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VISION AND OWNERSHIP

Understanding Economic Reform

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IMF

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VISION & OWNERSHIP

AN INTRODUCTION

Vision & Ownership An Introduction

I am a Pakistani who trained to be an economist to see if I could help my country seek its way out of a poverty trap. Unfortunately, all I bought myself was a job in an international organization.

My preoccupation with the study of my own country's economic problems remained strong and I continued to write and debate ideas for addressing such problems. Over the years, it has become increasingly clear to me that people like myself are truly marginalized from any debate on economic policy and reform in our country. The interaction of donor agencies and local bureaucracy determines all policy decisions. Civil society and thinking individuals are neither consulted nor taken seriously in such determinations.

As such prescriptions have failed, we hear of new buzzwords such as "participation" and "ownership." Yet the process remains much the same. A decade of developing this "participation" and "ownership" has not done more than to allow some chosen few academics to be hired as consultants by resident multilateral agency offices or to provide funding to some NGO's. Strategic thinking and planning continues to remain firmly in the hands of the entrenched bureaucracy at home and in the donor agencies.

In my career at the Fund, I was attracted to the position of a Resident Representative for various reasons. More than missions and reading about a country, it would give me the opportunity of knowing another. country like I know my own. Additionally, it would give me a stature to dialog with both the government and civil society. Indeed, it might even be an opportunity to test out some new ideas.

Sri Lanka was a particularly interesting choice for me. I knew my home country Pakistan and its political economy very well and had formed several hypotheses for it. The common colonial heritage and the South Asian regional association would reduce my startup costs as well as give me additional insight into Sri Lanka. Most importantly, I would be able to confirm my own views on the political economy of South Asia.

It has been a fascinating experience. I have learnt a lot and have been told by many that I may have contributed to policy and thinking in the country.

Ownership

All international agencies have correctly come to the conclusion that "ownership" of policy and reform is the key to success. But the concept of ownership is applied in many strange ways and needs clarification. I see funny examples of it all the time.

- ***"They must do all the thinking"*** approach. In one case, I recall a donor team take the easy approach of merely recording all that government had to say perceiving the ill-conceived laundry list of projects to be domestically-owned policy agenda. With great bonhomie and much development goodwill, the donor mission handed over the money. The ability of the government, the possibility of the money being used for buying personal or political power, or the poor conceptual design of the project was never in question. In the end, the loan was not used for any useful purpose.

- ***"Conference attendance"*** approach. In another, millions were spent in conferences where ministers were stars and their mere ceremonial attendance was considered ownership. The consultants behind the scene prepared everything and gave lectures to the usual suspects-NGOs and academics-when the ministers had completed their ceremonies.
- "**Consultant must be theirs"** approach. In another case, the donor funds were used to hire a consultant to write the report that the government would claim to own at the next donor forum. The consultant was the same person who had written a similar document before 'ownership" came into vogue! It seemed to me that the document and the policy proposals that it contains are the same that would have been obtained had the donors had not demanded "ownership."
- **"Wait for their ideas"** approach. Yet another interesting situation was where the donor representatives were flying first class to exotic destinations with no pressure on them because *ownership* had absolved them. They could relax and enjoy themselves saying that what could they do except enjoy a good holiday, if the government was not ready and did not *own* any of the reform.

Given where I come from-Pakistan-I have always been for *ownership* and actually believe it to be personally liberating. Almost three years as Resident Representative of the International Monetary Fund in Sri Lanka, I have been totally devoted to creating ownership of reform. Moreover, I think I have succeeded and have some interesting lessons on the issue of *creating ownership* to pass on in this book.

But let me begin with **my definition of ownership**. *Owning a policy or an idea is achieved once you comprehend it in all its dimensions-its conceptual basis, its ramifications and how to use and implement it.* The origin of the idea is totally unimportant to ownership. Thus for example, Pythagoras' theorem or Newton's laws or Einsteinian Physics, now belong to all of us who are willing to learn and invest in using them.

If we accept this definition, all four above approaches are incorrect. Who came up with the policy idea, who did the analysis, or who wrote it down is totally irrelevant! This does not absolve any one of the stakeholders from doing the analysis. Nor should it absolve any one of them from taking responsibility of the agendas adopted and actions taken.

In this view it becomes incumbent on all analysts to not only conduct very good analysis but also to communicate, explain and develop ownership. The question then should be how to create that ownership.

Why ownership by government may not be possible!

Most donor agencies tend to define ownership to be "Shared vision and activity support of program objectives with the authorities." While conceding that there is a need for developing a "breadth of ownership" beyond the government, it seems to me that we still rely excessively on the authorities "willingly assuming responsibility" for their policies although induced by funding possibilities.

I would argue that in most poor countries the underlying political economy considerations will not allow those who make up the government to "own" the problem. In other words, their "incentives" are anti-reform. Let me explain:

It is now more or less widely accepted that the most important reason that poor countries do not grow or successfully complete their reform programs is their poor, unreformable governance structure. Consequently, the core of the problem is the reform of the Government itself. An outmoded civil service that is highly politicized, overmanned, obsolete in its skills and knowledge and working according to outmoded procedures and management systems often characterizes such governments. Reforming such a system essentially means downsizing government reducing its power over the market and resources and particularly the induction of fresh human capital and technocracy in the Government. What this means is that the very people that we are asking to take over the ownership of reform are the ones who will have to be put out of their jobs. I do not see this as a viable objective.

Leading with Ideas

My hypothesis during my stay in Sri Lanka has been that if I led with ideas, I could influence minds and create ownership. My method was as follows:

- **Use the Socratic method based on provocative questions** to shepherd people in the right direction. On social occasions, I would raise questions on the economy from a libertarian viewpoint in view of the fact that Sri Lanka continues to be dominated by Fabian ideology. In that sense, I rather modeled my approach on the famous Chicago economists, like Friedman, Becker and Stigler.

- **Improving civil society understanding through debate!** The Fund representative is often required to make speeches in public places. Rather than repeat well-known Fund positions or seek to score points on the government, I chose to develop lighthearted but sound essays that were based on recent research in economics. The demand for these ideas surprised me. I departed from the traditional emphasis on macroeconomic issues. Instead, I initiated seminars and talk on themes such as "the role of government" "regulation" "institutional and market development" "new growth and what it means for policy," "globalization," and "the economics for education" etc. My research background helped me bring current research to bear on these issues and I found myself developing user-friendly surveys on these subjects that soon became very popular with the media. The invitations increased dramatically and I found myself addressing more and more interesting audiences, such as Lawyers, Microbiologists, Scientists and engineers. Newspapers and several magazines were very keen to publish my talks. More importantly, people would read them and approach me in shops complimenting me on my talks and the published versions. Several people found these presentations of ideas to be bolder than our statements on policy.

- **Direct participation in civil society groups.** Gradually, this effort led to people inviting me to formally initiate or join efforts that allowed me to deepen the dialog on issues such as education and deregulation. The difficulty now lay in getting these groups to consider long term efforts to develop themselves into informed and issue oriented pressure groups. Many long meetings later, I evolved the strategy of pushing them in the direction of developing high profile conferences in issues such as deregulation, financial market development and a vision for education.

It took about 18 months for people to start inviting me for serious ideas and analysis. I had to be very careful in how I put forward my views to be as self-effacing as possible. Gradually even the media wanted to talk to me again and again only for the economic ideas that I gave them from international experience and economic theory. The more provocative I was the better people liked it.

Using this goodwill and credibility that I have built up in civil society, I have been able to develop a number of interesting initiatives that in my view are educating civil society and leading to the development of its ownership of reform ideas. But even more importantly civil society is beginning to understand issues and is now developing pressure on the governance structures.

In my talks and conversations, I took great care not to critique Sri Lanka extensively. Instead I would use my South Asian origins and knowledge to make statements about Pakistan or South Asia that had obvious parallels in Sri Lanka. However, I would let them draw the parallels themselves. But here my Pakistani origins helped a lot.

The need for a guiding vision

I have always been uncomfortable with a sector-by-sector approach to policymaking underpinned only by a macro framework. Such an analysis is also funding driven and primarily based on outmoded models of economic growth that considered capital to be the main constraint in the path to economic progress. Governments are perennially chasing money in this scheme, signing deals and meeting piecemeal conditionality in each sector while trying to manage an impossible budget arising from the ever-expanding needs of each sector.

What is missing is a growth strategy-- a holistic view of where the people wish to go and how to get there! The people and their leaders are not dreaming any more as they did in the early phases of independence. Yes they are thinking crude numbers like wishing for high growth rate and greedily eyeing large increases in per-capita incomes but when they do, the only image that has been sold to them is that of obtaining more money from somewhere. Hard work, product development, productivity, efficiency and above all, innovation, are not elements of this wish.

I wanted to change this and introduce an element of understanding growth and what a growth strategy should look like and started to ask people, "What is your long-term vision for Sri Lanka? In other words, twenty years from now, would you still be a small tea producing, tiny tourist destination with a few small hotels?"
While these challenges led to a lot of interesting discussions, I began to push NGOs, government and business community to develop their own competing visions for Sri Lanka. After many fits and starts, the Ceylon Chamber of Commerce was the only entity that came up with a long-term vision for Sri Lanka. In the original design, NGOs and the Government agreed to participate in the conference. The government

backed out for political and bureaucratic reasons while the NGOs did not want to engage in an activity that generated no funds. Upon my advice, the Ceylon Chambers went ahead with the event! The Ceylon Chamber of Commerce has now been able to publicize their vision placing pressure on all segments of society to develop a debate on this. The government and NGOs have promised now to deliver their own ideas, as have other business groups. I hope that there will be a series of these vision conferences that will allow a widespread discussion of reform and the emergence of a growth strategy.

Box 1: The DEREG Conference

Will Sri Lanka attract the investment it needs from the global pool? Is there enough investment space? What are the hidden costs to completing investment projects? Are there any bureaucratic hurdles that delay legitimate investment projects? The Deregulation Conference asked the above uncomfortable questions with one aim in mind - to create an investment and market friendly environment in Sri Lanka as soon as possible.

The Deregulation Committee, during its short tenure, produced some in-depth research into the subject and highlighted some hard truths about the regulatory environment in Sri Lanka. The papers presented at the conference were of high quality and had delved deep into the issues of regulation. It is commendable that the papers in the conference have measured the regulatory cost in Sri Lanka is as high as 6%. What was noteworthy, also, was the keen attendance by some key Sri Lankan policy makers for the entire duration of the conference!

The main consensus emerging from the conference is the dire need for deregulation in Sri Lanka. Current labour and land laws were considered archaic and changes to existing regulations were identified as mandatory. Regulatory problems associated with port, customs, electricity and Inland Revenue authorities were also identified as major impediments for investment, and this warrant urgent attention.

The single greatest achievement by having such a conference is that it marked the beginning of a more open, consultative and visionary approach to policy making. It is hoped that this process would continue.

Deregulation and the need for good analysis!

Surprisingly, most analysts-who happened to be mainly expatriate consultants--had accepted that Sri Lanka had deregulated and liberalized its economy. My initial queries such as, "how long does it take to make an investment?" "Where can you invest?" confirmed to the business community the need for deregulation. Labor legislation was all that everyone was talking about. Yet, I could see that that although important, labor laws were not the only constraint.
The ‘looking for funding" approach stood in the way of the understanding of the role of regulation or for the study of "growth space" in the economy. Yet, when I took that view it was immediately obvious to me that important sectors such as the sea and air were closed for business, land was not available because of inefficient titling and

ownership problems, cumbersome procedures were irritating and time consuming, inept regulators

Box 2: Media must be privatized and private sector must have a role in education!

To preserve power and control of the economy, government structures in poor countries prevent debate. They do so primarily by controlling media, education and think tanks. Most reform agendas, even those pushed by donors, do not emphasize privatization or even autonomization of these structures. University education, in particular, is very tightly controlled to stifle any liberal or modern thinking.

As a result, there is hardly any debate or understanding of modern thinking on reform. Moreover, the outmoded system of management in government and education leads the best people in the poor countries to migrate. People, who harbor old ideas or do not have the requisite skills, therefore run key institutions.

The upshot of this process that has been in place for a long time is that there is hardly any understanding in reform ideas in these countries. The media discussions continue to push dirigise ideas promoting state led development. A review of the Op-ed pages in most developing countries will show how strongly anti-globalization and pro-socialist thinking remains even today because dominant thinkers continue to retain anachronistic ideas. More importantly, people in key managerial positions are protecting their turf and have little incentive to make a change.

hindered market development and so on and so forth.

To cut a long story short, many casual discussions later, the business sector led by Cubby Wijetunge convinced G. L. Pieris, then Minister for Industries, to set up a **Deregulation Committee (DC).** Since then most of the cabinet including the Prime Minister, and the President have blessed it. It comprises of many leading industrialists, some bureaucrats and myself. The Deregulation Committee is a permanent body, which is expected to conduct deregulation studies, create awareness of deregulation and prepare government White Papers on the subject.

With ADB funding, we were able to arrange a Deregulation Conference on February 16-17, which by all accounts was a great success. The DC and the conference has substantially changed Sri Lankan thinking on the subject and truly initiated a debate on the issue in the country (see Box 2). I recall in the early days of the DC, people were hesitant to use the term, deregulation, considering it to be somewhat inflammatory to the relatively Fabian body policy. But now everywhere the DEREG slogan-thanks to the hard work of Bandula Parera, Cubby Wijetunge, Noel Salvanayegam among others--is now been accepted.

No forums for debate!

Establishing a debate has not been easy given that there is no specialized audience or forums, capable of supporting serious discussion. Education and the media continue to be in the hands of government and they remain largely impervious to new ideas (see Box 1).

A self-serving bureaucracy to delay reform often uses the opposition to reform arising from a lack of understanding. For example, in Sri Lanka, labor reform is often postponed because of the union opposition to it. Similarly State Banks are recapitalized rather than reformed again because of an alleged lack of support in the population. Yet there is no attempt ever made to educate the people. This suits the bureaucracy and the government, as a captive bank is a useful escape valve when a runaway budget or a loss-making utility is in need of financing.

For reform to succeed, society's understanding of the reasoning underlying recommended policies must be improved. Although I have found that it possible to generate a debate on these issues, I do think that we need to give priority to the reform and modernization of universities and to the privatization of media to allow local talent to flow into these areas (see Box 1). This will allow modern ideas to creep into debate on policy and society. This will truly generate "ownership" in civil society and the populace.

Education is Key

More and more evidence on growth experiences of countries points to the importance of education. Having accepted the power of ideas and the fact that ideas must lead politics and reform, I search for the leaders of thought and the academic for a where thought will flourish. Unfortunately, in poor countries, for the best of reasons, governments and bureaucracies destroyed education.

BOX 3: Funding is available!

In developing reform initiatives, funding was never a constraint!

- The Swedish Aid -thanks to Peter Troste --provided for training and institutional mentoring for Central Bank Modernization. World Bank provided additional funding of $40 million for technology, HRM and the VRS. '
- For the Deregulation committee, ADB through Jaseem Ahmed provided funding and consultants to make it a success.
- ADB also came through for Inland Revenue and Custom reform.
- For the education conference, Holland and bilateral donors provided the funding with participation of the private sector.
- Fir the financial markets conference, each bank saw the importance of it and decided to contribute. Each financial institution bought a chair at the conference for Rs. 50,000.
- Training of members of parliament is expected to be funded By Sweden, Holland UK and US.

Reform of education is therefore critical but it is also a reform that appears to get the least priority. Leading strongly from a growth viewpoint, I started to talk about education and found myself invited to become a member of the Ceylon

Chambers of Commerce had set up a Human Resources subcommittee. Together we set up a Chambers Academia Round Table (CART), which has been meeting regularly for 2 years now to develop joint activities in University Education and reform. Dedicated people like Faizel Salieh, Dilmi, Tommy, Dharmasiri, Rizvi and others spend many an evening and Saturday planning many activities including mentoring, and management training for education.

My aim has been to develop the subcommittee to a pressure group for reform of education, which will break the government monopoly on education. For this we have now developed a **Vision for Education in Sri Lanka (or Education DEREG)**. We are now planning a conference for debating this and other competing visions in May of 2002. NGO's, government officials, students, academics as well as opponents of reform will participate to debate education reforms in the country. The subcommittee has plans to market their ideas before and after the conference and seeking to generate a national debate from this event. I was able to arrange funding for this through bilateral donors (See Box 3).

Once again, we have all found that reform is gradually finding acceptance in society. I have dreams that I may yet be able to revive efforts to set up a private sector business school. Many leading businessmen (Mano Selvanthan, Ken Balendra among others) have talked of it in the past, even developed some plans. During my tenure, I have been pushing them to proceed with the project. Although they continue to express the need, the costs of forming the collective still remain large and no one really wants to take the lead.

Financial DEREG

More recently I gathered the leaders of the financial firms as well as regulators for a discussion on financial markets at several lunches. It was generally felt that this sector was operating on outmoded laws that stifled development. Furthermore, fragmented development occurred in this sector as reform and developments originated from consulting/technical assistance assignments, which were driven by various uncoordinated donor agendas. But most importantly, the financial sector participants had no role in planning reform for the sector especially as the regulator and the consultant continued to view them with suspicion. **It was agreed that the financial system would conduct its own review of the financial system to come up with its own comprehensive reform proposal for the sector.** We are now working on this proposal to prepare for a conference on this issue on March 18-20, 2002. The agenda is impressive and the enthusiasm of the financial sector is catching. They have done extensive group work and developed some very nice papers. We hope that we will be able to prepare a benchmark volume on financial sector reform from this effort.

Modernizing Governance from within

An almost universal consensus now prevails that there is a need to build better governance in Sri Lanka. There are two views on how to go about it.

- Most of civil society that suffers from poor governance wishes for good things to happen in the public sector. More often than not, this is mere prayer for an overnight conversion of evildoers!

- Most of the external stakeholders, the donors, are attempting what is known as civil service reform. This normally consists of general rules and procedures and possibly some training to improve the productivity of the entire public sector without major restructuring or change of personnel.

To me both approachesare wrong. We cannot convert people and broad-based civil service reform does not work.

In designing reform, we must recognize the heterogeneity of the public sector. My approach, which has now been initiated in the Central Bank, has been to follow the "Re• engineering the Corporation" and "Reinventing Government" approaches and stop treating the public sector as a monolith. Instead of reforming the whole government, the focus must be on each government organization to build the change around sharply focused objectives and clearly measurable performance goals. Its management, human capital and processes would then be shaped toward achieving these goals in the most direct, transparent and open manner.

The first of these was begun at the Central Bank with an integrated plan for a) an internal consultative approach to clarifying objectives and examining current work processes, b) technology improvement, c) management and HRM improvement, d) training programs, e) skill refreshment through targeted retrenchment and replacement of critical personnel, and f) mentoring by a similar institution by an advanced country.

Box 4: The Central Bank modernization project

Consisted of the following five components;

- **Internal consultation** was built around a CBSL retreat July 2000. Considerable discussion in various focus groups before and after the retreat was conducted for sharpening objectives, streamlining processes, developing better management including human resource management and reorganization.
- **RiksbankMentoring:** I arranged for Riksbank of Sweden to assist CBSL in their modernization effort though a mentoring program for 2 years. Deputy Governor Nyberg is personally leading this effort and several teams from Riksbank have conducted preliminary visits to assess the form that this program should take.
- **Training:**Through a process of consultation within the CBSL and the Ministry of Finance, a comprehensive training program has been developed for the financial sector of Sri Lanka. Given the lack of skills locally for such high level training, we have a program based on importing high quality people form overseas The Swedish government has funded this program.
- **MDC:** The consultations of the Steering Committee and the Task Forces have revealed a very strong demand for improvements in management practices of CBSL. A **Management Development Center (MDC)** at the CBSL is just beginning to operate. It is expected to be an important vehicle for developing modern thinking and practices at CBSL.
- **Technology:** We brought in the World Bank to fund the technology. They were to provide funds for "an electronic payment system to CBSL including a full networking capability to CBSL and the financial sector of Sri Lanka
- **Skill replenishment program and HRM:** Years of poor HRM had led to considerable skill gaps in the organization. A new HRM policy was required in several critical areas, such as monetary policy and bank supervision. In addition, space was to be created through compensated early retirement and recruitment policy changed to allow better skills to be hired.

As expected, the implementation of this modernization effort has been uneven. However, ownership and awareness has been developed to a point that modernization will take root!

This new paradigm for governance reform as well as 6-pronged model for CBSL reform is now widely accepted by the policymakers. We have also identified several key departments of government as well as public sector corporations that will be targeted for reform along these lines. Thus the approach to governance reform will be to develop decentralized autonomous organs of government.

While this is a critical development in our approach to building governance, it is not fully operational in government for many reasons.

First, (And perhaps most important) strong leaders, preferably form the private sector, must be found for government organizations and given a clear objective of restructuring and reform. Moreover, they are not assured that their performance will be measured on successful change and change-management.

Second, Leaders are not given independence to run their institutions for clear goals. Instead, they are given political baggage incompetent managers and excess labor cannot be fired. If rents of the existing labor force are to be preserved, there can be no reform.

Third, Experience of restructuring around the world shows that change cannot occur without a change of senior management and skill up-gradation through an infusion of human capital. In poor countries, the political leadership often wishes for change leaving the current work force intact. This cannot work because the public sector labor force because of years of poor management, often suffers from poor motivation, lack of initiative and considerable skill depreciation. Neither training nor motivation can help when people have suffered for years under a poor system.

Fourth, Modernization occurs only when the culture and work ethic changes. Infusion of senior managers from the private sector is one way of doing it. They will bring a new approach to work and office interaction. However, the success will critically depend on enlightened leadership in the old method of work.

Fifth, Change cannot be in camera. It must be open and fully monitorable not by the media and some external agency. Here the new economic reform ministry must play a crucial role by making change open and monitorable.

Sixth, And finally, Leadership at every level in the country and in the organization must be committed to reform. And the population at large must be informed that the reorganization of government departments is in their interest! Though we all admire Lee Kwan Yew, we forget that this is exactly the kind of leadership that he inspires.

If the political leadership accepts these principles and relentlessly (like Lee Kwan Yew) pushes for their implementation, we might get the good governance that everyone wants!

Learning from my experience

I am told that I have been successful. At many important forums, I have been told that I have the best interests of the country at heart and that I am an honorary Sri Lankan. Amazingly, the media pushes me to give them more international experience and ideas emanating from latest research. Many people consider such transfer of knowledge to be very brave and compliment me in public places. Interestingly enough, various companies and professional and trade associations have invited me only because they feel that I am presenting fresh and innovative ideas.

To me this is an interesting approach to creating ownership: engaging civil society, participating wholeheartedly in civil society events, and above all leading with ideas and questions, catalyzing thought.

The Resident Representative interacts with the media, society and the government on a regular basis. An active Res Rep can learn a lot and establish lasting relationships. A technically competent Res Rep will be invited to participate in forums as well as civil society organizations if she shows an inclination to do so. If the Res Rep is capable of leading with ideas, the Res Rep can be very influential.

Too often, I hear the term research and academics being used with disdain. The myth has been that for Res Rep and other such operational positions, we need practical and operational people who will continue to practice the past even if the past did not work. I will argue with that approach and suggest that it was my research and academic background that allowed me to bring certain originality and freshness in the dialog.

The Res Rep role as a catalyst and primary analyst of structural reform initiatives must be more fully recognized and appreciated by all including civil society. There must be more effort to engage and even give feedback to the Res Rep for the Res Rep is more than a mere diplomat.

THE OPPORTUNITIES FROM GLOBALIZATION!

Globalization and the Future

Inaugural address for the 22nd National Conference of the Chartered Institute of Management Accountants (CIMA) in Sri Lanka
On 12-13 May 2000.
Conference theme: Finding the Future: Beyond the Bottom. line

Presented with this challenging conference theme, I thought that I would use the occasion to discuss globalization and how, contrary to popular perception, it offers opportunities to small countries like Sri Lanka.

The day of the conference, CIMA published a newspaper supplement with the following message from me.

"We live in exciting times. The global marketplace is growing and available to all. Technology is providing limitless opportunities and opening up new vistas. Indeed, these days, the future is ever present and full of opportunity. CIMA 's theme for its 22nd Conference "Finding the Future: Beyond the Bottom line" is, therefore appropriately provocative. It points to the need to look beyond the current bottom line by investing in the future at every level. It reminds us of the new challenges that are being posed to management at every level in modern society.
Exciting opportunities exist for every country, every firm and every individual. Sound and visionary management is required to take advantage of these exciting global opportunities. At the firm level, flexible and adaptable management will use rapidly changing technology for defining a future of growth, profitability and social responsibility. At the country level, open, responsive and cost effective governance will provide the backdrop to such firms but will also lead to substantial improvements in human welfare.

But management must remain aware of the fundamental lesson of the Internet revolution- that individual initiative and innovativeness must be released at every level. The chaos of such individual action led us from the industrial age to the information age. Progress will depend on finding and developing good governance that accommodates individual initiative at every level. Herein lies a lengthy research agenda some of which will hopefully be explored in the CIMA conference over the coming weekend.

I congratulate you on this thought-provoking conference. I hope that it will arouse the interest it deserves."

How to Benefit from the Future

Opportunities and Challenges

It is a great pleasure and an honor for me to be selected to present the Keynote address at the annual convention of Chartered Institute of Management Accountants in Sri Lanka. The title, **"Finding the Future: beyond the bottom line"** is memorable. It is cryptic, intriguing, and provocative. In many ways it symbolizes the exciting, "full of promise" and wondrous times that we live in.

We live in exciting times. The global marketplace is growing and available to all. Technology is providing limitless opportunities and opening up new vistas. Indeed, these days, the future is ever present and full of opportunity. CIMA provocatively reminds us to look beyond the current bottom line by investing in the future at every level. It reminds us of the new challenges that are being posed to management at every level in modern society. However, the change is perplexing! It has everyone, from Swaziland to Russia, from Kiribati to Seychelles buzzing with the new buzzwords: knowledge, e-commerce, IPOs, ISPs, websites, etc. Are we all going to benefit equally from this revolution? In some countries IT is being counted as a panacea! They are drafting IT policies, making IT ministries. They are already counting their software exports. They feel a few elementary courses in computing will suffice.

I think that, in all this excitement, we must pause and take some time to think on how the maximum benefit could be derived from the new opportunities that technology is offering. As the old American saying goes, "there is no such thing as a free lunch." Many of those salivating at the opportunities forget the challenges that the new environment offers. They also forget that seizing the opportunities may also require some "preparedness."

So let us examine the challenges that lie before us as well as the constraints that we are likely to face as we try to take the opportunities that are being offered to us.

What does globalization mean for small countries?

Before that, let us conceptualize the kind of environment that we are likely to face in the coming years. I think there would be little disagreement around the room if I claimed that the twin phenomenon of *increasing globalization and rapid technological advancement* would only strengthen in the coming years. What would this mean to us in the global village? I think, the rapid technological development that has spurred increasing integration of global economies will intensify the following 3 factors:

- First, we will continue to see a rapid decline in transactions costs - the costs associated with conducting economic transactions - everywhere. Consider the following examples.
    - Long distance communication is becoming virtually free with the advent of e-mail and web based telephone.
    - Similarly, obtaining, analyzing, and searching of information costs only your own time.
    - Shipping and delivery costs have also declined substantially over recent years.
- Second, sovereign controls and powers are going to diminish in the coming years. Cross border transactions have already become very difficult to police. Specifically,
    - It will become very difficult to maintain controls on domestic capital. No longer will it be possible to assume that savings will be retained at home or that it is possible to fully shelter your economy from the vagaries of the international capital market.

- Controls on information such as through censorship or manipulation of national information, are certainly obsolete.
- Domestic monopolies on media and education are going to be virtually impossible.

- Third, with the expansion of the global marketplace will come increasing competitiveness. The competition will not only be felt by business but also by government. The notions of domestic markets, domestic monopolies, decreasing cost industries and public goods have already changed substantially. These evolving concepts have permanently altered our conception of the role of government and the public-private balance. It is almost a certainty that the marketplace will further encroach upon the public domain.

In a nutshell, what this means is that the individual is being empowered at the expense of national sovereignty. Countries will have to be open. Either technology will enforce it or the costs of closing an economy for any length of time will be prohibitive. There will be no choice given increased capital, as well as human capital, flight possibilities. Since these flight possibilities are very sensitive to increased country risk and country-specific transaction costs, they will impose a certain discipline on country management and its ambits. Thus, sovereign decision-making will have to be subjected to openness. Individuals will have wider choices beyond national borders

Openness is no longer a choice!

Global opportunities have increased and will increase enormously. New goods, new discoveries are being made. Knowledge is being discovered. There are advantages of being connected. Exciting opportunities exist for every country, every firm, and every individual. The decline in costs associated with transactions and information flows will allow all countries to rapidly benefit from the global marketplace and all that it has to offer. Countries that are ready to take advantage of these opportunities will advance rapidly. In particular, countries will be able to benefit from the substantial research and innovation enterprise in industrial countries. It has been estimated that open economies benefit significantly from spillovers of research and innovation in industrial countries and that such spillovers effects can lead to substantial reductions in global inequities.

This is not to say that there will be no losers. Countries must be ready to receive the benefits of globalization. Openness has to be retained. Those that fight openness and spend large resources to retain sovereign control over information, capital and transactions will surely lose. However, in making this point, I must hasten to add, that this is only a continuation of past trends. Closure has always resulted in the domestic economy bearing certain costs. In the last fifty years, countries such as those in South Asia, that were more closed, were unable to partake of the opportunities that were offered to them. They grew at substantially lower rates than their more open counterparts. However, we can almost safely say that, in the coming era, the country that seeks to opt out of globalization will forgo more in terms of opportunities, and perhaps expend more resources in defending closure than it would have in any earlier era.

Openness is important but it is not free of risk.

The global market assesses country risk. Professional risk management firms analyze this risk and make it available to all. Based on this risk analysis, it rewards with capital inflows countries that are streamlined and well organized. Such rewards are also bestowed upon those that are engaged in strong reform efforts. By contrast, the poorly run countries are found out at an early stage and punished through rapid capital outflow. There is, therefore, a greater• than-ever-need to examine domestic governance and market arrangements so that you can present your best face internationally.

The bottomline is that, there are gains from globalization, but only countries that are prepared will benefit. What is this preparedness? Country management must prepare to face the discipline of openness. Countries that are *well run and market-friendly* will be rewarded. Unfortunately the converse is also true.

The Asian crisis was quite instructive. It showed us how vulnerable countries are to international markets when they have fundamental structural problems, in governance, in regulation, and in corporate governance. It also showed the ability of countries to bounce back if they are able to take strong and bold structural measures. The experience of the transition economies over the past IO years has also shown that countries that moved fastest and most persistently on structural reforms have done best.

Good Governance is the imperative of the time

What does governance mean in this milieu of openness, declining national control over the market, and increasing individual choices? My answer is that governance or administration of public resources, is going to increasingly emulate the governance of firms. At the risk of oversimplification, I will outline the following 6 principles that must lie at the heart of any new public management *I* governance reform.

1. The role of the government will have to be reconsidered to return it to the efficient provision of its core functions, which would include law and order, the legal and regulatory framework, the justice system, and the local public infrastructure such as roads, parks, and transport systems.
2. Like the firm, country administration will be required to be professional and result oriented.
3. In keeping with this need for performance-orientation and professionalism, HR policies in government will need to be similar to firms. Segmentation between the 2 labor markets - where one is a public or a private sector employee for life - cannot be maintained. There will have to be mobility between the two, if efficiency in public administration is to be maintained. This will mean that the whole gamut of HR policies, such as training, recruitment, remuneration, career advancement (promotions), will need to be reviewed taking a cue from the private sector.
4. Public services will have to be provided in a decentralized manner to allow greater community-sovereignty over their own services and governance.
5. Government monopoly on the provision of public services such as education and health will have to end. The recent information revolution has made the national monopoly on education redundant, while the government monopoly in almost all countries has resulted in the provision of low quality education. And we must always remember the creative energy of private universities in the US that have midwifed the knowledge revolution.
6. Finally, the end of ceremonial government. Like the management of a firm, governments will have to concentrate on administration and fade into the background.

It is then an inescapable conclusion that to benefit from globalization, reforming the governance structure along the lines suggested above is of prime importance.

Will the knowledge revolution make governance reform irrelevant?

My answer would be an emphatic no for the following two reasons:

- Key local public goods will be provided locally. These are law and order, the legal and regulatory framework, the justice system, and the local public infrastructure such as roads, parks, and transport systems. The quality of these systems will determine the local cost of doing business, which in tum will determine how much investment - foreign and local - will be located locally.

- The reduction in transaction costs makes it very easy to arbitrage local costs. The costs of relocating have also decreased remarkably, which is why you are seeing that many companies are now more mobile. BOA pulls out after 50 years from South Asia. BMW buys Rover and pulls out all within 5 years. This means that well managed localities and governments will see growth in their countries. Wales and Ireland are proof of this point. Addressing their governance structures, they have made their countries very attractive and are receiving large inflows of capital.

Will everyone benefit equally from the knowledge revolution?

"Knowledge" is the new buzzword, and all leaders everywhere are making major pronouncements and plans for developing and trading knowledge. But as in the past, many of these plans remain infeasible, because of several myths or misconceptions that have plagued development thinking since its inception. There is a class of people who benefit from the creation of the myth that **"Knowledge stands outside the education system."** They are peddling websites as an alternative for formal learning. There *is* a certain romanticism associated with the web.

Education is now trivialized to be an IT problem. We do not need to worry about it and need only to provide kids with computers. Instead of a school in every village, all we need is a computer with a network connection. Why worry about education in this environment?

You may find it surprising to know that this is *not* the first time that we have seen such an approach, that suggests that there are short cuts to development that lie outside the formal education system. Recall the old agricultural extension systems that seldom worked. Recall also, the old approach of "build only crude primary education systems" out of touch with modernity and neglect the university system and your own knowledge-development systems. They have created many countries with improving literacy rates that are not showing up in productivity numbers. India bucked the advice that it got, and created institutions of higher learning and research - the famous IITs and the IIMs. Today, they are the only poor country that has a sizeable software industry. I accept that the proponents of the romance with the web, are well-meaning and full of good emotions for the poor, but any argument based on knowledge development without a sound education system including a good university system, is fundamentally flawed.

This line of reasoning still begs the question, "where are you going to get your doctors, lawyers, engineers, etc?' You will still need universities with labs and libraries to produce them. Even with the web and the IT, the education method remains the same. Much like Plato and Aristotle, you still need to do your tutelage (or should I say apprenticeship) with a world-class intellect. No, ladies and gentlemen, Harvard, Stanford, Chicago, will not die anytime soon.

What excites everyone is the costless availability of a large amount of information. It is like a large library that is available in your living room or study. Moreover, the cost of sifting through the library is low. But as many of us know, to work your way through the accounting section of the library, training in accountancy is a minimum requirement.

True the Internet is becoming user-friendly and provides learning opportunities for the determined and the disciplined. But the educational establishment provides an environment to the youth of a country, and prepares them to be disciplined and determined with skills for analyzing and processing specialized information. In that context, the Internet along with the library will be an important resource in the educational establishment. It will be a complement and not a substitute.

We should always keep before us, the fact that the only LDC that has benefited from the IT revolution is India, and India is the only LDC that has invested in quality high education through IIT's and IIM's. Many LDC's now, for some years have been trying to run short• term computer courses in the hope of igniting on IT industry. They have drawn IT plans based on such courses. Unfortunately, their share of software exports in total exports, has not yet become significant. Indi~ s strategy of quality higher education is perhaps worth examining.

Looking at it form this direction, we need to perhaps moving away from the traditional focus on the quantity of education to the quality of education.

We have seen above, that those that organize their governance better will benefit from globalization. An additional measure that we can use for success is the development of education systems that are balanced and of high-quality, i.e., that allow for the development of quality education at the higher levels.

Domestic talent has no role in the running of domestic institutions.

I wish to draw your attention to my message for this conference. I think it contains a fundamental truth for today's environment. It said that, "management (both country and firm) must remain aware of the fundamental lesson of the Internet revolution - that individual initiative and innovativeness must be released at every level. The chaos of such individual action led us from the industrial age to the information age. Progress will depend on finding and developing good governance that accommodates individual initiative at every level."

Basically, to me the central message of the knowledge revolution is this **chaos of individual initiative and the respect for and reward of talent**. The one lesson that poor societies have not learnt is that talent is to be appreciated and rewarded. Build systems and institutions around critical talent and do not demur in rewarding talent.

Typically, large and poorly managed bureaucracies that resist change, characterize developing countries' institutions of governance or education. These structures are built only on lowest quality denominator of talent are considered to be adequate. And this typically arises from the lack of appreciation of the new discipline of human resource management. Since the government dominates all economic activity and is the largest employer, it sets the tune in this regard. The government reinforces the following:

- It acts like an unemployment insurance scheme for it neither rewards nor punishes any one.
- It also acts as an "employer of first resort."
- It is thoroughly demoralizing since it has removed the sense of honor that was intrinsically linked to building institutions.
- It has taken away the sense of achievement, the competitive spirit by denying meritocracy.
- Excessive centralization limits initiative and the spirit to build

Domestic talent has nothing else to do except migrate. It migrates into a multinational, or anywhere out of the country. Worst of all, it migrates into a sense of despair. Domestic institutions cannot benefit from their talent. Nowhere is this truer than in education, for education is never at the forefront of public service. Education bureaucracies manage education, since private sector-run competitive education structures are not allowed. Local talent does not do any serious thinking since that is left to consultants from the advanced countries. Only outmoded and menial tasks at home are available for domestic talent. The result is that domestic talent has no role in domestic policymaking and education. With this arrangement, many a poor country wishes to vault into the IT age, which, I think, is unachievable.

The nutshell of my message is that, **unless we develop governance and education structures for the twenty first century, we will not progress.** And the development of these structures must involve own talent and reward it accordingly.

Unfinished Agendas

Speech delivered at the Annual General Meeting of the Industrial Association of Sri Lanka (IASL)
On July 12, 2000.

I had completed one year in Sri Lanka and had begun to establish some relationships in the country. In my year, several initiatives were discussed, but there was limited progress on any front.

Cubby Wijetunga, a former planter and a respected business professional, was the President of the IASL and asked me to address the AGM. I thought I would do a mid term report, and also talk not just about Sri Lanka but about my country and South Asia as well.

In almost all South Asian countries there are stories on how in the early days of independence, South Asia was ahead of the Far East. They also talk about Singapore, Korea and Malaysia learning from South Asia. Then there is talk of how certain policy initiatives were first begun in South Asia. Policymakers are always pointing to slow-often infinitesimally slow-progress in areas such as liberalization and privatization with a painful expression saying that the world is not giving them enough credit.

I began to reflect on this state of thinking and focused on 'Unfinished Agendas' and 'the pace of reform.' These are the themes of this talk.

Unfinished Agendas

Time has indeed flown for my family and myself in Sri Lanka. I am now, almost in the middle of my term. I thought it is perhaps time to try and summarize key lessons from my experience here in Sri Lanka and what better occasion to do this than in this august gathering of friends. Indeed many of you have become very good friends since you have welcomed me with open arms, invited me to your homes and into your hearts. You have allowed me to talk to you freely as a member of the South Asian community -- a citizen of Pakistan. I came to Sri Lanka to learn about another South Asian country and to understand why South Asia does not grow. I have not reached the end of my investigation, nor perhaps ever will. But, I will present to you my interim report today.

My preoccupation in life has been to try and understand the process of growth and why growth does not occur in these unfortunate countries. Considerable experience of these countries as well as reading and empirical investigation has now taught me that there are at least these four factors that are required as necessary conditions for generating growth in an economy.

1. An economy must be open. By open I mean, truly open: welcoming of foreign investment; welcoming of its own citizens to go and invest overseas, and economic and political freedom to do things internationally as well as domestically.
2. A country must have good legal and judicial systems. After all, economic transactions rely on the presence of a good legal and judicial system. One that is able and capable of developing fast and quality justice.
3. There must be a small government capable of providing good governance. Good governance too is tied in with strong and good legal and judicial systems. But government must be small so that it gives ample room to a private sector to operate in an open environment.
4. I am increasingly coming to believe that a country in this global environment must come to accept its smallness. Thus, it is very critical coming to terms with your smallness. What it means is that the small country must seek to build an infrastructure of governance of society that is capable of supporting its smallness in the global arena. This is something we must all try and understand. I cannot presume to explain it fully, but I will only leave the question in your mind.

Then, if we understand some of the factors that are so necessary to creating growth, why is growth not occurring? In my mind, the answer lies in the following three factors:

1. In many of the poor countries there is lip service paid to reform. Some progress is made, but there are large unfinished agendas.
2. These countries resist loosening their grip on the past. Does it mean preoccupied with to resist thinking ideas from the past. They remain preoccupied with dirigiste thinking, ideas from the past such as socialism and government-provided goods employment.
3. Power is too concentrate in these poor countries. Power seeks to retain arbitrariness and power seeks to retain prestige. There is a dependency in these countries. By this, I do not mean economic dependence. I mean, there is a dependence of ideas in these countries; there is a paucity of idea generation.

Understanding growth and why growth is not occurring also brought out the activist in me. I continue to grapple with process of change. I continue to try and understand why change does not occur in poor societies. My conclusion is that this is primarily because poor societies lack ideas that are domestically owned and generated.

My study of history shows that ideas always precede revolutions. Take the French Revolution. Take the American Revolution. You will see that ideas of great thinkers such as Voltaire, Jefferson, all came before the revolutions. These ideas were widely discussed, debated and understood among the communities where change occurred. These ideas led to the development of a consensus for change and then that consensus created change.

But as I mentioned, poor countries are idea-poor. They depend on external sources for ideas. Their populations do not debate and understand ideas. Their power structures do not encourage the discussion and debate of ideas. How then, can change occur?

Change also occurs in environments where education takes precedence, where education is of a quality that fosters research thinking and idea generation. You will notice that poor countries do not encourage that kind of an education.

While civil unrest, wars, and social instability hinder the performance of an economic unit, these difficulties themselves arise from the underlying cultural stance of society. Much research is now available to understand the causes of political unrest as well as poor governance in societies that remain poor. I will trivialize the findings of these studies, by grouping them under one heading, "The Remnants of the Feudal Culture."

In many of the poor countries, the organizations of society still remain feudal in character. What do I mean by that?

- Recall that the feudal society is primarily a monarchy, where resources are monopolized and distributed by the arbitrary authority of the monarchy.
- Decision-making was very hierarchical. Patronage and a patrimonial approach to governance as well as distribution was the order of the day. Certainly no delegation of authority and no decentralization. In fact, exactly the opposite -- centralization.
- Debate, learning, and questioning, were all stifled. Human capital was not valued and there was no professionalism.

With that caricature of a feudal society, if you examine the way poor democratic societies are organized, even though they may go through the ritual of casting a democratic vote every five years, you will notice that the governance structures are fairly feudal in character.

I often joke with my friends in Pakistan that institutions are distributed among friends of the government, much as a feudal fiefdom was given to Dukes in the days of old. You can feel it in the corridors of these fiefdoms---the head of an institution is a virtual king. Those below him are just as scared as they were in the days of old.

Decision-making is just as arbitrary. Professionalism is little respected. Maybe even less because in the old days the knights of yore were professionals. A feudal society likes to waste resources, does not have growth in mind, and does not have organization and the respect of the individual in mind.

It is not surprising that this society is not a reform-oriented society. It is not surprising that the society will not try and finish any agenda of reform even if you pressure them to reform. A feudal society thrives on the fact that it will not develop hard responsibility. It develops an attitude of pampering where the serfs feel that all they have to do is pander to the feudal monarch and receive the benefits. These serfs are incapable of working in a performance oriented modem society. In fact, serfs themselves will resist a change in that direction.

The feudal society, both the serfs and the monarch will resist reform. If an outside agent attempts to initiate a reform in that society, both agents will fix to slow down the agenda of reform.

I know in my country and in South Asia, that there are a number of stories on how Singapore, Korea and many other countries that are now way ahead of us, used to come to learn from us. Quite frankly, I am tired of these stories. Yes, South Asia claims it began a number of agendas. Yes, it was the first in beginning a number of agendas. But sad to say, no agenda is completed yet:

- Take the liberalization openness process - unfinished and hesitant;
- Take fiscal consolidation - still a long way off especially since the government cannot initiate governance reforms that will improve the efficiency of fiscal management;
- Labor laws remain such that they benefit the labor aristocracy and make the labor market inefficient to the detriment to growth. They cannot be amended to bring them into modem times because of the few unions who need to be pampered and no one considers a serious dialogue with them to be an important agenda item;
- Take the time for conducting business with the government. In most advanced countries, such time is considered a waste for businesses. Uncertainty continues to prevail in the minds of investors with regard to the bureaucratic decision-making. De-regulation remains uncompleted;
- Take the reduction of the government's role through privatization. Governments still engage in retail; Governments still engage in pensions; Governments still engage in production. We have long detailed agendas of privatization that stretch into years;
- Take the financial system. Financially strapped, public sector banks continue to exist in an age when dinosaurs are an anachronism. Rules and regulations are continuously framed when the financial system appears not to develop. Despite over-developed regulation, risk diversification instruments do not exist. Why? Because the regulator will not allow them!
- Take governance -- we still work with an outmoded system of governance that is totally inefficient and steeped in the past. Yet, there is no constituency of change. Why? Because this time, the government workers resist the change and that provides the government with an excuse to resist change.

You will see in these unfinished agendas the common theme of conservative patrimonialism that resists change through pampering of constituencies.

Yes, education and human capital receive a lot of lip service. But, of course, the poor students are to be blamed for they do not see that reform is in their interests. Yet, nobody chooses to educate them on the need for reform and why it is so important for their future. Instead, I might not be far wrong if I said that the administrators of education who do not want the change, gleefully point to the students' resistance to reform.

In my own country, I am a little impatient about reform. With reform for a new millennium, I would return to my own home. But those in power, who benefit form the current inefficient system, give me the refrain that; "Do not rush! We are doing what we can. The people will not accept it. We must do it slow,"
"You do not appreciate our conditions. We must go slow."

I do not accept this any more. Two generations have gone while these people have been slowing us down. Two generations pampering those who resist reform is far enough. Society as a whole has paid a huge cost in terms of resisting this reform. Perhaps it is time now that we understand that the majority is suffering because of the unfinished agendas while we are pampering the privileged.

There has to be a clear recognition that there is no premium to being the first to begin a race. In the coming Olympics, we will all eulogize those who finish first. It is the same for countries. Those that complete their reform agendas will be rewarded and eulogized.

My final point relates to smallness. In my time here, I've had a lot of chances to understand and do some thinking on the concept of smallness. John Naisbitt, the future-gazer, notes in his latest book "Global Paradox," (1994) how globalization will empower the individual to the small.

Yes, Ladies and Gentlemen, your day has arrived. The individual and the small will rate the global world. Telecommunication and the Internet have empowered the individual. And that means the nation state, specially the small nation state, has to come to terms with smallness. It has to accept the role of the government that is in keeping with its size. It must not try to build vast regulatory structures and large governments. It must not ape large welfare states of yesteryear. If a small country is truly to benefit from smallness, it must also accept the dictates of smallness. That means the size of its governance structure, of its regulatory structure, of the way it organizes itself, is in keeping with this unit.

To combine smallness and openness you will find that considerable regulation will be done by the global market, thereby eliminating the necessity of building large regulatory structures. Remember, governance and regulation costs. In the US it is estimated that regulation costs each citizen over $ 6000 each year. In poor countries, such calculations are not available. Yet they, upon, slipshod advice continue to build regulation blindly. They never look upon their economic size, which is smaller than a small US city and ask, can we afford this large regulation and government? By now many of you know that I love to ask such provocative questions. Perhaps, all of us should do the same.

UNDERSTANDING GROWTH

The importance of 'Ideas' and Debate

Chief Guest at the 43rct AGM of the
National Chamber of Commerce of Sri Lanka
November 2001

I found it a very useful device to draw upon economic research and convey it to audiences to enable them to think anew and acquaint them with fresh ideas from the literature. One theme that I played upon a lot was the new growth literature and the messages that emanate from it. I played upon the following themes

- The importance of fresh thinking and hence the importance of a 'vision' for a country;
- The need for innovation and innovativeness; and
- What are the sound institutions that might be necessary for growth in a small county like Sri Lanka.

I used a lot of ideas form economic and business history to motivate an understanding of these ideas. It made the talks interesting and the ideas easier to grasp. People were generally very appreciative of this approach.

The importance of 'Ideas' and Debate

Economists have learnt from history that it is the power of ideas that drives growth. Growth is not about improving capital or increasing savings, setting up garments factories or hotels. Any of these activities can give you a temporary filling but never give you long-term sustainable growth. And the key issue facing us today is long-term sustainable growth!

To quote Paul Romer, the Stanford economist, "Old growth theory says that we have to decide how to allocate scare resources among alternative uses. New growth theory says, 'Bullshit! We're in this world, it's got some objects, sure, but its got these ideas, too, and all that stuff about scarcity and price systems is just wrong'" (Kelly, 1996,2).

I often ask people for their ideas on what will make their country grow. Invariably, the answer is infrastructure development, energy or IT. Nothing wrong with any of these ideas but it will take years to build a dam or develop a pool of software professionals. And none of them are unusual or innovative and all will be using yesterday's technology.

For long-term sustainable growth, we need innovation, daring, boldness to do things differently, and flow and sharing of information. I do not mean space or nuclear research. Innovativeness can be mundane as Starbucks coffee, or as imaginative as eBay.

Let me give you an example to illustrate. On a spring night in 1983, a chemist employed by the Cetus Corporation of USA (a biotechnology company, which is now a conglomerate involved in a variety of businesses including software development & construction) had a wonderful insight. While working on a narrow problem, Kary Mullis stumbled onto the principles of the polymerize chain reaction (PCR). The story behind this discovery is exciting because the stakes involved turned out to be so high. Mullis won a Nobel Peace Prize.

After Mullis had done his first experiment and shown that his ideas would work, many scientists did not appreciate its significance. He first conceived the idea of PCR while driving his car. While driving he created something very valuable - a list of instructions which he could write down on paper which others could follow. Because it was codified and transmitted to others, this software was soon being used by thousands of biologists all over the world. Molecular biologists were given a powerful research tool. Doctors got new diagnostic tests and police investigators could begin to lift DNA 'fingerprints' from biological samples.

What Mullis did was write software that other people could use when they tried to create software that production workers would ultimately use.

Unfortunately poor countries do not like ideas. They do not discuss ideas, they do not debate and most of all they do not value 'idea givers'. 'Idea generators' are everywhere. All societies, including yours and mine, have them. Unfortunately we lose them. They migrate! Why? Because we do not value them!

In your society and mine we invite ministers and powers that die but never the 'idea men'. Let me give you some examples of the power of ideas. Take the notion of the role of government. For example, the introduction of telephony into Western Europe during the latter half of 1800s.

Alexander Graham Bell took his newly invented telephone to England in 1878, but found little interest in it. That same year British Postmaster General declared to Parliament, 'It is evident that the instrument is at present unsuitable for the purposes of public telegraphy, and I do not, therefore, propose to introduce it in that branch of the Postal Telegraph service', (Holcombe, 1906).

Conventional wisdom held that telephone service was a natural monopoly leading countries to prefer that one firm should provide telephone service, which in Europe meant a state• owned, rather than a regulated private, monopoly.

The high public demand for telephony soon became apparent, and state telegraph agencies saw a potential threat to their revenues. Laws were enacted to include telephone in order to protect the telegraph. Austria & Belgium nationalized its private providers after granting concessions and France took over all private exchanges by force in 1889.

In contrast, Scandinavian public policies were designed to promote telephony and Stockholm saw the greatest benefit from competition.

By 1914, Stockholm boasted 24 telephones per 100 people. This penetration rate in comparison to and average of 11.3 telephones per 100 people in the 12 largest US cities, 6.6 in Berlin, 3.5 in London and 3.2 in Paris (Wallsten,2000).

In truth, countries with most liberal policies towards private provision, e.g. Norway, Sweden & Denmark - had the highest telephone penetration in Europe. Private provision was not a completely new phenomenon during the period (late 1800 - early 1900). Moreover, Rural areas, which many people still believe would not be served under a competitive environment, had better service across Europe on average under private provision than under government monopoly (Wallsten,2001,2).

My next example is education. The role of government in many developing countries, like in Sri Lanka, is that of the 'do-gooder' or the notion of free (or cheap) provision of education. Does this really achieve its good intentions?

The upshot is that students get that quality education that they pay for, i.e., a low quality education free. It is not the kind of education that the market wants. The result is that there are long duration of unemployment after graduation as graduates search for a job. When the market is unable to provide a job, often the public sector has to step in. Unfortunately, this means that the public sector keeps recruiting poor quality human capital further reducing the quality of governance. With declining public sector productivity and increased employment, pressure mounts for wage restraint and tolerance of rent-seeking further eroding governance.

Rational families with resources react by sending their children overseas to obtain an education that is more in line with both global and domestic business needs. With this better quality schooling (say an Oxbridge degree), the student faces a low probability of facing unemployment, better lifetime earning prospects, as well as global prospects. Not only has the Harvard, Oxbridge alternative proved to be superior to domestic planners' paradigm, the social divide increases to an explosive level. The rich get richer. The central purpose of education-achieving social mobility-has been defeated by this unthinking "do gooder" approach. Opportunities close for the poor; expectations of returns for higher education are built up but never really met. This is but another example of how good intentions are not enough for good policy!

Last Friday at Ananda College, I listened to Sudarshan Seneviratne, an archeologist from the University of Peradeniya, on your education system. Since I enjoy ideas and need to learn, I seek out these occasions and go to listen to personalities like Ray Wijeywardena, Paikiasothy Saranamuttu and Radhika Coomeraswamy.

Business forums like yours must give these people room and opportunity to help you develop alternative and different viewpoints.

I like to leave you with that thought. Thank you.

To be a Singapore ... or ---Understanding Sri Lankan Growth

Speech prepared for the Annual General Meeting of the Ceylon Chamber of Commerce
September 14, 2001.

The COC asked me to be the chief guest at their annual meetings which was an honor. During my stay in Colombo, I had worked very closely with the COC members on a number of initiatives such as deregulation, education reform and a vision for Sri Lanka. I could safely say that many of them had become friends and had developed a mutual respect for each other's professionalism. I was therefore keen to say something meaningful to my friends, the Businessmen at the COC.

On my part, I was truly impressed by the professionalism and dedication of many of them. They had also started moving toward a responsible Chamber by taking an interest in national policy issues. Their "Way Forward" -a movement for economic and political reform-- and "Sri Lanka First" -a bold initiative to put peace and negotiation above other agendas were very impressive.

I thought that this was an occasion for me to truly come out and be bold and give them a good analysis ef what I thought was holding back the economy. It would also allow me to tie it up with the theme of 'a vision for Sri Lanka' and to develop the background for the reform that I was proposing.

At the time of presentation, I was on a holiday in Lahore, Pakistan. Unfortunately, I could not physically be present at the meeting to make the speech. I was due back a couple of days before the event but Colombo airport was attacked by the LTTE on July 24, disrupting flights and preventing me from coming back in time. My friend Deva Rodrigo, Deputy Chairman at the COC made the speech on my behalf and must have done a great job for many people congratulated me for it regarding it as "very bold."

This assessment of the speech to me shows that people appreciate analysis more than pronouncements and criticism. They also appear to understand more about the economy, than officials and professionals give them credit for.

To be a Singapore ... or ---Understanding Sri Lankan Growth

I consider it a great honor to be asked as chief guest at the Annual General meeting of the Ceylon Chamber of Commerce for at least 2 reasons. First, you offer me the privilege of addressing an august body of Sri Lankan businessmen and women, business managers and professionals—and I would like to point out that this country's class of business managers as well as corporate governance is among the finest among the countries at a similar level of development. Second, my two years of working with you have not only convinced me of your professionalism and business competence but also won me many friends-and I welcome this opportunity to talk to friends in Sri Lanka.

Two years ago, I came to Colombo as a Pakistani friend looking for answers to South Asia's continued backwardness. I have learnt a lot and in my weaker moments fancied that I have also contributed to the understanding of the economic situation in Sri Lanka. I am now embarked on the last leg of my journey, the third year of my tenure at the end of which I will leave Sri Lanka. Perhaps this is a good time to share with you what I have learnt and how I think I might have lent a helping hand. I do hope that you will agree with me that I have been a true and useful friend while I have been here.

I am writing this in Pakistan where I have been on a holiday, which has been extended due to the Colombo Airport incident-this is why I am unable to join you today!! Finding positive and meaningful thoughts in the immediate aftermath of such a tragedy is not going to be easy. Fortunately, my economist's tunnel vision keeps me focused on the economy. When I come to my country or travel in South Asia, I cannot help but feel a certain sense of sadness at the myriads of missed opportunities.

I have always been curious about what makes poor countries grow-I came to Sri Lanka as part of this learning process. I would therefore like to use this opportunity to give voice to some of what I have learnt during my stay in your country.

The vision process

I have already had the opportunity to talk to you previously about the importance of developing a vision for your country. Many poor countries suffer from a lack of long-term vision. These countries fall into the trap of planning and quick-fix policy prescriptions with an excessive reliance on government intervention. But a vision is more like a prescient dream of a desirable or beautiful state. It must challenge the notions that we have grown comfortable with. It must force us to think anew, "out of the box", out of the ordinary. It gives us an opportunity to question the very assumptions that we so easily take for granted. It gives hope for the future and helps to unleash people's creative juices.

History provides many examples of visionary leaders. Martin Luther King changed the course of American history with his "I have a dream" speech. Lee Kuan Yew transformed Singapore with his vision. Jack Welch's management of Disney, Michael Eisner's transformation of Disney, and Edison's development of the modem research lab are but a handful of examples of visionary leadership that transformed the world.

Las Vegas is the true pinnacle of audacity and over-consumption. It was dreamt of and built as a fantasyland—a commercial extravaganza catering to all the customers' needs. You can be sure that it upset the Victorian establishment of the time. But today it has become a hub of not just gambling but conventions, entertainment, sports, etc. And yet the process of change and re-design continues. Creating vision is therefore a dynamic process, evolving with the times.

The development of a vision is not a government led or government owned process. It involves a much wider participation of society. The process itself needs to take place in an open and transparent manner within a competitive and free market environment. It need not even necessarily be a single vision—the process should be creative and free, allowing a free flow and debate of ideas. Attempts at adopting a command style approach in order to forcibly bring about a consensus needs to be strongly resisted. If at all, the only guiding theme should be to seek economic progress.

A visionary group or organization with truly visionary leadership can be a powerful force for change. I must congratulate the Chambers, especially Chandra Jayaratne and Deva Rodrigo, for taking the initiative in organizing and hosting the first Vision 2020 Conference in March. I had the privilege of being part of this process. This vision process must be pushed forward to the point that it moves people into discussing, educating and owning a different vision of
their country.

As part of developing a vision, you need to have an idea about where you want the country to be in a time period of, say, 20 years. In the long run, Sri Lanka has to be an open economy with minimal and invisible government. In my view, the comparators for Sri Lanka are countries such as Mauritius, Singapore, Dubai, Costa Rica etc. In the face of advancing globalization, these countries a;:e now moving to economic management that is based on emulating the management of many big cities in the West, such as London, Chicago, and Atlanta. After all, economically speaking many of these cities are much larger than these countries. Some notable features of this new form of country management include:

- Simple tax systems based on sales tax regimes;
- Limited administrations seeking only to manage core functions like law and order and justice. This would require substantial privatization and a reduction of government;
- Competing with each other for business by providing infrastructure and a good home for corporate investment. For this, administrations must be invisible and unfelt; they do not waste time, effort and money to develop planning, indulge in proactive monetary policy, undertake large fiscal projects etc.; and
- Providing a stable and open macroeconomic environment so that country risk is minimized.

Countries that are run along these lines will attract investment and business. My favorite party question that I have tried in many countries, "where in your country would you invest if Bill Gates gave you a $ 100 million" has frequently evoked the answer that it would be difficult to find the space. With the kind of governance structure that I have outlined above, absorption of the Gates' gift could be very easy. With a large and interventionist government, this is not possible.

Catching up with Singapore!

Newspapers in Pakistan, as in Sri Lanka, are continuously asking for the country to become "the next Singapore". This is a huge challenge. We desperately need an analysis of Sri Lankan growth to see what the potential GDP is and where the constraints lie. The state of 22 affairs is not very appealing. Sri Lanka's per capita GDP in 1999 was US$ 820. If the economy grows at

5% per annum, Sri Lanka will only be able to reach US$ 1300 in 10 years, and will reach US$ 2000 only in 20 years. Is this good enough? I am afraid not! In per capita US$ terms in 1999, the comparator countries are way ahead of Sri Lanka. For instance, Malaysia stood at US$ 3400, Mauritius US$ 3600, Republic of Korea US$ 8500, and Singapore US$ 29600. Sri Lanka will need to have steady growth of 8 % per annum for 47 long years, to reach the level of today's Singapore economy!! Still, there are two factors to bear in mind. First, maintaining a growth rate of 8% is a demanding task for any economy, leave alone Sri Lanka's war-torn economy. Second, other countries also grow!

To my mind the main reason that growth has been constrained is the large transaction costs being faced by business. As shown by many transactions-cost economists, similar to a physical system, absence of friction increases the efficiency of the economic system. Thus, friction lessness in transactions is desired for increasing economic activity.

What are these transactions costs and where do they arise? I have identified 5 factors.

1. **Cumbersome legal structure and process:** Cumbersome legal procedures arise from an overbearing regulatory and legal structure. For example, in Sri Lanka, the banking system is governed by at least 50 laws while another 50 regulate labor. On the whole, about 1500 laws apply to financial transactions, some of which remain unchanged since the 19th Century. Legal structure has a key role to play in minimizing transactions costs. The SEC has estimated that about 15 to 20 laws could replace the 1500 laws that currently apply and create an integrated framework for a more dynamic financial market
2. **The tax and the customs system are complicated** imposing a burden on business. Outmoded stamp duties, cumbersome reporting requirements and bureaucratic delays are an obvious impediment to investment and growth.
3. **Inefficient public enterprises,** which often have monopolistic positions, contribute to the large transactions costs. These inefficiencies need to be looked into. The need for public enterprise reform is crucial.
4. **Overbearing Regulation:** Market development is prohibited by an overbearing regulatory approach. For example, the stock market effectively has 2 regulators who are both reinforcing what seems like a cartel with excessive costs. Sri Lanka already has a large and onerous regulatory structure. Any attempt for institutional and regulatory strengthening, in my view, should mean nothing else but strong deregulation. Any attempt to set up regulators, should see that regulation is not seen as merely setting up another government department. We must ask who the regulator is and does he have the skills and the autonomy to do his job.

As an aside, I would lay before you some propositions of the burden of regulation on this economy. I hope that some researchers in universities, think-tanks or even the chambers will examine these in detail and quantify the losses. These are:

- The stock market has suffered enormously because of over-regulation needs to be seriously considered;

- The quality of education remains poor, access to education limited, as well as the final cost to the poor student high because of the prohibition of private sector participation. It is the poor who suffer from this prohibition. I take this opportunity to congratulate the Chamber's Human Resource and Education Sub-committee, under Faizal Salieh's leadership, for initiating a dialogue with academia to address some of the human resource constraints. Ventures such as these are the first step towards setting in motion a rigorous and radical reform process;

- Many sectors, such as the ocean and the air, are totally closed for business; and
- Entry into brokerage is prohibited in virtually all major markets, such as stock, foreign exchange, tea and government debt.

This is only a short list of the regulatory burdens that the economy bears. However, I would strongly argue my proposition, "**if this country is to grow, the governance issue has to be interpreted as deregulation and market development."**

I would be remiss if I did not congratulate, Minister Professor G.L.Pieris, and business leaders such as Cubby Wijetunga and Bandula Perera for setting up a deregulation committee and making me a member of it. This is a long-term task, which I hope the Chamber of Commerce will strongly support. The Secretary to the Treasury too has been pushing hard with his sectoral core groups with a similar purpose in mind. There is therefore some ground for hope but bear in mind that this is a slow and deliberate process requiring your support and push.

5. **Poor governance:** While repeating my proposition that "**if this country is to grow, the governance issue has to be interpreted as deregulation and market development,"** there are 2 aspects of the governance problem that I find are extremely important yet seldom highlighted. I would like to develop these a little if I may. These are:
    a. **HRM in government:** The inefficiency of the bureaucracy is another source of large transactions costs. This arises from a number of sources. But the most important source is a poor human resource management system that keeps an aging, unmotivated work force in a position of power over the private sector. This has now led to a severe shortage of skills and human capital in almost all organizations. These problems need to be addressed directly through a reengineering of the management process including human resource management while also engaging in a large amount of training and infusion of fresh human capital. However, we must contend with the fact that the highly centralized and protected education system is producing skills that are not in keeping with market requirements as has been voiced by the Chamber on several occasions.
    b. **Outmoded management and decision-making systems:** Decision-making in all organizations is very centralized, and management systems are based on systems that monitor inputs rather than outputs. Such systems lead to long waiting times and lack of boldness and leadership. Such management breaks the innovative spirit of middle management eventually leading to organizational collapse. Management is reduced to a small group constantly engaged in fire fighting. Such centralization has also eroded transparent, open and informed decision-making processes. This is not a recipe for good governance or growth.

How do we deal with these twin problems of modernizing management and HRM in government? Large-scale civil service reform has been tried and not found any success in many countries. Leaming from this, we have now begun a program of modernization of government departments and organizations one at a time. We must congratulate Governor A. S. Jayawardene, for taking a lead in this regard and beginning a strong program of modernization at the Central Bank. A strong implementation of this program will tell us a lot on how to conduct such reform and use that as a paradigm as well as a beacon in other parts of the government. Already there is a possibility that some other departments might follow CBSL's lead. A strong and modernized CBSL will truly be your partner in growth and development.

Conclusion

Ultimately, we have to accelerate growth in this country and to do so we must focus the reform process on ways to promote investment. Always bear in mind that country risk analysts measure and price transactions costs and weaknesses in public sector management.

Finally, the war! The war is obviously an impediment to economic development. I was at the Musharaf-Vajpayee summit in Agra and could not help wondering at the essence of South Asian nationalism that has kept most of the region at war for the last fifty years. But that is another story.

All of us desire peace and should push for it. But should we make the economy a hostage to the war? The preoccupation with war has diverted our attention from the structural problems that are impeding growth. It also sets in motion a short-term approach to policy. I urge you to break that mindset and think of how we can get the economy moving bearing in mind that prosperity may illuminate the path to peace.

Once again allow me to extend my apologies to you for not personally being there at your AGM. No one is sadder than me for I have truly missed being among my friends. I do hope that you will regard this contribution as worthy of such a significant event as your annual general meeting. And I do hope that you find my efforts in your country to have been worthwhile! I conclude by wishing you all the very best for your upcoming year. My fervent hope is that the Chambers will serve as a potent force for change in this country.

Thank you for your friendship and hospitality.

Dreams (Nightmares) of the Poor

At the Annual meeting of the
Toastmasters Club of Sri Lanka
January 2001

Another one of those clubs that professionals and businessmen in Colombo operate very well!

I had been mulling over the governance problem and making little headway with it. Meanwhile my uncle who had a reformer's zeal had died and I began to reflect on the life of my father and his brothers in Pakistan and how political turmoil as well as lack of governance reform had virtually robbed them of a dream.

I used some of this material in talks at the IPS, SLEA and other forums.

Dreams (Nightmares) of the Poor

The last of my uncles died yesterday! Four brothers, of whom one was my father, played important roles in various functions of the Pakistani public sector. But, all of them died sad and disillusioned. This is an emotional moment for me, so bear with me as I reflect on his death and attempt to understand why his last days were not peaceful.

Mourning his death, I was reminded of a dream that my father and his brothers shared of an independent and prosperous Pakistan. They regarded their education to be a privilege and felt almost duty-bound to serve the people. They believed in democracy, freedom, economic development and modernization and yet retained their cultural identities and roots. I grew up in their shadow. My childhood is full of animated conversations at family gatherings on economic policy, modernization and development. Little wonder then, that I live and breathe these subjects - only that I do so through the IMF.

In memory of Chacha Nisar - that is what I called him - I would like to talk of the dreams of the 4 brothers and how these dreams got shattered. Why did this happen? Why did he die a sad and unfulfilled life? To me, understanding what shattered the dream of my uncle and that of millions of my countrymen, is critical to understanding the process of development.

The brothers, along with the 50 million Pakistanis who got independence in 1947, dreamt of catching up with Europe and the US. They worked, and worked hard, to increase agricultural productivity, develop administration and planning, build barrages and dams, reclaim deserts, build schools and colleges, construct companies, railroads, and gas distribution lines.

Sadly, their idealism did not last. They died disillusioned, sad and unrecognized. My father's last letter to me was a sad and heartbroken admission of failure in achieving those ideals that he so carefully inculcated in me. He implored me to give them up and forget about returning home ever. This is now a common advice from fathers in Pakistan to their children.

Like Martin Luther King, Pakistanis too dreamt of a better world. They dreamt of progress and modernization. They wanted to build, make important discoveries, explore space, and win Olympic medals. They desired to stand as equals in the comity of men.

But nowadays many would say, "We had a dream. 50 years was enough to realize that dream. Unfortunately, we turned dreams into nightmares. Disillusionment is leading to a move towards religion and other crazy ideas to see if an alternative dream can be found."

Dreams were turned into nightmares not only in my country, but also in several poor countries around the world. While we are talking of poverty alleviation, we should bear this in mind.

Coming from a poor country, I have reflected long and hard on our failures and would like to share some thoughts with you. I invite all of you today, to help me deepen my understanding of these issues.
As you might expect, the cause of these shattered dreams lay in the ideals of the founding generation of my country. Two important factors that shaped their thinking also sowed the seeds of the later chaos. These were:

1. They were born in a feudal society and subconsciously carried their feudal values with them;

2. They acquired a western education in the post depression era when the suspicion of the market was at its height. While Marxism and Keynesianism were fashionable, big government, heavy-handed regulatory structures, and large and obtrusive government organizations, were being created every day. The depression created a suspicion of the market in the West, which they have overcome. But, we are likely to carry it into the next century.

The result was that our founding fathers believed in large and benevolent government and simply disliked the market. They also strengthened the government through strong controls that closed the economy off from the rest of the world. They succumbed to the fad of the day and followed socialist and Marxist ideals. Thus, they believed in mandated and government owned universities and schooling systems which delivered nationalistic education and not universally needed skills. This education system produced a poor work• ethic, politicized student bodies, as well as fundamentalism, sectarianism and all kinds of forces of fragmentation. But, it was still hard to convince them that the answer was less government in education and increased private education.

One part of the answer lies in the fact that we are trying to build a modem government on a foundation of a **feudal ethic**, which is reinforced by a poor quality nationalistic education system that prefers indoctrination to skill development. In many of the poor countries, the organizations of society still remain feudal in character.

What do I mean by that? Recall that the feudal society is primarily a monarchy, where resources are monopolized and distributed by the arbitrary authority of the monarchy. Decision-making was very hierarchical. Patronage and a patrimonial approach to governance as well as distribution, was the order of the day. Certainly, there was neither delegation of authority nor decentralization. In fact, exactly the opposite - centralization. Debate, learning, questioning were all stifled. Human capital was not valued and there was no professionalism.

Feudal management likes arbitrariness, lack of delegation, centralization of decision-making, and absence of clear delineation of objectives or authority. Institutions are personality dependent and are not rooted in excellence, clarity of rules and transparency. In short, institutions that empower the individual and incentivize the entrepreneurship and knowledge are never created.

Such a society is not a reform-oriented society. A feudal society thrives on the fact that it will not develop hard responsibility. It develops an attitude of pampering where the serfs feel that all they have to do is pander to the feudal monarch and receive the benefits. These serfs are incapable of working in a performance oriented modem society. In fact, serfs themselves will resist a change in that direction.

Even the Press is useless in a feudal society, for it knows only how to pander to the feudal powers. Independent and investigative views, either do not exist or are viewed only as a distraction. Feudal societies survive only where talent cannot survive and when they can be shut out from the rest of the world.

Despite their educational achievements, the first generation of government administrators in poor countries did not accept professionalism in government, and certainly not market-based rewards for professionals. In the feudal ethic, the professional is a mere servant and beholden to the monarch for gifts. In the new post-depression British tradition of Orwell and

Le Carre, public service was like accepting the cloth. The belief was that it needed no other reward than the opportunity to serve. The result was that professionalism in poor countries was respected less than even in the feudal days. At least in the old days, knights were professionals. To see this, consider the following facts:

- Public sector employment in poor countries has expanded rapidly in the last 50 years. The expansion has not been according to skill requirements of a growing economy but merely to provide employment regardless of qualifications for the incumbent government's political agenda.
- To describe **public sector human resource management** as archaic is to compliment it. It has no incentives for attracting, managing or retaining talent. Haque and Sahay (1996) have shown that:

    1. Public wages· have declined in real terms over time in many developing countries;
    2. Declines in real wages have been larger in poor countries;
    3. There is considerable wage compression. Wages at upper levels of public administration have been reduced so that at those levels they are considerably less than the private sector. Those at the lower levels are higher than the private sector. Thus, at the bottom of the public sector wage scales, we have created a labor aristocracy;
    4. The decline in wages has been accompanied by an increase in perks and other non-wage benefits that are not only harder to monitor, but provided at a higher cost than the value or benefit that the recipient derives;
    5. The result is that corruption and maladministration have increased and talent has left the public sector as well as the country (Haque and Aziz 1999); and
    6. Civil services in poor countries are typically hierarchical, unified, closed and non-meritocratic structures. They are very resistant to reform.

Handing over arbitrary feudal power to poorly qualified and poorly motivated people as well as giving them the post-depression mandate to arbitrarily expand the limits of their authority and close off their economies, has been the cocktail for disaster in these poor countries. I often joke with my friends in Pakistan that institutions are distributed among friends of the government, much as a feudal fiefdom was given to Dukes in the days of old. You can feel it in the corridors of these fiefdoms - the head of an institution is a virtual king. Those below him are just as scared as they were in the days of old. Moreover, the organization has no clearly defined objective or system of accountability.

I do not, however wish to leave you with the impression that the fault was entirely that of my parent's generation. Yes they accepted the fads of the day - feudalism and big government. But their blame has to be shared by those who took upon themselves the mantle of offering advice on development. Unfortunately, such advice was neither consistent nor the best.

Moises Nairn (1999), editor of Foreign Policy, has noted that fads of development policy have influenced policymaking in poor countries. In the fifties and sixties, development policy created planning, government led production, large public sector marketing boards, and development financial institutions. Government led growth was paramount. Financial markets were held hostage while national monies were abused. In the eighties and nineties, we were busy dismantling this "government is superior" approach. We moved from a closed economy, import-substitution framework to an export-led open-economy approach. Now we have moved to consider competitiveness and to worry about openness. We have been told that to preserve the environment, no power projects should be developed even though power was sorely needed. The poor country-educated technocrats are only recipients and not proactive participants in the making of this policy advice.

The donor-financed consultant had replaced domestic talent. All ideas came from the consultant and domestic human capital is now fully disenfranchised. There was no place for people like my uncle who retreated into a disgruntly early retirement at the ripe old age of 50. His cleverer colleagues had understood the incentives: *tum to corruption or leave.*

This statement - tum to corruption or leave - may sound hyperbolic, but it does seem to represent an important choice in poor countries. If you do not believe it, look at the excellent performance of the brain drain from these countries and compare it to the pervasion of corruption in the public sectors. Pakistani talent has risen to lofty heights in American corporations while Transparency International is citing domestic public institutions for corruption. Pakistani talent is abundant on Wall Street, yet the consultant defines reform at home which the local rent-seeking administration does not, in any case, wish to implement.

The new managers of economic policy and those who financed them, and their consultants, did not seek to build the public sector on modem lines through the empowerment of human capital. They still do not wish to do so.

Meanwhile, much research has shown us that the path to development and growth is through education, and the development of sound institutions that provide a framework for the functioning of the market. Private sector produces and market distributes and provides signals for production to take place. The government can only provide a secure environment and a legal infrastructure that will facilitate speedy market transactions.

We can only provide this good governance infrastructure through the nurturing of domestic talent through quality education designed for global excellence. But this education system must be complemented with a modem human resource management in the government that incentivizes the best human capital to perform for the public good. I would even argue that, to me the nationality of the public servant who manages our resources is now totally irrelevant. If we can get Alan Greenspan to be the Governor of the State Bank of Pakistan, or Jack Welch of GE to manage the major Pakistani Electric Utility, or John Reed of Citibank to run our major Bank should we not do so? Learn from the US! They do allow the inflow of talent from all over the world to every level of their organizations.

So dear uncle, I think I know the answer. It is really quite simple. The basic principles are as follows:

1. Build an education system that conforms to the need of globalization. Imbue it with the spirit of excellence and free it from the yoke of nationalism;

2. Change your public sector human resource management to attract and accommodate talent from everywhere. We know that HRM policy is not working if the country loses talent, instead of attracting it!

3. Maintain an open economy so that the government is kept in check and the country continues to compete with global standards and, if necessary, use global talent;

4. Lastly, it also means that the international community must foster the building of sound institutions and organizations run by quality human capital and with modem management. We must now be impatient with feudal management.

Is there hope for the poor? My friend Surjit Bhalla in Yesterday's Business Standard in India thinks so. He says: "the future for Indian citizens is bright because the world now conforms to John Lennon's visionary dream "Imagine there is no country". Globalization means freedom from the rapaciousness of national governments and from national private sectors. And globalization means the irrelevance of government which we have come to know and hate."

So, Chacha Nisar, rest in peace! Globalization is on our side and will help us achieve your dream. In one sense it already has achieved your dream. It has already given talented Pakistanis like Atiq Raza, my childhood buddy, the opportunity to create not one but two billion dollar empires in California - Nexgen and now Raza Foundries. Global success has been provided to him through globalization. Perhaps the next generation of "Atiqs" will do it in Pakistan.

We know that the feudal babus in government will resist globalization to the last but we also know that they are fighting a losing battle! Unfortunately, they still retain the power to damage another generation or two.

ROLE OF GOVERNMENT, REGULATION AND INVESTMENT SPACE

The Role of Government in Economic Development

South Asia remains so mired in thinking 'big government.' I have used this piece extensively in Pakistan as well as Sri Lanka to excite a discussion on the subject.

In December 1999, I first delivered this at a seminar at the Center for Banking Studies, the training center for the CBSL. To my surprise, this was not easily digestible and there was a fair amount of interest in it.

Mr. Sirisena of the Central Bank asked for a copy to send to be printed in newspapers. Both *The Sunday Times* and *The Island* carried it. Thereafter a lot of people commented on this piece teasing me on my 'Chicago viewpoint.'

The Role of Government in Economic Development

Origins of state activism in the Third World

Colonial administrations in the Third world cultivated the image of the state as the ultimate benefactor of the people as a means of facilitating their own survival. Favors of the state became an important means of winning political support and loyalty. An ally could be rewarded and an enemy could be neutralized by the offer of a title, land, or a government contract. Once the notion of the state as benefactor had taken root, the local population became dependent on the state, accepting the role of the latter as an agency for allocating the colony's economic resources. The colonial state often looked suspiciously on any private activity that developed outside official control because such independent initiative could represent a challenge to state authority, not only as an example of independent initiative, but also because it might result in the accumulation of capital, on which the state sought to maintain a monopoly to facilitate the colonial power's control over the indigenous population.

As the role of the colonial state expanded, local population increasingly lost their ability to take initiative and came to rely on the state for even the most minor of matters. They tended to develop the attitude that the state was the ultimate arbiter of their economic fate. The Deputy Commissioner[1] or some similar minor government functionary, therefore, became increasingly important in controlling their lives, and they turned to him more and more for their needs. This dependence stifled initiative and innovation. Community self-help, individual pride of achievement, and cooperative endeavors, all severely atrophied.

As the notion of the state as a benevolent deity became entrenched, any concept of a social contract between the state and its citizens, which forms the intellectual basis of democratic institutions, tended to be discarded at the popular level. The state could be kind enough to bestow some favors on individuals, but there could be no expectations from the state. It would have been subversive in this environment to suggest that the reason for having a government at all might be to provide certain public goods and services for the people, such as security, a legal system, economic infrastructure, and a healthy environment. Thus the old Kennedy saying was fully in effect; "ask not what your country can do for you but what you can do for your country". Ironically, in spite of the origin of this quote, the average American is always watchful of where his tax dollars are going and frequently raises the question with his leaders and representatives. On the other hand, people in post-colonial societies rarely hold their governments accountable for the economic implications of state actions.

This lack of government accountability has also characterized the views of intellectuals and economists in these countries. Steeped in the English Labor Party philosophies of the mid twentieth century (in South Asia and Anglophone Africa), in the French technocratic tradition (Francophone Africa), or in indigenous Structuralism (Latin America), these individuals have been quick to make the assumption that the state can and should have a large role in the economy. Despite historical evidence to the contrary, they have assumed that the state plays the role of a benevolent deity, above the fray of everyday economic and political life. In this role, the government is above reproach. Such intellectuals seldom stop to examine whether government actions have indeed succeeded in practice in influencing the allocation of the nation's resources toward socially desirable ends.

[1]Colonial India was divided into districts for administrative purposes, and the deputy commissioner was the government-appointed administrator of the district.

Most development economists, both foreign and indigenous, share this intellectual tradition. In technical jargon, they perceive the existence of a "planner's problem" to be solved in determining how society's scarce resources are to be allocated, and assign to the state the role of using its policy tools to ensure that the economy produces the right allocation. They see the government alone as capable of achieving the desired progressive objectives of redistributing wealth and income, promoting basic industry, increasing the socialization of production through direct public sector participation in the production of goods and services, and so on. A number of social welfare arguments are used to support their case. The poor illiterate masses are perceived as incapable of helping themselves; therefore the government must provide for them. As their benefactor, it needs to feed, clothe, educate, and look after the health of the poor. The rich, on the other hand, are perceived as too rich and overly fond of conspicuous consumption. Thus, equity considerations require the government to redistribute income. The private sector in developing countries is often viewed as short•sighted and incompetent or monopolistic. As such, it has little, if anything, to contribute to economic development. The aims of such thinkers are laudable, and these economists are undoubtedly genuinely motivated by their concerns for the poor. However, by failing to hold the public sector to account, they may be acquiescing in a situation in which resources channeled through the government flow from the poor to the rich, while shrinking the size of the pie for all concerned.

The contemporary economic role of the state in developing economies

As a result of such views, the state has come to play a very significant microeconomic role in much of the Third World. A large fraction of the typical developing country's resources is channeled directly through the government. In part this takes the form of public provision of certain services, such as education and health, a phenomenon which is also common in industrial countries. Additionally, however, the ownership of many factors of production (i.e., land, natural resources, and capital) has been retained by the state, and consequently public sector enterprises account for a large share of GDP. These include not only the traditional natural monopolies such as utilities, but also extractive industries, "heavy" industries such as steel that are perceived as "basic," the transportation and communications industries, and many types of manufacturing activities.

Even in activities that are left in the private sphere, however, the state tends to play a dominant role. Tariffs, quotas, subsidies, export taxes, and marketing boards regulate international commerce, and domestic economic activity is often subjected to a long list of restrictions. These range from mild ones such as zoning restrictions, to price controls, to license and fee requirements, to the outright prohibition of many activities.

In all these ways, the state has come to play a prominent microeconomic role in developing countries. The daily lives of people are affected in a very important and significant manner by the government. Much of social and economic activity is in one way or another affected by government policy or intervention: the education that children receive, the way people drive, the layout of communities, the quality of water and electricity supply, as well as the price and availability of many goods, are all affected by the government. The government, thus, affects the environment in which the business of daily living is conducted in a pervasive way. Because of this large and important role of the state, the manner and the efficiency with which the government conducts its business directly affects the productivity of the rest of society.

The record of public sector performance

In this setting, the questions that need to be addressed are whether the government has delivered on all that has been asked of it in developing economies, and whether it can conceivably do so, even in principle. The answer, unfortunately, would have to be a resounding "no" on both counts.

As to the past experience with government performance, instances of massive public sector failure abound in the Third World. Consider, as one of these, the fate of the government• regulated commercial banking system all over the developing world. Through controlled interest rates, and subsidized, directed credit, banks have been made into institutions for delivering gifts to the rich, and cheap loans to the well-connected, often at negative real interest rates, which are frequently not repaid. These gifts to the rich are financed by low interest rates paid on the deposits of the poor, who do not have the option of holding their wealth abroad and earning international rates of return, as well as by outright subsidies financed by various forms of regressive domestic taxation. In many countries, the banking system, which the private sector was managing rather efficiently, was nationalized. Over the years, the nationalized banks in several countries have virtually been driven to bankruptcy through the mechanisms described above.

Education provides another notable example of public sector failure. For example, in Pakistan, for over thirty years, Ln keeping with the views of many development thinkers, the government was the sole provider of education. Despite many plans developed by the government and their resident economists *I* scholars, and despite wasting considerable public funds on an overgrown education bureaucracy, neither the quality nor the extent of education improved. In the late seventies, the private sector was allowed to set up schools and an almost instantaneous and rapid growth in the number of schools occurred in almost all urban centers thereafter. Although there is a large variation in quality among these new schools, it is fair to say that on balance the new private schools have served to improve both the availability and quality of education in the country.

Regarding the question of whether the government *could,* even in principle, do everything that is asked of it, the answer again has to be no, for two reasons. First, and most familiarly, the information required to fulfill all the functions of the market is simply not available to the government. Economic planning has simply not proven to be feasible at the microeconomic level in the Third World, any more than it did in the countries of the former Eastern Bloc. The existence of a plan, both for the short term and the longer term, supposes that the government and its experts, resident or otherwise, know what needs to be done and how it should be done better than the rest of society. They know the goods that need to be produced, how they should be produced and the prices at which they should be distributed, better than the consumers who demand, and the producers who produce those goods. Because of this superior knowledge, the government sets up licensing schemes, provides subsidies and other incentives and allocates preferential credit. These assumptions have, however, been repeatedly falsified by unsuccessful government planning efforts.

But perhaps more importantly, the fundamental problem is that the existence of greed is not restricted to individuals in the private sector. Self-interest is found among public servants as well, and an over-ambitious microeconomic role for government simply creates too much scope for private individuals to feed from the public trough by appealing to the self-interest of those in public service.

When the government limits the scope of an economic activity by administrative fiat, for example, the restricted few who are permitted to engage in the activity receive economic rents, and the acquisition of such rents becomes a prize for which private individuals will compete by doling out favors to those in a position to allocate the rents. Similarly, taxes and subsidies will inevitably attract the attention of those who will ultimately pay the taxes or receive the subsidies. The expenditure of private resources in the attempt to influence such public decisions - i.e., rent-seeking activity - is not only directly wasteful of the private resources devoted to the purpose, but if successful, will undermine the very purposes for which the restrictions, taxes, or subsidies were created in the first place by altering the criteria on which allocation decisions are made. Perhaps more importantly, when such rent-seeking activity is *perceived* by the public to be successful, the legitimacy of the government is undermined. This will impair its effectiveness in other areas.

Rent-seekers, who rely on government licensing and the protection it offers, on subsidies, and on the availability of low-cost credit that is expected to be converted into a grant, are frequently not interested in operating a business enterprise over the long haul. Hence, industries that emerge as a result of such activities are often found to be "sick" quite soon. High rates of taxation and excessive import barriers result in considerable resources spent by enterprises on either bribery or evasion, both of which are wasteful activities.

Distortions such as these, that haye been induced by government policy, have served to create monopolies and preserve the wealth and privileges of the elite. An important adverse side effect has been that this policy has helped stifle financial markets in developing countries. An active stock market and actively traded stocks serve to exercise some discipline over the management of a business. Moreover, a well-functioning stock market draws the savings of the small saver into the most productive areas of the economy, thus enhancing economic growth. In many developing countries, because resources are transferred to the wealthy by means of government patronage, there is no need for businesses to approach financial markets for additional resources. Instead, they can easily use the influence their local power• broker has over a publicly owned bank or financial institution, or with a private bank forced by interest rate controls, to allocate credit administratively. Consequently, businesses remain locked under the control of families. The stock market value of the company seldom reflects its true value, nor do the shareholders get their proper share. The result is that neither is the market able to exert its discipline on management, nor does the small saver invests fully in the development of business and industry.

What applies to administrative restrictions, taxes, and subsidies, may be true *a fortiori* of direct public sector production and non-government public organizations (NGOs). Public enterprises are not subject to the discipline of the marketplace, as they are often granted tariff protection, subsidies, and cheap credit. Thus managers and employees of public enterprises often themselves receive rents, in the form of wages, salaries, and benefits out of all proportion to what they could earn elsewhere. In fact, running a public enterprise, or working for one, becomes a plum to be awarded to the favored few.

A recent approach to the problems of the public sector in developing countries has been to create autonomous public sector agencies intended to work towards specific economic objectives. These non-government organizations, NGOs, however, often reflect the standard government response to a perceived problem - to make the budgetary allocations, create a new agency, and appoint some government favorite as a chairman. An organization is born, the chairman and his favorites have perks and money to spend and no responsibilities or accountability. Years go by, and little is achieved except that the budgetary allocations for the new organization are increased each year. However, despite the increase in expenditures, the organization does not increase its productivity. In fact, in many cases, apart from broad guidelines laid out in its charter, no attempt is ever made to even define the productivity of such an organization.

The deficiencies of public sector performance are not simply a symptom of endemic inefficiency or corruption in the Third World. Indeed, the private sector has repeatedly shown itself to be capable of substantial innovation and efficiency throughout the developing world. Often choked by excessive government regulation, however, it is forced to operate outside the pale of government influence in the informal sector, which in many countries is now regarded as the engine of growth. Where regulation has been eased, the private sector has often responded fairly strongly.

The private sector is not infallible either, of course. Private companies can and will fail frequently. The difference is that when they do, their failure is often socially useful in a world with imperfect information, and the resulting losses are borne by those who have chosen to venture their capital. In the case of a government-run organization, the public does not discover the extent of the loss that is being incurred, or the fact that their taxes are paying for it, until it is too late. Thus the losses persist for a far longer period than they would if the money were coming out of the 9,\\-'ner's pocket. Consequently, unless government largesse is involved, only profitable and efficient private firms survive, contributing to the economy and to employment, while an inefficient government firm that continues to drain the budget is extremely hard to kill.

Rethinking the role of the government.

The thrust of the argument above, is that an over-ambitious microeconomic role for the government in developing countries has resulted in enormous inefficiencies and resource wastage in the countries that can least afford it. Moreover, this cannot be easily remedied through administrative tinkering or political change, because the problems are inherent in the way the government's economic role has been defined in these countries. What is needed is a fundamental, radical rethinking of the role of government in these countries, with a view to defining that role so as to maximize the efficiency of resource use in the economy as a whole.

In defining any role for the government, we must begin with an assessment of the current capabilities and quality of the government. At present, the government in many developing countries is truly in a state of crisis. Apart from the problems described above, the state is now in a position that it cannot even deliver on one of its most important and most fundamental functions, that of protecting life and property. This is a function of the government that has been understood since times immemorial, even in old tribal and feudal societies. Even in the provision of basic public goods such as sanitation, clean water, and other basic necessities, the government has not been able to keep up the earlier minimal standards that were set in colonial days. The growing ineptitude of governments has been combined with rapidly increasing levels of corruption and nepotism. The result is that the government is incapable of functioning according to any norm that we might consider desirable from the social standpoint. Before asking the government to set any policy goals or take on any new task, then, we must bear in mind this near-paralysis of government as currently structured.

The objective of a rethinking of the role of the state should be to achieve efficient government, so as to promote aggregate efficiency. We believe that a simple principle should guide this:

A government is likely to be *efficient* in its own operations, as well as to promote aggregate efficiency, if it seeks to achieve a small number of well-defined social objectives in the most direct, clear and simple manner. Translating this principle into operational terms, the goals of the government must be small in number, and must be clear and pre-announced. Transparent mechanisms must be put in place for achieving these objectives. For its own legitimacy and credibility, the government must be perceived as striving to achieve the announced objectives in ways that are widely understood by the public.

From what has been said already, it is clear that the government of a typical developing economy does not abide by the above principle. Regarding objectives, the government appears to have far too many objectives, most of which are often not well defined. Government announcements are full of good intentions, such as generating growth and increasing welfare. Such intentions are perhaps deliberately kept vague to allow the government maximum discretion in its operations. The result, as indicated above, is that the government ends up being a banker, producer of goods, controller of prices, and provider of all manner of services including, food, housing, medicine, health and clothing. In short, the government injects itself into almost everything.

Because of this large role, the government has frequently been rendered incapable of delivering on any of its myriad of objectives. There are many stories of bureaucratic meanderings without any obvious purpose or of individuals unable to get any action despite being shuffled from department to department in Kafkaesque fashion. Seldom can clear rulings be obtained on any issue, nor does the government base its running on clear, well• defined, pre-announced and simple rules. Often the rules of the game seem to be designed for the preservation of bureaucratic discretion.

Administratively also, there does not appear to be any effort on the part of the government to limit the number of its departments or to make sure that they are very distinct in their functions. In fact, there are often too many government departments which duplicate each other's efforts. Furthermore, within each department, far too many layers of bureaucracy exist. In Pakistan and India, for example, the following layers exist: the federal minister, minister of state, secretary general, secretary, additional secretary, joint secretary, deputy secretary, and section officer. It is not surprising that these eight layers of decision-making, serve only to isolate the senior managers in these countries - the ministers and the secretaries - from the populace that they are supposed to serve.

To remedy all this, the starting point should be a clear definition of the government's limited objectives, in keeping with the principle outlined above. In our opinion, the government should be confined to the following five activities:

a. *The provision of social contract goods and services.*
The primary duty of the government is to preserve the social contract by providing all its citizens, the wherewithal to live their lives to the fullest of their abilities. This would involve at the minimum, the protection of life and property. Once this is achieved, measures to improve the quality of life of all citizens could be adopted. However, the sequencing is important.

b. *Defining the economic rules of the game.*

Citizens tend to engage in economic transactions via contractual arrangements. These contracts and transactions must be conducted in a certain mutually respected legal framework if anarchy is to be avoided. In other words, as in all other human endeavors, an umpire or outside referee is needed. The government must be that referee. It must provide the framework within which citizens can transact peacefully. This task requires developing a body of laws and minimal economic regulations which are continuously updated in light of developments, to facilitate private contracting and transactions.

The private sector does not operate in a vacuum. The rules under which the private sector can and should operate need to be clearly and simply specified and also evenly and fairly enforced. The principal role of the government should be to specify and constantly review such rules with the goal of promoting efficiency in the operations of the private sector. In designing such regulation, the government should not tell the private sector how to conduct its business and what activities to engage in. Instead, it should focus on developing a legal framework that ensures accountability of management, both private and public. This would involve proper maintenance of records, public disclosure, and enforceability of contracts at all levels.

c. *Enforcing economic regulation.*

Laws and regulations would be entirely useless, and the credibility of the government would be questioned, if they are not backed by an adequate enforcement system. Hence a judicial system that is capable of dispensing speedy justice is absolutely essential. Unless such a judicial system is in place, individuals will find themselves, as they often do in many developing countries, appealing to some informal system such as thugs and protection rackets for the enforcement of contracts. This is wasteful and inefficient, as well as often abusive. A credible and efficient judicial system requires urgent attention in many such countries. Speedy dispensation of justice would be an important element of such a system. For example, shareholders should be able to bring to heel a recalcitrant or negligent management very quickly in an ordinary court of law without having to bribe the local or other administration.

d. The provision of public goods and infrastructure.

Public goods are those goods that are commonly consumed by all citizens. Since no one can be excluded from consuming them, such goods cannot be produced privately. The defense of the country is such a good, and it cannot be left in private hands. On the other hand, infrastructure such as communication networks or road networks tend to result in natural monopolies due to substantial economies of scale. Natural monopolies are often left in the hands of the government. In recent years, however, we have seen that the role of the private sector in developing infrastructure has increased considerably throughout the world. For example telephones, roads, and power-generation were, until a few years ago, considered to be activities that should be entirely concentrated in the public sector. But recently many countries have invited the private sector to participate in these activities. Argentina, for example, recently sold its telephone system by international bid.

The principle that should be adopted is that the government should get into infrastructure• producing activity, only where it is absolutely certain that the private sector will not enter. Even in such an activity, if at a later stage, private participation proves sufficient, the government should withdraw in favor of the private sector. One should always bear in mind that the government in no country has proven itself to be a cost-conscious manager over the longer term.

e. The promotion of health and education

We say the "promotion" rather than the "provision" because, though a microeconomic case can be made for a government role in these areas based on externalities associated with the provision of medical care and education, there is no requirement that the government be a direct provider of such services. Moreover, even if a direct government role is chosen, there is no case for state monopolies in these fields.

If we accept these activities to define the role of the government, then by definition, the state should abandon all other activities in which it is currently involved. There would be no role for the government then, in the production of most goods and services. Instead, public sector efforts would be better directed at maintaining law and order, as well as providing efficient and cost-effective regulatory and judicial support to the economic enterprises of the citizens.

The need for improved public sector management.

Implementing these ideas will require a thorough-going commitment to widespread privatization of activities currently undertaken by the state that do not fit under the guidelines proposed above, as well as liberalization of both external and domestic commerce. There is now a large body of evidence in economics that such steps are associated with large gains in productivity and accelerated economic growth. Several countries, especially in East Asia, have already traveled a long way along this path, though even in the successful newly• industrializing countries, the role of the state remains much larger than our guidelines would justify. Latin America, led by Mexico, has recently begun to move in this direction, and also in South Asia some tentative steps have been taken by India and Pakistan. However, much remains to be done in these regions, and in Africa which at present, lags behind.

The difficulty in modifying the existing situation is, of course, the existence of widespread and well-entrenched special interests, both within the public sector and in the "formal" private sector. At least four features of the current international economic and intellectual environment however, may make the present, an especially opportune time to implement reforms of the type described above throughout the Third World.

First, the developing world itself has undergone a period of acute economic crisis for the past decade. In such circumstances, old institutions and ways of doing things lose their legitimacy, and fundamental change is more easily contemplated. Second, the end of the Cold War through the collapse of the centrally-planned economies, has undermined the intellectual basis for the economic stewardship of the state over the private sector. Third, budget stringency in the industrial countries, due both to past debt accumulation and to the need to rebuild the formerly centrally-planned economies, will limit the flow of external resources to developing countries for some time and make it imperative that domestic resources be used more efficiently. Finally, new research in economics, sociology, and anthropology, is documenting the vitality of the "informal" private sector in developing countries, helping to change old perceptions about the potential of the private sector, if unfettered, to play a dynamic role in economic development.

As country after country is forced to undergo reform and adjustment in keeping with changing economic thinking and the evolving global economic environment, greater attention must be given to the ability of the public sector to deliver. As has been argued above, the quality of public sector management is of paramount importance for successful economic performance, including the success of adjustment efforts. Although this quality undoubtedly varies from country to country, the problems described above are widespread. Yet, policy reform programs seldom explicitly recognize the need to fundamentally rethink the role of the state in order to improve public sector management, leave alone giving this issue the priority it deserves. Perhaps, therein lies the answer to many unsuccessful reform efforts in the third world.

Why I believe in the free market!

Speech delivered at the
25th Anniversary and Millennium Annual Sessions of the
Organization of Professional Associations
on June 23, 2000.

Sri Lanka has a very impressive array of Professional associations. Unlike many poor countries where these structures are mere appendage of the governing structures, here in Sri Lanka, they are fairly autonomous and interested in discussion and debate.

The Organization of Professional Associations of Sri Lanka (OPA) was founded on 29th May 1975. The OPA is now in its 26th year and comprises of 32 Professional Associations with a combined membership of over 30,000 professionals. Notable member associations include the Bar Association, Institute of Chartered Accountants, Sri Lanka Medical Association and the Institute of Chartered Ship Brokers.

The stated objectives of the OPA are to assist the government in solving social, professional, educational and academic issues for the development of society. It envisions being an independent and vibrant apex body of Professional Associations of varied disciplines, to be guided by high professional standards in providing leadership and development of professions, with the acceptance of the community as a body contributing to national development.

OPA holds annual meetings and regular seminars not only for professional development of its membership but also for the discussing issues of social and economic concern.

Mr. G. C. B. Wijesinghe a respected accountant and a thinker, as well as a past president of the OPA, was intrigued by the message that I was giving on various forums in Colombo. He wanted me to address the OPA at its annual sessions and asked me to discuss an intriguing theme-Lionel Jospin's *"Yes* to the market Economy, *No* to the Market Society."

Why I believe in the free market!

A famous joke that economists love to tell, explains economic organization in terms of a capital asset, namely 2 cows. It goes like this. If an organization has two cows it would be:

- **Socialist:** You keep one and give one to your neighbor;
- **Communist:** The government takes them both and provides you with milk;
- **Fascist:** The government takes them and sells you the milk;
- **Nazi:** The government takes them and shoots you;
- **Bureaucratic:** The government takes them both, shoots one, milks the other, pays you for the milk and then pours it down the drain;
- **The development advisor or the IFI:** Get rid of one; force the other to produce the milk of 4 cows and then act surprised (blame it on the country!) when it drops dead; and
- **Capitalist:** An entrepreneur sells one, buys a bull and in a few years has a herd of cows: government takes part of milk for taxes and provides security and market integrity but remains out of the entrepreneur's way.

In a very humorous manner, this conveys the essence of our understanding of various forms of economic organizations. As is obvious from the way in which we organize the two cows to be able to consume the milk, the choice of various ideologies such as communism, socialism, and capitalism is really one of defining our attitude to the role of government in society. In order to understand these issues more carefully, let us examine economic growth and the role of government through history.

Fairy Tales

Ever since human settlements came into existence, society has had strong central leadership and powerful individuals have formed government and curbed individual freedom. Curbing of individual freedom insofar as it pertained to curbing crime, enforcing property rights and providing law and justice was advantageous to human welfare and people gladly surrendered individual freedom. The state or the tribe also offered some form of social insurance to weaker members and those upon whom misfortune may have fallen.

Conceptually all this is very simple. There are advantages to forming collectives. The principles are all very clear. Rational, honest, kind, caring, and decent people should easily be able to live happily ever after in such collectives. This is what all fairy tales are about and why we remain fascinated with the tribal I feudal age. If you recall, there was always a kind and benevolent king to make the story work. If he was not kind, caring, and benevolent, Gods would intervene to make him so. Remember Midas!

Practically, the organization of the collective meant that rules of the organization (laws) needed to be defined and enforced. This naturally led to the development of judicial, executive and legislative powers with the powers of legal violence resting with the collective. Some person-the king in the old days, nowadays a democratically elected leader-had the authority to wield this power. Unfortunately, fairy tales do not depict reality. More often than not, kings were tyrannical and greedy.

The history of kings is bloody and that of the reigned is even worse. The people only saw misery and toil, often not even owning what they worked for. Frequently, they were mere canon-fodder for various territorial wars that were only fought for the aggrandizement of the monarch. Only in places like England and some other countries of Northern Europe was the sovereign, over the course of many centuries, forced to yield some rights to the citizens. The struggle against the avarice of absolute monarchy begins with the Magna Carta in England and goes through events such as the revolt of Cromwell, the insurrection of the colonies in North America, to the various parliamentary reform movements, which finally empowered the people through universal suffrage in the twentieth century. Many other countries were not so lucky. In China, which took the lead in scientific discovery with the invention of paper, printing, paper money and gunpowder, the monarchy and its mandarins stifled progress for the selfish purpose of maintaining their own control over the country.

Interestingly enough, only in countries of North Western Europe such as England, France, Holland, Belgium, and the Nordic countries, was monarchy pushed back sufficiently enough to give space to the development of modern institutions that fostered individual effort and creativity. Not surprisingly, these countries were the cradle of scientific achievements and progress. It was these countries that began the unpunctuated path of scientific discovery.

Out of the immigrants of the countries arose the United States, which learnt well from the innovative thinking on the European tension between state and individual sovereignty that it adopted a bill of rights which strongly empowered the individual like never before. For the first time, ordinary but very well educated people wrote a constitution. This effort drew upon all the learning of the time. In particular, it recognized explicitly the need to limit the power of the state as well as the power of each organ of the state. It put in place a wide variety of checks and balances to ensure that power-hoarding of all manner was avoided. The founding fathers firmly accepted the advice of Edmund Burke that "there is no safety for honest men but by believing all possible evil of evil men," (1791,249) and embedded it in their constitution. Not surprisingly, the mantle of world progress shifted to the USA where the individual effort and rights of all kinds were totally unencumbered. Technological advancement accelerated beyond imagination in the USA.

Meanwhile, Europe was still fighting yesterday's sovereign wars. Two World Wars were fought for various national reasons. Sanity prevailed after millions of lives were lost and now we have a united democratic Europe. Monarchies are retained only for tourist fascination. Europe began to learn from its student -USA, strengthening capitalism, the free market, and the rewards to individual effort.

I hope that this very quick review of the well-known facts convinces you that human history is, quite simply, the evolution of the relationship between the state and the individual. More specifically, wars and the revolutions and the ideologies that have caused them have all in one way or another been a result of the tension between state and individual sovereignty.

Yes to the market!

Historical review also shows that economic conditions and human welfare improved as the state power was limited and individual sovereignty was increased (see figure 1 below). Never has humankind seen such an increase in incomes as those that occurred in the nineteenth and the twentieth centuries. This was a period when individual property rights were strengthened especially in America, states allowed markets to evolve unfettered, and the philosophy of free trade and capital flows was accepted. In short, this is the period of market growth, where the limitations of the state have been recognized. Per capita incomes.

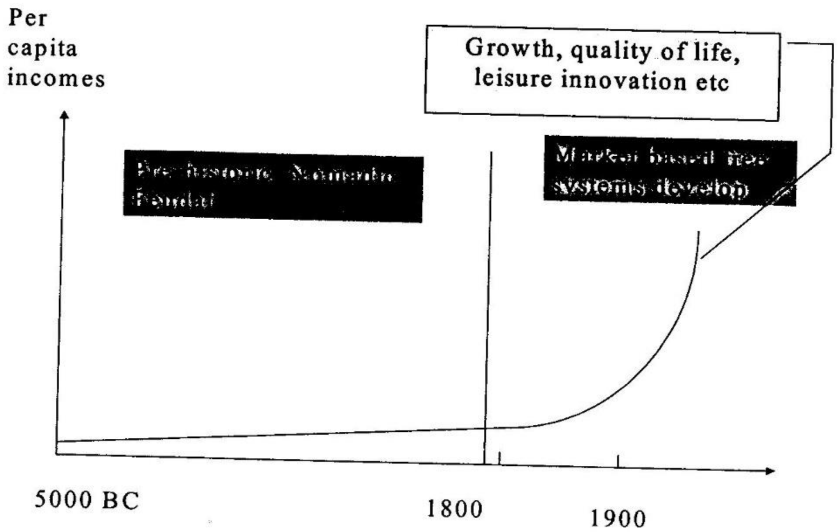

Figure 1: World income through history

Never before have the welfare of the vast masses been improved by so much. Among the advanced countries, growing economies have created gainful employment opportunities for virtually the entire population, and limited poverty to but a small proportion of the population. Consumer goods have become a household opportunity with Baccarat and Tiffany's serving the new middle classes through shopping malls instead of the monarchs through palaces. The range of consumer goods seems to infinitely expand as science progresses in response to the need to develop new goods for the insatiable appetite of the market.

In this period, the quality of life has vastly improved for most people who live in advanced well-organized societies. Spending on leisure as well as the amount of leisure time that most ordinary people now consume have increased enormously. Progress and research have increased the lifespan of people, and provided them with more productive lives with less pain and sickness. Education, no longer a domain only of the nobility, has been made available to all. The new market economies have also offered, all of us, more opportunities to excel in areas of our own choice. Whereas in the past, a musician or a Thai boxer had to live on handouts from the monarch, today, thanks to the market, he can actually fare very well in the new entertainment markets.

The market has also shown remarkable dynamism in its ability to provide for the many and diverse needs of humanity without any visible coordination. With property rights (including intellectual rights) established, market driven research has established a virtual production line of innovation. All manner of custom-built products have ensued; financial engineering allows many contingencies to be dealt with; specialized stores and services provide for different segments of society while focused design and research is helping those with specialized tastes and needs.

Dickens, Steinbeck and Sinclair

Why then do we continue to be suspicious of the market? It is hard to come up with a complete answer to this question. I would like to present three hypotheses as suggestive of an answer.

My first hypothesis is that the classical literatures that we all grew up with and that still have an enormous allure simply because of the genius of the authors like Dickens, Steinbeck, and Sinclair sisters presented a grim picture of the prevalent social conditions during the early phase of the development of market economies. Pictures of poorhouses, labor living in squalid conditions, abject poverty, long and tedious work hours, boring work, exploitation of workers, oppressed people, etc., have been deeply embedded by this literature in our minds.

Yet we forget that even while these authors were writing and abject poverty had not been eradicated, the market had developed a heart. The New billionaires with their monopolies that Sinclair and Steinbeck were criticizing, had chosen to donate a large mass of their fortunes to foundations that were to use them for the welfare of humanity. It was thus that Carnegie and Rockefeller created their foundations that continue to perform great philanthropic tasks even today. Much of American research and education has owed a substantial amount to these foundations. Since then, foundations have multiplied at a rapid rate with the trend now firmly established that new fortunes will be used thus for the welfare of humanity at large. Thanks to these, cancer research is supported, scholarships are given, social welfare programs are run, community development is funded, and institution-building is fostered in the third world. Some of the finest universities in the world are the result of such philanthropy in contrast to the poor quality university that has been fostered by the marriage of official lending and poor-country autocratic government.

My second hypothesis is that for centuries we have accepted the fairy tale that our sovereign, who is kind and merciful, will protect us from the beasts that lurk at the edge of civilization. To us, the notion of the market and individual sovereignty is akin to being thrown at the mercy of the forces of nature-the very forces that we sought to protect ourselves from when we coalesced to form society. Alone at the mercy of nature was an overwhelming risk that forced our forefathers to accept the tribal yoke and eventually the feudal tyranny. Without state protection now, the market appears overwhelming. Folklore, including the literature of the last century, have all shown us how the vagaries of the market can lead to financial panics as well as vicissitudes of fortune that are too great for ordinary mortals to bear. The specters of the great depression and the more recent economic crises in many countries have again reinforced the image of the protective state and sovereign.
Such images reinforce in the ordinary people, especially those of the poor countries, the notion that the sovereign or the state is their only ally protecting them from the excesses of nature, which manifest themselves in modem times through raw unencumbered markets. The ancestral memory of sovereign protection of the flock from wild nature further strengthens this perception.

My third hypothesis relates to intellectual leadership in the poor countries following independence. Whatever intellectual leadership that led the way to independence, gave way very quickly to the post-independence thinking that was being provided by the development thinking which, in a very well-meaning manner had gained ascendancy as colonialism receded. The Western thinker I academic who had helped the colonial process by accepting gracefully the civilizing mission of the developing world found the new mandate of economic development a natural extension of their earlier objective. Happily for them, the prevailing ethos of the time was the socialist I Keynesian that sought to strengthen state leadership and intervention in the economy. Quite fortuitously, Lord Keynes had created international agencies to continue the civilizing mission and foster growth and development in the poor countries. The new development thinker in the West had two natural handmaidens to do her bidding without leaving the comforts of first world citizens-the international agency and the local, strongly centralized, often-oppressive, government. Thus we have names such as Papnek, Streeten, Ranis, Stern etc., advising us through the World Bank and USAID and their advice receiving priority in our countries while visionaries like Salaam/ were forced into exile.

As we find out later in the eighties and the nineties, those who led in development business were not the best economists nor were they backed in their advice by the rigors of academic thinking and investigation. Anne Krueger (1997) notes in her presidential address of the American Economic Association, development economics was "a *mixture of touristic impressions, half truths, and misapplied policy inferences*[2] ". Later Robert Lucas, Paul Romer, Robert Barro etc., turned all of development economics on its head and revealed to us what most serious economists such as Milton Friedman had been saying all along that there are no separate economic principles for poor people.

The development economist had accepted all manner of strange folklore for poor dark people. For a while they actually debated whether poor dark people are rational or not. The rationality of the peasant was strongly questioned; they were not considered to be saving as they should; they were stupidly producing more children than was desirable; they did not believe in education and poverty; they were not as productive as they could be; they did not take on new technology as rapidly as they should; they had no markets and did not know how to develop them. The list goes on. These matters were actually debated in scholarly journals, by more serious economists from. Chicago like Friedman, Becker, Harberger, and Schultz. At that time, unfortunately their challenge was not taken seriously.
What was to be done in such a situation where the poor people in poor countries are so irrational and ill-educated? Fortunately, big government backed by big aid financing was there! The development thinkers found natural allies in the two, who in turn gave them the respect and the spotlight that their profession back home was not willing to give them. The result was that the myth of market failure was spread wide in these countries. How can the market solve the problem of poverty? Market economies are based on exploitation of the poor. Besides, these countries do not have basic needs, which can only be provided by the government. Government intervention is required from the teaching of elementary hygiene to people, to providing them with good seed and inputs, to building infrastructure. Schooling too must be a government domain as must be the preaching of good behavior including saving and birth control. Why should such a government not have monopolies on the media, education, input provision, etc? Why should such an economy not be closed for the good of the people?

This poor quality intellectual leadership dies hard. South Asia, which was among the more advanced poor regions in the world at the end of the colonial era, still clings to this thinking. It is with great pain that one still hears all manner of speeches exhorting a large role of the

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[22] Professor Abdus Salaam (1926-1996), Nobel Laureate in Physics (1979), the only Nobel Laureate of Pakistan
My emphasis

government and denouncing the private sector. The echoes of this early development thinking resonate anachronistically in South Asia.

My emphasis Now that we have seen government failure in abundance in South Asia where poverty seems to increase rather than decrease, I find it hard to accept the precepts of our development advisors. I cannot accept that poor (dark) people are irrational. When offered the opportunity, these people have shown the alacrity and the understanding to take it up. For example, people (very often the uneducated), from remote areas of Kashmir, the Tribal areas in Pakistan, Kerala, Sri Lanka have all responded to migration opportunities arising all over the world. They have even figured out methods of beating the immigration barriers. With their savings they have helped their families with investments, housing and consumer goods. They have been robbed off their savings only by poor government decisions such as inflation, vagaries of policy and outright default as in the case of Pakistan.

Left to themselves, these people are capable of entrepreneurship. Such talents they have, are displayed very well in alien environments, but not at home where the government will not give them space to do so. That is why I would strongly urge the rollback of the state to give space to the market. The people have the ability and the wherewithal to function and develop economically in the market place. All they need is the space!!!

Regulation and Smallness

Early in my tenure here, I got into a series of discussions with CBSL, treasury officials, donor agencies and several Sri Lankans on the appropriate level of regulation in the economy. Exhortations for more regulation were bombarding the government virtually everyday. There was an excessive fear of assumed market excesses and a keenness to keep things under control.

At the same time, there was a general level of comfort that had been created that the economy had successfully completed the first generation of reform for opening up and deregulation.

In this atmosphere, I decided to go a little on the libertarian side to unlock a debate on regulation. Not only there was a very keen debate, deregulation began to take center stage in economic debate.

The success was beyond my expectations. Within a year, a Minister for industries had created a Deregulation Committee staffed by very prominent businessman and senior officials. This committee was later blessed by both the President as well as the Prime Minister and is working well. ADB is funding it and I have been appointed a member.

Now we also have a Ministry for Economic reform because the Prime Minister has recognized the need for the creation of such a ministry. One important area that the ministry has been charged with is the review of regulation to facilitate market development and speedy transactions.

I first presented this to 2 Rotary Clubs. Rotaries are very active in Colombo. About 15 clubs hold weekly meetings and they are very well attended with a variety of topics under discussion. I will particularly remember these clubs as I made some excellent friends there. I was invited to these by 2 very good Sri Lankan friends, Tilka De Zoysa a dynamic businessman, and charming gentleman Ruzly Husain.

I spoke at a number of clubs and used my public sector reform material as well as education material to motivate discussion.

Regulation and Smallness

I am a Pakistan economist, preoccupied with why my country does not achieve growth and respectability. No matter what I do, I will be judged as a Pakistani and be tainted by the problems and achievements of my country. I cannot return to my country as a professional because institutions there, are not inviting of professionals. As here, they prefer donor• credentialed consultants.

I came to Sri Lanka to see if I could learn and contribute. My attempt is to learn as much as I can about Sri Lanka and to contribute through raising awareness and debate about certain critical issues.

Tradition has it that I should read out a speech that presents the last analysis of the economy by the Fund: a bit of praise; a bit of spice; some key statistics; a big broad brush of the economy; but little that is new.

I see your society through the lens of an economist and the heart of a fellow South Asian; a brother from Pakistan.

The title of my conversation with you is "Regulation and Smallness." I do not know whether you are intrigued by it or not. I have been very intrigued by it since I came here and found that the government is engaged in a search for an insurance regulator, a pensions regulator, a consumer protection act, banning and monitoring the ban of a genetically modified food and many more such activities.

Smallness

Economists believe that all countries (including the US) are small in relation to the global economy. This is by no means, is pejoratively intended. What this means is that no country is capable of influencing the global market place in any meaningful manner for a sustained period of time. For example, the US and the other G7 countries have recognized that they will not be able to influence their exchange rates, financial valuations and many other important economic variables.

I remember the famous Marxist book in the 60's on monopoly capital by Baran and Sweezy used to have a cover that showed that India had a GDP that was smaller than the seven largest companies in the world. The Center for Policy Analysis in England has recently conducted a study that shows once again that the world's largest corporations are bigger than all developing countries.

Let us put some perspective on the size of Sri Lanka. Sri Lanka has a GDP of US$ 15 billion i.e., it produces output of US$ 15 billion. If we compare this to outputs of small US cities as well as multinational corporations, it will put some perspective on our question. Small US cities like, Richmond, Va. Charlottesville, Va. and Raleigh, NC, all have outputs above US$ 30 billion. There are more than 100 US companies with sales larger than US$ 18 Billion and we were still going with our search engines. For global companies, the cutoff point for the top 100 gives was sales of US$ 33 billion.

When you put any country in such a perspective, you begin to understand more realistically, the limitations of government intervention in such small countries.

Sovereignty?

It seems to me that many countries, especially poor countries, continue to hold on to a conception of the state from the earlier feudal times. People continue to view the state as an all-powerful paternal entity that insures against all risk and provides for all occasions. In keeping with this view, the state too seeks to maintain the wasteful pomp and glory of yesteryear. It is not surprising that governments are large and unaccountable. Strong and predatory states are created and the government rules rather than serves. Most important of all, economic rights are not provided. On the contrary, strengthening of the state requires controls, laws and regulations that inhibit individual economic freedom. For all the best of paternal reasons, such states have denied economic rights for the last 50 years. To protect the citizenry of Pakistan from I know not what, it was denied passports in the sixties, hard currency throughout its history, consumer goods, leisure travel, foreign movies, etc. This is while the state again in our best interests maintained a monopoly on the media, banking, airline, telecommunication, power, oil, and gas, and many other sectors.

Interestingly enough, this notion of sovereignty treats all countries equally. For example, it has been alleged that all sovereign bonds should be viewed as risk-free given that they have the ability to tax their populations arbitrarily. Sovereign risk must therefore be less than corporate risk. But should that be so, when corporations are bigger, have better business plans, and have lower overheads (smaller governance structures)? Much of recent history has been plagued with this flawed conception.

In keeping with these misconceptions, small countries seek to emulate the big countries in building a government. Complicated constitutions are adopted and an apparatus of nation building is put in place without regard to cost. What is worse is that international advice too is being given in a uniform manner to set up the same institutions in all countries regardless of size. Thus for example, every country has been advised to put in place a stock market, a securities and exchange commission as well as a credit-reporting agency. All countries are attempting to put in place relatively large regulatory regime that seems to be drawing upon the post depression experience of the US. Interestingly enough this is being done at a time when the US is dismantling its regulatory structures.

In thinking about the role of the state in the economy, especially the regulatory structures that are needed, let us be a little more original and sensitive to the needs of economic development.

The market did work before government intervention!

International economic integration has been taking place through history. Schoolchildren learn of how explorations brought us closer together. Even at the height of the feudal state, limits on trade and migration were quite limited. This process had really culminated in a world where movement of goods and capital was quite free at the end of the 19th century. Massive flow of capital from West Europe to rapidly developing economies of Americas, Australia and others took place before the First World War. Net capital outflow from Britain reached 9% of GNP and it was almost as high from France, Germany and Netherlands. Compare this with outflows from Japan and Germany of about 4-5% of GDP in 1980s. In addition, at the end of the last century there were no restrictions on the movements of people. In fact many countries did not even require customs and immigration checks. Movements of goods were similarly unrestricted in much of the world. Driven by this openness, this period saw rapid market development and technological change. We forget that during this period and even in much of history, governments have not had that large a role in the economy as we have dreamt up in recent times especially in poor countries. For example, countries did not have the freedom to print currency. Money was only printed to the extent that a country had gold reserves to back it. Developing countries that did not have gold used the currency board approach to once again force monetary discipline on them. Such credible mechanisms for monetary discipline were backed up by fiscal conservatism. The notion of using financial closure to tax domestic citizens was not accepted. Nor was it considered appropriate to have all manner of arbitrary taxes in any reasonable post-feudal regime.

This was before the age of socialism and governments generally assumed that their role was providing security, law and order and justice. This form of governance was to be provided without unconstrained fiscal and monetary policy. It seems that we had good governance and economic freedom then, and we let it go! What happened?

Depression economics

With the onset of the Great Depression, countries imposed extensive controls. Suddenly, the role of government was extended to managing risks for the economy. Lord Keynes provided the intellectual wherewithal for this. He argued that countries should use active monetary and fiscal policies to insulate themselves from unnecessary volatility.

The post war development economics took Keynesianism to the poor countries and applied it uniformly regardless of size and. stage of development. They went further and put in place planning and reinforced an already paternal form of government. They were strong believers in the excesses of market as well as the irrationality of the traditional people. Consequently they relied on government monopolies and encouraged nationalization and government guarantees of employment, banking systems and bailouts of failed businesses.

Newly established governments immediately developed a liking to the policy freedom and the ability to use both fiscal and monetary policy for political advantage. Soon this led to the development of costly and corrupt government.

Even when the planning/nationalistic/government led model failed, and the IF is adopted the Washington consensus that argued for fiscal consolidation, openness as well as a reduced role of government, the envisaged reform was not easily forthcoming. In many countries, it was the government that had become the vested interest. Those who benefited by the planning regime - planners, state owned enterprise employees, union members - strongly resisted reform and for decades inefficient government interventions that had been put in place in the early days of nationalism were not dismantled.

Experience shows that these governments are very quick to put in place a new regulatory body but very slow to remove one. Unfortunately, as Deepak Lal argues, there are too many closet socialists in the international consulting scene who retain their suspicions of the market and continue to scaremonger and recommend regulation in various guises '.

- Scaremongers point to the East Asian crisis among others to argue for the retention of controls on the movements of capital. Governments who thrive on controls are quick now to postpone even a domestic discussion of openness. Meanwhile they continued to practice financial repression. Poor policy advice and power-hungry bureaucracies and politicians love stories that reinforce suspicions of the market. Speculation and metaphors like "thin" and "young" markets abound without definition or proof. Volatility is considered undesirable. Recommendations for regulation and market controls are quickly implemented. Removing regulations is strongly resisted!

- The scaremongers also preach that all markets must have strong regulation. In fact, the regulator must be put in place first. Now we build a regulator for every market, sometimes even two. For example, many countries have both the stock exchange and the Securities & Exchange Commission behaving as regulators. Often, regulation is put in place before the market is allowed to develop: Rather like disciplining a child in the womb.
- It is enough merely to have an office of a regulator. The skills of the regulator are never called into question. Governments have been quick to accept this advice and build an office to offer a job to any bureaucrat who may or may not know that market or how to regulate it.

Understanding regulation

While there has been a wave of deregulation among the OECD countries, there seems to be a hangover demand for copying the dying post-depression Western regulatory systems in the poor countries. The policymakers who were trained in the government-led regimes continue to harbor all manner of suspicions relating to the market (see Box 1). For deregulation to take hold, there must be a wholesale change in the attitudes and training of the public sector. Those who continue not to understand markets and the need for markets for growth will stifle growth if they are handed power of the public sector. It is for this reason that I would argue that we should define our governance reform to be **"the introduction of modern human resource management for the objective of market development."**

There has been much talk of deregulation and liberalization around the world in the last two decades. In recognition of the failure of the early attempts at lessening the role of the government in the economy, good governance was thrown up as a slogan. Unfortunately, governance has been defined in many abstract ways and not according to my definition above. Certainly, little attention has been paid to the HRM aspects of public sector management.

Box 1

Commonly held beliefs of the PS bureaucrats

- Private sector is less capable and more dishonest than the public sector
  - □ Licensing regime, not the public sector, corrupted them
  - □ Private sector must not be represented in key policymaking bodies
  - □ No need to ask about training and credentials of public sector. Always capable of directing the market
- Public sector is the guardian of the poor
  - □ Can design good intervention for benefit of people
  - □ All intervention is good
  - □ The guardian angels must work in camera-policy discussions cannot take place in public
  - □ They are above criticism-criticism could lead to volatility and crises
- Markets need public sector nurturing
  - □ Volatility of any kind is bad
  - □ Prices must be controlled
  - □ Speculation must be outlawed
  - □ Markets cannot be left unregulated
- Foreign investors and capital inflows are destabilizing
- Public sector controls prevent crises
  - □ Volatility means crises

The result is that reform is regarded as rules and procedural changes that are to be implemented by the very people who grew up in a control-oriented, rent-seeking environment. Their incentive schemes as well as training routines are left untouched. The result is that these individuals react strongly by dragging their feet on reform or a poor quality implementation that vitiates the very objective of reform.

The local Sir Humphreys too have many ploys up their sleeves to slow down reform. There is "The unions will not allow it!", "We have to go slowly because of our culture", "our markets need to learn", and of course "We are looking into it" and have been for the last decades. They have designed clever privatizations that leave the golden shareholder (government) the right to interfere; privatize the telecom with a monopoly etc.

Regulation is also deeply buried in the system and people who manage and implement the system. Even if we change all these proponents of regulation, Box 2 shows it is not easy to root out regulation from the system.

You can also see the relationship between the mindset of the bureaucrat (Box 1) and the number of different and diverse ways in which regulation is imposed on us (Box 2). For example, the education controls were imposed in the spirit of nation-building and of course that is not something that the private sector can be entrusted with! If private sector is allowed into this activity, they will cheat people by not providing quality education and of course they will charge too much and exclude the poor. Oh! If the financial market is unregulated, we will have irrational crises. And of course national considerations meant that economic activity must take second place to ceremony. As you can see underlying all this argumentation benign smothering approach of the bureaucrat, stemming from her arrogance that "she knows best."

The cost of regulation

Through years of overbearing government, the public sector has developed a number of allies in civil society who argue for big government and strong and intrusive. There needs to be wide debate on this subject to truly understand the role of regulation in a poor country like Sri Lanka. In such a debate, we must also be able to learn from the experience of the world and understand what the limits and costs of regulation are.

Box2

Examples of regulation

- **Education:**
  - Education bureaucracies. tend to be large and inefficient thriving on a jealously guarded monopoly.
  - Typically provide poor quality education
  - No private education allowed—if it is allowed, the monopolist provider of poor quality public education wishes to regulate
  - Examinations and syllabi are regarded as government monopoly
- **Financial markets:**
  - Self regulation controlled by government o Entry controlled by government
  - Narrow institutions in sharply defined sectors
  - Foreign competition not allowed since capital transactions are rigidly controlled o Capital controls allow financial sector to be invisibly taxed
  - Heavy government involvement and poor legal infrastructure results in poor quality assets of the financial system accumulate because the *un-modernized* legal system and government interventions seek to protect the defaulters
  - Instruments are not allowed given the fear of volatility
- **The *un-modernized* legal system:**
  - Does not facilitate transactions
  - Does not recognize the time value of money and dispense speedy justice o Property rights not well defined and exchange of them facilitated
  - England and real property titling methods outdated for creating public sector rent-seeker
  - Opportunities Cumbersome laws geared for regulation and not for market development
    - E.g. Permission required for all manner of transactions such as appointment of a bank managers, conducting a forward tea auction.
- **Closed sectors:**
  - For the sake of maintaining government monopolies like telecom, public utilities and airlines, many sectors are closed to investment
  - Security and morality another reason for closing off sectors.
- **Poor quality interface with government:**
  - Tax systems and customs cumbersome
  - Public sector continues to maintain a cumbersome control structure through its control of regulation, utilities and property rights
  - Government retains threat of expropriation
- **Large *un-modernized* public sector:**
  - Clinging to old ideas
  - Poor HRM encourages poor human capital development
    - Encourages rent seeking
    - Encourages reliance on controls rather than an analytical market-based management
  - Monopolizes too many sectors hence limited role for private sector
    - E.g. In many city centers, land for commercial development may even be monopolized by government
- Burden on the economy for size too big for the economy
  - Leads to poor fiscal policies and uncertainty of the policy regime

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result is obvious when you observe that despite all the regulation, the US saving and loan crisis occurred.

Regulation is also not cheap. It has been determined that in the US, regulation costs about $6000 annually per family. Those who rush to build regulation do not appear to recognize that the proposed regulatory intervention will cost taxpayer's money. Nor do they do a cost• benefit analysis to see if the expense is justified.

The proponents of regulation are also fairly quick to point to corruption as a social evil. But then they fail to see that corruption arises from regulation. Their pet answer is to have another regulator (a bribery commission) watching corruption. Ultimately someone has to answer the question "Who is watching the regulator?" and "is he or she a Saint?"

Fountains of Paradise - Defining Investment Space!

Speech delivered at the Annual General Meeting of the Planters' Association on September 17, 2001.

Planters association is one of the oldest associations in Sri Lanka representing one of their pioneering industries. As a powerful lobby, they were used to inviting ministers and statesman. As, Mahendra Amarasooriya, Chairman of the Association noted in his address of introduction, it was the first time that they had invited an IMF Representative. They had done this because they had found some of the speeches that I had made in the media interesting.

By now, I had visited some plantations and even seen some factories. Thanks to Vivendra Lintotwalla, Chairman of John Keells, I have had a detailed tour of a plantation and a factory.

All I needed to prepare for this speech was to learn some Plantation history. Thanks to Ken Balendra and the Keells people again, I was able to learn the history and found it remarkable that such an amazing effort, which changed the Sri Lankan landscape, was the result of a pure pioneering spirit.

In contrast, today, despite exogenously supplied financial and technical assistance, organized. governments and large private sector enterprises cannot complete a small sized power plant or a simple 18 mile highway in 5 years. It seemed like an interesting contrast to develop. Rather than talk about real projects and ruffle feathers, I drew upon the work of an 'adopted' son of Sri Lanka, Sir Arthur Clarke, an author millions of us admire. I was delighted that I was able to amuse Sir Arthur as well with this contrast.

After making this speech and getting to know the pioneers, I had to visit the original plantation, John Taylor's Loolecandera. I thank Mohan Samarakoon, a dynamic citizen of Kandy, for giving me a detailed tour.

Fountains of paradise - defining investment space!

It is a great honor to be the chief guest at the 14ih Annual General Meeting of the Planters' Association of Ceylon - a group that I have come to admire and respect in my stay in Sri Lanka. In fact, on my visits to the plantation country and in particular to a couple of your tea factories, and of course to the famous hotel, the Tea Factory, I developed a yearning for the plantation culture. I do wish that in some life I will experience the romance, the adventure and the organization that I see enmeshed in the plantation dream.

As you all know, many of Sri Lanka's prominent businessmen, have arisen from plantations. When I mentioned to some of them my recent infatuation with plantations, their eyes glazed over in fond remembrance of their cavalier days when they ran little cities in the hills. I submit to you that it is this enormously rich management experience that a young man or a woman gets in running these complex and very modem enterprises free of bureaucratic yoke that makes them the great Sri Lankan managers like you that I meet today. The young plantation managers that I met in my brief sojourns into the hills even today display the pride, aplomb, and high-spiritedness of an adventurer I manager. They remain the cowboys of Sri Lanka.

The plantations fascinate me because they are the product of visions of daring adventurers. I cannot help but imagine the boldness, initiative and organizational capacity that it took to cut down dense forest, ward off wild animals, build roads, plant coffee and when that failed to switch to an alternative - tea. It is mindboggling to drive through the hills on those narrow winding lanes which in themselves are engineering marvels even today.

The Early Planters

Hats off to those early planters from Scotland who incurred all this hardship and permanently changed Sri Lankan landscape, economy, and society. I will not bore you with historical details for I am sure you know more than I do about the history of this wonderful episode in your history. Let me tell you what I, as an economist, admire them deeply for;

1. Their boldness of vision. It was not doing the usual. They were not handicapped by conventional wisdom. They did it their way.
2. They were very Darwinian in their outlook. It was survival of the fittest for only the fit could take this enormously challenging task. These pioneers took their own risks, did not seek any government help even when the coffee plant was devastated. They invested their own money and waited for 8-9 years before they saw their first returns.
3. They were true entrepreneurs who took risks, but also were ready to change their plans and strategies. I remember one writer paying tribute to these men: "The first generation of planters in Ceylon were adaptable men who were not resentful of change."
4. They did not wait for any consultants or advisors to tell them what to do. The functional, intuitively simple and yet ingenious design of the old tea factories that rely on natural forces to help in the maturation of tea, speaks of the self-sufficiency and quiet confidence of the pioneer planter.
5. The plantation was a *great training ground for modern industry*. It was perhaps the first effort at integrated industrial form of organization in Sri Lanka. Not only is the planting systematic, it is plucked in a well worked out rotational manner too, so that the bush does not grow beyond a certain height. It is graded and processed to a certain taster's perfection. At all levels, organization and professionalism is required. Timing and management is important. This meant a higher order of discipline and training than would have been found in more traditional agricultural activities.

The more I learn of plantations, the more I begin to wonder: "Would such a visionary adventure be possible today in Sri Lanka?" Please do give me your answer whenever you like.

The Fountains of Paradise
Let me ask a few questions to sharpen the original thought. Let us say you discovered, as Sir Arthur Clarke fictionalized in *the fountains of Paradise*, that there could be an elevator from Sri Lanka to a satellite in space from which interstellar transportation would take place. Except, let us say that you could build not one but several such elevators. This venture would require a lot of land, energy, and other inputs. Imagine all of us are at a meeting to plan this great new venture. I have prepared my list of basic questions that any investor would ask. Let me run it by you!

- *Question I:* To open this whole new sector, would you be able to obtain the land that is necessary for such a venture?
- *Question 2:* What sort of permissions would be needed to build?
- *Question 3:* Would the government and various external agencies have to first conduct a sector analysis and spend years planning and preparing a project for such an effort?
- *Question 4:* Would you then get all manner of credit and advice to set it up, which will also shackle you to bureaucracy that is unproductive?
- *Question 5:* How much of your time would you spend on your project and how much in meetings and paperwork to please the government?
- *Question 6:* How much freedom will you be given to experiment with your own approach to the problem rather than externally driven ideas?
- *Question 7:* Would you ha-ye the human capital to manage such a technological enterprise? Like the plantation sector of the 19th century, would you be able to import human capital? Or put it differently, would you allow the John Taylor of this sector to strike roots here and do the pioneer work?
- *Question 8:* Finally, how long would it be before you were able to hoist one of these elevators? How long would it be before you were able to develop this sector?
- *Question 9:* Would other countries, like Singapore and Mauritius beat you to it?
- *Question I0:* Would you rather make an elevator here or in one of those countries?

This may sound strange and funny. But truly, economic growth occurs as bizarre ideas like plantations (and it could be space elevators in the future!) come to fruition through the efforts of pioneers like Taylor.

Imagine yourself in the latter part of the nineteenth century. If someone had told you that some crazy fellow called Edison was developing a light bulb and a movie projector and that we would live with perpetual light as well as watch movies, what would you have said? Furthermore, what if there was a government regulator telling him what lighting should look like and what sort of movies could be made? The world would be very different to what we know today, if that had truly happened.

The need for investment space
Yes! Growing societies need to give individual entrepreneurial spirit a lot of room. There must be space - both physical and regulatory space - for making all manner of investments. Investment cannot be made on command. No one but the driven, like Bill Gates, knows what and how he or she will deliver in the market. New goods like cell phones and new ideas like FedEx and Starbucks generate growth. Do you believe that they happen mainly in the US

because the US has some genetic advantage? Or is it because in the US there is space for such ideas to develop? I must answer this first question in the negative when I see Jeronis De Soysa as one of the pioneer planters with no foreign help. He started on 1835 and all his staff was Sri Lankan.

Ladies and gentlemen, my reading of your history suggests that we must review our notion of private sector development and economics. But as my joke on South Asian policymaking goes; "how many economists in poor countries does it take to make economic policy?" The answer is "none, they have all migrated overseas or rigid bureaucracies will not allow them into policymaking!"
We continue to retain a very patronizing attitude towards the private sector in poor countries, where private sector development programs continue to rely on credit provision, some education of the private sector, as well as a considerable buildup of legislation and regulation for the private sector. We target investment through incentives and other fiscal inducements. The sector-picking mentality, where policymakers have in mind the industries that are to be developed, remains virtually intact. We justify our rather narrow approach to private sector development through poorly conceived ideas of stages of growth where a poor country must first produce agricultural goods, then move on to garments, graduating to leather and light machinery and finally climbing up the technology ladder to cars and machinery. It is this kind of reasoning that led all countries to attempt a car industry to a point where there is now a global excess supply.

It is this same reasoning that has so enslaved even the entrepreneur in poor countries that they now display herd behavior and operate under an expectation of a paternal government who will use poor taxpayers' largesse in their favor. Garment and hotel trade is developed as a result of incentives offered by the government. Few produce branded, quality products that are more than mere commodities. Few have the differentiated product like Aman-resorts. As a result, I would conclude that these ventures are exposed to an excessive risk but they continue to be hopeful of government support. Not really a good way to run a business!

Nowadays, I am amused to hear everyone tell me that IT is the hope for poor countries where there is limited modem education! But those who argue for it want the government to take the lead.

Unfortunately, decades of Keynesianism, socialism, and generally poor thinking have resulted in the three communities - business, thinking, and government - developing a pathological co-dependency. This co-dependency must be exorcised if there is to be investment space and growth. The knee-jerk reaction that government must lead in every area and cover all risks has led to a situation that has stifled true entrepreneurship.

Government must recede!

Economics is a much-maligned profession. Even my old aunt thinks she knows all there is to know of development and lectures me on policy. *Murphy's law of economic policy* states; "Economists have the least influence on policy where they know the most and are most agreed; they have the most influence on policy where they know the least and disagree most vehemently." To this I would add *development economists*, who prescribe policy that is not I based on modem economics. But then a development economist is one who wants the government to flush the toilet after he has created a mess.

Serious economists will not give you pat solutions based on government led growth. Growth is a multifaceted, messy business not amenable to fine-tuning and control of bureaucracies. No planner, no policymaker, no economist can tell you where the next investment opportunity lies. This is the fundamental tenet of *efficient markets* that Classical economists knew well and that Chicago has now effectively resurrected. In a nutshell, what this theory says is that all moneymaking ideas will be taken up by those who discover them. All those who sell moneymaking ideas, obviously hope to make more from selling the idea than using it. After all, if she could, why does she not make the next million herself instead of giving you the idea?

I repeat, **"Growth is a multifaceted,** messy **business not amenable to fine-tuning and control of bureaucracies."** Growth is fresh ideas! Growth is Taylor planting tea, Edison with his research lab and GE, Disney making cartoons, Graham Bell making a telephone and then AT&T dreaming of an across Atlantic cable, and then setting up National Geographic and so on and so forth.

This is what I find most fascinating about your plantations. Their history shows us how it is the self-willed men driven not only by the profit motive but the ambience and the adventure of plantations that delivered to us this industry that is now so critical to your economy. It is the pursuit of such dreams and visions that delivers to us, economic growth. The modem state needs to recede to allow such initiatives to be taken. It must provide the investment space that self-willed men like Bird, Taylor and Lipton need. And you and I independent analysts and stakeholders in the economy must argue for that space for investment. Economic History of Sri Lanka-My little time line

Economic History of Sri Lanka-My little time line

200AD	• Traders start to visit Sri Lanka
1505	• Portuguese establish a stake in the country mainly in coastal regions. • Main activity continues to be trading and warring.
1602	• Dutch enter • Drive Portuguese out in 1656 • Still not able to fully subdue Kandy • However established strong legal foundations. Gave Sri Lanka Roman Dutch Law. • State monopolies on many commodities • High tariffs and taxes
1796	• British enter and by 1815 unite the country with the takeover of Kandy • Open Island to European enterprise Trade increased enormously. • Allow Land to be used. Establish property rights • Strong emphasis on establishing communication •"Whatever, the Dutch tried to do, the British did better. Their mode of governance was based on liberal ideas which helped to maintain a good relationship between rulers and the ruled"
COFFEE	
1740	Introduced by the Dutch
1825	First Highland plantation in Sinhapitiya, Gampola
1831	Colombo-Kandy road completed
1845	25,000 acres under coffee
1857	80,950 acres
1860s	Ceylon becomes the world's largest producer of coffee
1867	Railway opened to Kandy
1868	Coffee reaches its highest peak
1869	Orange spots appear. Beginning of the virus attack
1877	360,000 acres -Coffee at its peak
1889	Coffee plantation sector collapses
1890s	250,000 acres under coffee destroyed o "It was coffee and not constitution and legislative enactments, that acted as the catalyst in the economic transformation from old to new Ceylon." o "The first generation of planters in Ceylon were adaptable men who were not resentful of change" o "Rugged Life and hearty carousel"
Tea	
1825	Bird starts plantation
1830s	Taylor starts plantation
1867	First commercially planted tea on Loolecondera estate. 10,000 acres under tea
1872 1875	First recorded shipment of tea (23 pounds valued at Rs 58/-) Ceylon Tea first auctioned in London
1877	27,200 acres under tea. Colombo Tea Traders Association formed, Agency Houses formed
1883	Ceylon's first Tea Auction
1887	17,000 acres under tea
1890s	Nearly all coffee planted uprooted and tea camelli planted in its place
1897	205,000 acres under tea
1900	380,000 acres under tea

NOT JUST LAW BUT “LAW AND ECONOMICS

Law and Economics

Speech delivered at the National Law Conference organized by the Bar Association of Sri Lanka
on January 20, 2001.

In many discussions, officials and market participants in Sri Lanka pointed to the need for legal reform to allow progress to be made. A number of amendments and new laws were under discussion. The World Bank had for about 2 years an ongoing law reform project in place.

Progress on all these activities was very slow and frustrating. The attitude of officials was in the direction of writing fairly detailed and complex laws that valued regulator control over market development. Courts also viewed market behavior such as merit-based promotions and employee termination with suspicion and contra human rights.

In my discussions, I had drawn attention to the growing literature on law and economics as well as some latest research on the link between legal systems, laws and economic development.
Mrs. Perera, f lawyer and Director of the Welfare Department at the Central Bank, while noting that she did not agree with all I said, asked the Sri Lanka Law Society to invite me as a Keynote speaker at their annual conference.

I regarded this as an opportunity to bring out some of the literature on the subject in a reasonably user-friendly manner. I also used this material at a seminar in Punjab University, Lahore and got comments from faculty there as well as from the legal department at the Central Bank.

Law and Economics

Dreams of freedom have enshrined human history to reach a fever pitch in the twentieth century but remain elusive at the beginning of the twenty first century. We have learnt that freedom must include rights - both human and economic - including choice of education, secure property rights, freedom from regulation and socialism, from bad governance, to take one's own risks and decisions, control of future etc. Indeed we are far from achieving these freedoms, especially in poor countries.

If we are even to get near the dream of societies that seek to provide individuals with these basic rights, we must learn from all that is new and leapfrog using the frontiers of learning. Unfortunately, the people in poor countries are insecure about learning given that education has been usurped by the state and the managers of this education system continue to use syllabi and books from the past. In this scheme of things, new developments really do not reach these countries. Poor countries, therefore, do not really appreciate the story of how "bold and presumptuous" economic research has changed the manner in which we view the role of the government, social policy, education, and the subject of today's talk-law.

It is no secret that lawyers dominated the history of the struggle for freedom. The constitutions they devised still provide the foundations of civil society. Sadly economists were not even on the fringes. They were not even consulted. In my country, there were hardly any available to be consulted. Today, I wish that, at independence, there had been some good economists around to help in writing the constitution as well as in defining the earlier architecture of governance. I submit to you, and hope to prove to you in the course of this talk, that if economic progress and improvements of living standards is an explicit goal of modern society, the economic vantage point must be seriously considered in framing laws and constitutions.

Fukuyama, the famous sociologist, in his famous essay " The End of History" (1992) argues that ideological battles such as between communism and capitalism may have now ended. He says that we no longer need to fight with ideology. Instead, he says the only battle is that of economic progress.

Economics now offers us a paradigm for improving our understanding of societal arrangement including law, sociology and politics. Even the critics now consider economists' approach to studying these subjects, and it is not surprising that the arrogant economist would assault the citadel of conservative politics, i.e. law. Everything including the law must take this ascendancy of economics into account. Without doubt, economics today is a dominant social science that cannot, and should not, be ignored. It has made strides in understanding human behavior and the forces that underpin human welfare and we must use that knowledge to restructure and organize our societies for economic progress.

Understanding human behavior: the importance of incentives!

Law seeks to treat the symptom: Economics, the cause. Lawyer wishes to legislate the problem through rules and punishment: Economist works on motives and incentives.

Box 1: Economic approach to understanding human behavior

Economic approach to human behavior, as accepted since the time of Adam Smith, and highlighted by Becker and Friedman, among others, begins its analysis by assuming the following of all human beings:

- **Selfish**-willing to do everything to ensure not only personal survival but maximize personal consumption.

- **Rational**-All human decisions are taken on the basis of a welfare calculation, which leads to maximum personal advantage. Calculation does not require any complex mathematics or computation but it does mean that people understand and use all available data and information.

- **Forward-looking**-In making their rational calculations, individuals will plan for the future and if any information is available on the future they will use it. In addition, their actions and decisions at any point in time will take into account possible reactions of other people in the future.

This notion of self-interested, rational and forward-looking individuals maximizing their welfare offers a powerful tool for explaining many aspects of human behavior. If it is to their advantage, they will cooperate, steal, invest and so on. Using this method of analysis we can understand a range of human choices. For example, Becker, the 1992 Nobel Laureate has shown that marriage, divorce and fertility decisions are all made with reasonably well• defined economic considerations in mind. Similarly, education and occupation choice decisions are made according to an economic calculus. In each case, large empirical investigations have been used to verify these theories. By now, we understand enough about these decisions to frame social law and policy that facilitates good decisions.

In this scheme, rational and forward-looking individuals search for information and use and analyze it to their advantage.

We operate in markets. Markets trade goods and information and maintain reputations and offer market-based solutions. However, the combination of costly, private, and asymmetric information and rational, selfish, and forward looking individuals leads to strategic behavior where contracting parties will seek to take advantage of each other. The lawyers' perspective here is to put in enough controls to ensure that all parties' welfare can be looked after through ex-ante legislation. Economists on the other hand recognize that;

- Legislation itself creates incentives for strategic behavior. In other words, people will find a way to bypass laws or position themselves for alternative interpretation of the law. This is how, for example, all manner of informal markets have developed around the world;
- Laws are costly to enforce and when enough "informal" or extra-legal activity has developed, enforcement weakens; and
- Markets have developed alternative approaches to enforce contracts and induce good behavior of participating agents. We must understand these mechanisms and write laws that will reinforce market based good behavior.

One example of how taking incentives into account changes our approach to defining rules, laws and regulation is that of accidents and insurance. Traditional approach looks at accidents mainly to compensate the victim. Law and Economics approach emphasizes incentives towards safety. This is where liability fits in. Does liability insurance negate I incentives for safety? It does. Premium or coverage are linked to precautions and accident history. Does victim's insurance also affect liability system?

Box 2: Understanding Information

Information is;

- **Costly to collect:** It requires real resources to find out all that you might need to know to make economic decision;
- **Private:** Given that information is costly, whatever is collected can be regarded as private. In some cases, which involve unobservable private actions, it may actually be impossible to get. For example, the owner of a firm may never be able to perfectly observe the actions of his manager; and
- **Asymmetric**: Consequently, decisions have to be taken on the basis of differing amounts of information. Economic agents know that each of them have differing amounts of information and will base their relations on this knowledge.

Another example of how insurance changes behavior is deposit insurance. The presence of deposit insurance has been found to make bank management more inclined to take risks.

Understanding Contracting: The Principal-Agent problem

According to Posner (2000) an agency relationship, in its simplest version, is a relationship in which one person, the 'principal', benefits when another person, the 'agent' performs some task with care or effort.' The problem arises since one person's welfare depends on what another person does. For example, company owners are principals; workers and managers are agents: Owners do not have complete knowledge, and therefore, employees may pursue their own goals and reduce profits. More generally, the agent may act in her own interest rather than in the interest of the principal. The agent may also not disclose all of the information, and agent' actions may not always be observable. [1]

[1]Everyday life is full of examples of the Principal-Agent problem. For instance;

1. Owners of a firm hire a manager to manage the firm.
2. An employer hires an employee to perform the work.
3. A client hires an investment advisor to manage his portfolio.
4. Employees hire a pension fund manager to manage their pension contribution savings
5. A car owner hires a mechanic to assess the repairs needed for her car
6. A patient hires a doctor's services.

Professional management controls most large firms on behalf of shareholders. Monitoring management is costly due to asymmetric information. Managers may pursue their own objectives. Workers may not work hard and may cheat and steal. Of course the law provides for obvious malfeasance and fraud on the part of managers. But the legal process, which may impose large and unnecessary costs, may not be economically efficient.

Principal-agent incentive problems can be dealt with thorough market based contractual arrangements. Contract law must be written to allow such contracts to be constructed according to the needs of market participants. Other laws relating to financial markets must allow markets to be developed to a point where market mechanisms can be used for writing market-based contracts.

But remember, contracts are not detailed promises of a moral nature. On the contrary, they are incomplete promises or rough guides for behavior. Performance of the contract may not be feasible at times and fire exits must be available to both parties. For example, contractual obligation to disclose information depends on outcomes, and not on some moral to tell truth. Should contracts be rescinded? If there is a breach of contact, you have to pay damages and compensation. Existence of escape hatches increases the value of contract. A contract is socially undesirable for parties to perform if costs of performance outstrip benefits. Contract improves risk allocation and incentives to invest provided contract law must allow flexibility in the writing of contracts as well as speedy enforcement.

The need for government intervention

The traditional approach has been to use the excessive muscle of the state to deal with all potential problems. For example, even the licensing of companies was a cumbersome and restricted process that inhibited business. However, how and where the government must intervene and how the law must be written for this intervention, is -something that must be studied from the point of view that allows economic resources to be utilized optimally.

For example, the ownership of land is not a simple concept. Your ownership of a piece of land can be directly affected by your neighbor should she choose to, say, start oil drilling on it, or start a loud discotheque or some polluting venture, or even permit her cattle to wander onto your land and destroy your crops or house. In such an event what are your options? Civilized society requires suing in a court of law. But think about it, it is not a piece of land that you own but a bundle of rights related to the use of the piece of land.

What is also clearly accepted is that the incumbent whose rights have been violated has the right to collect damages. If your neighbor builds a tall hotel and ruins your swimming pool's exposure to sun, you should be able to collect damages. The new hotel imposes a cost on you making its builder liable. This rule forces him to include that cost in his investment. This is what economists call an external cost or *externality*.

But, as Ronald Coase (1960) pointed out in an article that laid an important part of the foundation for the economic analysis of law, that answer is too simple. It may be true that if the builder of the new hotel is not liable he need not consider the cost he imposes by locating his building where it will shade his neighbor. But if he *is* liable, the neighbor at an earlier stage need not consider the cost he imposes by locating his swimming pool where a building on the adjacent lot will shade it, thus forcing the owner of that lot to either leave it empty or build and pay damages. What we have are not costs imposed by one person on another but costs jointly produced by decisions made by both parties.

Part of Coase's solution to this problem is to restate it in terms not of external costs but of property rights. One of the rights of value to the owners of both hotels is ownership of the stream of sunlight currently falling on the pool. If that right belongs to the owner of the land on which the sunlight now falls - the owner of the old hotel - then the builder of the new hotel can be held legally liable for interfering with it. If it does not, he cannot. The right is of value to the owners of both the adjacent pieces of property: One needs it to protect his swimming pool, the other to permit him to put up a building that will shade it.

Box 3: Incentives-based management

The market has several means that allows shareholders and managers to reach economically efficient contracts. For example, manager's incentive can be aligned through stock options. But then there must be clear indicators of performance of the company. The best indicator is a stock price, which in any case is required for writing such a contract. Poorly managed companies can be subject to takeovers given that the more efficient management that takes over can better maximize shareholder value as well as make a profit for itself. Once again a market, which values firms efficiently through widespread trading, enables such reallocation of resources.

The market approach to management is practiced every day in business and comprises of designing a reward system to align principal and agent's goals. Assume that you are a manager of a restaurant and you have to motivate your waiter to work hard. Your responsibilities are to decide whether to pay a fl.at wage or a piece rate, whether to allow pooling of tips, etc. You will need to create an incentive structure that rewards the outcome of high levels of effort can induce agents to aim for the goals principals set, including:

- Formal incentives (e.g. piece rate wages, bonuses, stock options) based on verifiable measures of performance;
- Foremen, fellow employees, bosses or boards of directors monitor work inputs and outputs;
- Punishment for malfeasance; and-:

All these highlight the need for a meritocracy to encourage a forward-looking employee to exert more effort.

The solution suggested by Coase was not liability but trade. Define the relevant legal rules so that one of the parties has a clear right to the stream of sunlight. If it is worth more to the other - if the gain from building the hotel is more than the cost of moving the swimming pool - the other can buy it. Thus Coase, by looking at real cases in which courts had to decide among competing uses of land, radically revised the economic analysis of externalities.

Box 4: Defining Property

The Coasian solution is to define property in order to minimize the costs associated with many incompatible uses, such as, factories and recording studios, or steel mills and resorts. We call the right to decide what happens two feet above your land - "ownership of land". Should flying a mile above be called that?

Why do property rights exist? They provide incentives to work, innovate and improve, prevent waste, destruction and stealing. Remember the rule, *Finders-keepers* which still applies to mineral exploration and fishing. It should also be remembered that there is enough evidence of a strong positive relationship between intellectual property rights and power of innovation.

But if law fixes liability, rather than assign property rights, then there is no trading.

Quite contrary to legal centralism - the doctrine that assigns law a central role in determining what people do and what society is like - there are institutions that actually do a large part of what law is supposed to do. Close-knit groups tend to develop efficient norms, and in a wide variety of situations, people resolve conflicts without recourse to law.

According to Coase, there can be many solutions to the problem, be it market, regulation, or legal. There is no reason to assume government intervention is the best. Hence a rigorous study using economic analysis is necessary to understand outcomes before prescribing. As Coase says, *"All solutions have costs and there is no reason to suppose that government regulation is called for simply because the problem is not well handled by the market or the firm. " (* 1960)

Box 5: Order Without Law

Ellickson, in his Order without Law (1991), looks at how neighbors in Shasta County California settle disputes. Shasta County confirms Coase's rule. With bargaining, the legal rule would affect the pattern of side payments - who had to pay what to whom - but not the use of the land. Ranchers believe that in open range the driver is strictly liable for damages to cattle (the motorists "buys the cow") while in closed ranged the rancher is strictly liable ("buys the car").

Ellickson also notes how people use i~w as last resort, and use norms and reputation instead. Law, in Shasta County, is very much less important than most of us believe. He uses simple observations of the real world to throw cold water into the faces of legal theorists of almost all sorts. Legal rules cannot serve roles assigned to them by doctrinaires if nobody pays any attention to them.

If ill executed, government intervention will be even worse than non-intervention. Coasian analysis requires hard work and sophisticated analysis and knowledge. Regulation cannot be left to poorly trained bureaucrats in the poorly managed, talent-less public service with no professional standards. Society is better off without regulation and inhibiting powers of such people.

Law must take a market-based approach

"Economic analysis of the law," which is a new subject developed out of the University of Chicago, seeks to examine, what law should do to facilitate the economy and market transactions. The vantage point is unashamedly economic development and the maximization of human welfare through strong economic growth and increased economic opportunity for all. In this framework, it is recognized that:

1. Law should provide a framework based on minimum rules that **allow for market development to allow market based contracts to be written.** It should allow and facilitate takeovers, allow and facilitate stock options and LBOs, and strengthen tradable property rights. Law should also allow new markets and instruments to develop;
2. Law must minimize transaction costs. It must understand economics and take view that economic value of transaction is to be maximized. **Speedy justice, which understands the time value of money, is a fundamental cornerstone of this framework;** and
3. **Law must facilitate economic transactions, since social welfare naturally increases with output (GDP) growth**. Thus, modern law should not be vindictive or feudal, but seek to facilitate growth and market transactions. Also, it should enhance competition and the efficient use of resources, which includes strong property rights and efficient risk taking.

To the extent that economic analysis helps us perceive consequences of laws and legal decisions, especially consequences that are not obvious, it is useful to anyone trying to make or understand law. If imposing a life sentence for armed robbery results in more murders, that is an argument, although not necessarily a decisive argument, against doing it. If restrictions on the terms of leases make both landlords and tenants worse off, that is an argument, probably a decisive argument, for letting them set the terms themselves.

Assessing Economic approach

Economic approach provides a good tool to analyze legal systems. It shows how many legal rules, which do not have obvious economic raisons d'etre, undoubtedly reduce social welfare. Don't judges and lawyers, then, need training in this approach? The United States provides the answer. Law and economics approach developed at Chicago and is used mostly in US. It increases the efficiency of the system, provides efficient risk allocation and incentives to invest, and eventually leads to higher growth. But, most parts of the world are still unaware of these developments. Law and Economics is an accepted subject in the US. It has changed the way we approach economics, and devised new fields of study such as constitutional economics, which perhaps has the most important implications for poor countries. It is sad that it has not been introduced here in poor countries.

We can learn a lot from this approach in conducting legal reform in poor countries. Legal systems in poor countries must be made market friendly and timely. Law should be written for economic efficiency, with understanding of both law and economics. Economists should play a vital role as legislators and "handmaidens" of judges. Judges should be paid well and trained in economics to recognize the value of speed and risk. Law must seek to increase output and value.

Market friendly law and regulation should minimize transaction costs, facilitate contracting and refine property rights. The legal system should also recognize social product and growth of output as a goal. There should be less detailed law and more room for economics. There should be room for market to conduct and define contracts. The ultimate purpose of law should be to provide a backdrop to the market.

Box 6: Economic vs. Traditional Approach

- Fairness is important in the traditional approach, but not in economic approach. Punishment is not important per se, it is important only as a deterrent. Traditional approach focuses on damages and compensation; economic approach is concerned with efficacy and social costs of enforcement and imposition of sanctions. In the economic approach, liability system is socially worthwhile if its social benefits exceed its litigation related costs.
- Economic approach is always concerned with optimal allocation of resources and economic progress. It is therefore forward-looking and not seeking to redress the past. For example, given the risky nature of business, resources must be allowed to move quickly to better uses. Speedy and a well-known transparent process of bankruptcy is therefore fundamental to it.
- Dispensing of justice is costly. Settlement out of court should be encouraged. Optimal litigation must be decided on costs (to plaintiff, defendant and state) and benefits (private and social). Settlement out of court is likely if system of justice is well defined and transparent on issues of costs and benefits, speed of justice, disclosure before trial, appeals, class actions, and alternative dispute resolution.
- Law enforcement is expensive. This leaves us with several policy choices. Should high probability of detection be desired? Should heavy fines be levied? Low probability-high penalty strategy may not be feasible, because agents' assets limit monetary penalties, and society's willingness to enforce is a problem. ,·
- Economic approach considers the legal system as a wrong tool for redistribution. Legal system should only concern itself with achieving efficient economic outcomes and deterring crime. Hence, judges should not try to enforce employment and do redistribute justice.
- Since contracting is mostly market based, it requires markets that allow trading of rights, maintaining fair value pricing and liquidity through continuous trading. Law is required to provide the enabling environment for such markets. In this approach, the focus is on providing the legal environment that facilitates trading of rights.

EDUCATION

The Knowledge Process!

For years, I have watched universities in Pakistan deteriorating. It has also been one of my fervent desires to be associated with education reform and rebuilding in my country. But I have always found that the area was totally dominated by the so-called education advisor/consultant who was very narrow and rigid in his/her thinking.

Thinking in this area appears to be led by the earlier benign socialist notions and are not really based in an understanding of history, the impact of education on growth and the economics of education.

Sri Lanka is especially interesting in that it has made enormous gains in the education sector by achieving near universal literacy rate and high school attendance rates. But there are several issues that need to be addressed: substantial excess demand for university education exists; quality of education is generally regarded to be low; language of instruction remains a politically charged issue as well as an issue that affects the global opportunities for students.

The gentlemanly Deva Rodrigo, a quiet and very effective business leader invited me to address the Colombo Club, Sri Lanka's oldest club. It was indeed an honor to address this cJub and we both agreed that education should be the main theme.

I used some research that I had done in the area to develop ideas on the knowledge process that had been at the back of my mind for a while.

There was very happy outcome from this encounter. I was invited to be a member of the Ceylon Chambers of Commerce education sub committee. We have faithfully worked on this committee giving of our spare time-weekends and evenings. I met committed people like Faizal Salieh, Tommy, Dilmi and Dharmasiri. Their dogged determination will indeed create the pressure group on education that will truly own and champion education reform in this country. Indeed, I am proud to have been a part of this effort.

The Knowledge Process-Why the University/Research cannot be ignored! Or the folly of development advice!

Since their inception, developing countries have slavishly followed development advice. Unfortunately, this advisor carried no risk while the country was always held responsible for the fallout of the advice.

One such piece of advice that has always bothered me as an economist from developing countries is that relating to education. For years, the advice given to poor countries was to build education sequentially. First, get universal literacy, and then develop secondary education to be followed up by college education. Implicit in this was the message that research and advanced studies were best left to the advanced countries. It was almost a stages of development argument where you could only progress to the next stage if you had completed an earlier stage.

For example, The World Bank in its Priorities and Strategies for Education in 1995 says that "the high rates of return estimated for basic education in most developing countries strongly suggest that investments to improve enrollments and retention in basic education should generally have the highest priority in countries that have not yet achieved universal basic education." And again a few pages later, "as the basic education system develops in coverage and effectiveness, more attention can be devoted to the upper-secondary and higher levels."

Any attempt at arguing against this was stifled by the powerful lobby of development economists. Certainly, all of us from poor countries were totally marginalized from this debate. All manner of education expert has done various reports and plans for the poor countries all of which seek to develop this sequential approach to education. The upshot has been that university and college education has been severely neglected in these countries. The impact on the thinking and research segments of society has been the worst. Virtually all poor countries have no research bodies capable of generating policy-oriented work. None of them have any form of R&D activity anywhere.

I will argue that this truly has been the folly of development advice for which the poor countries are now paying a heavy price. Let us see why!

The Knowledge Pyramid

Figure 1 shows what I would call the knowledge pyramid, which frames every profession within a country. The general practitioners including primary and secondary school teachers, and some skilled government and private sector workers make up the base of the pyramid.

As you climb up the pyramid, professionals with a deeper knowledge of what their professions are needed. They must know their subject in greater depth and have the ability to keep up with what is happening in their professions. As we are all aware, disciplines and professions advance at an extremely rapid rate. Unless there are adequate numbers of researchers/advanced academics at the tip of the pyramid, the ability of the entire profession to keep pace with the frontiers of the discipline will be seriously impeded.

The peak of the pyramid (the research oriented university-based academic/researcher) is where the pyramid can drink off the trough of global knowledge, which is growing so rapidly.

Unfortunately, if a society has not invested in university education, the peak is missing. The headless pyramid finds itself continually unable to keep pace with global developments.

Thanks to development advice, many poor countries continue to retain and nurture a headless pyramid. This may perhaps be the biggest stumbling block now in the path of reform and progress.

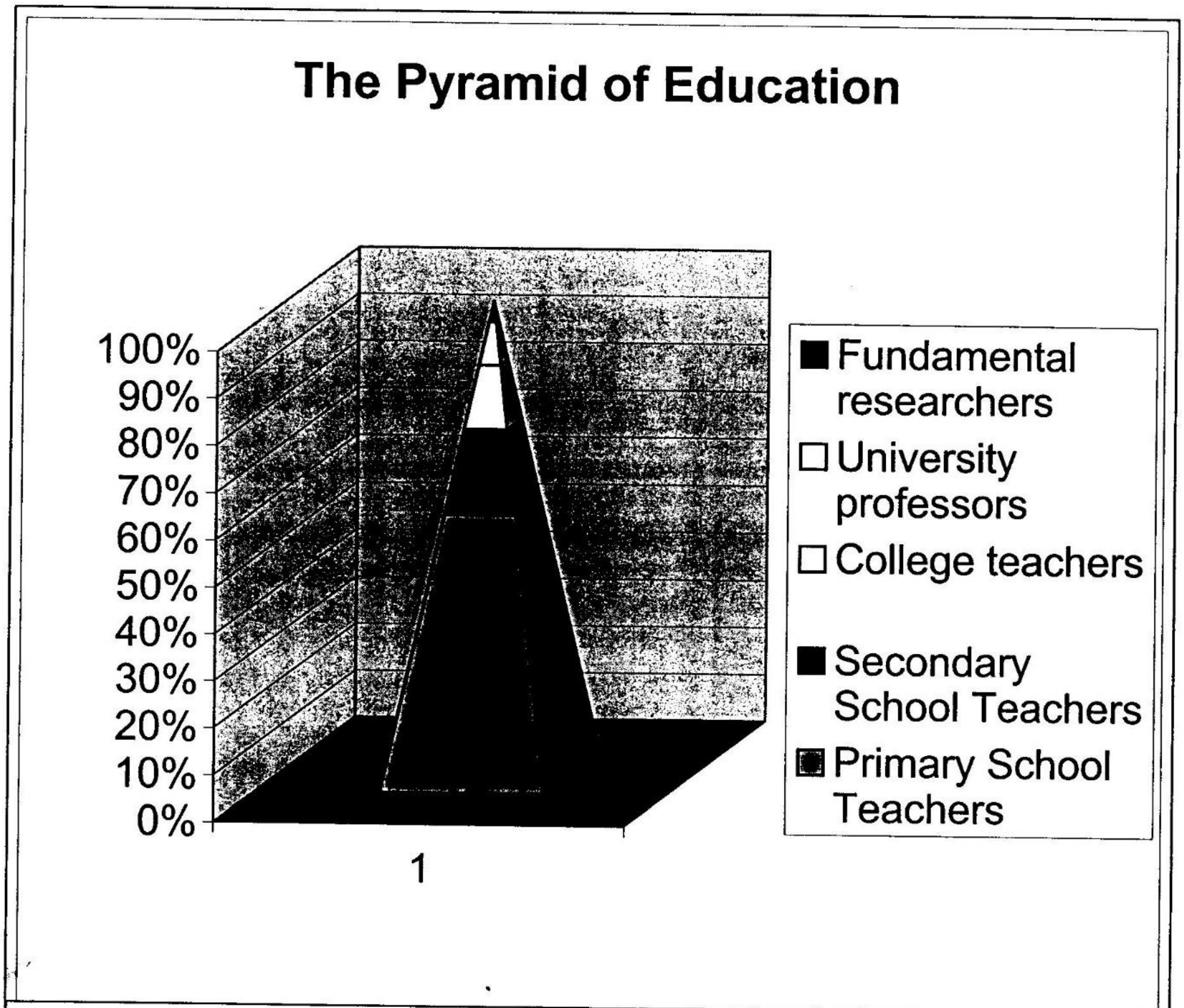

Figure 1

The importance of the 'Peak'

Even where aid has build universities, it has focused on buildings and facilities and regarded professors and researchers as secondary. Once again implicit in the design was the intention to deal with knowledge that is not at the frontier. But the advisors and project designers were too short sighted to see that knowledge which is not at the frontier is yesterday's knowledge.

1. **Keep the challenge in research and depoliticize universities**

It is not surprising then that in many of these countries, universities are teaching from books and notes that are decades old. The focus on buildings and sequenced approach to education I meant that all the incentives were against research. Professors and students were all motivated away from research. The former began to regard university life as a form of retirement while the latter group was left alone without a challenge to find an alternative outlet for their excess energy.

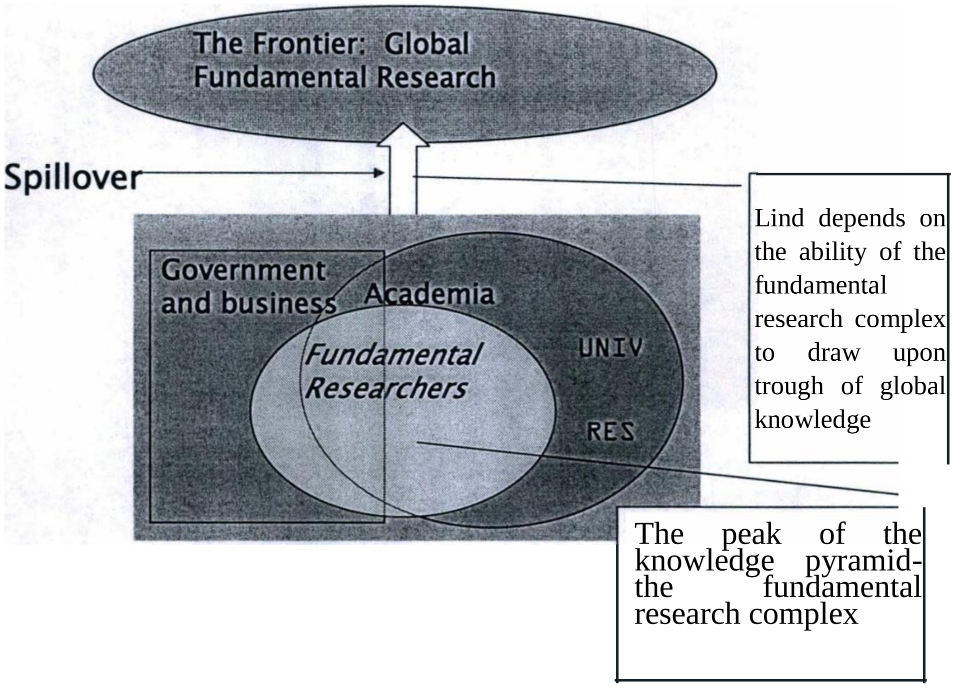

Figure 2

It is not surprising that students channeled their energy to uninformed political activity. Universities became a hotbed of radicalism and when that lost its luster students turned to religious fundamentalism. Extremism and continued certification of the uninformed has continually led to declining standards. The self-righteousness of this extremism will not even allow a serious debate on economics to be now conducted.

2. Benefit from Knowledge spillovers

Numerous studies have shown that there are spillovers to R&D spending in the world. Estimates suggest that a 10 percent increase in R&D spending in the US will lead to, on average, about a 0.7 percent increase in growth in the poor countries. The term average is important for it means that the impact will be spread across developing countries to produce an average of 0.7 percent. Needless to say, countries that are better positioned to benefit from this spillover will claim a larger share of the gain from the global research network.

Figure 2 makes this point by showing a bird's eye view of the peak of the pyramid. Unless there is a critical mass of fundamental research capacity that is capable of interfacing with the global research frontier, the country will remain frozen out of new developments at the frontier.
3. Understanding and developing modern institutions.

3. Understanding and developing modern institutions

Research has shown that an acceleration of economic growth that facilitates a catch up with rich countries requires the development of well-founded institutions that have roots in society and body politic. Time and again attempts at transplanting these organizations through international aid have failed. Instead it seems that if these institutions are created endogenously through increased awareness and learning that takes place through a domestic debate and understanding, they would be better rooted in society. Figure 3 shows that if a society is open and capable of absorbing knowledge from the global frontier, the chance of this awareness and understanding increases.

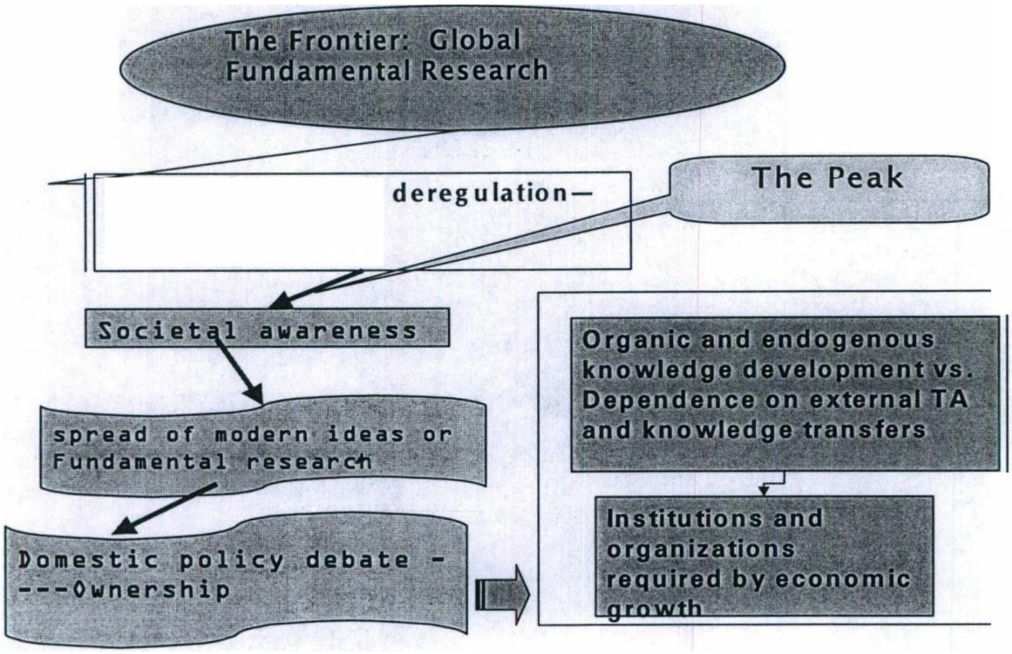

Figure 3

4. Setting standards and syllabi

The question of who will lead the education system has to be faced up front (see figure 4). In Pakistan, for example, science and history syllabi were left to those who had managed to divorce themselves from the global frontier of knowledge and used fundamentalism as refuge. By this means not only were they able to maintain their own pre-eminence but also to feed students either outmoded or false knowledge. The harm that was done was great. Yet the system had no one to challenge the standard setters or standards that were set. K. K. Aziz, one of the country's best historians wrote about it as did Parvez Hoodhbhoy, an MIT Physicist. But since those who did not accept global standards now controlled the universities, there was no debate.

This is an important point that the advisors of a sequential approach to education development forgot (see figure 3). A more balanced approach that allowed research and higher education potential also to be nurtured may not have led to the situation where students are increasingly getting a substandard education. These ill-educated students are not productive enough to get private sector jobs. Periodically, the government has to step in and employ them in the public sector. The public sector continues to grow but with unproductive workers. Governance is constantly declining in quality leading to yet poorer institutions and slower growth.

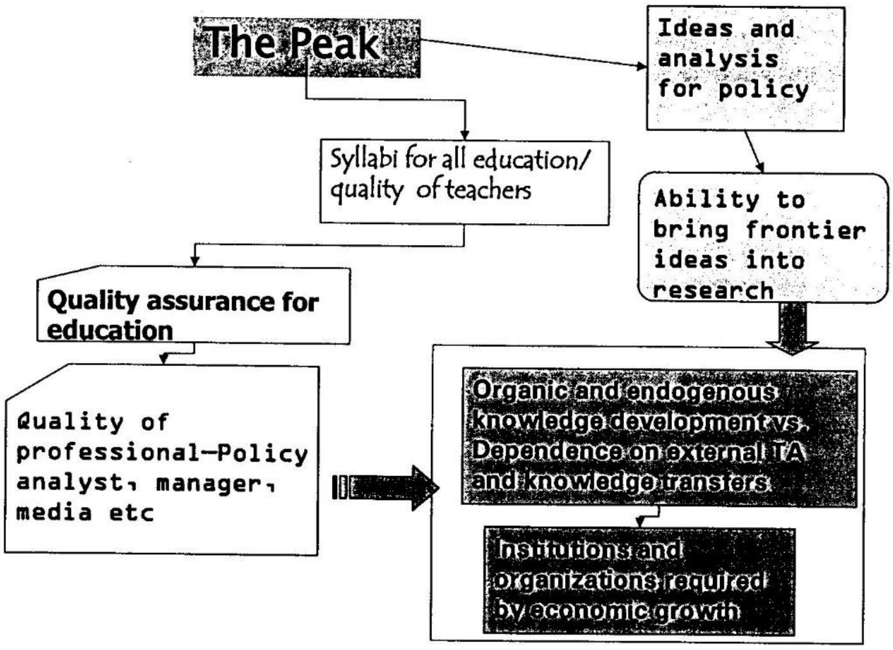

Figure 4

The 'peakless' pyramid that the sequential approach developed has led in many countries to this cycle of despair where poor quality and politicized education reinforces low growth and vice versa. Sri Lanka has a very high literacy rate having followed the sequential approach and yet has a higher education system that is not producing the quality manpower that business demands. Every year or two, these graduates lobby their way into a mass hiring by the government.

Society suffers many times over in this scheme of things. First, the closure from the global frontier of knowledge that has been achieved erodes professional and educational standards. This leads to the development of a poor quality workforce lowering productivity. These low productive workers become the obligation of the state thus further lowering productivity. Slowing growth and a higher wage bill eventually leads to a combination of high taxes and a high debt burden, once again reinforcing slow growth.

5. Conducting policy analysis: where do policy ideas come from?

Figure 4 also makes an interesting link between the peak and growth and institutional development. For good policy, governments need analysis and research that will allow informed decision-making. 'Peakless pyramids' that have been created in many poor countries keep them dependent on expatriate development advisors. This approach has now been used for 50 years with few positive results. The quality of these consultants is very variable. Their knowledge of the countries is often poor and they have limited time to improve it. Most important of all, they are not held accountable to their product in any way. They merely produce a report with recommendations. If these do not work out there is no method to make them pay for the mistakes.

Domestic research capacity for policy-framing has the distinct advantage of knowing the society and being rooted in it. This means the incentives of these individuals are properly aligned with progress. They gain (or even lose) in reputation if their analysis is good. In other words, they have a vested interest in performing well on their research and policy suggestions.

In some sense it is unfair to say that the there are no local leaders of thought even in the 'peakless' poor countries. There always are. As pointed out above, in a system of education where quality has been eroded and there are no professionals standards, these leaders of thought can set their own standards that may be totally at odds with those prevailing in the global frontier. This closure allows them to pervade society with all manner of counterproductive ideas. Nationalism, fundamentalism and many other extreme ideologies have been used by such intellectual elites to keep their monopoly on ideas intact and keep society segmented from the global knowledge frontier.

Conclusion

I hope I have made a convincing case that an investment in quality higher education that is research led is of the greatest priority for any society no matter what its stage of development. Development advice has begun to recognize the importance of higher education but has still to make all the linkages. Essentially, I find that this approach continues to suffer in five fundamental ways:

- It still regards such education to be "tertiary" -a geological term that continues to suggest sequentialism. I would argue, as I have done above, that it is absolutely essential to the bedrock of education and not tertiary at all;
- It is still not a research-focused approach that seeks to break the barriers to the global frontier. Thus the system is still viewed as local and local standards and accreditation are being developed;
- The approach is incremental and will continue to adversely affect generations of kids and keep society segmented from the expanding knowledge frontier. Given the enormous advantages to developing a quality higher education system, the costs of delayed reform are not being fully accounted for;
- The approach remains infrastructure focused and not researcher and people focused. The incentives and the conditions in which the professor and academics function are among the last factors that are addressed. This is the peak of the pyramid and reform design must ensure that the best and the brightest flow into it and then are motivated to contribute to the expansion of global knowledge.
- Although, some lip service is being paid to what is known as the development of tertiary education, it is still not finding itself into the heart of major reform programs of poor countries. Any review of the major programs such as structural adjustment and poverty reduction programs will reveal how little a weight is given to such reform.

However, why lament the expatriate advisor? The answer as usual "lies in us and not in our stars." Reform must begin at home. Perhaps it is time poor countries began to understand and debate these ideas and take charge of their own reform. The path to progress lies there!

Education Policy and Reform

The theme of education was of interest to several groups so I kept developing it in several gatherings. These new ideas found a lot of interest. I was invited to deliver a keynote address at the annual conference of Sri Lanka College of Microbiologists on May 11,2001 who wanted to review the notion of change and modernization in education. I also addressed the Symposium on "The Future of Universities: Challenges & Opportunities" organized by the Education Research & Study Group at University of Moratuwa. There was gathering of educationists comprising of a fair number of vice chancellors of universities where again I made a presentation on education.

In the summer of 2001, I initiated a brainstorming at the COC Education and HR subcommittee at which we concluded that this committee would take up the challenge of hosting a national education conference and present its own vision. They have worked hard at
developing the conference to elevate the debate on this subject.
They have asked me to present a keynote address at this conference and the material presented here as well is in 'the knowledge process' and 'Institution Building' will form the basis of my remarks.

Does Free Education Reduce Income Inequality?

This very interesting question is of great public policy significance and deserving of attention and debate. Let us put it through the lens of an economist for an interesting perspective. Unfortunately, in poor countries of South Asia such as yours and mine, there is a deliberate intent to drown this question in emotion to prevent us from examining it in earnest.

Why me?

Let me begin with why I feel qualified to answer this question. I think that it is important for all speakers to present their credentials to an audience to enable it to make up its mind on whether it is learning or merely wasting time.

I grew up with a dream of an academic career in Pakistan and for that trained myself the best I could. In the process, I went to the University of Chicago and studied with several Nobel prizewinners. Gary Becker who fathered social economics and the economics of education changed the way we view education and social policy. I hope to show you how in the course of this discussion.

As can be expected with all great work, Becker was not alone in what he did. Nor is great work ever static. A great Becker associate, Sherwin Rosen extended our understanding of education, occupational choice and the nature of labor markets enormously. The Nobel Prizewinner of 2000, Jim Heckman developed several econometric techniques to improve our measurement of human behavior.

In this tradition, I myself have worked with large datasets to measure rates of return to education, the choice of employment status, family formation, family, farm consumption and storage decisions. Continuing the Chicago tradition, I have published papers on some of these subjects in academic journals.

With that, I hope I have established my credentials and we can now begin our discussion of education policy from a hard-core economist's perspective.

You may well ask why are we even discussing this subject when education is totally free on this island and education unquestionably increases social mobility. We economists, especially those from Chicago, love such incidences of obvious well-meaning subsidies. We love to analyze them and show *that things are not what they seem.* In order to answer this question carefully, we need to understand the subject of economics of education. It is that foray that I wish to make today.

Please bear with me through this adventure with an open mind. For nationalistic and idealistic reasons, with the best intentions in mind, we in the poor countries created a distorted and muddled education system. Without even realizing it, we had created a powerful vested interest that has now for decades willfully obstructed not only change but also a meaningful debate on the subject. I submit to you that even though many of you may not agree with the economist's viewpoint, it is an important dimension of the problem that cannot be left unaddressed. I therefore entreat you to allow this viewpoint an honest airing. Let the students and all other stakeholders honestly examine it. It is up to all parties to accept or reject this view after a serious debate.

Who gains from education?

Becker (1964) developed on the common sense notion of education being an investment in a person's future. Since the dawn of civilization, people have invested part or all of their youth to acquire a skill. This ranged from apprenticeship to formal schooling. They paid for this skill acquisition with their time and a combination of servitude and fees. Through history, people have invested in themselves in this way because of the expectation that wage of a skilled worker is higher than that of the unskilled. No one can deny these simple observations. Mothers have used these to imbibe their children with ambition.

Becker used this simple observation to allow us to understand the economics of education. If we can observe the skill gap, i.e., the difference between earnings of various skill levels and the unskilled wage as well as the costs, we can determine the rates of return to the education. With this data we can quantify the investment and use lifetime returns that the skill would earn to determine the rate of return that the person making the investment has obtained. This has been done time and time again in all countries. Thus economists use the term human capital to refer to the accumulation of skills and education.

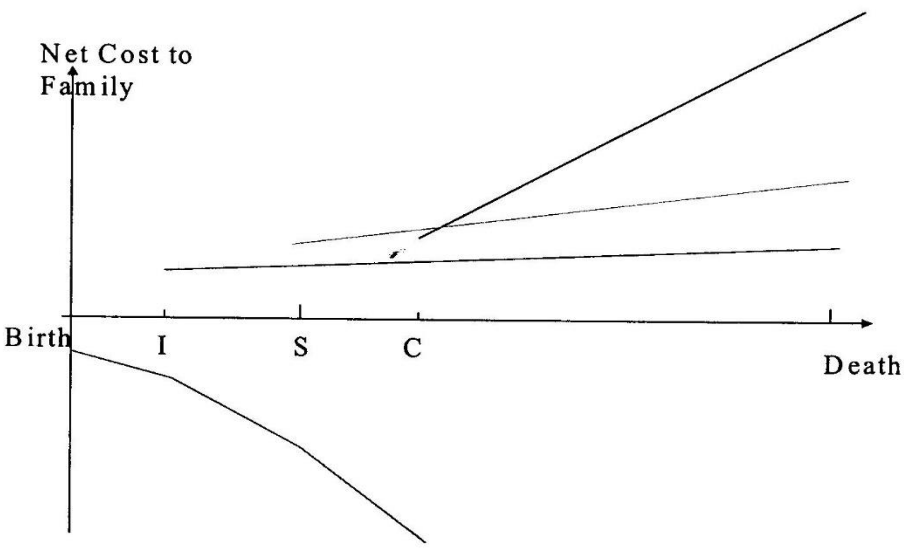

Figure 1: Understanding the economics of education

Figure I shows a very simple representation of this economic analysis of human capital accumulation decisions. It shows lifetime earnings of an individual given her education choices. From birth, the person is an expense to her family and therefore only record outflows which increase with age till the point I, when that person reaches school-going age. At that point, the family has a choice either to let the person enter the child labor market or to send her to school. If the option to enter the labor market is accepted, then she earns a low unskilled wage represented by the lowest shallow positively sloped curve for the remainder of her working life. On the other hand, if she enrolls in school, for the schooling period there are only expenses and no earnings. However, after the schooling has been completed at Snot only is the earning potential higher but so is the possibility of salary increases during the person's lifetime. Hence the middle positively sloped line that is steeper than the unskilled wage profile. At this point, the person and the family again face the decision to continue schooling or not. If college is accepted once again there are higher costs associated with it and its completion leads to higher earnings as well higher increases in earnings through life.

Can we observe wages and costs carefully enough to make this analysis meaningful? This is an area that we need to examine carefully. All of us have a notional (or should I say an emotional view) of the subject. The socialist among us would like to compress or eliminate the skill gaps and reduce the cost of investment of zero. However, they do so as I will argue below, because they cannot understand the Beckerian analysis of Human Capital.

To measure costs of acquiring education carefully, both direct (fees) as well as opportunities forgone (time taken to gain education which could have been spent earning a wage) must be considered. In making their decisions, people form their expectations of lifetime earnings that would derive from the skill that is to be acquired.

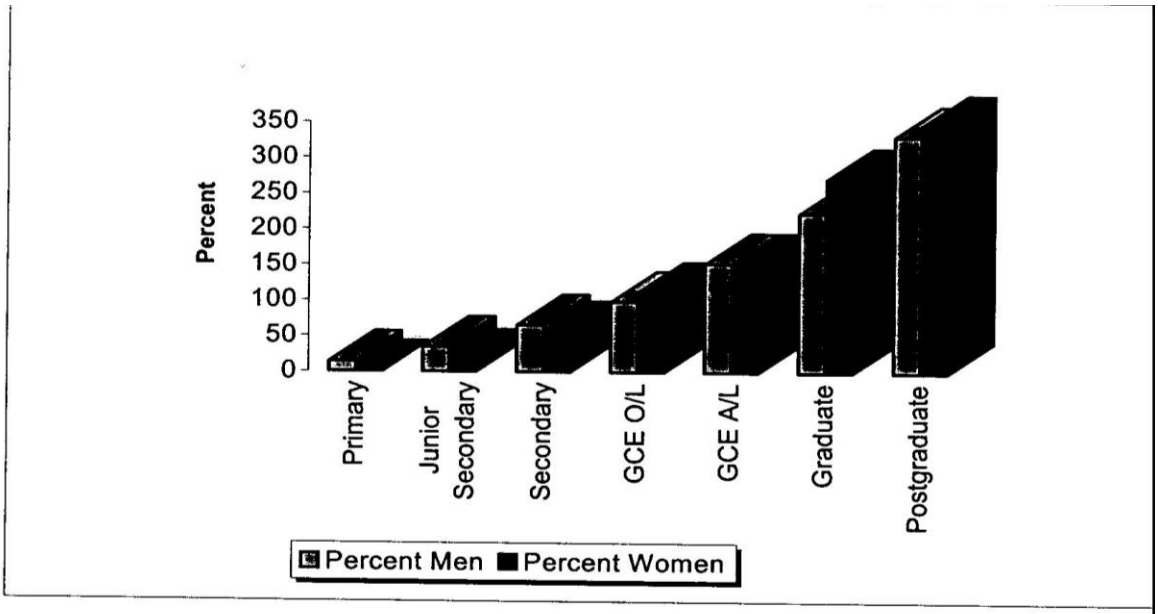

Figure 2: Private Rates of Return to education (Aturupane 1998)

Figure 2: Private Rates of Return to education (Aturupane 1998)

Estimates of rates of return to education as well as of skill gaps in Sri Lanka are presented in Figures 2 and 3 (Aturupane,1998). Aturupane has used large sample surveys and sophisticated econometric techniques to make these estimates and they can be considered to be reasonably representative of the education market in Sri Lanka. The first thing to note about these results is that they are in keeping with the theoretical picture just shown in Figure 1. Secondly, as suggested by our theory, completion of each additional certification leads to increased earnings and a higher rate of return. Finally, rates of return too are increasing in the level of education reaching as high as an annual rate of return of 20 percent for a university degree.

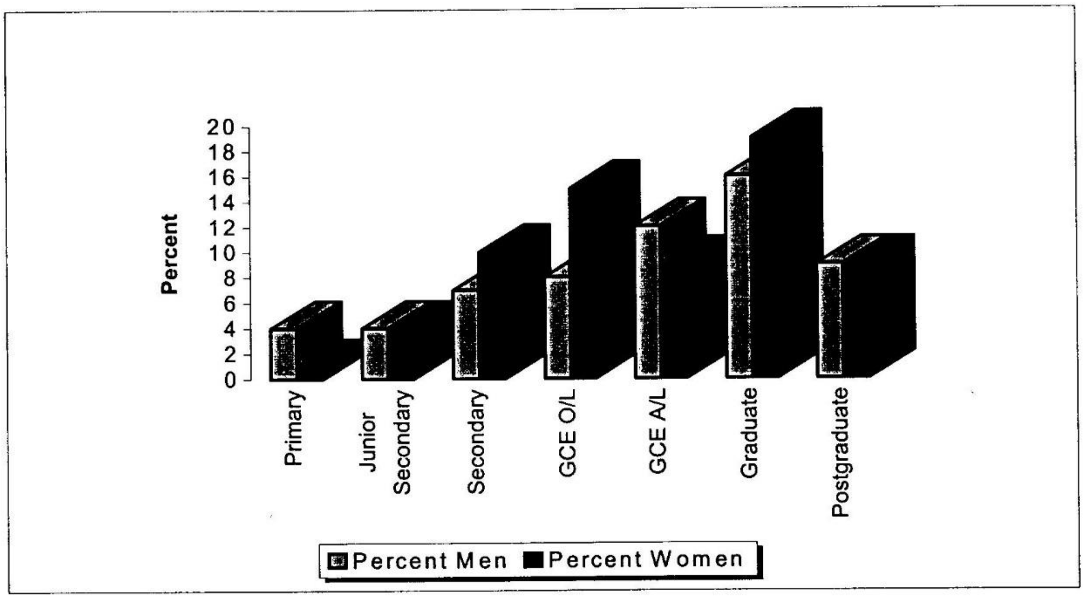

Figure 3: The Impact of Education on Earnings, 1997 (Aturupane, 1998)

The Quality Factor

We can safely conclude that education is a good investment and that there are fairly substantial gains from education. Rational individuals are quite prepared to pay for a few years with their time as well as through their family resources in order to derive benefits for a lifetime. However, what is not captured in analyses like Aturupane's is that the returns to education depend on who you are trained with, i.e., your certification matters. In other words, people also buy the education that fits their needs.

Contrary to the desires of those of us who are more socialistically inclined, nowhere in human history have returns been standardized. All of us know that a Harvard, Chicago, Stanford, or MIT certification is worth more than that of the University of Punjab, Hyderabad etc. Even in the earlier times, Plato had to go train with Socrates. Through history, we have seen great centers of learning to which people from faraway gravitated often at considerable expense.

More choices are good for students and families

The investor calculus of Becker is all about offering choices to students and families. They are free to choose careers, as well as the quality of their training for a particular career. They do so based on the market-based information and opportunities that they have. The market must be free and open to offer them jobs in the various professions as well as be able to supply them training facilities for those choices. But bear in mind that offering people choices does mean that they carry more risk. For example, students may invest in a declining field and realize it too late. More choices also means quality differentials which will translate into earnings differentials. In other words we have to live with increased inequality.
Most important of all, offering families choices means less planning and more market. If families and individuals are to make independent choices and benefit from them, the education system must be based on competition which seeks family business-not a nationalized, centrally administered system of education.

The "do-gooder" approach

Unfortunately, there are many who obfuscate issues through emotional argument. Any number of arguments are concocted to suggest that in the name of not being at the "right stage of development," "nationalism," "the need to civilize," and "oh! I speak for the poor." Their buzzwords merely deny students and families choices.

Then of course, there are the vested interests of the education sector - the large bureaucracies of education management and the other stakeholders who now are making a living out of the current system and would be hurt by a change.

All these groups, the "do-gooders" and the vested interests coalesce to reduce family choices. Each of them adopts a preaching posture to argue that the state knows best, the educationist knows best and debunk the market with all manner of scare stories based more on fiction than fact. Oh yes, they are on a civilizing and planning mission.

Ultimately, all these people wish to achieve is to put everybody on the lowest common denominator. But do they actually achieve even that? Let us see what the notion of free (or cheap) education achieves

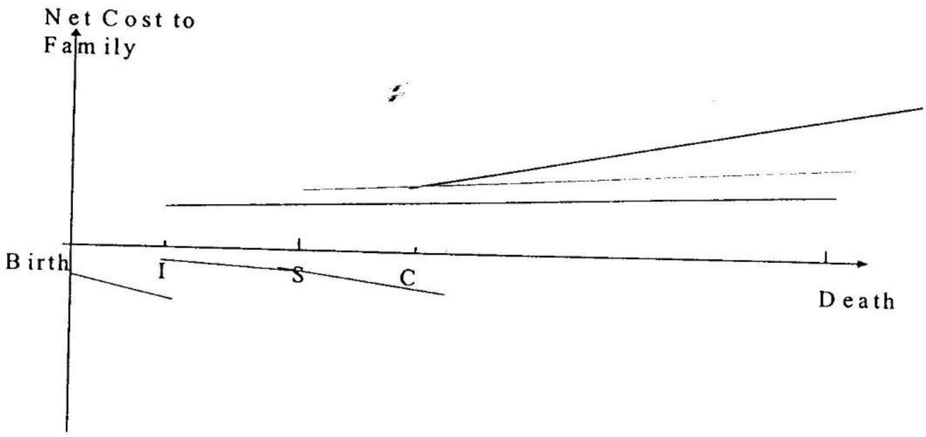

Figure 4: Becker's analysis of the socialist approach

- Figure 4 shows what the Becker diagram suggests would happen if the 'do-gooder" socialist approach is accepted. All they achieve is to push all the curves towards the horizontal axis. Families are subsidized so that the cost of schooling and college is not that much different and the returns for all forms of education are also squashed. If an active policy on compressing incomes is pursued then the lifetime wage lines get compressed as if a tax was operative. Even if an active incomes policy is not pursued, the wage lines will be pushed down for reasons given below.
- The responses of the academic institutions, the student community as well as the families are to become lax in maintaining the quality of the education. The subsidy undermines the stakeholder status of the parents and the students and undermines the incentives of the teachers to perform. In such an environment nobody has ownership of the system and society as a whole suffers at the hands of a poor quality product of such an education system.
- The upshot is that students get that quality education that they pay for, i.e., a low quality education free. It is not the kind of education that the market wants. The result is that

there are long durations of unemployment after graduation as graduates search for a job. When the market is unable to provide a job, often the public sector has to step in. Unfortunately, this means that the public sector keeps recruiting poor quality human capital further reducing the quality of governance. With declining public sector productivity and increased employment, pressure mounts for wage restraint and tolerance of rentseeking further eroding governance.

- Rational families with resources react by sending their children overseas to obtain an education that is more in line with both global and domestic business needs. With this better quality schooling (say an Oxbridge degree) the student faces a low probability of facing unemployment, better life time earning prospects, as well as global prospects.

Not only has the Harvard and Oxbridge alternative proved to be superior to domestic planners paradigm, the social divide increases to an explosive level. The rich get richer. The central purpose of education-achieving social mobility-has been defeated by this unthinking "do• gooder" approach. Opportunities close for the poor; expectations of returns for higher education are built up but never really met. This is but another example of how good intentions are not enough for good policy!

Box 1: An illustrative scenario

Is Free Education Free? Understanding Implicit taxation of Students in Poor Countries Assumptions

- Domestic poor quality education earns 25% less that overseas degrees (say Oxbridge)
- Domestic students graduate, say 3 years, later given the short supply of university seats or lagged effects of past closures.
- Higher probability of unemployment (say takes 5 years to find a job)
- Starting Salary for a local graduate of *Rs* 10,000; growing at 15 % per annum; rate of discount of future 10%; working life of 25 years.
- Education free in domestic universities; foreign universities cost US$ 20,000

Immediate loss to domestic student:

- With these assumptions, the graduate of the domestic university forgoes Rs 1, 180,615 .10 merely from late entry into the job market.

In economics terms this is a loss to society and a *Tax collected by education authorities!* It is what they get for inefficiency, wasted years and for poor quality education.

Loss to domestic student over lifetime

- Foreign graduate makes NPY of Rs. 6,114,862.77
- Local graduate because of the initial handicap of late entry into local market and inferior quality education Rs. 1,304,044.15 Net gain for local graduate Rs.1,304,044.15 –Rs. l, 180,615.10 =Rs 123,429.05
- Net gain for Foreign graduate Rs. 6, 114,862.77 –Rs.5,220,000 =Rs 894,862.77

Upshot: A Foreign Graduate despite higher initial expenses accumulates more wealth over the lifetime. Therefore, the present education system does not provide equal opportunity!

Who pays for this policy?

- **The poor.** Their expectation of an improvement in their standard of living is robbed of them. They spend years educating their kids and end up with a cheap low quality education that does not command market wage. Eventually their children enter the educated unemployed pool and if are they lucky end up in public sector employment

where they are continuously looked upon with suspicion. They are ruled out of the lucrative multinational job as well as the global job market.
Let your imagination go with you for a while and you will see how the poor students really get hurt even more than this in the real world. I could equally argue foreign graduates have a steeper career profile, get more opportunities to get more senior jobs such as the CEO, as well as get more international opportunities. When you factor these in, the difference between the 2 groups widens. Box 1 shows an illustrative calculation on how the poor student loses out relative to those who can afford a quality education overseas.

- **Society** also loses as social tensions increase. In some countries the pools of the urban educated unemployed tum to crime. It also bears the cost of low quality useless education and crime.
- **Governance and the budget.** This policy creates graduates with low quality but with first class expectations. To mitigate social problems and protest, governments often adopt a "give them government jobs!" approach. Under pressure the public sector employment is expanded with low quality human capital to levels that are beyond what the budget can bear. The misplaced education policy now translates into a governance problem as/well as a fiscal problem. Growing fiscal pressure and an increasing wage bill means existing resources must be spread over a larger employment base. Haque and Sahay (1996) have argued that declining real wage as well and the concomitant lowering of standards induce the incentive for corruption. At this point we get into a self-reinforcing cycle of poor governance.
- **The taxpayer:** With the deterioration of governance and the fiscal situation, the tax burden has to increase.
- **The economy:** Eventually with growing governance and fiscal problems as taxes increase and more productive people migrate, growth slows down. Rather than dealing with the potentially explosive situation of education reform, governments find it easier to impose more controls. This further aggravates the economic situation.
- **Again, the poor.** The rich have diversification and migration opportunities while the poor have nowhere to go except tighten their controls on a weakening economy. The victims of the system become more and more risk averse and protective of that which they appear to have. As they get poorer the more they seek to maintain the hollow subsidy on poor quality education.

It is quite clear that through the best of intentions but with very poor analysis, we ROB the poor!

Who gains

The poor are deliberately misled and scared by the vested interest-the single most important impediment to change!!! They seek to maintain their monopoly. They create a deliberate confusion on the issue of private sector's role in education. They prevent private entry into education by using scare tactics arguing that the poor will suffer. They like to impose national curricula and examinations on grounds of nationalism and humanitarianism but in reality it is to maintain their protected status. Typically this is done to maintain their power, privilege and comfortable lifestyle at the cost of the student (see box 2).

Box2

Typical characteristics of education in poor countries

- Limited capacity utilization (Short working days, long periods of closure)
- No extra curricular education (Lectures and seminars beyond the regular)
- No faculty mobility
- No faculty research—at best some low level consulting
- Best professionals from country are overseas -not invited to teach (No joint appointments)
- Syllabi old and outmoded—Rely on outdated texts. Limited use of current research papers. New developments in subjects are introduced with long lags
- Use of outmoded notes
- Large admin/faculty ratios
- Centralized systems with power held closely by education ministries. Autonomy severely resisted.

Various authors, including some competent academics, write with frustration about these education systems to bring home the point that vested interests are blocking entry to protect their own interests. One such author from Pakistan-Abdus Samad-has written several poignant essays on this theme. He writes about his desire to become a competent Pakistani academic was thwarted to a point that forced him to migrate in a moving essay called *Why I became An Exile.*

"Those of us who managed to break in eventually were in for another rude shock. Those who had control of the educational establishments did not wish any serious and new information to be conveyed to the students and would do anything to retain their hold on their institutions. In fact for all intents and purposes it appeared that all the corrupt forces in society were united in their efforts to ensure prevent the youth of the country from gaining an education. It was almost a conspiracy. The campus was used for the purposes of generating active street-level political support. The campus was used as a means for appropriating funds from the budget for personal gain. What it was not used for was an education." (Samad, 1993)

In another essay in the same book, entitled *Have all immigrants deserted Pakistan*, he interviews several expatriate Pakistani professionals and reports on the constraints that they face to participating in development at home. Here is an extract:

> "Three academics-- professors in electronics, economics and mathematics-- argued that despite the ardent desire to return, there was no way that they could do so. All three of them had had experience of working in Pakistani universities or research institutions. All three had repeatedly tried to go for short professional visits to the country. One of them had also worked for a considerable period of time in one of the largest research institutes in the country. He was finally driven out." (Samad, 1993)

Sadly, the youth are taxed without their knowledge and misguided into protecting the monopoly of the vested interests. In tum the vested interests are also not collecting the entire loss of the students. They are realizing only some additional leisure and saving some effort to make a change.

The Urgency of Education Reform!

Through the nineties much economic research has been conducted on the growth experiences of the world and we are now beginning to understand that growth is not merely an accumulation of physical goods. The finger is now pointing to education and human capital development as being one of the most important determinants of sustained economic growth. A poor quality education system may be one of the most important reasons why poor countries do not grow.

It is interesting that Milton Friedman had summed it up well with considerable prescience to the government of India in 1955 in his now famous ***"A Memorandum to the Government of India 1955."*** He had said:

- "There is a tendency not only in India but in most of the literature on economic development to regard the ratio of investment national income as almost the only key to the rate of development"
- "In any economy, the major source of productive power is not machinery, equipment, buildings and other physical capital; it is the productive capacity of the human beings who compose the society"
- "By this Writer's estimate, only about one fifth of the annual rate of growth in the United States can be attributed to the direct effects of investment in the usual sense; four-fifths must be attributed to the growth in the productivity of human beings."

It is a pity that India did not listen to him carefully enough. Indeed, I am sorry that in my country there were no economists to hear what Friedman said. He was RIGHT!!! And now all economists, futurists, management thinkers, and corporate heads all agree with this line of reasoning. Several new books are now talking of the knowledge economy and the knowledge worker as the cornerstone of such an economy. It is all about knowledge and education and outmoded education systems will not help economies progress out of the poverty trap. [1]

Perspectives on Higher Education reform!

The principles of higher education (or university) reform can be gleaned from the experience of the American Universities that have been the powerhouse of education in the 20th century and are the model for education management that the rest of the world is now following. These principles are summarized in Box 3.

Conclusion

Education remains an emotional subject on which limited debate takes place. Given its centrality to economic development, it is not a subject that can be ignored. In fact, education reform must be given priority. We need to understand the economists' perspective on education as well as review the development of educational institutions especially in countries like the US. Most important of all we need to treat the subject like educated people—rationally and dispassionately.

[1] See for example, Senge (1990) or Edvinsson and Malone (1997), among many others.

Box3

Principles of good University management: Learningfrom America

Policy changes

- Free up education—This does not mean privatization of public sector universities. Merely that public sector universities need competition to improve their efficiency:
    - o Allow private sector for profit as well as not for profit education;
    - o Allow quality differentials among universities to emerge rather than keeping all at lowest common denominator.
- Retain public subsidy to education but target it towards the poor;
    - o Allow equal access to quality education through some form of voucher scheme so that public universities have to compete for subsidy resources by providing quality education. Eliminates the need for a UGC. Makes parents, rather than UGC, choose.
- Remove education ministry from managing educational institutions to determining policy.
- Even though the vested interests would argue for it, there is no need for accreditation or regulation! There is a global accreditation business that is doing very well ranking universities based on various market criteria. They are preferable to local bureaucracies.

University management

- Faculty focused system - The management of education must be squarely in the hands of researchers:
    - o Well paid independent faculty;
    - o Teacher determined syllabi.
- Research based-excellence driven:
    - o "Publish or Perish!"
- Decentralized management with faculty and a large degree of departmental autonomy
    - o Hiring and firing decisions at departmental level:
    - o Academic decisions at departmental levels;
    - o President only for fundraising and coordination;
    - o No role for education ministry (worth repeating).
- HRM in universities focused on quality research and education and not retaining lifetime low quality guaranteed employment.
- Internationally competitive hiring. Faculties at most good universities are now global.

Institution Building - Lessons from History

There are lots of interesting lessons to learn from history. The manner in which universities were built is fascinating and to my mind gives us a lot of insight into what has been done wrong in the developing countries. In particular, we need to review how the US in merely 2 or 3 decades moved from no research based universities to the best universities in the world.

I used this research in many gatherings (Colombo Club, COC education committee) to challenge 2 myths in education in Sri Lanka:

That all education must be managed centrally in a huge education bureaucracy run by the ministry of education

That private sector should not play any role in education

The American decentralized educational management, where professors were controlled the agenda and curricula challenged these prevalent myths.

Institution Building-Lessons from History

In the post-war world, numerous attempts at all levels-multinational, bilateral and domestic have been made to foster growth and development in the low-income world so that these countries could catch up with their richer brothers from the industrial countries. Why has growth not been faster? What can be done to make these countries achieve a more balanced and sustainable growth? These are the important questions of the day that are preoccupying all serious positive social science and development policymaking. To a large extent, many of the answers that are being derived relate to the failure of these countries to develop key institutions. Most practitioners and thinkers are now in agreement on this issue but remain perplexed at what is required to develop these institutions. Public sector's attempts at developing the institutions within its fold have not succeeded. The fostering of non• governmental institutions also remains fairly uneven in its results. Donor funding for institutional support too has had very limited results in view of the extensive history of sectoral and institutional reform that has been supported by substantial financial and technical assistance resources.

One element that the practitioners and thinkers in the area of institution-building seem to be paying little attention to is the origins and development of more successful institutions in the world. Most of the institutions that command international respect are in the Western industrial countries. These include major universities such as Oxford, Cambridge, Harvard, and Chicago, think tanks such as the Brookings, Carnegie, Rand, court systems, Stock exchanges and central banks, etc. How did these come to be established and develop to gain respect of the society around them? What was their contribution to the society in which they were situated? These are important questions that may allow us to understand the difficulties with institution building in the low-income countries. We examine the history of two major universities in the US to derive some important implications for institution-building.

Rockefeller, Harper and The University of Chicago

The University of Chicago (UofC) offers us a wonderful opportunity to look at institutional development in modern times and at a rapid rate. The traditional universities such as Oxford, Cambridge, and Harvard have a long history of development. UofC, on the other hand, was set up in 1892 and had established itself as a major research university by the turn of the century and a few years later had begun to contribute to key economic policy issues such as the setting up of the Federal Reserve Board and to major advances in science such as the splitting of the atom. Let us review the essential ingredients of this success.

The birth of university was the result of a happy circumstance where a major philanthropist, John D. Rockefeller (JDR), was supported and joined by the entire educational community of the time in the venture to set up a major higher education establishment in Chicago. JDR, the richest man of the time and given to very aggressive business practices, remains one of the most important philanthropists of all times. In his life, he gave some half a billion dollars to various institution-building enterprises and set in motion a tradition that his children are continuing to date. This is an even larger some of money if we adjust for amount of inflation that has taken place in the last 80 years or so since his death. In today's prices, JDR would have given away something like $ 7.7 billion.

[1] long time series data suggests that the change in the CPI between 1913 to 1995 was 1536 percent.

However, even more interesting is the manner in which JDR made his gifts to allow the flower of an institution to grow. JDR was not a distant or an overbearing contributor interested in receiving accolades. He took a keen interest in selecting the man who it was generally believed could undertake such an enterprise--William Rainey Harper. JDR lacked the arrogance that came with power and money. He would not expect Harper and others who were interested in the "proposed college at Chicago" to come to him. He would not summon them as he could, given his wealth and power. Instead numerous letters written by Harper to others involved in the project show that JDR would undertake lengthy journeys to visit him in places like Poughkeepsie and New Haven and as Harper records "he seemed to have nothing to do except to talk with me." He would even wait while Harper taught his class so that they could resume the discussion.

When the university started functioning, JDR announced through Gates, his close associate in most charitable and personal investment and business matters, "While he (JDR) is, of course, closely interested in the conduct of the institution, he has refrained from making suggestions, and would prefer in general not to take an active part in the counsels of the management. He prefers to rest the whole weight of the management on the shoulders of the proper officers. Donors can be certain that their gifts will be preserved and made continuously and largely useful, after their own voices can be no longer heard, only in so far as they see wisdom and skill in the management, quite independently of themselves, now. No management can gain skills except as it exercises its functions independently, with the privilege of making errors and the authority to correct them." Goodspeed, another member of the group involved in setting up the university also records that "Mr. Rockefeller, never, under any circumstances, could be induced to recommenqthe employment or dismissal of a member of the faculty or give any advice whatever regarding the teaching force." JDR resisted the overbearing management and interfering benefactor who drunk on his wealth presumed to know it all. In fact, frequent references to his restraint and respect for professional management can be cited.

JDR was not interested in accolades or praise. When the university opened its doors in 1892, he was invited to a formal opening ceremony with pomp and show, but "he advised against any formal opening ceremonies and thought it would in any case be hardly possible for him to attend." He did not visit the university till he was finally persuaded to attend the quinquennial and the decennial celebrations those being the only two occasions that he visited UofC. His sentiments are best captures by his own speech at the quinquennial celebration, "why shouldn't people give the University of Chicago money, time and their best efforts? Why not? It is the grandest opportunity ever presented. Where were gathered, ever, a better Board of Trustees, a better faculty? I am profoundly thankful that I had anything to do with this affair. The good lord gave me the money and how could I withhold it from Chicago?" He noted that he had merely made "a beginning" and said that "you have the privilege to complete it." The institution-building philanthropist realized that his money was only a part of the process and without the main participants doing their bit, his donation, no matter how large, would not bear fruit if a dedicated management did not emerge to develop an outstanding academic environment. He was therefore conscious of not exaggerating his role and therefore stifling the venture.

JDR's respect for academics and professionalism, and his skill as an institution-builder again shows up when he decides to give complete autonomous control to Harper who was the major visionary of the time. JDR was hoping to set up a college with a few hundred thousand dollars. Harper wished for a university and with an emphasis on research and graduate education at a time when even Harvard was a mere undergraduate institution. Harper's plan was much larger in scale than that envisaged by others who were involved in the project. As Rockefeller biographers, Harr and Johnson note, "he wanted to rival Oxford and Cambridge, the great German Universities, and the best schools in Eastern United States." Harper's thinking prevailed because JDR always maintained that he was merely providing the money and he did not wish to involve himself in running a university.

Harper set himself the task of "organizing an institution of a distinctly new type" and considered it to be an "educational experiment" that had to prove itself. From the beginning, he planned a university steeped in original research and investigation. He encouraged publication and developed the concept of a university press. As a result the now famous University of Chicago press, the publisher of the Encyclopedia Britannica was founded. To encourage research, departmental journals were encouraged. Among those that were founded then, several such as the *Journal of Political Economy* are now among the leading research publications in the world. He encouraged continuing and part-time education. To make education more convenient for the student, he developed the quarter system with continuous graduation, thereby breaking away from the tradition of graduating only in the summer.

The success of Harper's experiment is evident in the following. First, almost all his ideas are universally accepted now with all major universities adopting the themes that he propounded. Second, UofC remains one of the finest universities in the world claiming the largest number of Nobel recipients on its faculty. Third, UofC's name has been associated with many of the important academic events of this century.

Harper set about hiring a faculty before the university was established. He wanted to get the very best and in particular was looking for "head professors" who would develop their own departments. Goodspeed notes that "he sought big men, men already established and recognized as exceptionally able." Harper worked very hard to get the faculty he wanted. He was willing to increase the salaries of people he wanted by substantial amounts. Harr and Johnson note that "he (Harper) wanted to assemble the most brilliant faculty in the world by paying an unheard salary of$ 7,000 per year." (1988,15).[2]

Harper knew that in order to attract a good faculty, he must provide them with an atmosphere to flourish. Though himself an academic of considerable achievements with many books and publications and numerous important university appointments, he was not in competition with his .faculty. He recognized the need to encourage and develop is faculty. "He rejoiced in the growing reputation of members of the faculty as though they were his own. Every distinction they received gave him pleasure. Every book they published was a source of satisfaction to him...he was proud of the honors they received and he watched the development of growing scholars with joy and pride." Harper established the approach that continues to be followed by most major universities-- to hire the best, attracting them with incentive pay packages, and allow them to do their research and writing free of restraints

2 Equivalent to $ 108,000 in 1995 using the CPI data presented above.

An undertaking of this size was not possible without major funding. Between 1892 and 1915, JDR provided a princely sum of about$ 35 million to the UofC in keeping with his vision of participating in "the grandest opportunity ever presented." In today's dollars, this is equivalent to about $536 million. It was a large and liberal grant that allowed the academic vision of Harper to flourish. To place this in perspective, consider some of the loans arranged by the World Bank to finance the development of education in developing economies for the reform of the entire education sectors in developing countries. For example, in Pakistan, the World Bank arranged a Social Action Program, part of which is education with financing of$ 200 million in 1994 (World Bank, 1995). Similarly, a sector loan for the reform of the "middle schooling" was provided for $115 million in 1992. Contrast with JDR's donation, the numbers are worthy of further thought.

The upshot of this marriage between a generous grant from a non-interfering philanthropist and a talented visionary for rearing the institution created a marvel in the academic world. The university started in the year 1892 with a very strong faculty of 128 faculty members who were to teach 594 students with 276 in undergraduate departments. "Harper succeeded in attracting extraordinary faculty and a large and impressive student body and in establishing important innovations in higher education"(Harr and Johnson, 1988, 28). Over the years, the university has been among the foremost contributors to fundamental research in many areas. Many notable academics, Nobel prizewinners, path breakers in their own subjects have been associated with the UofC-- too many to enumerate in a paper such as this. In academics, the UofC established a name for itself very early in its life and retained a position of eminence, thanks to the ingenuity of its founders. And that is something that we should try to learn from.

Jeffersonand the University of Virginia

After his retirement from public life and two terms as president, as an old man, Jefferson developed a plan for public education and gave the last years of his life to its realization. He had been reading up on educational methods and techniques in other lands as well as talking to specialists for years. The plan that he developed for the state of Virginia was perhaps one of the most ambitious projects of the time for education in a free republic. He was seventy five years old when he developed this plan.

In this plan, he divided his educational system into three parts-elementary school, high school, and university. Elementary schools were to provide instruction in reading, writing, arithmetic, and geography. They were to be free to all children, for Jefferson insisted that it was the duty of government "that every citizen ...should receive an education proportioned to the condition and pursuits of his life." However, being the lover of liberty, Jefferson hesitated to make attendance in elementary schools compulsory. Coercion of any kind was so distasteful to him that he would not see it applied even in so vital a matter as public education; he was prepared to tolerate the rare instances of a parent refusing to let his child be educated, rather than forcibly educate a child against the will of the parent. High schools were to teach sciences and languages, and to provide, at public expense, preparation for the professions. These were to be established throughout the State, within one day's ride of every inhabitant.

The crown of the whole system was to be the university. It was to be composed of a number of professional schools, giving instruction in what Jefferson called "useful" branches of science. These professional schools were to train architects, musicians, sculptors, gardeners, economists, military and naval scientists, horticulturists, agronomists, physicians, historians, clergymen, and lawyers. Jefferson's plan has several parallels to that of the university of Chicago. Jefferson knew that he wanted a major learning center and used all his elder statesman powers of persuasion to persuade the state legislature. To the skepticism of the legislators Jefferson reacted by saying that they "do not generally possess information enough to perceive the important truths, that knowledge is power, knowledge is safety, and that knowledge is happiness."

It is interesting to note the kind of support in those days that a venture like the university had from eminent people. Among the twenty-four Commissioners appointed for the organization and location of the university, former presidents Jefferson, Madison, and Monroe. The three men met often at Jefferson's famous house, Monticello and made plans for the founding of the university at Charlottesville.

For the next six years Jefferson lived only for the University of Virginia. The institution was to be the crowning glory of his life, and upon it he lavished all his energies, his talents, his hopes. Jefferson did everything himself. He raised money and drew up the architectural plans himself. He procured the workmen, including the importation of sculptors from Italy. He prepared all the details of construction.

Jefferson's greatest difficulty in building the university was financing. He had designed his institution on a grand scale. The originally appropriated sum of $15,000 was of course inadequate. By patient political persuasion, he obtained $300,000 from the legislature for the construction of the buildings --a tremendous sum for those days. The university which is still considered to be one of the beautiful campuses of the world, was built according to Jefferson's architectural plans and. specifications .

But Jefferson well knew that what makes a university is teachers, and not structures. It was difficult to find a faculty of the requisite quality in the new country. There were few universities and colleges the United States at that time and the existing ones lacked the trained scholars in sufficient numbers, or of caliber high enough to draw upon for the University of Virginia's needs as envisaged by Jefferson.

Jefferson wanted only the best men in their fields, and the best were available mainly abroad, particularly in England, "the land of our own language, morals, manners, and habits." He sent an American scholar, Francis Walker Gilmer, to Britain to induce scholars from universities of Oxford, Cambridge, and Edinburgh. He also set in motion his powerful connections in England to help him get the first-rate scholars who would be willing to undertake the arduous journey to America.

To Samuel Parr, the eminent Oxford classicist, he wrote, "We are anxious to place in it none but professors of the first grade of science in their respective lines." And he asked him to assist Gilmer to find the men. To Dugald Stewart, the famous Scottish metaphysician, Jefferson made the same request in almost identical words "anxious to receive none but of the highest grade of science in their respective lines." By these means, Jefferson succeeded in assembling an excellent faculty of seven professors, only one of whom was a native American. This was John Taylor Lomax of Virginia, who was given the chair of law. The others included George Tucker, a native of Bermuda, professor of moral Philosophy; George Long of Cambridge, England, professor of ancient languages; George Bliitterman, a German, professor of modem languages. Apart from these Georges, there were Thomas Hewitt Key, an Englishman, professor of mathematics; Charles Bonnycastle, also an Englishman, professor of natural Philosophy; and Robley Dunglison, likewise an Englishman, professor of anatomy and medicine. The salary of the professors was $1,500 a year, plus a rent-free house, plus a fee of $20 from each student.

Conclusion

In both examples, we find that there are several common threads. We could review other examples and most likely will find the same commonalities. It seems that the key ingredients for the creation of a successful university are as follows:

- the prime mover of the institution was an important, gifted and respected individual with a dream;
- adequate funding; in one case we saw a generous grant from a non-interfering philanthropist, and in the other funding from a state legislator that was in awe of a living legend helped realize the dream;
- a talented visionary-- with an emphasis on vision and innovation--for nurturing and rearing the institution;

- the assembling of the best available faculty and, more importantly, the ability to induce the required academic talent away from across the seas if necessary;
- a management structure that recognizes that talented and inspired people should be allowed the independence to pursue their cherished research and investigative instincts.

The current approach to developing these institutions in the low income countries depends too heavily on a collaboration of governments and aid-giving agencies, both of whom are plagued by complex bureaucracies. Plans are drawn by international experts who occasionally fly in to supervise and instruct at a huge cost. Buildings and the international consulting expense is often the-largest cost component of this project. The hiring of the faculty remains relatively low on the list of priorities if we judge by the salaries offered and the efforts put in to find such faculty. In the views of this establishment, domestic talent is considered to be inferior to foreign talent and therefore is offered lower salary incentives as well as a lower stature in the hierarchy. Indeed the highest salaries in any country are those of donor agencies and multinationals and these too place local expertise of all kinds well below expatriate staff. Naturally, the response to this discriminatory arrangement is that the more capable people move into the donor agencies or multinationals. The more capable who can migrate, leave the country. It is not surprising then, to find many talented professors from Africa, Asia and Latin America in major universities in the west. Yet none of them, despite efforts, are able to find any position at home.

This approach leaves no room for a "Harper" to take charge of his institution and make it happen. He will be hidebound by plans drawn externally, rules and reporting requirements that will leave him little room for his innovations. Moreover, given the view of inferiority of domestic talent, no effort is made on the part of the sponsors to find that special "Harper". Instead they think that any retired government official and any minor academic from the North can create a "Chicago of the South." And the "Harpers" and "Jeffersons" of the South are left to seek employment in the aid paraphernalia in the local office at a salary above that in domestic institutions and at an international salary if they migrate to the Northern capitals in international institutions.

Presumably, the experts know better and have achieved an optimal arrangement of the allocation of talent. The results if judged by the numerous universities that have been created at substantial cost in many poor countries only to languish in decay would suggest otherwise. Perhaps, it is time that we did consider the role of domestic talent to be other than troops in the aid infrastructure.

We Need A Vision

The Need for a Vision

Speech delivered at the
American Chamber of Commerce in Colombo
on March 23, 2001.

Upon my arrival in Sri Lanka, I began to think of how I should guide my thinking to be best able to offer policy advice to the Fund and the country. My Pakistani origins and preoccupation with seeking an answer to my country's problems always focused me on the issue of why such countries do not grow at a fast enough rate to catch up with advanced countries.

In thinking about these questions, it was natural to ask the following two questions:

- "What is the long term vision that Sri Lankans have for their country?"
- "Where will the required growth in the economy to produce that vision come from?"

The questions started an interesting process of discussion and debate. Crisis orientation and traditional thinking had inhibited any serious thinking on what the strategic completive advantage of the country might be.

I organized a meeting of the business community, NGOs and the government on developing a debate on a vision for the country. It was agreed that a conference would be arranged to allow all three groups to debate their visions. Chandra Jayaratna and Ceylon Chamber of Commerce (COC) kept to their bargain and delivered a vision, which they have tirelessly developed and publicized. This has now forced other groups also start thinking on discussing long term issues.

This was just prior to the vision conference that the COC was organizing. Since I had been pushing all civil society groups to move away from the current political tribulations and engage in long term visionary thinking, I thought I would attempt a visionary thinking of my own and it turned out to be this. The speech was very well received with the Sunday Times and the Business Today Monthly magazine carrying it.

This is one innovation that I am particularly proud of. There are three important reasons why we should encourage and facilitate this everywhere.

1. I think that this is a simple method of developing long-term thinking, getting people to focus away from the current crises and there are too many of them in poor countries.
2. It also allows people to "think out of the box." In the short term they feel too constrained by political economy and resource constraints.
3. Understanding the long-term issues free of short term constraints, develops a better understanding of the required structural reform and develops ownership.

The Fund mission always has a somewhat shorter-term focus in mind given their need to retain short term macro-balance. If the Resident Representative facilitates this discussion on long term vision and structural issues between missions, it can possibly lay a better, well owned and well• understood foundation for a good Poverty Reduction and Growth Strategy.

As a small aside, many people commented on my trade off between the power of money and the power of ideas. After this they stopped asking me the normal 'poor country' question: "how much money are you going to give us this year?"

The Power of Ideas vs. The Power of Money

As IMF Representative, I bring to Sri Lanka two gifts. One is the gift of money. The other is the gift of ideas. Which do you think is more valuable? Unfortunately, too many people in poor countries have got used to considering the gift of money as the more desirable one. I was pretty comfortable in my notion that the second, the gift of ideas, is the more valuable gift until I was reminded by my friend, the Governor of the Central Bank, of how Greek society valued Socrates' gift of ideas. It may sound funny, but poor countries still treat their thinkers with the utmost of disdain. In my country, Pakistan, the only Nobel Prize winner, Abdus Salam, died in virtual exile and continues to be not recognized at home.

That notwithstanding, I still insist that, for the development of a society, it is ideas that matter and not money. In fact in this world of global capitalism where money knows no borders, the global market is capable of supplying any amount of money that a society needs for its development. The only thing that stands between society and money is imagination and ideas. So I go along undeterred trying to plant the seed of ideas in the hope that long after I have departed, this seed will take root and the tree of change will grow!

Economic theory has debated this issue for some time. Nobel Prizes have been awarded to Chicago economists like T.W. Schultz, Gary Becker, and Robert Lucas for arguing that economic growth and economic development is mainly a function of human capital, ideas, imagination and innovation. It is what is now hitting the management literature through writers such as Drucker, Senge, Naisbitt and Champy who are talking about the knowledge worker. It is because of their rdea-driven, innovation-led growth, and not because of the money at their disposal, that rich countries grow richer while the poor countries never seem to break out of their poverty trap.

Rich countries respect ideas, respect innovation, respect human capital. Theirs is a true meritocracy of human talent. They revere people like Einstein, Hawkins, Edison, Kettering, Lucas and Becker, while the poor countries are a net supplier of research capital to the rich countries. Consider how many Sri Lankans are exiled only because they have talent and have acquired an education? This is why Bhagwati, Sen, Khorana, Naipaul and Rushdie reside in the West!

What better place to talk of human capital, innovation and ideas, and the meritocracy of talent, than the American Chamber of Commerce. After all, American society, blessed with the limited burden of history, has had the luxury of being irreverent, bold and innovative. From the very beginnings when a bunch of shopkeepers and farmers rose to the grand intellectual challenge of writing one of the most democratic of constitutions, American history has honored heroes like Thomas Jefferson, John Adams, Alexander Hamilton, Edmund Burke, Benjamin Franklin, and Thomas Edison, all great thinkers of their time. Not only has American society been a host to the wretched of the earth but also the home and laboratory of all the thinkers and researchers of the world. It is indeed a meritocracy like none before it. And it is the richest country in the world as well as the engine of global growth. Need we wonder any more on the power of ideas!

Yet, our poor societies do not appreciate the power of ideas. They are still looking for money and eschewing the jewels of ideas cast before them. Because of my origins, my quest has been to understand economic growth and how to accelerate it. I am now convinced that we have to emulate the American aristocracy of the intellect. I am now totally convinced that societies that are led by ideas, by visions, will develop. The only question is, how do we move to that state? A very difficult question to answer.

Why do I think that a long-term vision is necessary? The answer is very simple. In order to plan your journey, you must know where you are going. Without knowing where you are going, taking any path will not help. It is your destination that determines where you are going and other factors determine whether you take the scenic route, the quickest route, or the lazy route. Those of you who are mathematically inclined or have any engineering background will see immediately that any dynamic system=and an economy is a dynamic system=must be guided by a long term vision. Your long-term vision determines the steps that you have to take today and in the future. Think about it. Every business, every child, every career, is guided by a goal. You go to a financial planner, you go to a career planner, you go to a banker, and he will always ask you your long-term goal.

Should the country practice any less? Yet, I am amazed at the number of countries that have meandered through the years without a proper vision. At best, they have succumbed to the very narrow vision of the development thinker, guided only by crude ratios such as literacy rates, poverty rates, and all other measures. If anything, these ratios mismeasure reality. Taking these crude ratios as guidelines we have evolved a sequencing of policy action where we put all on hold until we alleviate poverty, or effect literacy, or some such strange measure that in itself is very inexact and quite possibly outdated. In effect, this approach is welfare• based and creates an expectation of government guarantees and subsidies.

This approach of following elusive ratios, packaged development advice and fostering an expectation of government guranteed welfare led to the creation of large governments for the command, control and regulation of the economy. These overly large governments with an impossible mandate naturally proved to be a drain on the economy. Crisis-ridden or near• crises economies continue to lurch from one payments crisis to another to feed large and hungry governments.

Managing these crises has resulted in a further loss of any sight of longer-term goals of the economy. Every one is so busy dealing with the current crisis, as well as protecting their own interests in the midst of a crisis, that no one has the time or even the inclination to consider "goals, objectives and visions." The crisis orientation creates "short-termism." The political cycle, which unfortunately in democracies runs in five-year, six-year segments, also hinders the development of a long term vision for society.

"Short-termism" characterizes all policy discussion in these countries. This is especially visible in corridors of power. Parkinson like, there is much busywork but no real attempt at systematizing where this work is leading to. They are all very important and arrogant in dealing with today's problem even though the proposed solution might lead to tomorrow's problem. Should you ask why they have no time to build institutions and teams for better governance in the future, you will promptly be told with considerable venom and authority, "Can you not see we are busy fighting today's crisis?" This is not a joke! I have had many an important person in many countries say this to me, while he/she is creating another mess in settling the current crisis. If only he/she would take a moment to reflect and find conceptual clarity. Lamenting this situation, David Ignatius, in a recent International Herald Tribune article, noted that modem day politics, especially that in developing countries, lack a dynamic and passionate leader like Maggie Thatcher. True, it is only visionary, passionate and dynamic leaders like that who will lead and manage far reaching reform for a long-term vision of society that radically restructures and reorders society, thereby unleashing all its innate innovative urges.

What then is a vision? A vision is not your typical government-designed 5-year plan, policy prescription or budget! Literally, a vision is like a prescient dream of a desirable or beautiful state. More importantly, when a group and/or an organization share it with a visionary leader at the helm, it is a powerful force for change as well as development of value. American history provides us with many wonderful examples of such vision. Perhaps, the most magnificent example of a visionary statement that resounds in all our minds is Martin Luther King's "I have a dream" speech that moved America and changed it to a more humane country. A vision must necessarily challenge the notions that we are comfortable with, make us think "out of the box", but also give us hope and unleash our creative juices.

Such visionary thinking originated in America. America has been built more by its very diverse visionary corporate leaders than by its government. Enormous corporations like Disney, GE, Ford, IBM, Microsoft, Intel etc., have each become larger than many of the poor countries because of pigheaded and extremely courageous leaders who were all dreamers. It took guts to dream of mass-producing the model T, to dream of inventing movies, record players and videos, the computer and then the internet. Imagine conceiving of a Disneyland and actually building it in the 40s. But the true pinnacle of American audacity and over•consumption, but also daring, is Las Vegas. They dreamt it and built it-a fantasyland, an extravaganza that fulfils all your needs. Yet, they change and redesign it every year. Much as it might upset Victorian sensibilities, it is now the hub not only of gambling but of conventions, entertainment, sports and much else. As I said, the vision, and management of that vision, is dynamic.

There is much to learn from America and Las Vegas. And we in poor countries would do well to understand that. What does America have to teach us about forming our own vision?

1. A vision is not a government owned or led process. Any review of US history would tell you that all the major developments took place in corporate America in an era before the government got interested in interfering in economic affairs. In fact the "open range", competitive and free market environment fostered maverick behavior like the Disneys and Rockefellers.
2. Since we are thinking in open market economy terms with the government as only another agent, there is no single vision that guides society. The urge to adopt a military, command or Soviet approach to the development of a vision, where a consensus must be arrived at, must therefore be resisted.
3. There is only one guiding theme to the vision process: it must unashamedly seek economic progress. In doing so, it must be farsighted, iconoclastic, innovative and unconstrained by culture or the past. This is not to say that it should be irreverent, but only that it be creative and free.
4. In its innovative spirit, it must challenge the current arrangements of society in a very creative way and seek to create a more dynamic economic environment in much the same way as the "reinventing government" movement did in the US in the nineties.
5. Various visions must always be under debate and scrutiny by all stakeholders. This creates ownership and prepares the ground for reform. Think tanks and universities are the best places for such debate to rage for considerable periods of time before it is politically

considered acceptable. If the private sector is allowed to flourish, the Rockefellers and the Carnegies will create such organizations. However, this can only happen in a deregulated environment.

I know that many of you will be extremely frustrated if I leave you without giving you my thoughts on a guiding vision for Sri Lanka. I will follow Goethe's advice in doing this: "boldness has genius, power, and magic in it." (1749)[1] I urge you also to cast aside timidity and be bold in your thinking. After all, we are discussing the long term--say 20 years hence. Is it not possible to be daring in dreaming of a new world in 20 years? Let me put it to you in a series of questions to which you could give your answers; after all, it is your country.

1. What is the size of government that a small country like Sri Lanka can afford?
2. What is the nature and size of regulation that you should have?
3. What regulatory structures and structure of government should you have?

In order to answer these questions, perhaps you need to consider the size of Sri Lanka relative to other economic organizations in the world. Too many mistakes have been made in poor countries in merely aping the West in the creation of institutions of government intervention without due considerations to size and what can be afforded. In answering these three questions consider the following:

1. Of the world's 100 largest economic entities, 51 are now corporations and 49 are countries.
2. If we take sales to be comparable to GDP, Sri Lanka is smaller than the 200 largest companies in the world. The 200th company employs 12000 workers while the Sri Lankan government employs about 800,000.
3. Regulation and protective government is not cheap. In the US, regulation is estimated to cost about $7000 per family and the US has less regulation than many European and developing countries.

Perhaps it is time to focus on the kind of government and regulation that a small "company" like Sri Lanka can afford. In considering these questions, we must also be aware of who Sri Lanka's comparators are. Is it India that you should be looking towards or copying regulatory structures of places like US and Europe? Or is it Dubai, Mauritius, Singapore and Hong Kong that are very conscious of the global investors' needs? Will Sri Lanka ever be as open, business-friendly and inviting of foreign investment as these countries? Should you strive for that and in what time frame?

I said before that the vision must be a combination of a set of visions that Sri Lanka's own Disneys, Gates', Carnegies develop. But the government must step aside and allow them to do so.

- What if somebody wishes to create a Waikiki Beach-style string of hotels and a board walk with a clear beach running all the way from the Port to Mount Lavinia, perhaps even to Bentota. That would truly make Sri Lanka a tourist destination.
- How about a cruise ship industry or a tourist boat industry to allow the ocean yield per tourist to increase? Sri Lanka currently makes the least use of the ocean among island economies. Imagine an island where you use only cars to move from one coastal city to another!

[1] Johann Wolfgang Von Gothe (1749-1832) - German Philosopher

- A tourist paradise must also have tourist attractions a la Las Vegas. Please do not fall into the trap of only thinking of gambling. As I mentioned, Las Vegas is now the convention center of the world, the entertainment center of the world and the family tourist spot of the world. But then people must be allowed to build outrageous structures like theme parks and pyramids.
- How about developing a Colombo Financial Exchange that learns from Chicago and New York? Such an exchange would house not only equities and high-grade debt but also all manners of paper and of course commodities. Should it envisage housing a tea exchange that will allow forward and futures contracts?
- Why should a beautiful country like Sri Lanka not also be an offshore education market for the 1.3 billion people of the subcontinent? Harvard, Chicago and many other world class universities are now establishing campuses across the continents. Will Sri Lanka benefit from this movement?

These are only some examples of dreams and visions that your country could have for rapid development. Would a dreamer be able to do any of these even in 20 years? Do not tell me that financing is the constraint. Financing is cheap. What is necessary is the ability to let dreams tum into reality. Will the regulator, the government, allow such dreams to be turned into reality?

So my theme is that for dreams and visions to be realized, we really have to address the issue of the role and structure of governance in the country. Like many other poor countries, Sri Lanka has spent many long years building regulatory structures that the US developed in the great depression. These structures were built to be risk averse and protective, not encouraging of innovation and dreaming. They served a purpose in the immediate post depression world. But they were found to be outmoded in the 80s and 90s in the US and Europe and much of the last 2 decades have been spent dismantling them. Why should Sri Lanka continue to develop these now dated structures?

As an economist, I interpret regulation to be not only explicit legislation but also that which is implicit in the rules of business, in the lack of modernization of existing structures and in the hangover of earlier thinking in the mind of the so-called regulator. In developing countries, perhaps, red tape and low productivity government is perhaps the biggest drag on investment and growth. If you want to achieve the dreams of US development, you must focus on the speed with which business transactions can be completed in this "just in time" world. Is 20 years enough time to develop such a lean and mean government that is invisible to the process of business?

I will close by congratulating Chandra Jayaratne and Deva Rodrigo who are leading the effort of the Chambers of Commerce to develop a process for discussing and debating a vision for Sri Lanka. Day after tomorrow they are hosting a conference leading the way with a presentation by Chandra. Chandra and Deva have done much to make business idea-driven and we must congratulate them on it. I wish the Chambers every success on their journey on which I am fervently hopeful they will be joined by the government as well as civil society. Perhaps in that fashion we will be able to move this country away from "short termism" to focus on longer-term issues, to prepare and own the architecture of governance for the 21st century. I have no doubt that if that happens Sri Lanka will grow to overtake many of its comparators! Chandra, Deva, I hope that you will find my little effort at raising questions on your vision useful on your journey!

A Design for a Vision Process

Background note for the development of the
Ceylon Chambers of Commerce Vision conference
March 22, 2001.

Having raised the issues of the Vision Conference and motivated all to talk about it, I felt obliged to give it some structure and coherence.

This sets out what my ideal on how a vision process should be led and conducted.

We never really followed the process as described here because there was no agency or official blessing of it.

Having sent the impact of this quest for a vision, I have little doubt that this is truly an interesting approach to developing a growth strategy for a country. Consequently, it should be very useful in the development of a poverty reduction and growth strategy in a country.

How do we conduct such thinking? One approach is laid out here. I think that this approach is particularly useful for a wide-ranging debate to be conducted and for the reform process to be fully understood.

The Vision process

Why we need a vision process?

- • There is no long-range guiding vision that is shared among the stakeholders in Sri Lankan society. What comes closest to it is a goal of growth and poverty reduction that is frequently preached to them by donors. But in trying to achieve that, they rely on prescriptions that are uniformly applied all over the world. Thus they are following the same path as India, Pakistan and so many other countries. They build the same architecture of governance-large weight government with an overarching regulatory umbrella creating an unrealistic expectation of large subsidies and unrealistic insurance. Emulation of other country strategies has led to government incentive led apparel industry and a government-owned and ravaged pension fund.
- Without discussing and debating a vision, the country will continually look toward the government for its development and the government will continually follow available fads in the development thinking.
- The government is now politicized, inefficient, and bloated. It lurches from one crisis to another and is unable to stay the course with any announced intention. All policy actions, including the budget are not managed according to announced commitments.
- All groups in society, businesses, labor, students, NGOs etc. have got used to the largesse of a fiscally irresponsible regime that has been in place for decades. They operate only on short-term incentives. It is no wonder that investment activity is not at the level required for sustained long term high-growth.
- If we are to change this, there must be a wide-ranging debate on the vision for Sri Lanka. It is only when civil society and government share a very different vision that change and reform can be well rooted in society. In other words, a wide-ranging debate on the vision will generate understanding of the needed reform and hence create ownership

My view of the vision process
My vision for such a process is as follows:

- In my view it has to be an all-inclusive process where at each step more and more segments of society are included.
- It should consist of a series of conferences (6 to 8 over 2 years) to allow discussion and debate to take place. This will also facilitate many different viewpoints to be incorporated and discussed.
- No one group should own the process. A different group or person should organize each conference.
- Conference proceedings must be published and publicized to enable them to be widely debated.
- Each conference must confront the proceeding of the earlier conference to develop a debate among Sri Lanka's key thesis. Each writer must attempt to identify hypotheses thrown up by another to safeguard intellectual property rights and give incentives to idea production.

- **A steering committee** of motivated and committed people should manage the process.

Management would consist of:

  - o Whetting and commenting on ideas for each conference;
  - o Unifying the vision process by developing links between conferences and ideas;
  - o Developing broad support through judicious use of the media in society for the vision process;
  - o Ensuring paper quality and safeguarding intellectual property rights;
  - o Developing a debate by guiding authors to connect their work with previous conferences;
  - o Arranging keynote speakers (foreign and local) for each conference;
  - o Raise resources and manage the vision process.

- Steering committee should meet at least once or twice a month to keep track of the process.
- Membership of the steering committee must not be restricted but it should draw only self motivated and interested people.
- Two old-style command approaches should be resisted:

  - o The tendency for achieving consensus and a common vision must be resisted. There is no reason for agreement on every last detail. The approach should be only to debate and understand competing visions and to understand and critique the underpinnings of competing hypotheses. But no more.
  - o No one can speak on behalf of Sri Lanka. All groups and individuals must speak on their own behalf and not for society at large.

- **Resist chauvinism!** -We live in a globalized world and therefore must resist localization. Whereas, I would like to start the vision process with strong Sri Lankan participation, my proposal would be to always keep a perspective of globalization. Let us not go back into history, or do "small is beautiful" approach, or look for a Sri Lankan way. Outsiders must be introduced into the debate and the process. However, it must be managed well so that:
  - o Locals do not get crowded out;
  - o Donors do not take it over;
  - o It is not taken up by some donor bureaucracy and becomes another IFI publication.

The experience thus far

For a year now, I have been working on initiating a wide-ranging discussion on the long-term guiding vision (or visions) for Sri Lanka.

I congratulate the COC for being the only group that was able understand the visron underlying the vision as well as the only group that has delivered on their commitment. As an economist I am not surprised to see that the profit-making sector is the only one that is fast enough to understand a new idea. The non-profit sectors, the government' and the NGO's were unable to join at this stage for bureaucratic and financial reasons. We hope that they will join at a later stage.

Donor Support
Donor support will be required to make this process a success. But I would be leery of:

- Offering too much money too soon;
- Shackling the process in too much donor bureaucracy;
- Overly mothering the project through consultants and monitoring.

My approach would be to let the Sri Lankan intellectual leadership show some initiative and for the donors to support them. It is only through such a process that the change managers in Sri Lanka will emerge.

How To Reform Government

Understanding Governance

This little piece on management issues resonates beautifully with the actual life experience of so many people. I have used it a number of audiences and reactions have ranged from gasps to hums or smiles of approval.

I also used this to motivate the need for improved management in the public sector.

During the CBSL modernization effort, a major impediment to reform was the crisis management mode that every one was working. This method of work left little time for serious reading, discussion and debate or even training.

If public sector productivity is to improve, management issues will need to be addressed to allow

- Considered and informed decision making to take place,

- Staff to be properly motivated and incentivized to embrace change and modernizaton, and

- For every level to feel empowered and delegated.

Recognizing this need Jo change attenuated system management, I worked hard to create a Management Development Center at the CBSL as part of the modernization process.

This module was also a part of my public sector training and seminar presentations and discussions.

Understanding Governance: Attenuated Organizational Structures

For long now, we have known that poor governance is perhaps one of the most important causes of sustained poverty that prevails in many countries. The increasing transactions costs that arise from poor governance, retards investment and keep economic growth at levels that will not allow the country to escape poverty.

But what does poor governance mean? If we simply say that poor governance is all that which causes poverty and slow growth, we are merely stating a tautology. We must attempt to define poor governance more carefully.

One aspect of governance that amazes me, is the extent to which we continue to run government with poor o**utmoded systems of management.** A very important component is the complete absence of **human resource management** in government. Let me explain this by reviewing some history.

Attenuation

A typical government bureaucratic system in poor countries is extremely inefficient, uninnovative, and inertia-ridden. Everyone complains of it but all feel unable to change it. I submit, we have to attempt to understand these *attenuated* systems. According to the dictionary, *attenuate* means *to reduce in force, value, amount, or degree or to weaken.* These are truly weakened systems in the sense that they appear to be overworked, out of their depth, and are merely patching things together without a clear vision of where they are going. There is a sense of despondency, of not being in charge. The few productive people are overwhelmed with work. Let me explain how.

What are the characteristics of governance organizations in poor countries?

- They have no vision.
- They are change-resistant.
- They are reactive rather than proactive.
- They rely on direct controls on an authoritative model rather than that of a service provider.
- The work distribution is very concentrated with the bulk of the work being done by a few individuals.
- Most of the work force is unmotivated and hostile to productive change.
- These individuals concentrate decision making to accumulate power. Concentration of power and decision-making is inefficient, and destructive to collegiality and professionalism.

- Training and skill development and retention are not priorities

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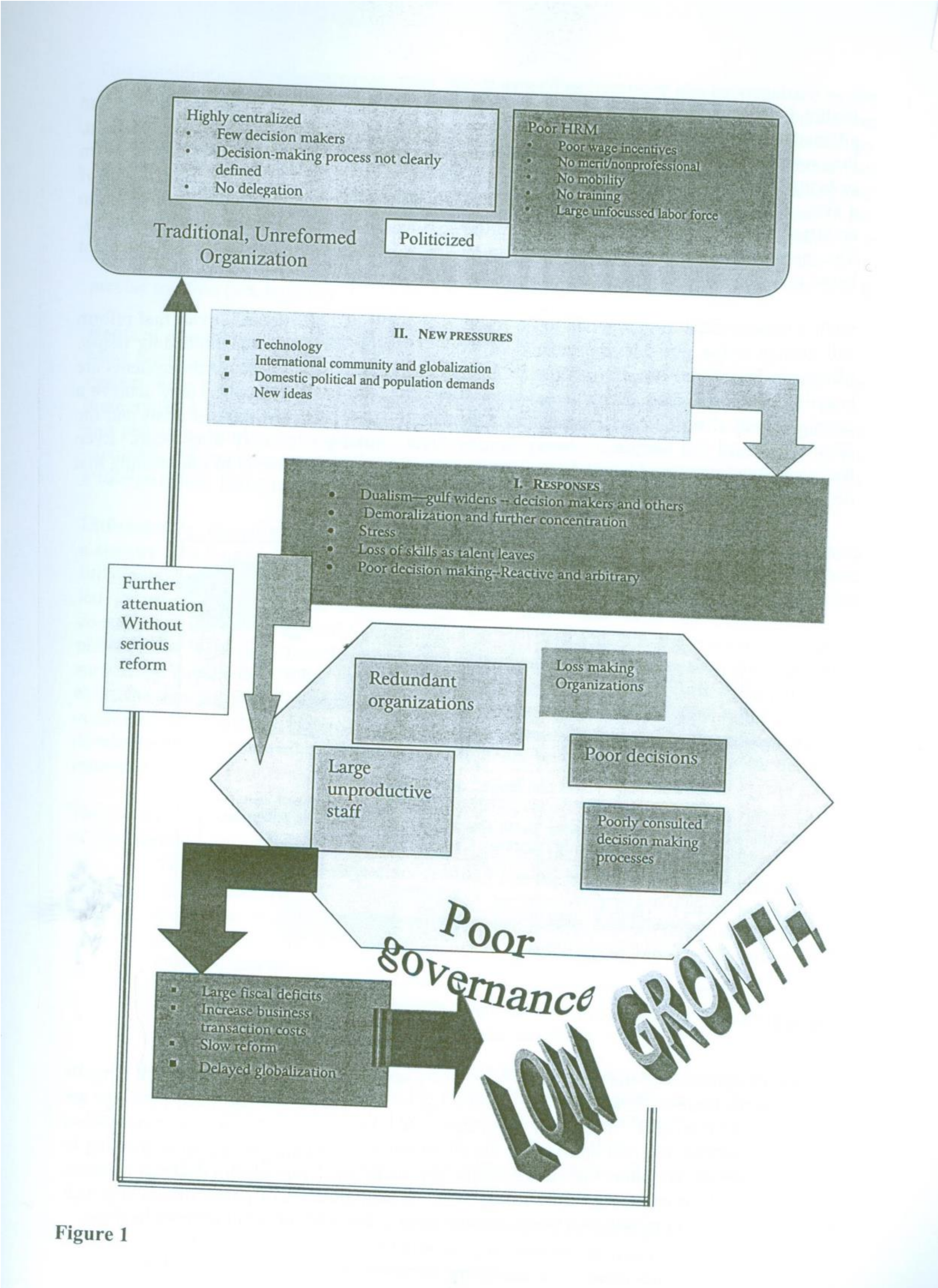
Highly centralized
Few decision makers
Decision-making process not clearly defined
No delegation
Poor HRM
Poor wage incentives
No merit/nonprofessional
No mobility
No training
Large unfocussed labor force
Traditional, Unreformed Organization
Politicized
II. NEW PRESSURES
Technology
International community and globalization
Domestic political and population demands
New ideas
I. RESPONSES
Dualism—gulf widens -- decision makers and others
Demoralization and further concentration
Stress
Loss of skills as talent leaves
Poor decision making--Reactive and arbitrary
Further attenuation Without serious reform
Redundant organizations
Loss making Organizations
Large unproductive staff
Poor decisions
Poorly consulted decision making processes
Poor governance
Large fiscal deficits
Increase business transaction costs
Slow reform
Delayed globalization
LOW GROWTH
Figure 1

Figure 1

Figure 1 presents a schematic view of how structures with these characteristics can become attenuated and lead to low growth. As traditional organizations refuse change and evolution, they react in a patchwork fashion to fresh challenges. This results in processes breaking down or being stretched, as well as the concentration of power and decision making in the hands of a few. Since seniority is based on longevity rather than merit, the managers are often an assortment of close advisors and trustees of the boss who may stand apart form the hierarchy. The increased centralizing not only leads to less transparency but also decisions that are not based on extensive consultation and review.

Such a concentrated system tends to be reactive and full of bottlenecks. Given that reform and change is not possible, the method of work is one of dealing with impending issues. Moreover, because only a few people are manning the stations and because the systems are heavily centralized, most events and developments are only dealt with when they achieve a certain degree of seriousness. The system appears to be in a perpetual state of crisis and the people involved are carrying a heavy burden often working extremely long hours. Even though burnout rates are high and people even suffer physically, power is so intoxicating that no one will reform the system.

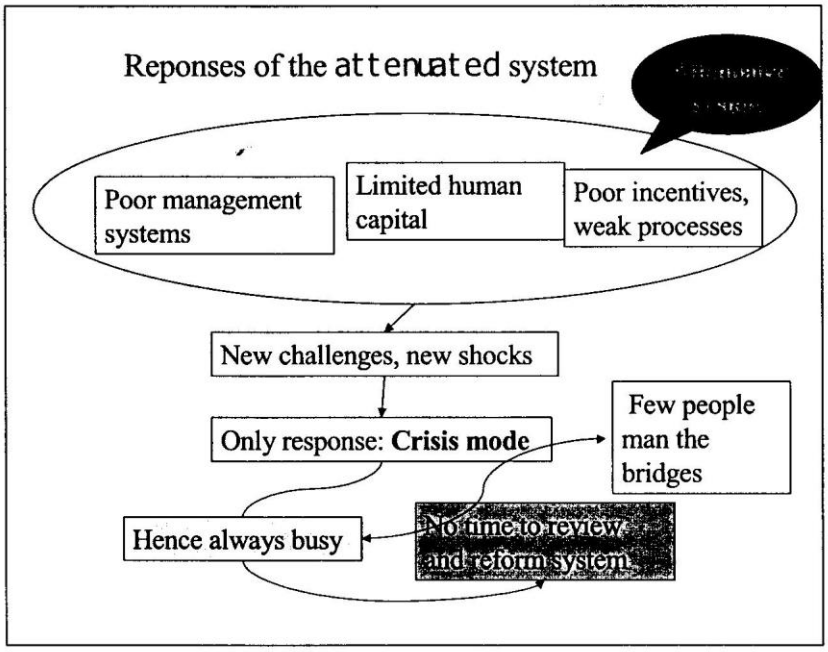

Figure 2

Given poor systems and the need to carry so many unproductive people, busy-work prevails in these organizations. There is no time to read and consider. Unending series of meetings are supposed to lead to work. Too many departments and too many people means co-ordination and more meetings. It is not unusual for the entire workday to pass moving from meeting to meeting. Meetings are often without agenda or any decisions. Even when a decision is taken, no systems exist for recording them. In any case, the centralization of power means that such decisions can be over-ridden on a whim, hence vitiating the need for serious record keeping.

This combination of a "continuous crisis" mode as well as busywork can be visualized by the following examples. Imagine a building with a fundamental design flaw in the foundation, which leads to one of the walls on the top floor falling down every day. Those who occupy that floor, spend the entire very busy day repairing the fallen wall only to find another one awaiting them the next day. They are continually involved and indeed, very busy fixing one of the walls. But never do they have the time to study the architectural plans to figure out the design flaw that will free them off this continuous drudge. Similarly consider a fire in a nuclear reactor. Those who are trying to put it out are continuously throwing more water in it. They create a lot of noise, much *'busyness'* but no time to research the problem and find a precise solution (see figure 2).

Roots of attenuated organizations

Most poor countries inherited a system of government from the colonial government. This system had been developed for the nineteenth century. The bureaucracy has to be congratulated for coping with the early demands of independence without much preparation and planning. While the politicians were busy protesting colonialism and later enjoying the accolades, the bureaucracy contained the transition, put in place several new institutions, like a foreign office, that a colony that graduates to a country requires.

Unfortunately, the politician could never truly understand the technical aspects of governing a country. As Samad (1993) argues they charged into Westminster style democracy without fully considering advancements in constitutional law. The political instability that prevailed led to populist regimes that experimented with "isms" and ideas that sought to create consensus at the lowest commo;} denominator in all areas. Unworkable and utopian welfare philosophies were used to cultivate political favor among key segments of the population such as the bureaucracy, more vocal formal sector unions, more volatile urban populations. In short, the new political system created incentive structures that were inimical to the effort that economic development required: work ethic in these countries was destroyed, markets development was inhibited, progress in education was retarded, and interface with the world repressed.

The adverse impact of this process was felt in the most profound manner in the bureaucracy of government.

- The dictates of the new politics required that the independence and professionalism of the colonial civil service, should be destroyed and replaced with a more malleable, easily manipulated, politically involved one. Decision making and professionally independent efforts were severely discouraged and could be very costly of careers
- Expansion of government jobs was a very easy way to buy votes. Government jobs were also used as a form of unemployment insurance.
- The growing public wage bill could only be reconciled with increased government employment through reducing the average wage in the public sector. New populist socialist ideas also required a more egalitarian wage structure. Thus the managerial *I* professional cadre was taxed while the unskilled, entry-level cadre was compensated better than their comparators in the market. Broadly speaking this has led to a deterioration of skills in government.
- Growing government, deteriorating skills, and the influx of poor quality talent, has resulted in declining productivity in government, increasing use of power and authoritarianism to plug emerging problems, and mushrooming corruption. The result is that work and decision making slow down, while introducing cumbersome and meandering procedures, not only because of poor

understanding but also to facilitate corruption. Controls and various other market inhibiting devices are created for the same reasons.

Powerless and unmotivated

Bureaucracies in many poor countries voice similar despondent messages. Most people will say," things will never change here - why bother." Those who are close to power will say, "We are too busy to worry about change." The tragedy of poor governance is that no one is prepared to truly change the root causes that have been identified here (see box 1). Too much time has been wasted trying to put in place large-scale civil service systems that cut across all departments. That approach still treats the public sector as a unified whole.

Box 1

Signs of an attenuated system

- Multiple and often conflicting objectives of the organization
  - No decision on these for a long time
  - No clear processes linked to each objective
  - Unclear objectives and processes lead to overuse of the word "co-ordination" leading to added meetings and committee work and delays
- Centralization - Few people do the work
  - All key decisions involve same people
  - System depends on individuals and not organizations
  - Organization has few people with core skills required for the principal objective of the organization
  - Large and demoralized work force o No delegation of authority
  - Diffuse line of command
- Poor incentives for promotion or work
  - Long waiting periods for promotion o Lack of mobility
  - Eg: Non-portable pensions and other factors that do not allow people to leave
  - Non competitive hiring - only internal promotions
  - No risk taking - supposed "O"risk tolerance - result: no creativity
- Too much process - no real output
  - Frequent complaints of no time - very poor or zero time management
  - Many meetings - Acting only in crisis - "busyness" the only form of work o No hard decisions - frequent revisions of decisions
  - No hard decision – frequent revisions of decisions
- No internal regeneration capability
  - Dependent on external advice
  - Work through worrying rather than sustained research and analysis
    - Paranoia develops as crisis takes over, transparency a casualty

We must recognize the diversity of modern day public sector and resist such uniform treatments. Instead perhaps we must work on a department-by-department or an organization• by-organization reengineering based on the following principles.

I. The incentive to centralize arbitrary decision making with no clear, well-identified transparent process.

2. While lip service is paid to reducing controls and regulation, this must be a part of a reengineering of departmental processes to make them open and transparent under delegated authority.
3. Without a concerted effort to fix the HRM - better incentives, mobility, improved merit• based prospects, better training - the reengineering of departments will be more or less useless. There must be clear up front commitment to rebuild the human capital in the organization.
4. It should be recognized upfront that, given years of skill depreciation and despondency, it is quite possible that change leaders may not be available from within.
5. Attenuated systems thrive on crisis orientation, which in tum leads to an environment where learning does not take place. One important goal must be to develop long-term visions and to encourage research, thinking and analysis. There must be a lot of time for reading and training.

Any serious reform of the public sector must be based on these 5 principles if the productivity is to be seriously improved. It is also this reform that will empower the local talent in the public sector to play its proper role in the economy

Public Sector Reform

Surprisingly this subject has always made economic policymakers uncomfortable. Early in the post-colonial phase, they ignored it. Of late, when all else failed they turned to looking into broad based civil service reform maintaining the public sector monolith and seeking efficiency gains through training, wholesale retrenchments and some procedural changes. Two decades of tinkering with this strategy produced little in terms of serious improvements.

Before I came to Sri Lanka, I was critical of these large civil service reform episodes. Working in Sri Lanka allowed me to develop alternative strategies.

This paper was prepared for the Pakistan Society for Development Economics annual conference of 1999 when I had just started my position in Sri Lanka. It draws upon the economics of organization to argue a more micro, human resource based approach to organization reform in the public sector. I do not understand why the standard development economist refuses to use these tools to develop ideas on reform of government.

I drew upon this paper to make presentations on this subject at the CBSL seminars and-training and at the Institute of Policy Studies seminar.

Ideas presented here were used to develop thinking on CBSL modernizatio
n.

Incentives and human resource management in the Design of Public Sector Reform

The 'Development Approach' to Governance

We, in Pakistan, should be very happy that the global development community has finally accepted the centrality of public sector reform (also known as improved governance) in the quest for improved living standards in poor countries. Development economics is a subject that is based on the interpretation and observation of some Western academics and Western donor-based agencies. We should have some sympathy for these leaders of development thought and policy for they have struggled with integrating the prevailing theme (fad) in Western thought and philanthropy with learning about the societies and economies that they were supposed to be prescribing for. Using the principle of "ends justifying the means", they defend their reliance on the current "fad" as well as on the only clearly visible, organized and powerful actor -- the government, no matter how inefficient— they would.

The result is that this approach led to a long era of government-led development, which centralized policy- and decision-making, initiated planning, and created a wide range of public-sector institutions. The role of the government was thus extended into areas that were conceptually indefensible. In this manner, the public servant grew into her new much more lustrous and looser robes. A bloated, over-centralized, and a private sector inhibiting government was created to be the observation and implementation outpost of the development word. This was the first step in the transformation of the public sector in the direction of misgovernance.

The large, growing and domineering public sector, while inhibiting growth and development, was hungry for resources. Reacting to the bloated public sector and the distortions that were thereby created, the distant leaders of policy and thought developed the "Washington Consensus." The new buzzwords were "remove distortions", "get the prices right", "fiscal consolidation", to be followed by "privatization and internalization." Disjointed efforts at dismantling the earlier planning structures and SOEs developed a fragmented public sector. Fiscal consolidation was achieved through sporadic efforts at expenditure reduction and revenue raising. Since reducing public sector employment was politically risky, expenditure• reduction measures often relied on nominal wage freezes, which eventually translated into real wage cuts. The public sector reacted to these strategic attacks on its recently expanded mandate in three ways:

- By slowing down reform in critical areas so that it's grip on resources could be maintained;
- By seeking alternative means to make up for the real wage cut that the public sector employees were experiencing. Thus, "perks" -- legalized and non-transparent means of non-wage resource extraction -- became a major form of civil-servant emoluments while the tolerance towards corruption significantly increased;
- The more skilled, the less corrupt, as well as those seeking a more reform-oriented approach opted out of first the public sector and later, as opportunities shrank domestically, out of the country.

The result was a bloated and fragmented public sector, which had rapidly lost skills and also developed a tolerance for corruption and inefficiency. It is not surprising that in this milieu growth and investment slowed down sharply and perceptions of country risk increased sharply.

What is surprising is the continued oblivion all of the main development thinkers and agencies of the West to the crying need to understand and prepare a strategy for a sound public sector reform.

Development indicators measuring social and economic health have all remained fairly stubborn in the face of changing fads of development thinking and donor advice and funding. This frustration has lately led to interest in the catchall term -- "governance". However, despite the adoption of the new term, reports and discussion on this subject either remains shallow or continues to define governance in traditional terms. The development thinker is still trying to obtain indicators of poverty, education and health to name a few. The problems facing the people in many of these countries may be different. For example, a review of writings of the intelligentsia in countries such as Pakistan reveals that important problems that are leading to low levels of productivity and high perceptions of country risk are:

- poorly managed urban sprawls;
- rising crime rates;
- poor infrastructure;
- an extremely low quality of service provided by the public sector; and
- a distance centralized, overburdened, overbearing and predatory state.

Ignoring this, the development-thinker has gone from saying that civil service reform is not important or something that can take place at a later stage of development to the stage of a belated recognition but then regarding it purely as a process or budgetary phenomenon. Hence their emphasis on downsizing, departmental closedowns, further centralization of hiring and firing. You only have to review all the public sector work on developing countries to verify my claim.[1] Interestingly enough, through this process of learning and erosion of public sector efficiency, there has been no element of remorse or "mea culpa" from the development economist. Adroitly, they are able to pass the blame entirely on to the poor countries. But then poverty is a curse and the poor can do no good, including think for themselves!

Unfortunately while the development economist was learning, the intelligentsia of a country was being increasingly marginalized. The systems in developing countries were being rapidly corroded. Their role was being totally denied in the development thinking and practice and by those who controlled resources or were in a position of influence. In the thinking of the development theorist, reform was viewed as an exercise in retrenchment, accounting, and a set of laws and processes that can easily be defined through the long arm of the international consultant. Domestic human capital of the concern country appears to play a limited role in this scheme of things. Sure there is a reference to weak incentives and the lack of domestic skills in the public sector, but the thrust of the argument remains that their reform can be entirely designed and driven by external thinking and human capital.

[1]See for example, the World Bank and OECD reports and the work by the public sector reform experts in the Bank. There is some passing reference to the need for human resource management as well as possible wage compression. However, the emphasis is entirely on capacity building, transparency and accountability building a better legal framework, all of which are basically euphemisms for more technical assistance. Domestic human capital and incentives for the use of it are not of interest.

Fortunately for the poor countries, the transformation of the former communist countries has drawn better economists into looking at issues of economic development and growth. We are, therefore, on the verge of some exciting new findings on public sector reform m developing countries using the *principal-agent* and *asymmetric information* paradigms.

In this paper, I shall draw upon these developments in economic theory and country experience to show that a well-designed public sector reform must rely upon quality human capital of domestic origin, whether such human capital be available either at home or overseas. Without the partnership of such human capital, neither can the reform be properly conceived nor can it be durably implemented!

Learning from Incentive and Organization Theory

Much research has been conducted in the theory of *incentives in organizations* in the realm of neoclassical economics and this can be used to understand civil service reform. Basically these theoretical developments are based on two important paradigms:

- The fundamental point of departure for understanding any human behavior is the recognition of ***selfishness*** that is inherent in all human actions. This viewpoint is fundamentally opposed to the commonly held view that derived from the 19th century liberal view, which saw the government as a benevolent protector of the poor. The *public servant*, as the name implies, was considered to *selfless*, kind and caring, devoid of the need for worldly goods and desires. Such angels would work for the common weal with no caring for family and the future! Clearly this view is incompatible with the paradigm of selfishness.
- ***Information is costly*** to collect and people may have different amounts of information available to them, which they will use to their advantage. This means that all exchange must now take into account the information asymmetries and the cost of obtaining information. Public sector regulatory intervention is often required where informational asymmetries prevent the market from working. However, this also gives selfish public servants an opportunity!
- This world of selfish individuals possessing asymmetric information leads to certain understandable forms of behavior and certain approaches to analyzing such behavior have been developed.
- **Moral hazard** *(hidden action)* when one party has the incentive to shift the risk onto another uninformed party.
- **Adverse Selection** *(Hidden Information)* whenone party has more information about a market transaction.

To deal with these issues, an analysis of contractual relationships, known as ***Agency Theory*** has been developed. An agency relationship is defined through an explicit or implicit contract in which one or more persons (the principal(s)) engage another person (the agent) to take actions on behalf of the principal(s). The contract involves *delegation* of some decision• making authority to the agent. Agency problems emanate from conflicts of interests, which arise out of selfish behavior in the presence of incomplete information, are common or endemic to most economic relationships.

Agency analysis has been used extensively to analyze how workers, managers, directors or investors respond to various incentives Self interested economic agents can be motivated in roughly three ways:

- **formal incentives** such as piece rate wages, bonuses, stock options and relative performance evaluation are based on verifiable **measures of performance**;
- foremen, fellow employees, bosses or boards of directors **monitor** work inputs; and
- **career concerns** inside and outside the firm may encourage a forward-looking employee to exert more effort.

The longest peacetime expansion in the US history owes a lot to these new developments in economic theory. Stock options, participation in the benefits of new discoveries in both monetary and non-monetary terms, and other clever contracting mechanisms have been designed to align incentives of managers and shareholders. They have led to an increase in the profitability of the US firms. Such incentive-based schemes drawn from the agency literature have also found their way into performance-based governance schemes. Examples of such schemes can now be found in countries such as New Zealand and the UK. As always, it takes a while for development theorists to catch up with serious economics since they are too busy following a diffuse agenda and patronizing the poor. Consequently, agency theory has only recently begun to be used to understand public sector reform in developing countries.

The need for Professionalization and Decentralization

We live in a specialized world and there are limitations on the mental capacity of the human mind. The costs of producing and transferring knowledge prevent any single individual or a small body of experts to monopolize any form of decision making or expertise (Jensen and Meckling (1992)). If knowledge valuable to a particular decision is to be used in making that decision there must be a system for partitioning out decision rights to individuals who have already have the relevant knowledge and abilities or who can acquire or produce them at lowest cost. Clearly, competent *professionals* who have incurred the costs of acquiring such knowledge as well as shown the inclination (and hence the comparative advantage) for it should be given the responsibility of taking such decisions.

Because all individuals in a firm are self-interested, simply delegating decision rights to them and dictating the objective function each is to maximize is not sufficient to accomplish the objective. A control system that ties the individual's interest more closely to that of the organization is required. The control system specifies.' [3]

- the performance measurement and evaluation system for each subdivision of the firm and each decision agent *(monitoring);*
- the *reward and punishment system* that relates individual's rewards to their performance;
- **Job Mobility** with better career possibilities inside and outside the firm encourages a forward-looking employee to exert more effort;
- There is neither guaranteed employment nor a guarantee of a promotion with seniority

[2] This control problem is solved in a capitalist economy by a system of alienable property rights. The inalienability of rights within an organization means control problems must be solved by alternative means.

[3] Specification of the performance measurement and evaluation system *merely* states the objective function. If reality is different, self-interested individuals discover and understand the performance measures and evaluation system on which their rewards and punishments depend. Thus if the prevailing culture suggests that rewards lie in bribery and corruption which will not be checked, no amount of codification of good rules and procedures and exhortations for honesty will motivate them to stop them from taking the more profitable route.

or age. Promotion is strictly on performance and subject to external competition. At any level, an outsider can and will be brought in to if such an appointment will help increase profits.

The complexity of modem society and the specialization required, forces firms to seek a *decentralized form of management.* Determining the optimal level of decentralization requires balancing the costs of bad decisions owing to poor information and those owing to inconsistent objectives. In the extreme case of a completely centralized organization, the costs owing to poor information are high while the agency costs owing to inconsistent objectives are zero. The costs owing to poor information fall as the decision rights are delegated down to lower levels in the organization. Assuming the usual convexities and continuity arguments, the optimal degree of decentralization can be found to occur where the right is collocated with the specific knowledge relevant to the decision.[4]

Decentralization often results in two widely used divisional performance measurement rules known as *cost centers and profit centers.* Cost centers are subdivisions that are directed to minimize the total cost of providing a specified quantity of service. Profit centers are more independent than cost centers; their budgets are more likely to be variable than those of cost centers. In general these centers place fewer knowledge demands on the CEO. The key point to note is that such centers are often given considerable autonomy within an expectation of performance.

The "multinational" has learnt!

Learning from "the theory of organizations" as outlined above, the multinationals, especially the American companies have built large and powerful global conglomerates. The empires are built on talent or the use of professionals, regardless of their origin. We all know of the contribution of the Pakistani talent to the development of global blue chip companies such as AST Computers, NEXGEN, Advanced Micro Devices, Citibank, American Home Products, Saudi American Bank, Bank of America, Ethan Allen to name a few. In each of these companies Pakistanis have played a pivotal role. The multinational management has followed exactly the principles of incentive and organization theory:

- They have created an atmosphere of professional meritocracy, by hiring the best professional that they could find regardless of creed and offering them a lucrative and prestigious career;
- Allowing these professionals a large degree of autonomy within a decentralized environment;
- They have held these professionals to high standards. Performance is closely monitored;
- Good performance is generously rewarded through bonuses that in a short span of time make millionaires out of talented individuals;
- Bad performance is sharply penalized through instantaneous job loss as well as fervent prosecution of malfeasant behavior; and

[4] The optimal degree of decentralization depends on factors like the size of the organization, information technology (including computers, communications, and travel), the rate of change in the environment, government regulation, and the control technology.

- Career advancement is purely talent-based. Talent and not age or seniority is the only criterion for advancement.

It is interesting to note that through the application of these sound managerial principles that are firmly grounded in economic theory, corporations such as Citibank, Hoechst etc are able to pull record profits in distant locations. They do so through their decentralized system of management and often relying purely on local talent. In many of these countries governments are unable to draw upon this local talent because of their outmoded managerial and pay structures!

Box 1

Human resource management in Public Sectors in Developing Countries

The public sector has traditionally been viewed merely as a transfer mechanism. The available evidence on wage, employment and human capital policies in the public sector wages suggests the following stylized facts:

- Poor public sector incentives for attracting talent:
  - Public wages have declined in real terms over time in many developing countries;
  - Declines in real wages have been larger in poor countries;
  - At the senior levels, the private sector wage is much higher than the public sector wage, while the opposite is true at the lower levels;
  - There is considerable wage compression: Wages at upper levels of public administration have often been reduced by more than those at the at lower levels;
  - The wage declines have been accompanied by an increase in perks and other non-wage benefits that are not only harder to monitor but provided at a higher cost than the value or benefit that the recipient derives; and
  - Corruption and maladministration increases with declining real wages.
- Stabilization programs affect fiscal adjustments often through declines in real wages in the public sector;
- Civil services in poor countries are typically Hierarchical, unified, closed and non-meritocratic structures;
- Donor-led CSR efforts thus far have not yielded any success.

See Haque and Aziz (1997) for details

Rethinking Public Sector Reform Strategy

Development thinking continues to rely on the government to meet the challenges of progress. An important question that needs to be asked is "whether the government in its current oversized and corrupt form capable of leading any development activity?" Or is it likely that assigning new roles to the government will lead only to the rapid development of further means of seeking rents?

As noted above, governments have clearly grown excessively and have developed a penchant for control and power. At the same time, if international ratings such as Transparency International, Business International Index and the ICRG are to be believed, maladministration and corruption have also increased. Meanwhile, human resource management in the government clearly leads to a poorly motivated public sector that does not attract quality human capital (see Box 1).

Attempts at reform must develop a view of an efficient government =one that in the most direct, clear and simple manner seeks to achieve a small number of well-defined social objectives. The design of government must attempt to incorporate dynamic efficiency by trying to continuously improve its productivity by means of periodic public reviews of the functioning of the government activities.

Clearly, any reform will have to conduct an audit of current government activities and institutions with a view to clarifying the need and objectives of all institutions. It should aim to eliminate waste especially by closing down useless tasks and non-performing institutions. It should aim to bring government back to governing and not taking over the economy or the private sector.

Reviewing the theory of organizations suggests some important principles of improving productivity in the government.

- An important change that needs to be made is that of reviewing the recruitment and use of human capital in the key area of governance. This would mean a careful market-based review of cash remuneration. For without that, productivity in government will not be increased, nor will the civil servant be motivated to carry through the reform. The current system of remunerating government servants results in strong incentives to corruption as individuals with less education and increased proclivity to be corrupt opt for such service.

- A smaller government with more efficient and professional staff should seek talent from everywhere. Like all other markets, the market for government jobs should also be subjected to external competition. Recruitment should be continuously conducted at all levels and not dependant on one exam only. As much as possible cross flow between private of management from the private sector to the public sector should be encouraged. Mobility should be strongly encouraged.

- Career concerns are an Important source of incentives for productivity and good behavior. Automatic promotions after time in grade with no evaluation of productivity should be abandoned. Clear and well-publicized productivity guidelines, which are easily monitorable, should be established for public positions.

- Emphasis should be placed on the development of institutional autonomy and hard budget constraints. Decentralized decision making and autonomous cost and profit centers are among the important factors contributing to the strength of the corporate world and should be adopted in the government too.

Building Capacity: human capital flight vs. technical assistance

While public sectors have been oriented towards wage compression, and economies have been growing slowly, the optimal response of those with skills, was to migrate. We have a fair amount of evidence on brain drain suggesting that there may be a talent pool that poor countries to draw from (see Table 3 and Haque and Aziz (1998)). Given the relatively short supply of skills in these countries, even non-spectacular numbers appear to have consequences for institutional capacity. Haque and Kim (1995) show that there is an output and income loss with the migration of skills.

A standard approach to dealing with the issue of loss, or lack of, scarce skills is the provision of technical assistance. International agencies and bilateral donors such as United States Agency for International Development use this approach extensively. Skills that are scarce in a developing economy provided by short-term, expatriate advisers, typically, at compensation levels higher than those prevailing in international markets. [5] This is to compensate for undertaking the hardship of moving from metropolitan centers. The high cost of the technical assistance is justified since it is expected that institutional development will be encouraged as the human capital input of technical assistance can galvanize a modern system in a short span of time. Once the system has been set in motion, the local human capital can maintain it at the low salary structure prevalent domestically.

Most countries that utilize technical assistance experience a substantial amount of brain drain. For equity and other considerations, the technical assistance model prevents the migrants from a country to return as part of technical assistance. Any person who has been a part of the brain drain can only return home at the low domestic salary and not at the technical assistance level of emoluments. The UN has actually mandated a salary structure in their offices that are situated in developing countries. Bear in mind that the UN local office jobs in many of these countries are among the more coveted. The structure of the professional policymaking/social science labor market is as follows: the lowest paid jobs are in the public sector; locally the UN jobs are preferred; and should the person be willing to move, headquarters jobs are desirable. It is not surprising then that the public sector lacks skills. What is surprising is that the question of the costs and benefits of the alternative channels of brain drain repatriation and technical assistance for institutional development in developing countries, which should be of obvious interest, are seldom studied.

Suppose, as is usually the case that skilled workers have already migrated. In this case, the comparison needs to be made between attracting an expatriate and a resident of the higher come country. However, Haque and Khan (1997) have shown that for the same income compensation, technical assistance programs will attract higher skilled migrants than experts from a higher income country.6 Consequently, technical assistance cannot be a substitute for the approach being proposed here--a comprehensive reform of the civil service that fully utilizes domestic talent. [7]

Reform of the Pakistan Civil Service

Reportedly, misadministration and corruption in Pakistan are high. Given the current level of wastage, we have management problem and not a resource problem. It is widely believed that the current system is elitist without being professional. Learning from organization theory, the following can be suggested:

- *Pay-scales must be attractive enough to compete for quality.* The current system of remunerating government servants results in a) strong incentives to corruption and b) individuals with less education and more incentives to be corrupt opting for the

[5] Typically, technical assistance is made available in areas of public sector responsibility such as institutional weaknesses. In such areas, the public sector rigidly maintains an uncompetitive wage structure (see Haque and Sahay (1995) and Haque and Kim (1995)). Frequently, policy intervention of donors, especially for short term stabilization, results in a reduction of public sector wages (See Kraay and Van Rijckeghem (1995)).

[6] For proofs of proposition 6 and 7, see Haque and Khan and Haque and Aziz (1998)

[7] A piecemeal approach to reform based on technical assistance can, in certain cases, lead to unbalanced development and less than durable solutions. For example, the enclave" approach has been used for quick results.

service.[8] Salary scales must be set to attract the required human capital to be attracted to public service. This means, departing from the notions of dedicated public service and moving towards a system of market-based salaries within government.9 As in many countries, such a policy would also mean decompression of pay scales and hence the tolerance of greater inequality in government;

- *Performance-based remuneration must be transparent and in cash.* The bulk of the civil servant's salary should be only in cash. The government should not be in the business of managing houses and cars. These perks are often abused and consequently, impose a heavier a burden on the budget than salaries alone would. Unfortunately, no study has been done of the cost to the taxpayer of maintaining these perks. Nevertheless, we can easily assume that cars are maintained by the government at greater expense and have a shorter life than those in the private sector;
- *Greater mobility and openness to external competition:* The current closed shop system should be closed down and replaced by a new system that relies on open recruitment of the best people from all over given the spread of Pakistanis in the world. Recruitment should be continuously conducted at all levels and not dependant on one exam only. As much as possible cross flow between private of management from the private sector to the public sector should be encouraged. Conflict of interest issues will arise but they will be no worse than today where the system is rife with corruption. Selection of good professionals through open and transparent means: Open recruitment should be conducted at all levels from among all available competent professionals and not just those in the government. Such appointments should be subject to some form of scrutiny of the public. For example parliament or parliamentary committees could confirm senior positions like secretaries after open hearings and expert witnesses;
- *Develop performance-based, and not seniority-based, careers:* Automatic promotions after time in grade with no evaluation of productivity should be abandoned. Clear well-publicized productivity guidelines, which are easily monitorable, should be established for public positions. Periodic public reporting on progress and performance indicators should be mandatory. Individual and departmental responsibility could also be enforced with some citizens' or the elected representatives' collaboration. For example senior bureaucrats could present annual reports of their department activities to parliament or parliamentary committees allowing the media to inform all of us.[10]
- *Career Streams and Institutional autonomy:* Perhaps the single largest factor that is constraining the flow of human capital into government is the unified National Pay Scales (NPS). These grades have established the relative price of doctors, lawyers, economists, engineers, market regulators etc. and have locked them very rigidly

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[8] It is now widely rumored that the high scorers on the civil service are now opting for Customs Service as opposed to the traditional District Management Group or the Foreign Service.

[9] The current low salaries are creating a virtual acceptance of corruption. What is worse, once corruption acquires acceptability, candidates with better educational background and consequently less prone to corruption are less likely to offer themselves for government service.

[10] Job performance would be monitored by the mechanisms suggested above. However, they should be supplemented with regular and intensive training activities. Such an approach as well as offers from other sectors will automatically throw up the good officers who may or may not be promoted depending on external competition.

against each other. Thus, for example, a Nobel laureate like Salam can only be a grade 20 professor in his own profession of research and academics while civil servant who was successful in his exam 30 years ago will be two grades above him in grade 22. Similarly, a world famous neurosurgeon like Ayub Umayyia cannot aspire beyond grade 20 in his own field. The professionally qualified also recognize that professionalism is only capable of taking them upto grade 20, and attempt very quickly to work their way into the political, non-professional world to make their way to health secretary, secretary energy etc:[11] [12]

- *Uniformity and egalitarian policies favoring large centralized governments are outmoded.* No system anywhere in the world locks local government, provincial administration and the federal government into rigid hierarchy as the Pakistani system does. The NPS clearly specify that the functionaries at all levels in the local administration are paid less and fall lower on the NPS scales than those of the provincial government and the latter are at a lower level on the NPS than the federal officials. Thus, for example, the provincial secretary is a grade 20 official the equivalent of a federal joint secretary. The establishment of such a hierarchy means that the local levels can really not compete for human capital of independent decision• making with the federal government;
- *More autonomous professional institutions with hard budget constraints should be established.* Regulatory bodies, such as the Securities and Exchange Commission and the Power Regulatory Agency, and service provision agencies, such as educational and health provision institutions are prime candidates for such autonomization.
- As far as possible these autonomous agencies have to be subjected to supervision through boards of directors that are rooted in their clientele--the people who demand their services. Often the government retaining enough residual control to interfere in the organization washes out such autonomization attempts. This is through the government control of boards and the hiring and firing including the tenure of the CEOs of such agencies. Rather than have a public services commission that attempts to ensure that equality in recruitment is maintained across all institutions, perhaps an alternative commission might be set up to investigate and make public the performance of such autonomous agencies.
- Financing should only be provided based on the achievement of clearly stated objectives. Managers of those institutions should be very seriously held accountable for the management of the finances of the institution and the meeting of the objectives of the institution. They should be forced to public audits and be subjected to an

[11] This has been the most harmful to education where all professors and teachers have been relegated to a position that is inferior to that of administrators who not only get paid better but are also in charge of resources. A university a professor is valued less than university administrators and bureaucrats. Professors therefore have no incentive to hone their skills in their subject; instead they vie for administration jobs such as the vice chancellor. The quality of teaching has, as a result, suffered and less and less of the truly qualified teachers are offering themselves for teaching positions.

[12] Responding to the incentives of the political system, the professionally qualified are prepared to trade their professional competence for a political appointment. In this way we have lost many a capable doctor, lawyer, economist and engineer to the political maneuverer-cum- bureaucrat. What is worse is that the incentives are set for the young to not specialize in a profession and towards political maneuvering

public examination annually. In such a system, we will see that the managers will have to value professionals and not treat them like second-class citizens. [13]

- *Performance should be monitored and non-performance and malfeasance should be penalized.*

The Need to Retain domestic human capital

We must not move along without paying tribute to some of the local talent that even in these adverse circumstances chooses not to migrate. However, those that remain for their own reasons are scattered and overworked, and frequently unable retain their professional edge.[14] Whatever remains of governance and administration often falls on the few skilled individuals who remain in the civil service. Professions rarely exist in any serious manner in these countries. Those with skill who have not migrated often do not have the resources to do any serious independent work. More often than not, the only choice open to them is work for the local branch of the donor office in a junior position.

The Question arises, "how is policy analysis and formulation conducted in such an environment?" The answer is that it becomes the responsibility of the international agency by default. All information on socio-economic development in these countries is to be found in the reports of these agencies. Domestically, there are no more than a handful who understand these issues and reports, and they are heavily involved in the negotiations and the work of the international agencies. Few, apart from them have access to much of this information. The debate on the issues is restricted to the staff of the international agency and the senior technocratic officials with the former having the luxury of the time and resources to actually conduct serious inquiry. The latter, being in such short supply and spread thinly over the many administrative functions of the country can, at best, act as informed discussants.

Policy ideas originate in donor and international agency offices and are transmitted to the government. Between these two groups decisions are taken. At times, a limited effort is made through a seminar to inform concerned people of the findings. There are two important limitations of approach:

1. Policy initiatives have limited local input or participation and hence may not be fully in consonance with local problems. Hence it is easier to follow the "fad" in- the west rather than learn about what is needed domestically.
2. There is limited domestic ownership of a product whose origins lie overseas. It is no wonder then that serious efforts at privatization and downsizing of government were resisted for a long time at considerable cost to the country. Often when these ideas are implemented, they are often resisted by locally or nullified through lackluster implementation.

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[13] Managers should have clear tenures and depart once their tenure is over. The current system of high turnover or exceptionally long tenures is harmful to institutional development. At the initial stages especially, every effort should be made to recruit managers from the non-government and private sector.

[14] Under-funded and low quality universities serve to drive away good faculty rather than develop any critical masses of serious academics in their departments.

Surprisingly, the current approach to policy formulation has not been examined using the incentive framework. Are the interests of the governments and the donors always in consonance with those of the people? Are the donors who formulate policy always fully informed? Where is the quality check? How is accountability enforced? It is hard to see how mistakes in making policy are even discovered in the current approach. There is little serious review or criticism of the research underlying policy except by those who prepared the policies in the first place: developing countries.

FINANCIAL MARKET DEVELOPMENT

Development of Financial markets

Republic Commemoration Lecture delivered at the Center for Banking Studies on May 25,2000.

Financial market work is often done in a patchy fashion by various agencies leading to a very fragmented development. For years this has been of interest to me and I was particularly interested in my assignment to see if I could possibly enhance the understanding in this area.

When the governor asked me to present this lecture, I thought that a survey of the subject with insights on the function of the financial system and the implications for regulation would be interesting. The published paper was circulated.

I have since used the paper for presentations and training at CBS, SEC and other forums.

Since then, I have had a chance to develop a relationship with the financial system. We have discussed financial market reform frequently but little has been implemented.

Now I have started an initiative for a broad conference on financial reform where all participants are contributing. This will be a bold departure form the past if we are able to pull it off well. The new reform ministry is expected to take a deep interest in this issue.

This paper is expected to serve as background material for this conference.

On the Development of Financial markets in Developing Economies

Introduction

The finance dimension of economic development has often been treated as an afterthought by researchers and politicians alike, because it is considered to be too *sophisticated* to matter for *simple* economies. In addition, institutional aspects of economic development were neglected while policy and research focused on improving the *real* side of the economy. Recent research, however, has shown that institutional arrangements, such as legal, financial and economic rules underpinning exchange have very real consequences for emerging economies (Barro (1997)). Experience has also revealed that financial development, including stock market development (as measured by market liquidity, capitalization, turnover, efficiency of pricing of risk, etc), is correlated with current and future economic growth, capital accumulation, and productivity improvements (Levine and Zervos (1996)).[1]

The relationship between financial market development and growth should be of particular relevance to low income countries, given positive linkage between growth and poverty alleviation. Development economics and policy has, therefore, now started to include the development of legal and financial infrastructure as necessary for the generation of growth. This evolving thinking on development has generated renewed thinking on the appropriate strategy for financial market development and the institutional design (financial institutions as well as regulatory institutions) that might be required for it. In particular, the relative roles of banks and other financial institutions, the timing and sequencing of their development, remain issues of continuing policy interest.

It is the policy premise of this paper that the financial sector policies in emerging economies should focus on enhancing, rather than inhibiting, the multiple roles of financial markets. Likewise, the depth of the financial market infrastructure has to be judged on the basis of the efficiency with which these various functions are carried out. For instance, the mere erection of stock exchanges is inconsequential, if the environment is hostile against opportunities for risk-sharing and liquidity provision and transformation. Moreover, the mere existence of banks is of little value, if their existence is merely to purchase government securities at the expense of commercial lending. In fact, such practices prevent banks from serving as informed agents or intermediaries on behalf of the society, and hence building vital information capital for efficient allocation of resources. Unfortunately, this pattern of financial dis-intermediation or dysfunctional intermediation is still observed in many emerging economies.[2]

The paper is organized as follows. Section II is a critique of the dominant perspective in economic (and financial) development and the associated financial sector policies. Section III provides a functional perspective to policy guides in financial market development. Section IV provides a brief assessment of the functionality of observed financial systems in emerging economies by using the functional paradigm as a benchmark, with a focus on the African experience. Taking these observations as a challenge, Section V provides financial sector

[1] This is in contrast to the previous literature which had focussed almost exclusively on banking development and growth.

[2] Only recently has the functionality of the financial system been appreciated in the context of economic development in developing countries [Levine (1997)].

policies, guided by the multiple functional role of financial markets and incentive, and market-based, regulatory schemes. Section VI concludes.

I. **Finance in Development**

A. Finance in Development

The explosive financial reforms and liberalization processes that have taken place in emerging economies have been largely inspired by the dominant thinking of Mckinnon-Shaw (1973). the thesis established an important linkage between financial system and economic growth, but reinforced the exceptional emphasis on the banking sector and elimination of financial repression. ending financial repression meant liberalizing financial prices (interest rates, exchange rates) and lifting credit ceilings. simultaneously countries are presumed to follow indirect monetary policy to control inflation. although, these financial liberalizations have yielded positive real interest rates, they have not produced the desired results of increased investments and savings.

Similar to the area of trade and development, the view that development economists had of the role of financial markets in economics was also heavily influenced by a series of "widely accepted facts and premises about the underdeveloped countries," which were "a mixture *of touristic impressions, half truths, and misapplied policy inferences* [my emphasis]," (Krueger (1997)). She notes that the *impression* of the development economist, that prices and markets in these countries did not work, as well as the desire for forcing a faster pace of development, led to the design of activist and interventionist policy in trade and industry.3 The prevalent view was that developing countries had to make a "big push" from their existing concentration in primary commodity production, the terms of trade for which were on the declining trend, to the production of higher value-added manufacturing goods (Nurske, 1958). Trade and macro policy, as well as market development, including financial market development, were considered to be means toward the objectives of the "promotion of this faster pace of development" and the 'big push" for industrialization.

This early view of economic development determined the path of development of these markets in many developing countries. Much of the debate on the role of financial markets in economic development has been reacting to major events as they have occurred. The major constraints to economic development were perceived to be the shortage of domestic resources to meet the investment demand and the lack of external resources for import of capital goods that were required for the desired industrialization (Chenery and Strout, 1966). The role of financial markets in this scheme was merely to collect and provide savings for industrial development." Foreign exchange controls, with surrender requirements for export, were put in place to conserve foreign exchange and concentrate it in the hands of the government planner who had the master-plan for development.

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[3]How the development economist perceived developing countries and economies is relevant to the understanding of the evolution of economic policy and institutions in those countries. For example, development economists debated for years whether the peasant in developing countries was rational in the sense of responding to economic incentives [see Schultz (1964)]. Note this is similar to the Krueger's contention on the stylized facts that shaped trade policy in the early post-war period.

[4] In other words, the focus has been on the *quantity* of capital. However, the functional properties and the *quality* of capital need to be guiding principles in financial sector reforms.

Banks were among the first financial institutions that policy encouraged but "primarily to promote economic development" and not "primarily to make profits" (Fry, 1995). The promotion of development objective led to increasing intervention in the banking system of developing countries by the government and donors in this early period. These ranged from the imposition of selective credit controls and financially repressive arrangements, such as high reserve requirements, interest rate and credit ceilings, and direct nationalizations of banking systems.[5] The banking system that was created through such policy was inefficient and overtaxed. Large operating costs and lending for purposes other than pure bank profitability has resulted in years of banking sector difficulties that many countries are still contending with. Lindgren et. al. (1996) note that "since 1980, over 130 countries, comprising almost three-fourths of the International Monetary Fund's member countries, have experienced significant banking sector problems."

B. Unbalanced Development: Growth of Informal Markets

Because of this view of development, "postwar financial development in developing countries differs in several important respects from financial development in the industrial countries" (Fry, 1995). *First,* the pace of development was forced in developing countries with government intervention occurring with increasing frequency. *Second,* concentration is far higher in the banking industry in developing countries now than it was in the industrial countries prior to World War I. *Third,* financial systems are segmented with several specialized financial institutions that were created for meeting particular development needs limited in their competition with each other.

The lack of instruments and market rates of return in these repressed financial markets led to the development of *informal* or curb markets. These markets, which sought to circumvent official controls and to provide market rates of returns to savers, performed many functions, including loans, and forward and foreign exchange transactions.[6] Very little real research was collected on these markets or regulation developed to allow these markets to be "formalized", but they were regarded with a considerable degree of suspicion.[7] Even the McKinnon-Shaw (1973) thesis, that "has been the main basis for financial sector policy and advice over the last two decades, looked upon these markets as inefficient and not contributing to the productive sectors" (Fry, 1995). This school of thought or thesis argued for financial liberalization (withdrawal of financial repression and the introduction of market rates of interest) to allow for better investment allocation and for increased savings mobilization through the *formal* financial sector, which was considered to consist only of commercial banks, and away from the unproductive *informal* market.

The debate in the area of finance and development through the seventies and eighties has been on the pace of financial liberalization which has been interpreted as the withdrawal of financial repression. The neo-structuralists saw some merit in curb markets and a slower pace

[5] Specialized financial institutions, such as agricultural and industrial development banks, were also encouraged to compete with banks. Fry (1995) notes that the World Bank's approach to financial sector development changed in 1980 with the Philippines report, "The new stance favors despecialization, the promotion of competition and a broader view of financial development."

[6] For a detailed analysis of informal financial markets in developing countries, see Montiel, Agenor and Haque (1993).

[7] Wai (1980) questions whether "such arrangements should even be called markets, "while Chang and Jung (1984) describe the curb market as "non-competitive, less developed, and fragmented."

of liberalization, but they too were primarily interested in the role of domestic savings mobilization through the official banking system. Even the issue of the development of sound banking systems through improved regulation is a relatively recent development. As Fry (1995) notes (page 315) that "in a 134 page report on the security market in Bangladesh in 1980, only 2 pages were devoted to supervision and another 2 pages to accounting disclosure in a chapter entitled the peripheral areas."

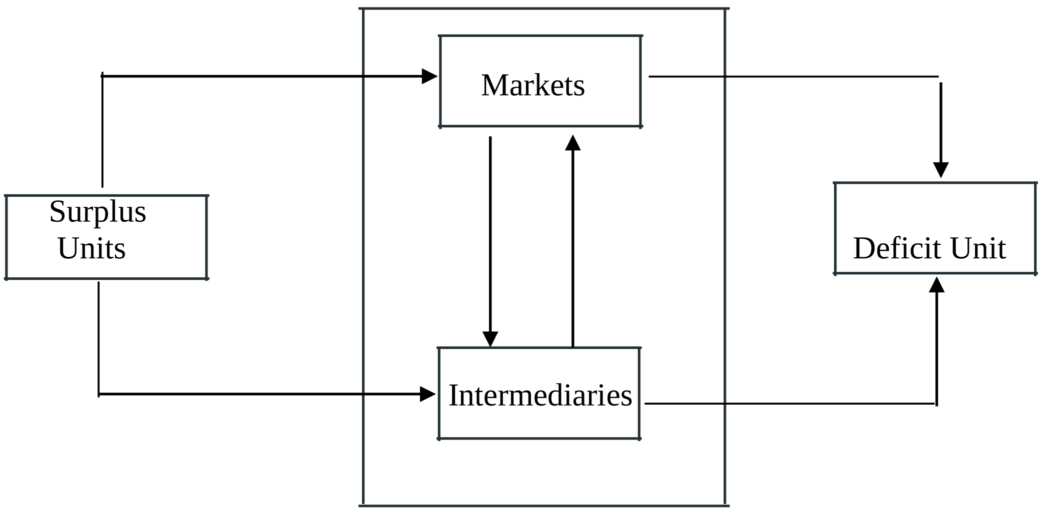
C. The Suggested Sequencing

The dominance of banking institutions in financial systems prevails even today in the thinking of financial development. Fry (1995) argues that, in a low income country, "any financial development program should start with the development of markets far simpler and shorter term such as treasury bills and certificates of deposits rather than equities." Similarly, White emphasizes that "banks are likely to (and should) be the relatively important providers of finance in economies that are at their early stages of development, and short term loans should be the primary financial instrument. Securities markets and money markets are likely to (and should) become important only at later stages of development" (Zahid, 1995).

Box 1

The Financial System and the Flow of Funds

The financial system comprises of savers *I* lenders who provide the finance capital, **investors /borrowers** who know what to do with the capital, markets for stocks, bonds, and other financial instruments, **financial intermediaries** (such as banks and insurance companies), **financial-services firms** (such as financial advisory agencies), and **regulatory bodies** which govern all of these institutions.



Funds flow from the surplus units to the deficit units via financial markets and intermediaries. In a typical LDC, both the markets and intermediaries tend to be government owned and government controlled. The largest borrower also happens to be the government.

Arguments in development finance have often been based on the observed dominance of commercial banks in financial markets in developing countries. However, in making these arguments, it is being assumed that this is the natural evolution of such markets, although the whole literature on financial repression has been noting for years the extensive interference of governments in financial markets. In reality, the development thinking and its influence on the policy maker set up an institutional infrastructure that was so biased toward commercial banks and other official credit agencies that any other attempts at *financial innovation* were immediately regarded as *informal,* and hence were never allowed to develop. A more agile regulatory and supervisory system should be accommodating of financial innovation by giving it more formal recognition and structure through appropriate disclosure and reporting net. Unfortunately, path-dependence in the policy and regulatory structures has kept financial market structures continually biased toward commercial banking and stifled other forms of financial market development. Below we will approach the issue of financial market development from the perspective of multiple *functions* of the financial system. We do so by bringing paradigms in financial theory to bear upon issues of financial development.

II. The Functional View of the Financial System

The prevailing policy perspective, which has viewed the financial sector as a mere conduit for capital mobilization, results in financial liberalization/reform programs that perhaps unduly emphasize banking sector and depository institution development. This perspective is not consistent with modern finance for two reasons. First, it does not take into account the deeper roles of financial sector under conditions of *uncertainty* and hence the effects of liberalization targeted only to capital mobilization. Under uncertainty, there is not just capital allocation (supply-side) that is the sole issue, but the issue of risk allocation (demand-side) is also paramount. Second, in an environment characterized by a host of imperfections in information dissemination and observability, incentive problems are likely to prevail. In this case, capital markets provide for efficient contracting among conflicting parties and for disciplining of corporate insiders through markets for corporate control.

In the modern view of finance, the financial system is based on markets that are used to provide financial services to households, business firms, and governments. The markets are governed by institutional arrangements that have been prescribed by law and various intermediaries - firms as well as individuals - provide the services required by decision• makers i.e., those who demand capital and those who supply capital. Typical financial intermediaries include banks, investment companies, brokerage houses, and insurance companies. Their products include checking accounts, commercial loans, mortgages, stocks, mutual funds, insurance contracts, and a wide-range of derivatives. Financial markets for a particular financial instrument may be based in a physical location (e.g., New York Stock Exchange), or they may have no specific physical location allowing trading through computer and telecommunications networks linking securities dealers and their customers (e.g., over-the-counter market or off-exchange markets-in stocks, bonds, and foreign exchange). The modern financial system is global in scope with financial markets and intermediaries interlinked through a vast international telecommunications network, to allow a continuous transfer of payments and the trading of securities.

Financial markets and intermediaries change over space and time according to the size of the country, complexity of transactions, available technology, as well as differences in political, cultural, and historical backgrounds. Even when the names of institutions are the same, the functions they perform often differ dramatically. For example, banks in the United States today are very different from what they were fifty or a hundred years ago and they are also very different from those in Germany, Japan and Korea. Consequently, in order to understand the financial system, we will take the vantage point of the functions that these markets perform in an economy. We do so for two reasons:

- the functions of a financial system do not change much over time and space while the forms and functions of institutions and intermediaries do;
- the forms of financial institutions are a product of innovation and competition among participants for the more efficient performance of functions of the financial system.

Studying financial systems from a functional view has important implications for sequencing and development of financial markets and products, banking and equity markets, and insurance and derivatives in emerging economies. The financial market development path should also be anchored by this functional view and not necessarily guided by the path that it took in the advanced economies.

Box2

Arbitrage

Much of finance theory relies upon the notion of Arbitrage or the Law of One Price. This law states that, in competitive markets, if two assets are equivalent in all respects, they will have the same price. If prices are different, then rational market participants would seize the profit-earning opportunity offered, by buying in the low-price market and selling in the high-price market. Therefore the price difference will be wiped away almost instantly and only a single price will prevail. For this reason, prices play an important role; all relevant information is encapsulated in the price of an asset. This is the essence of price discovery.

The most fundamental role of the financial system remains that of intermediating between savers and investors such that efficient resource allocation of the available resources of the economy is undertaken. From this viewpoint, we can determine the following six basic or core functions performed by the financial system:

- **Function 1**: **The Mobilization of Capital**. Unless financial markets are able to provide market participants with a variety of instruments of differing maturities that are traded in markets that have the depth to allow speedy exit, capital mobilization will be less than adequate. For example, capital providers desire liquidity (ability to exit on short notice), risk exposure, while entrepreneurs need to commit capital for long-term investments. Financial markets resolve this divergence through provision of alternative instruments to facilitate diversification, and allow for maturity transformation. These *liquidity* and *maturity* transformation functions of financial systems are very basic functions that require instrument and market development.
- **Function 2: Risk Management and Resource Allocation.** In an environment where uncertainty prevails, risk sharing and insurance are the two most fundamental functions that a financial system provides. A well-functioning financial market enables multiple investors to share a project's risk allowing high-risk, high-return investments to be undertaken. In the absence of such risk-pooling and risk sharing arrangements, such high-risk, high-return projects may be *rationed* out of the market, destroying, rather than creating, value for the economy. Financial markets, therefore, facilitate allocational efficiency. Risk-allocation mechanisms supported by well-functioning financial markets allow for diversification, hedging insurance and leveraging.

- **Function 3: Pooling of resources and diversification of ownership**. A financial system provides a mechanism for the pooling of funds to undertake large- scale indivisible enterprise that may be beyond the scope of anyone individual to undertake. They also allow individual households to participate in investments that require large lump sums of money by pooling their funds and then subdividing shares in the investment. The pooling of funds allows for a redistribution of risk as well as the separation of ownership and management.
- **Function 4: Information Production, Price Discovery and Exchange of Control.** Price signals contain information on quantity, scarcity and value, and thereby help agents allocate resources to their best use. Nowhere is this more true than in the financial sphere!" A well-functioning financial market processes and aggregates all available information into the value or price of the commodity. From a welfare point of view, the financial system, through this price discovery function, allows capital to flow toward its most productive use and bring about allocational efficiency.
- **Function 5: Facilitating Better Governance and Control.** Financial markets promote efficient governance and control of an organized enterprise (especially on a public trade corporation) by exerting *external* pressure and discipline on its operation. In the presence of uncertainty and informational asymmetries, the allocation of capital involves the control of capital so that it is efficiently exchanged to allow it to be put the best use. Inefficient management is typically removed through takeovers which allow unfriendly raiders to accumulate shares in the open market and take control of the firm. Often, the very *threat* of such takeovers is a powerful mechanism for disciplining management. In its absence, management becomes entrenched and misallocates or misappropriates resources from the firm leading to far-reaching economic inefficiencies.
- **Function 6: Efficient Clearing and Settling.** An important function of the financial system is to provide an efficient way for people and businesses to make payments to each other when they wish to buy goods or services. Modem day complex transactions involve movements of goods, services as well as financial assets across time, space, and, quite often, across national borders. Efficient payments and settlement technology allows the speedy completion of such transactions. If financial markets are to handle large transactions rapidly, clearing house and depository functions are necessary elements of the enabling environment. Long delays in intercity check-cashing and lengthy time requirements for registration of financial assets are serious impediments to market development. A payments and settlement systems depend on the supervisory and regulatory system that eventually stands behind the final settlement of all transactions. In an economy where the such system is not very efficient, transactions will be primarily cash-based requiring the maintenance of idle cash balances.
- **Function 7: Dealing with Incentive and Agency Problems**. Modem finance theory views the firm as a *nexus of contracts:* shareholders/owners borrow form creditors and delegate the task of running the firm to professional managers. Ownership and control of the firm is, therefore separated. The various relationships are determined by contractual relationships that are written within the regulatory umbrella provided by the government. Financial markets promote *contractual efficiency* in an environment characterized by incentive conflicts and hence lead to allocational efficiency. Incentive contracts for alignment of diverse interests between management, shareholders, and bondholders can be facilitated through financial contracts.

[8] A major failure of a simplistic view of development finance, based on resource mobilization, was the suppression of price signals (through interest and credit controls) to channel savings toward politically guided investment priorities. Repressing price signals (or, equivalently, returns) has often led to a misallocation of capital with disastrous consequences for economic welfare and a country's well-being

Since the root of modem financial regulation is thought of revolving around alleviation of the consequences of market failure, regulatory intervention is often thought of as a *substitute* for the markets' functions. However, the newer literature, both in finance and other fields of economics, has shown that it is more appropriate to think of markets and regulation as *complements*. Similarly to enhancing the efficiency of financial contracting, markets contribute to making regulatory arrangements more efficient. The fundamental mechanisms are also very similar to the arguments presented regarding contractual efficiency: by conditioning regulation--the application of rules and regulator's incentives--on *market-based information,* regulatory outcomes can be significantly improved upon.

Box3

Agency Problems

Agency problems refer to those that arise when one party serves as an agent for another. The two major types of problems are that of moral hazard and adverse selection. Moral hazard arises due to hidden action when one party has the incentive to shift the risk onto another uninformed party. Adverse selection is due to hidden information, when one party has access to more information. Agency problems occur due to a conflict arising out of selfishness. Regulatory and legal systems need to take these incentive problems into serious consideration.

In the context of financial markets, some potential agency conflicts are:

I. Managerial agency: A potential conflict between the shareholders, who are the owners of the firm, and its managers who are the shareholders' agents in managing the firm.

2. Debt agency: A potential conflict between the shareholders, who are the owners of the firm, and its debtors who have the first claim.

3. Social agency: A potential conflict between the regulators and society whom the regulators are expected to serve.

Financial markets have the ability to deal with such agency problems. Contractual efficiency is facilitated through the ability to write market-based contracts which deal with these incentive problems and attempt to align diverse interests. For example, stock options and performance-based contracts provide the incentive for achieving clear and measurable market-based targets thereby aligning shareholder and manager interests. Tradable contract allow for the possibility of liquidation to ensure adequate pricing of contracts.

The manner in which financial markets have evolved is summarized in Table 1.

The system in many of these countries remains dominated by banks. Other markets play a very limited role with commercial paper and derivatives being virtually non-existent. Given the priorities accorded to capital mobilization and the financing of the public sector, banks tend to be inadequately supervised as well as lacking the incentives to appropriately manage risk. The result is that many banks have large non-performing loans. Systemic banking crises have increasingly been experienced which because of the implicit deposit insurance that the government is forced to provide impose a huge cost on the economy: In 1995, Japan was estimated to have nonperforming loans from 10-25% of GDP; Argentina in the early eighties suffered about 20-55% of GDP; and Chile in 1982 suffered a loss of about 13-42% of GDP (Caprio and K.lingebiel,1996). Often the crisis remains hidden for quite a while, and is even exacerbated as in many of the developing countries, because banking structures are not competitive and often even substantially government owned.

Table 1: Characteristics of Financial Markets in Less-Developed Countries

Type of Market/Institution	Features of Development
Banks	System primarily based on banks. 1/ Weak supervision. Non-performing portfolios in many countries leading to systemic crises in many countries. 2/ Concentrated and oligopolistic structure. Government owned or recently privatized. Large spreads to cover banking system difficulties. Financial repression: used as a means to finance government.3 Implicit deposit insurance provided by government.
Equities	Limited role. Weak supervision and regulation. Inadequate information and disclosure. Thin markets. Suspicion of insider trading. Market valuation not fully reflected in stock price. No takeover threat.
Government debt instruments	Recently developed in poor countries with varying stages of secondary market development.
Private debt instruments	Very few countries have these.
Foreign exchange	Few of the poor countries have well-functioning foreign exchange markets.
Derivatives	Non-existent.

1/ See Zahid (1995) and World Bank (1987).
2/ Caprio and Klingebiel (1996) records that in many developing countries a financial crisis had taken place in the eighties and one of the principal causes that they identify was weak supervision that affected the risk taking incentives for bank management.
3/ See Fry (1993) for an analysis of the effects of financial repression .

Table 2: Functional Assessment of Financial Markets in Low-Income Countries[10]

Function	Assessment
Capital mobilization	Limited instruments and exit is not easy from markets other than bank deposits. Debt and deposit instruments concentrated toward a shorter term.
Managing risk	No derivative markets. Limited ability to diversify across markets.
Diverse ownership	Illiquid and poorly supervised stock markets do not inspire faith in the small investor limiting the pooling of ownership and the diversity of ownership.
Information development and price discovery	Illiquid, thin, and poorly supervised stock markets inhibit the process of price discovery. No takeover threat as a disciplining device. Limited ability to arbitrage across markets.
Providing clearing and settlement	Non-competitive institutional structures combined with weak regulation leads to inadequate development of clearing and settlement systems.
Dealing with agency issues	Since market discipline is absent, optimal contracting is difficult for the overcoming of agency problems. Limited ability to allow use different markets for this purpose.
Attracting inflows	Volatile inflows to take advantage of arbitrage situations only.

The functional paradigm of Section II allows us to assess the functionality of observed financial systems. Most low-income countries have undergone extensive economic and

[10]For more detailed information on the entries in Table 2, see Fry (1993, 1996), Lindgren et. al. (1996), Caprio and Klingebiel (1996) and Levine (1997) among others.

financial reforms which have moved them away from earlier 'repressive' regimes, characteristic of the pre-adjustment era, where governments played major roles in determining credit flows through a system of subsidies, interest rate ceilings, credit allocation and direct intervention. Despite the positive and encouraging developments in the restructuring of financial systems, stock market development and banking development in low--income countries are grossly *incomplete.* This may also suggest incompleteness in financial reforms and liberalization.

We can also derive from the literature an assessment of the functionality of financial markets in developing countries. Table 2 Summarizes some of the information that is available. Given the lack of depth in these markets and the limited number of instruments, it is quite likely that the needs of market participants--the need for liquidity and maturity transformation--are not met. Consequently, the principal functions of financial markets--that of mobilizing capital for growth and improving resource allocation--are not obtained. The heavily bank-based system may not provide an adequate number of instruments to allow risk to be diversified, control to be easily exchanged and for information to efficiently aggregated in price. Weak supervision and regulation further distort the incentives for efficient financial intermediation. Non• competitive institutional structures combined with weak regulation results in an inadequate development of clearing and settlement systems. Since market discipline is absent, optimal contracting is difficult for the overcoming of agency problems and there is virtually no threat of a takeover faced by a poor management. Such countries have limited attraction for foreign capital and perhaps have to face more volatility than others.

IV. Implications of the Functional View

To repeat, our premise is that financial sector policies should be guided and anchored by *functionality* of the financial system. Using the functional approach we wish to provide a policy agenda facing an emerging economy in its effort to develop financial markets. At the core of our discussion of the ingredients for financial market development are mechanisms for fostering *public confidence* and appropriate incentives for a well-functioning financial system. No amount of knowledge or technology, or even economic fundamental, makes financial markets workable unless there is an environment of trust and public confidence -i.e., even playing field, open and honest market place, fair treatment of participants by securities operators, honest and transparent management of public companies. In view of this and the preceding discussion, we can conclude that the without the provision of an adequate public infrastructure, financial market development is not likely to be well founded. It is the development of this infrastructure that policy should seek to develop first.

A. The Necessary Public Infrastructure

In the development of public confidence and informational efficiency, the government has a vital role to play in ensuring enforceability of private contracts, and creating an environment of transparency and investor confidence. It is perceived as an independent efficient arbiter of financial disputes as well as the last resort for speedy enforcement of all contractual arrangements. The mere existence of legislation, which declares and grants inalienable property rights, is insufficient. An independent judiciary strongly enforcing and protecting these rights, must stand at the core of such a system.

Financial market development must be underpinned by a credible, national regulatory scheme that promotes, rather than inhibits, private initiative, whereby investors and savers build confidence in the financial systems. Without this foundation, the financial system will be deficient in terms of *informational* and *operational* efficiency, vitiating public confidence, resulting in inefficient pricing of financial assets, as well as inhibiting liquidity and reducing turnover. It is this lack of a regulatory foundation that is an important reason why market development remains poor in less-developed countries. Following the approach taken in the advanced economies, it seems appropriate that government regulation of financial markets should be more of an *oversight* over *self-regulatory* agencies, such as the stock exchanges and brokerage industry. Self-regulation builds on the capacity and wisdom of men and women inside the member firms that participate in the capital market process directly rather than government bureaucrats who lack intimate knowledge of the day-to-day functions of markets which are increasingly sophisticated.

Box4

The role of the Regulator

Financial markets develop through innovation. It is therefore important to recall that over-regulation of the market dampens attempts at financial innovation. A regulator cannot be expected to function as an all powerful agency in full control of every minute detail. Many LDCs also make the mistake of developing regulation before developing the market itself.

A good regulator is like a good referee. The regulator would make sensible rules and allow players to compete vigorously. The regulator's presence alone would be sufficient to ensure fairplay from most market participants. Monitoring efforts need to be focussed only on the few players who do not seem to be playing by the rules. Active intervention is needed only when the market threatens to get out of control. The best regulator would essentially be invisible; markets do not need to notice his presence. The regulator's presence needs only to be felt rather than seen.

Financial regulators also exert a levef of control over the market. The fairer the rules and regulators, the better the condition in the marketplace, and therefore the more attractive the market becomes to the prospective participant. This is the essence of financial market development.

B. Sequencing of Financial Reform

In industrial countries, the development of financial markets followed a particular historical sequencing: commercial banks developed first; followed by the development of primary markets for government debt and paper; primary markets for equity and commercial paper were then developed; secondary markets followed; and finally the markets for derivatives arrived. Motivated by the view that less developed follow the development path of the advanced countries, development advice has tended to follow this historical sequencing which is really based on the accident of discovery.

This approach, however, does not permit any "institutional leap-frogging." The difficulty with a stages of financial market development is that it does not emphasize the need for developing a full set of institutions necessary for market development early in the development cycle. As a result, a partial set of institutions is developed that, very often, exacerbates market incompleteness. Moreover, as we have seen there are complementarities across markets and hence institutional complementarities that can be exploited if the historical sequencing were to be relaxed. Espousing a functional perspective on financial system development permits this issue to be side-stepped. By focusing on the various functions and letting the development cycle determine their natural sequence, one automatically sidesteps the kind of institutional fallacies that have often plagued policy advice for financial development.

C. Fostering Financial Innovation

In most developing countries another form of financial repression that had been adopted was a resistance to financial innovation. Concerns for a potential adverse impact of financial innovation on the stability of the financial system through increased systemic risk are natural and even felt in more advanced economies. Financial innovation increases market depth and efficiency as well as expands the menu of instruments and mechanisms available for the performance of financial functions. Risk is better priced and trading increased which may contribute to increased volatility.[11] The new equilibrium will have greater social value (output) but has become more risky (with greater market volatility).[12] However, increased volatility may tempt the policy-makers to stifle innovation, discouraging foreign competition and investment and curb domestic speculative trading. Such ill-conceived policy interventions have been observed in many economies.

It is misleading to assess the efficiency of capital markets based solely on volatility. Volatility is produced by market activity and production of new information that impacts prices. Market efficiency should be judged by the speed of adjustment to new information, and in this context, it is possible for markets to be more volatile as they become more informationally efficient. In other words, increased market volatility may be reflecting increased informational efficiency and even allocational efficiency. Indeed, the most inactive markets (such as those in the low-income countries), exhibit perhaps the least volatility, only because they are most inefficient and dysfunctional.

Perhaps it is easier to appreciate the foregoing point by looking at the impact of financial liberalization/reform. To understand the increase in volatility following interest-rate liberalization, consider that before the liberalization, banks targeted less risky clients, including the priority sectors stipulated by the government, since they were mandated to charge not only rates that were divorced from credit risk. The riskier ventures, irrespective of their net present value, must have been rationed out of the credit market. Post-liberalization investments might now tum out to be more risky and of higher quality in terms of net present value. Add to this the fact, that market participants are now involved in trading and producing information.

Finally, it should be recognized that financial innovation takes place both in the formal and *informal* sectors. Informal sector develops as a response to official impediments. The official response for too long has been to stifle it. As such, it is a in response to a perceived need for a financial innovation.[13] Consequently, rather than discouraging the informal sector, regulators should by guided by signals coming from the informal sector for fostering innovation in the formal financial sector.

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[11] Indeed, it is possible that greater speculative activity and greater participation by international investors in the local stock market leads to greater trading activity with more information production, and possibly more price volatility.

[12] The specialization in trading risk according to comparative advantage makes society better off.

[13] Informal sector can provide signals to policy (see Montiel, Agenor and Haque (1993)).

D. Market Development
Market development has been impeded more by the regulation or the lack of it than any other single item. Rather than stifle innovation and trading in the market place, including erecting barriers to globalization, policy-makers should facilitate liquidity and promote market transparency. Government policies should be targeted toward reducing the costs of the financial system. These include costs relating to trading, intermediation, and legal enforcement. Trading costs can arise implicitly from the lack of market development. In a nutshell, the policies should create an enabling environment for capturing the full functional potentialities of markets. For instance, there is a need to build capacity in the provision of risk allocation facilities.

V. Conclusions
The accumulating evidence on the positive linkage between finance and growth and the evolving thinking on development have generated renewed thinking on the appropriate strategy for financial market development. This paper has approached the issue of financial market development from the perspective of the functions of financial markets. In the traditional development view, financial markets are regarded to be useful only for the mobilization of domestic financial resources. However, from the viewpoint of modem finance, they additionally allow for risk pooling and sharing among market participants, allow for price discovery, promote efficient governance and control, facilitate international capital inflows, as well as enhance contractual efficiency, and regulatory efficiency.

The prevailing policy perspective, which has viewed the financial sector as a mere conduit for capital mobilization, results in financial liberalization *I* reform programs that unduly emphasize banking sector development. The short-sightedness of this perspective is amply characterized by way of a comprehensive discussion of the role of financial markets, through their multiple functions, in bringing about allocational efficiency in an uncertain economic environment with imperfect information and incentive problems. Thus, it is the policy premise of this paper that the financial sector policies in emerging economies should focus on enhancing, rather than inhibiting, the multiple functions of financial markets.

As noted above, the financial system in developing countries has been stifled by the government which is not playing the role of the guardian of the system but that as the largest provider of financial services in the system. The system is dominated by inefficiently run government owned financial institutions which subject to considerable political interference, have developed a poor quality portfolio of assets, substantial overstaffing and poor human capital. Money and capital markets are small and trading is generally carried out in government securities and in equities of a relatively small number of companies. The government finds the commercial banks captive for absorbing its securities: by its pre• emption powers to obtain funds at below market rates and through its policies on subsidized and directed credit it has heavily burdened the financial sector. Cumbersome legal processes for contract enforcement and the indifferent application of accounting, auditing and supervision standards have contributed significantly to the poor performance of financial institutions.

The financial sector in these countries is, therefore, unable to perform many important financial functions that we have identified above. Risk sharing arrangements, hedging, and portfolio diversification, are all limited by the lack of availability of instruments. Market solutions to dealing with asymmetric information remain limited in view of the difficulties of contract enforcement, and inadequate regulation and supervision of financial institutions. The inordinately large role of government in this sector as a supervisor, regulator and owner of institutions and instruments, has resulted in limiting arbitrage so necessary to market efficiency. Moreover, the moral hazard associated with this system has led to the nationalized banks accumulating a large portfolio of bad debts, the cost of which will be borne by the taxpayer.

Against this background, the design of reform should be very mindful of the functions that will be required of the financial system. For market development, it is very important the at the government quickly move out of the provision of financial services to that of the regulator of the system. This would mean that an immediate priority should be to put in place a supervisory and regulatory base at the center of the financial system. This supervisory and regulatory core should foster market development but through letting private initiative and innovation take the lead. It should seek only to deal problems related to asymmetric information and moral hazard, through disclosure and direct surveillance. There must also be adequate legislation - such as a framework for speedy contract enforcement, debt recovery, and bankruptcy - to support the financial system.

The importance of developing markets helps in the achievement of many objectives. In addition, market and instrument development tends to be complementary. For example, allowing forward markets to develop in foreign exchange can reduce the vulnerability of the SBP. Another example is that of stock market development, which may be an important means for introducing transparency into the privatization process. Capital market-based privatization can, in tum, also enhance the deepening of existing stock exchanges.

The regulatory and supervisory agencies must be independent professional agencies responsible for the soundness of the financial system. Research has shown that independence of the central bank is very important for the effective conduct of monetary policy and the sound supervision of the banking system. While developing the regulatory core, vigorous efforts will have to be made for privatization of government interests in banking and security markets. The policy of financial repression where high liquidity ratios for banks provide a captive market for government paper will have to be discontinued. The private sector will have to be given room to develop financial services with the diminishing role of the government.

Demystifying Central Banking

Training Seminar for the
Central Bank of Sri Lanka
August 14, 2000.

"Irredeemable paper money has almost invariably proved a curse to the country employing it"

Irving Fisher (1911)

In an effort to facilitate the modernization of CBSL, I conducted a seminar at CBSL on the subject of Central Banking. I found that there was a certain unquestioned. smugness about the central bank being a self-appointed guardian of the people. This was also based on an inherent suspicion of the market and a faith in the ability of the central bank to know the 'right path' and deliver it.

My intent was to educate my audience in the history of central banking and recounting episodes of 'money mischief - to use a term from Friedman.

I used this material in different ways at various central banking conferences and training occasions to unlock a wide-ranging debate on the subject. I was very happy when I found that even at lunchtime, many central bankers would discuss these ideas with me and we developed very interesting and dynamic debate on the subject. I hope it contributed to the development of a more realistic attitude towards central banking in Sri Lanka.

Demystifying Central Banking

> "If monetary sovereignty or independence is not worth much in today's global capital markets, and if seignorage is quite small in a noninflationary world, then the costs and risks associated with a national central bank and a national currency become harder to justify."
>
> Jerry Jordan (1999)- Federal Reserve Board.

Central Banks are mighty powerful institutions that are little understood in poor countries. Reflecting this important position of the Central Bank, Sri Lankans call their Central Bank "Mahabank!" In other words it is the biggest Bank of all or quite rightly the Mother of all banks.

It is with this in mind that I wish to give you a more balanced perspective, perhaps one that is somewhat humbling for central banks. Perhaps this is necessary because in all this glory, central banks in poor countries have lost sight of the limits of their power. Central Banking is a relatively arcane subject and only the most serious of economists can fully fathom it. As a result, in poor countries, there has been little questioning of the role of central banks. Whereas in the West, they are continuously questioned and reviewed and have their share of harsh critics. For Example, Grieder (1987) in a famous book called the *Secrets of the Temple* says that central banks are a "crucial anomaly at the very core of representative democracy."

It is therefore justified to ask the following questions: What is a central bank? How did such an institution come into being?" What should it do? Has there been mission creep? Does every country need one? Should every country have one?

The Evolution of Central Banking

We have forgotten how young an institution central bank is. In fact, Central Bank as we see today, was created only in the zo" century! Consequently, most of human history has been lived without an institution like the central bank to be the most powerful bank in the country. The first central banks arose in Europe in the 17th and 18th centuries "to finance an apparently insatiable appetite for war" (Deane and Pringle, 1994). For example, the Bank of England was created in 1688 to finance war with France. Spain followed in 1792 to finance its role on the American war of independence. Similarly, Bank of France was created by Napoleon to finance war.

By the end of 19th century, there were 15 central banks in Europe. Throughout the century, the power of these institutions was growing. They evolved from being financiers and bankers to the government combined with commercial and profit activity, to becoming clearinghouses and virtual monopolists of currency issue. Nevertheless their currency issue powers were severely curtailed by the commonly held rule that all currency issues must be fully backed by gold or silver and that the value of the currency in terms of gold or silver had to be maintained. As Friedman and others have shown this discipline imposed on the central bank by the Gold Standard was very good for inflation and economic progress.

The US, which because of its frontier tradition was the strongest believer in a competitive market, resisted even a limited role for a central bank. It's visionary Secretary of Treasury, Alexander Hamilton, created a Bank of the United States to be a banker to the government but a few years later Congress refused to renew its license. Another attempt was made in mid nineteenth century and again it was defeated. Note issue, clearinghouse arrangements, correspondent banking and all other modem central banking facilities were strongly in the hands of various private sector organizations throughout the nineteenth century.

Japan and Germany, which were relatively late coming to industrialization, developed central banks as an act of deliberate modernization. Bank of Japan created in 1882 to confront rising inflation and inconvertibility, was explicitly given note monopoly and charged with controlling inflation. Similarly Reichsbank was established in 1876 as a central bank closer to what we now know.

By the tum of century, we had a mixed bag of nascent central banks limited in their ability to influence the economy. They still combined commercial operations with some vague public duties. The issue of whether the central bank was a monopolist on the issue of currency was not yet settled. Certainly, it had not acquired the tasks of bank supervision and even the role of lender of last resort had not been fully established yet. Though it had no formal independence, the metal standard more or less enforced independence.

A series of banking crises (panics) in 1873, 1884, 1893, and 1907, finally led the Congress to pass the Federal Reserve Bank legislation in 1913. It took the great depression to establish the Fed with full monetary policy, lender of last resort and an independent Board with Treasury officials removed.

War compromised central banking and in an ironical manner developed it. Convertibility was abolished for the needs of financing a war during the American Civil War as well as the two world wars. Fiat money control and monopoly as well as capital controls were strengthened as a result. Dealing with rebuilding a war-tom economy also was used as an excuse by the Weimar republic and the Japanese central Bank to print excessive money. These episodes led to the development of the idea of an independent Central Bank fully in charge of monetary policy. Bundesbank was the first such Central Bank to be given strong independence in 1957.

Independencefrom colonialism breed scentral banks

As colonies, most of the present poor countries had some form of currency board arrangement. Either they used the mother country currency or they operated a currency that was fixed in value to the mother country currency and could only print what they had for reserve backing. Convertibility was guaranteed. There was "no exchange risk, no exchange control, no monetary discretion, no control over note issue. "

There was a rapid spread of currency boards in colonial governments between 1912-1945 and they were a very profitable institution. This arrangement kept the domestic economic policy in a very strict discipline. Increases in money supply could only occur if the country earned a trade surplus. Inflation kept at level of mother currency level since money that was not backed by real trade surpluses could not be issued. The monetary authority provided no lender of last resort facility. But then there was no need since mostly multinational (or mother country) banks operated there. Certainly this arrangement did not allow for direct government borrowing from the monetary authority.

Why did currency boards die? This is a subject that in itself is perhaps worthy of historical research as and when the postcolonial governments allow access to records. However, it is now clear that upon independence most countries rushed to form a central bank. "A CB was as proud a symbol of its independence as a state airline. Yet all too often, the airline made a loss and the central bank had to finance it- and much else besides." (Deane and Pringle, 1994).

Why the rush to develop a CB? As the above quote suggests the temptation to develop dependent central banks for independent countries was too great. These dependent CBs in new countries existed to serve the interests of the state, as defined by local politicians and dictators. In that sense they were efficient engines for inflationary finance and financial repression. But they could do this under a regime of capital controls, which served to maintain all manner of distortions.

If now many major thinkers and writers such as Jordan (1999) and Deane and Pringle (1994) are critical of the decision to set up central banks, it should be noted that in the setting up of central banks, there was a fair amount of advice from the development advisor from the West. "The advice offered by the Western Economists was well-meaning but breathtakingly naive. They assumed for a start that all these countries would remain faithful pupils of Westminster democracy." (Deane and Pringle, 1994)

Well meaning development economists in the tradition of Keynes mistrusted markets and emphasized government led growth. They believed that the early growth models of the Harrod-Domar variety provided them with all the answers provided they had the money. A central bank was therefore needed for economic development to provide "Capital Funds in Underdeveloped countries" (Nevin, 1961). He argued that whatever the risks, the advantages of a central bank contributing to development outweighed the disadvantages.

The Fiscal Abuse of CBs: The rise of a Repressive CB

Armed with the development mandate, governments quickly saw in the central bank the silent and easy means of taxation. They saw no problem in inhibiting financial sector development through distortionary restrictions so long as this concealed form of taxation could provide revenues for hungry government coffers, as the state grew larger and larger.

Capital controls were intensified to an almost absurd point to enable domestic populations to be taxed implicitly through higher than global rates of inflation (inflation tax) as well as lower than international rates of return (financial repression tax) is to be collected. Central banks used several methods to ensure this form of taxation. For example, direct interest rate controls were used to keep rates well below what would have been obtained in international free markets. High reserve requirements were used to tax bank deposits directly. Government directed credits at low interest rates reduced bank profits and lowered the return to depositors. Similarly, restrictions on banks, and other financial instruments were used to favor lending to governments at lower than market rates. What is common in all these examples is the fact that governments are able to implicitly collect a tax (the financial repression tax) by borrowing at lower than market interest rates. In many countries this has been a significant form of revenue collection.

Inflation tax has not been trivial in many developing countries. It was as high as 25 % of GNP in Chile, Argentina, Mexico, and Peru in the eighties and at about the same time as high as 33 % of government revenues in Yugoslavia. The record of central banking with regard to their prime objective of maintaining the value of money has not indeed been spectacular. The average rate of inflation across all developing countries over the period 1973-93, has been over 20% annually. Many countries, in Latin America, Asia and Europe have experienced hyperinflation. Central banks in their zeal to collect revenue covertly for the government have worked overtime in developing countries to regulate and restrict the development of financial markets. They would like to keep a narrow and largely nationalized or government controlled banking system at the center of the financial system. They will not allow any form of competition to develop for such a banking system. Strict regulation on the development of other instruments has been maintained by central banks in many poor countries. Informal markets creep up to bypass central bank regulation much to the distaste of the central bank. In that sense, they have become the biggest regulator in the economy.

Central Bank Independence?

Reviewing the experience of central banking over the 20th century, several economists, like Cukierman (1994) and Rogoff (1985), have focused on the institutional design and incentive mechanism of central banks for providing their product - a stable, low inflation currency. They have now established that an effective central bank must be independent, focused solely on its core function of price stability and have a reasonably refined and transparent process for monetary policy making. Any function, including supervision of financial institutions, which conflicts with the primary function of price stability, should be given up.

Empirical evidence gathered from a large number of countries shows that there is a strong negative relationship between central bank independence and inflation.

Independence is defined as

- A tenured governor responsible to a board that has no ministry of finance or government person on it.
- A staff that is totally independent of government service.
- Clear goal of inflation target.
- Total control on money supply and all instruments (such as interest rates, monetary aggregates, exchange rate) that would be required for the conduct of monetary policy.

However, independence does not mean no accountability which requires;

- A Board, wide enough and that has an adequate representation of civil society to make the central bank responsive to the needs of the country.
- Periodic reporting to parliament and the public.
- Transparency in policymaking through;
- Announcement of monetary policy framework.
- Publication with a reasonable lag of records on the deliberations of monetary policy.
- Announcement of targets to hold the central bankers accountable to them.
- Clear process of accountability.

The unfortunate result has been that an inefficient banking system has been kept afloat by the overbearing central bank at the cost of the domestic depositor and the domestic economy. Such a banking system needs large spreads between the lending and the deposit rates to remain afloat. These spreads basically tax both the depositor and the lender and slow down business activity. These inefficient and overtaxed banking systems continue to be a drain on the economy. An IMF study in 1996 (Lindgren et. al) noted that "since 1980, over 130 countries, (3/4 of IMF membership) had significant banking sector problems." Needless to say, these problems have to be paid for and there is only one way to do that to increase domestic taxation in one way or another.

One of the biggest drawbacks to reform such financially repressive system is the inefficient banking system. Central banks that enjoy this power of regulation and control gleefully point to the possibility of a banking crisis as reason for continuing their controls. The inefficient banks are often carrying a portfolio of non-performing loans that is unexposed because of the controls. Such banks will also find it very difficult to operate in an open, more competitive environment because its management, risk-management and credit analysis skills are inadequate for a market environment. In essence, this inability to reform the banking system and the threat of a banking crisis hold up the much-needed financial system reform. It raises the two interesting and perhaps somewhat uncomfortable questions. First, what incentives do bank managers and central bankers have to undertake the reform if it means giving up power and working harder? Often they may not have the skill to make the transition and hence may even lose their jobs. Second, is it that a banking system crisis is an inevitable cost of making the necessary reform?

Mission creep and return to original objectives

Central banks had a simple mission to provide the population with a stable means of making payments. This meant providing them with currency, which retains its value over time since that currency is to provide a means for holding wealth. Unfortunately, in poor countries, central banks have often failed to provide the stability in the value of the currency that they were charged with. For example, "Argentina's experience with floating exchange rates and other forms of independent monetary policy has been disastrous. From the time the central bank was established in 1935 until 1991 the peso depreciated against the dollar by a factor of 3,000,000,000,000. That leaves dollarization as the only choice that experience suggests will provide stability."

Instead of focusing on their core. function-price stability, central banks in many developing countries have moved well beyond, to the control of real economy, distribution and welfare. Hiding behind a closed economy and the unquestioned mandate of economic development, has allowed them the ability to consolidate their power and truly expand beyond their original purpose. They have also been very willing allies of governments and ministries of finance to enable this mission creep to take place.

As outlined above, the result has been a large degree of financial repression and a relatively poor performance on inflation control. Perhaps two additional costs need to be documented. First, the lack of market development and the continued regime of controls have resulted in inadequate development of market-based monetary policy processes and skills at central banks in poor countries. Long periods of technical assistance from international agencies have not resulted in monetary frameworks that rely on well-developed money markets, or where intermediation costs are low.

Second, various market distorting mechanisms, such as capital controls, directly controlled narrow banking, large reserve ratios are maintained to achieve the objective of financial stability and relatively low inflation. Remembering the old adage, "there ain't no such thing as a free lunch," how is this stability and low inflation arrived at in the presence of distortions? The answer is obvious: growth and financial market development are sacrificed. Like commercial banks, central banks too, do not develop skills for operation in a free environment when they are operating in a closed, protected situation. This lack of skills is an important unrecognized constraint in moving to the new more-market friendly environment. More often that not, central bankers, to hide their own inabilities, point gleefully to the risks that might be associated with a move toward openness and market development. The leadership of the bank must be very focused on, and must regard themselves as the ultimate champions of price stability. Since all economies grow and experience trade cycles, price stability should not be interpreted to mean an inflation rate of 'zero'. There would be periods of inflation and deflation, unnecessarily disturbing market expectations, if monetary policy aims at a Orate of inflation. For this reason, it is considered that monetary policy must aim for a rate of inflation of 1-3%, which is somewhat in line with the real growth in the economy.

Central Banking Requires Skill and Research!

Central banks have to achieve a desirable inflation rate indirectly while allowing the market to work. It does this principally through the supply of its monopoly commodity-money. This allows it to influence the market and set, or affect key prices such as interest rates and exchange rates.

To do this efficiently, central banks must be

- Knowledgeable of financial markets;
- Knowledgeable of the process of inflation and what determines it;
- Knowledgeable of the past, current and prospective developments in the economy;
- Respond with research and a deliberative process to deal with unexpected developments in the economy.

The key word everywhere is the need for knowledge and adequate research and deliberation. It is not surprising that central banks in the advanced countries operate like think-tanks, housing a large collection of serious economists and conducting a vast amount of economic research.

They are continuously engaged in a debate on what approach to monetary or inflation management is the best.

In contrast, developing countries have stressed central banks that have no research culture. Few of them have monetary/macro skills. Often the training that they get is at best in general development economics—too far from what is required.

The Conduct of Monetary Policy

There has been considerable controversy on the limits and powers of monetary policy. It is now increasingly accepted that central banks must have a very clear and targeted program from keeping inflation under control. However, this means that the central bank must understand inflation, be able to adequately track it, including judging its expected behavior. Box 1shows that monetary policy is an exceedingly complicated task and must be conducted by people steeped in macroeconomics, following all macroeconomic trends at home, in the global markets and in academic research for understanding in improving and changing every day.

The central bank cannot be and is not a government department. Unfortunately, for years, it has been nothing more than a government department in many poor countries. It has been an unthinking organization, with little research and analysis. How then have they been able to conduct monetary policy and yet control inflation? The simple unthinking approach is to keep a very controlled economy in place citing the possibility of a crisis and high inflation. In these countries, even today after 30-50 years of post independence:

- All key prices, food, fuel, interest rates and exchange rate are controlled;
- Capital is not allowed in or out of the country so that domestic residents are forced to hold only local money and securities. Foreigners cannot present new opportunities to local investors and offer a substitutable asset to central bank issued money;
- The domestic financial system is highly regulated by the central bank and the government. Often the government is the only intermediary, owning a large part of the banking system, pension funds, saving banks and even mutual funds. It is easy for the public sector to collude for market outcomes.

This approach can provide a reasonably stable outcome to the country. The only difficulty is that it will be an equilibrium that will impede market development; slow down the provision of investible resources to the private sector; and most important of all distort risk-taking. The eventual outcome is growth that is considerably below potential for long periods of time.

Supervision and Insurance

In poor countries, central banks are often inspired more by crisis management than by monetary policy. The focus appears more to be the avoidance of a financial crisis than the development of financial markets. Such banks often place a great deal of emphasis on the supervision of banking systems and deposit insurance-implicit or explicit.

Bank supervision, which again is an evolving and complex subject, can be mistaken for tight control of the banking system by the central bank. But this tight relationship itself may be subject to several difficulties. For example, banks could end up using this relationship to their advantage. Large banking spreads are but one example of banks using this relationship to cover their inefficiencies. This is a simple exercise in game theory which tells us that, the knowledge of central banks desire to control banks for a more stable banking system, empowers the banking system with strategies to use the central bank principle to their advantage. Another example of this behavior is bankers asking for more controls and limitation of licenses to strengthen their monopolies all in the interest of stability.

Central banks and supervision departments in poor countries, not being steeped in the latest research often exaggerate the importance of supervision of the banking system. No one is tempering their enthusiasm with studies by Kaufman (1996), Calomiris (1993), and others that have shown that there has been no appreciable reduction in crises after supervision was introduced to the world. Similarly, they need to understand that even though Basie method of supervision is desirable, there is evolving thinking on the subject. Argentina and Chile have introduced supervision of banks that places more emphasis on market-based information than the current system that relies only on accounting and supervisor generated information. Research is being conducted even as we speak on how, in a rapidly changing, technologically-intensive market-place, regulators and supervisors can better predict problems rather than spotting them after the event. Deane and Pringle (1994) note that supervisors are often "reviewing yesterday's problem rather than today's and certainly not tomorrow's." The purpose of supervision is merely the prevention of systemic bank crashes. It should not concern itself with individual bank failures unless such failure threatens the banking system as a whole. In poor countries, the combination of a fragile under-developed and segmented financial system and an unmodernized central bank that lacks modern skills, leads to situation where these principles of supervision are misunderstood. More often than not, these central banks hate bank failures of any kind and are very proud of preventing them. They do not distinguish between individual and systemic bank failures. It is not surprising then that many of them do not even have an exit strategy available for banks.

If this thinking prevails, then the supervision and the lenders of last resort roles are mixed up into the provision of implicit deposit insurance. In the US, it has now been established that the Savings and Loans crisis was a result of the regulator's abhorrence of bank failures linked with the provision of deposit insurance. The managers of the S&Ls felt so protected by the safety net around them and found the regulators so pliant that they took excessive risks. Consequently, nowadays, in designing, a safety net for the banking system – supervision, lender of last resort, and deposit insurance—it is normal to examine the inherent incentive problems of all concerned. Once again this requires very careful and competent examination of abstruse economic concepts.

Poor Country Central Banks-the Need for Modernization

- Continue to be control oriented and working towards objectives set in a socialist/planning era. The result is that they lack clear (or have too many) objectives and instruments.
- Large staffs collected for political reasons form an earlier era. Requisite skills for the development of modem market based monetary policy not available.
- Poor human resource management policies that have been inherited for an earlier era enforce equality with penalization of merit and talent.
- No process for monetary policy formation and little knowledge in civil society on the subject. Not even historical research allowed on the subject so that a reasonable critique is developed.
- The lack of effective policy and skills leads to reliance on controls and regulation. It is not surprising to find many regulatory and monetary policy weaknesses in such countries.

Why Central Banks?

It is indeed surprising why there has not been an adequate debate in poor countries on the subject of central banking. Even the donor agency and the consultant has been silent on the pros and cons of central banking taking it as a dictum that "every country, no matter what its size, must have one." Or as Klein (1974) argues "few areas of economic activity can claim as long and unanimous a record of agreement on the appropriateness of government intervention as the supply of money." This has never been an accepted law in economic theory and in recent days is increasingly receiving a challenge.

There was a lively debate on the subject all through the nineteenth century. Even Walter Bagehot, who wrote a famous book called Lombard Street in 1873 which is regarded as a classic on the subject, preferred free banking in theory, but felt that abolishing the Bank of England was impractical. In the post war era, the debate was silenced somewhat but even then several powerful intellectuals advocated free banking, i.e. banking freed from the presence of a central bank. Nobel prizewinners and among the zo" century geniuses of economics, Hayek (1978) and Friedman (1959) have both questioned the desirability of discretionary monetary policy. Hayek argues for free competition in the provision of notes and deposits by competitive banks within a laissez-faire system. Friedman advocates adoption of a rule for rate of growth of money.

More recently, there has been a revival of interest in examining, questioning, and analyzing structural necessity for a central bank. This has been primarily a result of the poor performance on central banks in delivering low inflation, a crisis free banking system as well as reasonable financial market development.

Globalization has also struck a blow at national currencies. Capital controls, behind which certain central banks were hiding inefficiencies, may be more difficult to sustain in the new environment. Attempts at generating financial repression tax may lead to capital flight.

Such thinking has led to eminent thinkers like Dornbusch to argue that national currencies may be obsolete. "New nations create money even before flag and national airline whatever it is it is bound to be pathetic ... The price of misconceived nationalism: the number of zeroes increases steadily, and ever more patriotic images on the back fail to make up for the degradation of purchasing power. national dilettante management of currency is too expensive, particularly for poor countries aspiring to international respect and prosperity" (2000,1).

The new buzzwords are currency boards and dollarization or very simple rule based monetary policies. The thinking behind these new ideas is simple: to understand more fully the benefits of national currency, the constraints placed by the new globalized environment. The issues are complex and deserving of attention by central bankers in these countries. Unfortunately, central bankers n these countries appear to have no time for reading and understanding and express the thought that these new ideas may not be practical.

History, however, does not wait for anyone to make up his or her minds. Hausman, Chief Economist of the Inter-American Development Bank argues that it is only a "Matter of time" before national currencies of smaller countries disappear. He advises US bureau of printing and engraving to take a hint and consider "something other than drawings of founding fathers be put on dollar bills? Great artists, scientists with more universal appeal. How about a woman"(1999, 79).

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