transparent regulation. However, there needs to be clarity in terms of the respective roles of the public and private sectors in investment, wealth creation and employment generation. The conditions of public finances are an important determinant of the nature of the state's role in the economy. In the Sri Lankan context, growth and development cannot be accelerated on a sustained basis without increasing private investment, given the lack of sustainable public financing. Government policies must deliver predictable and consistent signals to boost both public-private partnerships and private investment.

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