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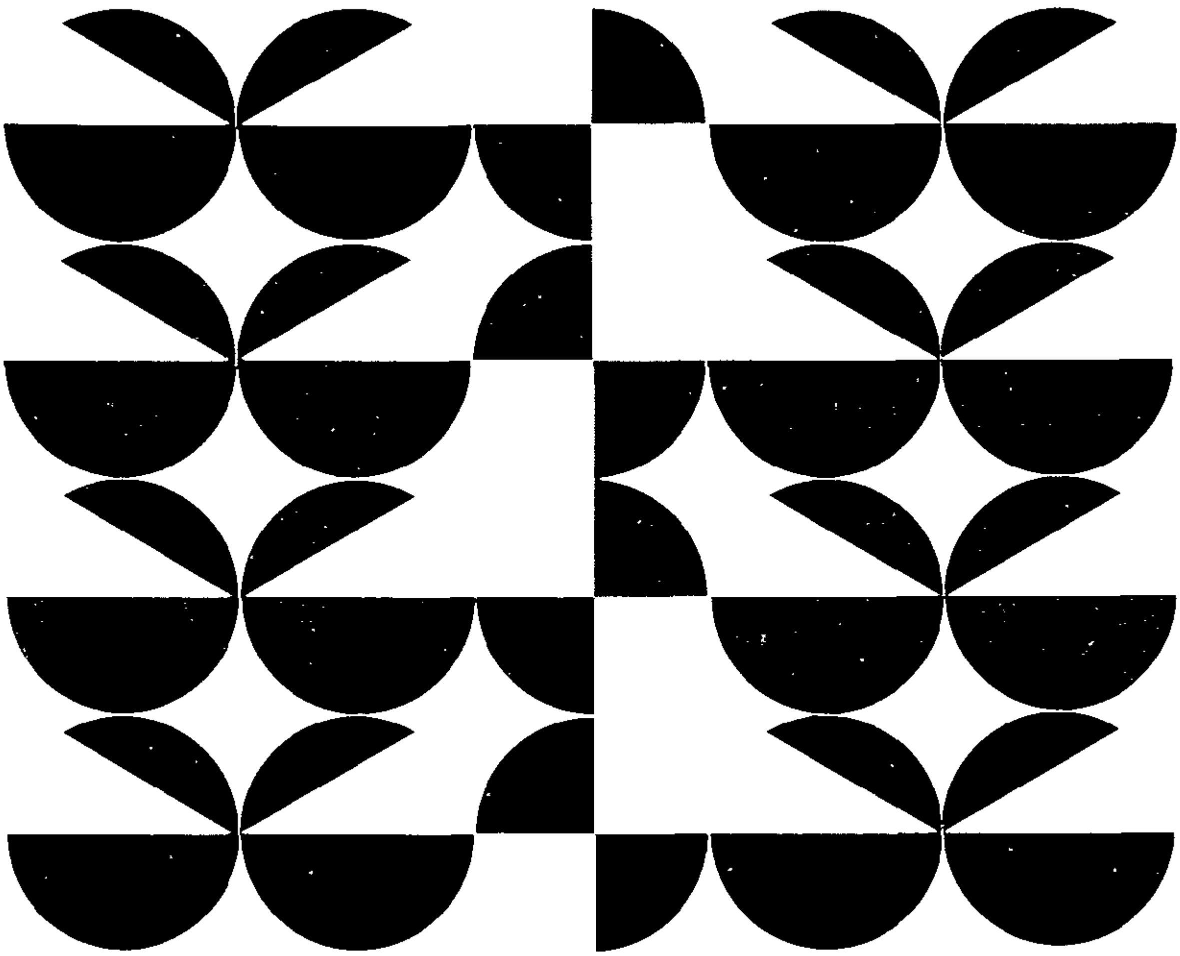
Economic Liberalization in Developing Countries: Some Lessons from Three Case Studies—Sri Lanka, Egypt, and Sudan



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Economic Liberalization in Developing Countries: Some Lessons from Three Case Studies Sri Lanka, Egypt and Sudan*

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A.I.D. DISCUSSION PAPERS

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I. Introduction

The governments of many developing countries have over time assumed increasing amounts of control and influence in their economies. This paper will examine the process of reversing this trend and the problems of transition that have begun to occur in a number of developing countries in the last several years. The process of economic liberalization will be analyzed specifically for three countries - Sri Lanka, Egypt, and Sudan. The lessons from the experiences of these three countries will be discussed in a concluding section that attempts to generalize about the problems of transition and how to promote practically economic liberalization in developing countries.

The reasons for the relatively heavy degree of government influence on the economies of developing countries are many and complex. Many developing countries achieved their independence after World War II, and the new governments that assumed control often faced political, economic, and social situations that demanded their strong intervention. Developing countries that had already achieved their independence by the twentieth century, especially those in Latin America, were virtually forced by the economic disruption caused by the Great Depression and World War II to rely on greater government intervention. The early literature on economic development in the 1950s and early 1960s also leaned toward a strong role for the state in the form of central planning and large public investment. Various ideological movements, usually related to either nationalism or socialism, also tended to promote a strong role for the state. Finally, given the objective of rapid development, state intervention was required in certain areas because of market failures and economic realities.

The experience of developing countries with strong state intervention has been generally disappointing. The limitations of state-protected import substitution strategies were so apparent that one of the strongest early supporters, Raul Prebisch, eventually argued for a shift toward export promotion. [1/] Various studies on state-owned productive enterprises have shown them to be typically inefficient and poorly managed. [2/] Price controls and subsidies have often seriously distorted resource allocation, discouraged the private sector, and constituted a heavy drain on the government budget. [3/]

The shortcomings of state intervention in the development process and a few remarkable "success stories" based on free market strategies (e.g., Korea and Taiwan) have caused some governments to attempt a policy reversal through a reduction of their control and participation in the economy. The process of economic liberalization, however, has proved to be significantly more difficult than the initial establishment of government controls and ownership. Whereas productive enterprises can be nationalized overnight, they are not so easily returned to the private sector after extended public ownership. High levels of import protection can be imposed quickly, but their removal after industries become accustomed to freedom from competition can be a sensitive, political problem. Likewise, producers and consumers become accustomed to price controls and subsidies and resist their removal.

Other studies have analyzed particular aspects of economic liberalization, such as international trade liberalization, but have not addressed comprehensive liberalization across a wide variety of policy changes. [4/] Still other studies have analyzed stabilization programs which often include aspects of liberalization but primarily emphasize the treatment of severe balance of payments, budgetary, and inflation problems. [5/] This study will analyze in a general way the process whereby a government decides on and tries to implement a definite economic policy shift away from state controls and intervention toward a greater reliance on free markets.

The extent of government controls and intervention in developing countries varies considerably. Any process of economic liberalization, therefore, will also vary according to the base situation to be reformed, and the political framework within which the reform is to be implemented. Given this high degree of variation, the following key areas of economic liberalization can be identified as those that are mostly commonly addressed by governments:

1. international trade and exchange policies;
2. controlled prices and subsidies;
3. credit and banking controls;
4. public fiscal policy; and
5. state-owned enterprises.

Although the elements to be liberalized differ in each of these five areas, the liberalization process in all cases can be viewed within the following analytical framework. Economic liberalization almost invariably results in an immediate gain for some groups in the economy and an immediate offsetting loss for others. It is, of course, the prospective losers who are likely to object to the measures and thus make the process of economic liberalization politically difficult. Groups that stand to sustain an immediate loss from economic liberalization are precisely those groups that were favored by previous government intervention and controls, such as those with access to import licenses or to credit allocations, or those benefiting most from particular subsidies.

A key element, therefore, in successfully implementing a liberalization program, is the difficult task of addressing the concerns of the prospective losers, who often belong to politically powerful groups. This task can be accomplished in several ways. First, if economic liberalization is to result in an increase in overall efficiency and economic growth, the immediate losers may stand to make substantial gains over time. It is important that they be made aware of these gains. It may also be possible to compensate them directly in the short run. For example, importers who lose previous favorable treatment regarding import licenses could be the target of specific tax cuts or import liberalization measures, and consumers who suffer from subsidy removals can be the recipients of wage increases.

Under normal circumstances, however, losers from economic liberalization, even if they stand to gain over time, will perceive themselves as sustaining a net loss. Under these circumstances, it is still possible for the government to ameliorate the adverse effects and minimize to the extent possible the negative political reaction. For example, measures can be introduced in phases in order to cushion their adverse impact. In addition, political support from those who stand to gain from the liberalization can be mobilized.

Governments can sometimes make the argument that liberalization reforms are required in order to obtain critically needed support from international donors and financial institutions. Finally, however, it is the political strength and stability of the government that will dictate to what extent expected opposition from the losers can be tolerated.

In the following three country case studies, economic liberalization was pursued and implemented to varying degrees. It will be clear from the analyses presented that the extent of liberalization achieved was largely dependent on the political and economic interaction between the governments and those groups that stood to lose from the liberalization.

II. Country Case Studies

A. Sri Lanka

1. The Control Regime: Sri Lanka experienced an extended period of government controls and participation in its economy before the process was finally reversed with the 1977 election. This period was most notably characterized by successive governments' consistent commitment to and strong state intervention to promote the social welfare of the people. The origins of this commitment go back to the pre-war British Colonial Government which expanded the public education system and introduced food rationing during World War II. The system of subsidies was extended immediately after World War II with the expansion of food rationing and partial subsidies to the entire population and the introduction of free education from pre-school to university. Other subsidies were gradually added over the next 30 years in areas such as health services, water, energy, and public transportation. By the mid-1970s the food subsidy accounted for 18-25 percent of total government expenditures and current education and health expenditures for an additional 21-24 percent.

Price controls on consumer items and producer inputs were pervasive and constituted a large part of the system of subsidies. In addition to price controls, many government controls in other areas of the economy were established. The international trade regime was characterized by a restrictive import licensing system, high import tariff levels, an export licensing system, high export taxes, and a fixed overvalued exchange rate. In the money and banking sector, interest rates were controlled at low levels and preferential treatment for loans accorded to public corporations. Minimum wages were legislated, although real wages generally have been kept relatively low, partly due to the impact of subsidies in reducing household expenditures.

In order to finance the heavy subsidy burden, government tax rates have been high. The critical tree crop sector (tea, rubber, and coconuts), which still accounts for over 60 percent of foreign exchange earnings, bore a large part of this burden. In addition, the maximum individual income tax rate was 70 percent and the maximum corporate income tax rate was 60 percent. Finally, government corporations took over an increasing share of total industrial production. By 1977 government corporations accounted for almost 40 percent of industrial value added compared to less than 2 percent in 1961. Most of these government corporations are large, employing an average of 2,000 workers each. They are predominantly engaged in heavy, capital-intensive industry that also tends to be highly import-dependent. The bulk of the tea, and to a lesser extent rubber and coconut subsectors, were also nationalized.

Although the effects of over three decades of extensive government controls and intervention are diverse and complex, general agreement probably exists regarding the two following judgments:

(a) Sri Lanka's extended period of government intervention succeeded in achieving notable social progress in the areas of health, nutrition, and education;

(b) over the same period, the government of Sri Lanka failed to generate consistent economic growth.

In the area of social progress, the system of subsidies in food, health, and education resulted in social indicators that are quite high relative to Sri Lanka's level of per capita income.[6/] For example, its life expectancy at birth of 66, infant mortality rate of 42 per 1000 live births, and adult literacy rate of 78 percent are far above what would be expected in a country with per capita income of about $200. Sri Lanka also succeeded in reducing its population growth rate from over 3 percent in the 1950's to under 2 percent in the 1970's, a phenomenon probably closely related to the progress in health and education.

Sri Lanka's economic growth over the extended period of government controls was uneven. During the 1960s, economic growth was fairly strong with an annual average growth of 4.7 percent in GDP, 8 percent in industry, and 6 percent in rice production. Economic growth from 1970 to 1977, however was uniformly poor, with about 3 percent annual growth in GDP, and agriculture and industry growing at 1.9 percent and 2.3 percent respectively. It should be noted, however, that within the low-income countries (per capita GDP of $300 or less in 1977), Sri Lanka's growth of GDP is about average and growth of GDP per capita above average because of its relatively low population growth. Although it is not possible to argue that government intervention was the primary factor in Sri Lanka's uneven performance in economic growth, by the 1970s it appears that a number of factors associated with government intervention were having a negative impact on growth. Under the burden of heavy subsidies, public savings had all but disappeared. Private savings and investment were discouraged by the high tax rates needed to finance the subsidies, price controls, and the threat of nationalization.

The impact of the control regime on employment and income distribution should also be noted. The employment problem has been aggravated by increasing numbers of educated people without corresponding increases in white-collar jobs. Sample surveys have shown a consistent increase in the unemployment rate for at least 15 years prior to 1977. [7/] Analyses of income distribution have more mixed results, showing a general improvement in income distribution but a worsening of the distribution of consumption. [8/]

2. <u>The Process of Economic Liberalization</u>: Sri Lanka reacted to the deteriorating economic situation of 1970-77 by overwhelmingly electing in 1977 a new government with a platform designed to decontrol the economy and stimulate the private sector. The new government lost little time in enacting a broad range of economic liberalization policies.

The policy reform package announced on November 16, 1977 addressed a number of the basic areas of government control. The exchange rate was unified at a sharply depreciated rate of Rs 5 = US $1.00 (from Rs 8 = US $1.00) and allowed to float. Import and exchange restrictions were liberalized, and interest rate reform was announced. In addition, price controls on most commodities were lifted and food rationing was eliminated and subsidies were focused on the poorer half of the population.

Recognizing the profound impact of these policy changes, the government implemented them carefully and in combination with other policy changes designed to cushion their impact. For example, the import liberalization was complemented by changes in the import tariff structures in order to ensure adequate protection of domestic industry and to discourage luxury imports. In order to cushion the impact of reductions in subsidies and price decontrol, wages and salaries were increased and an income supplement of Rs 50/month was provided for the unemployed. In addition, subsidies on sensitive commodities such as wheat flour, fertilizer, petroleum, bus transport, and infant milk foods, were not eliminated immediately but decontrolled in steps over 2 to 3 years.

Although the main objective of the policy reform package was to encourage the private sector, a major secondary objective was to increase the government's capital budget so that it could finance an ambitious, largely physical infrastructure-oriented development program. In 1978 government tax revenues more than doubled over 1977 and capital expenditures almost doubled due to the policy changes. The main factor was the exchange rate reform which greatly increased export revenues denominated in local currency. The government implemented large increases in export duties on tree crops in order to absorb part of the increase in export earnings in this sector. High world tea prices during 1977-78 also helped. Although the exchange rate reform also increased the cost of subsidies, the actions to narrow the recipients of the subsidies moderated the size of the cost increases.

The government followed up its initial policy reform package with a series of further reforms that maintained or even strengthened the initial reforms. In the area of trade and exchange policies, the government has continued to allow the rupee to float. Exchange controls have been further liberalized, particularly regarding overseas travel and education. The government has also moved towards eliminating public sector import monopolies regarding several important commodities.

In the area of money and banking, the government followed up its 1977 reforms with further increases in interest rates in 1980. With increasing inflation (partly due to price decontrol), these raises in interest rates have not succeeded in keeping real institutional interest rates from being very low or negative. In order to ensure adequate credit to the private sector, the government has recently established credit ceilings to public sector corporations. In order to improve the flow of credit, a National Development Bank was established in 1979 and branches of international banks were allowed to operate in Sri Lanka.

Further progress has also been made in the sensitive area of consumer subsidies. A system of food and kerosene stamps for families with monthly incomes of less than Rs 300 was introduced on September 1, 1979, to replace the previous system of specific food subsidies and rationing. The revised system included upward adjustments to reflect family size. Price adjustments for rice, flour, and sugar in 1980 resulted in a decline of the share of food subsidies in public revenues from 19 percent in 1978 to 12 percent in 1980. Subsidies for petroleum products (except for kerosene) were eliminated in 1979. Price increases have also occurred for public transport, electricity, post and telecommunications, and water.

Besides price decontrol, the government has taken a number of other actions designed to increase producer incentives. Import liberalization, exchange decontrol, and the reduction in public import monopolies have increased the availability of inputs and reduced distribution and marketing margins. Successive reductions in tea and coconut export duties and the elimination of export taxes on all but one of the minor export crops have encouraged increased production in these sectors. Replanting subsidies have been increased for all tree crops. The establishment of a free trade zone should encourage increased foreign industrial investment in Sri Lanka. In addition, a variety of tax incentives, including special depreciation provisions and reductions in corporate tax rates, have been established for foreign investment within and outside the free trade zone.

Little action has been taken to reduce or eliminate public sector corporations. The manufacturing units of the State Textile Corporation were contracted to (but not sold) private management. There was a proposal to do this also for the large tea estates, but instead the two large public tea corporations were broken into eight units to promote greater efficiency. For the most part, the policy direction of the new government has been to improve the efficiency of existing public sector corporations and to discourage expansion of public corporations. The private sector will be relied upon for most new productive investment in industry and services. The main measures to improve the efficiency of public sector corporations have been price increases to raise financial profitability and reduction of import monopolies to increase competition.

The policy reforms described above are wide-ranging in their impact. Only the most notable of the policy changes have been discussed, as a large number of more detailed and supporting reforms have taken place.

3. Assessment of the Economic Liberalization Program: The economic liberalization program introduced in 1977 can be judged both on its impact on stimulating economic growth as well as its political acceptability in view of the upcoming 1983 elections. Although the liberalization experience is barely three years old, the government implemented it so expeditiously and on such a broad front of policy issues that it is already a fairly rich case study.

The economy's response to the new policy reforms has been impressive. Since 1977 GDP has risen at annual rates of growth of 8.2 percent, 6.2 percent, and 5.6 percent, more than twice the average rate of growth over the 1970-77 period. Nearly all sectors have shared in this rapid growth. Open unemployment has been reduced from about 20 percent to around 15 percent. It is difficult to differentiate the effects of policy reforms from exogenous factors such as the favorable weather and world commodity prices that Sri Lanka experienced in 1977-78. Improved growth rates in the non-agricultural sectors such as manufacturing, mining, and construction, however, were certainly caused to a large extent by the more favorable policy framework toward the private sector.

Gross investment has reached an unprecedented 26 percent of GNP compared to levels before 1977 that rarely exceeded 10-15 percent. The free trade zone and other tax incentives have attracted investment proposals valued at over half a billion dollars. Domestic private savings have increased more slowly from an average of 12.7 percent over 1970-77 to 15.9 percent in 1978 and 14.8 percent in 1979. This moderate growth in the savings rate probably reflects at least in part the low or negative real interest rates that have prevailed in spite of increases in nominal interest rates. A large part of total investment has been financed either from government or foreign sources. Sharp increases in foreign aid and remittances from abroad also helped Sri Lanka's foreign exchange situation after 1977.

Although the economy has shown impressive gains since 1977, by 1980 the government's program had run into serious difficulties. These difficulties have emanated in large part from the decision to combine the economic liberalization program with an ambitious public investment program that was initiated when external circumstances such as oil prices and world cost inflation were particularly adverse for Sri Lanka. Much of this public investment is physical infrastructure designed to support private sector activities (e.g., the Mahaweli power and irrigation program and the Export Processing Zones), but the gestation periods are fairly long. Moreover, another major initiative is the large public housing program that does not directly improve economic productivity or employment. The government has increased its share of total investment from 37 percent in 1974-78 to 59 percent in 1979. Given the country's scarce financial, human, and productive resources, the public sector may well be "crowding out" private sector investment. The private sector has continued to complain of a scarcity of medium and long-term credit due to the government's preempting such major sources of quasi-private savings as the retirement and insurance funds for public corporations and investments.

The public sector investment program obviously became overextended when budget deficits reached 41 percent of government expenditures in 1979 and 53 percent in 1980. Although part of the problem was caused by external factors such as an adverse change in the terms of trade, more predictable problems such as the effects of price decontrol and construction bottlenecks would have suggested a slower pace of government investments. As a result of the government's overextension, alarming increases were evidenced in 1980 in the budget deficit, domestic credit, inflation, and the balance of payments current account deficit. Although the government has reacted quickly by severely reducing the 1981 budget, it is now in the politically difficult position of having to cut or stretch out programs that it had promised. In order to stabilize the economy, it may also have to reduce subsidies and social services more quickly than is politically feasible. There is already concern that due to inflation the nutrition levels of lower income groups without improved employment are being threatened. This reflects in part the fact that the government has resisted increasing the nominal value of food stamps. In a period of economic stabilization, it may be difficult to maintain a strong growth rate. Thus, much of the government's flexibility in progressing with its liberalization program has been replaced by some painful economic and social trade-offs.

The political climate is obviously critical to continued progress in the economic liberalization program. Although the government was able to implement a broad package of reforms on the basis of the 1977 election mandate, re-election in 1983 will depend on whether the electorate has realized tangible benefits from the program. With the prospect of economic stabilization and restraint over the next few years, these kinds of benefits will be difficult to generate or even to keep from being eroded. The 1977 election was the sixth successive time an incumbent government was voted out of office. In the past, the few Sri Lankan governments that have tried to reduce the real level of subsidies were promptly defeated at the following election. 9/ The task of the current government is formidable in that the people must realize at least some short-run benefits of what is essentially a long-run development program in order to compensate for the short-run reductions in consumer subsidies.

The government's program of reducing subsidies and decontrolling prices has been carefully planned and well executed. Areas of particular sensitivity were identified early and special arrangements made in order to cushion or compensate for the impact on the people. For example, food and kerosene subsidies were not eliminated, but merely focused more on the people who really need them. Prices of particularly sensitive commodities, such as wheat flour, fertilizer, petroleum, bus transport, and infant milk foods, were decontrolled in phases. Wages were raised and an income supplement for the unemployed introduced to cushion the impact of increased prices. Import liberalization was accompanied by a revised tariff structure designed to give at least some offsetting protection to domestic industry. All of these compensatory actions served to placate those most affected by the liberalization program and avoid serious social and political upheaval that might otherwise be expected to follow such far-reaching reforms.

A major lesson to be learned from the Sri Lanka experience with economic liberalization to date, therefore, is that, although the program was well planned and executed, combining it with an ambitious public spending program is fraught with danger when external signs are not read accurately. It has forced the government into a posture of stabilization and restraint during the period approaching the 1983 election which will be critical for showing continued growth in economic output and employment. The need or appropriateness of public investment in the areas chosen is not being questioned, and unpredictable external factors certainly contributed to the problem. The government's desire to show significant progress quickly is also understandable. The serious consequences of an over-extended public investment program, however, point to the need for allowing for adequate margins of error and the bureaucratic ability to react quickly to signs of stress in the balance of payments and government budget.

Another lesson is that the relative timing of austerity measures as opposed to measures designed to effect eventual benefits is a sensitive and troublesome problem. This is a problem not only in democracies like Sri Lanka where governments worry about forthcoming elections, but also in countries where unstable socio-political sutuations threaten a government's survival. Part of this problem is to achieve a balance between long and short gestation investments. Because Sri Lanka chose to emphasize long-gestation investments, they felt it necessary to act quickly and in a large way so that hopefully some of the benefits would accrue before the next election. This was a high risk decision that perhaps should have been moderated by a greater share of short-gestation projects.

B. Egypt

1. The Control Regime: The Revolution of 1952 in Egypt ushered in an extended period of strong government intervention in the economy that lasted until the initiation of Sadat's "Open Door" policy in 1974. The rationale was a popular reaction to the corruption of the previous Farouk regime and its inequitable impact on the people. The process at first was gradual, with the government intervening in a few selected but major sectors, such as the comprehensive agrarian reform of 1952 and the decision to build the Aswan High Dam shortly thereafter. The government took equity positions in a few industrial companies in 1954, nationalized British and French economic interests in 1957, initiated the First Industrial Plan of 1957-60 that expanded public investment in industry, nationalized Bank Misr in 1960, and culminated in widespread nationalization of private interests in 1961.

Thus, within a period of little less than a decade, the non-agricultural private sector in Egypt was virtually eliminated. Private sector activity was relegated to small-scale industries and private investment was severely circumscribed. During the 1960s and early 1970s, public investment accounted for about 90 percent of total investment, compared to about 28 percent in 1952. Public sector industrial production grew to account for over 80 percent of total industrial production.

Although the nationalizations and growth in public sector investments were the most obvious elements of state intervention, the government was concurrently extending its influence in many other parts of the economy. A basis for the extensive state intervention was the introduction of comprehensive planning with the First Five-Year Plan in 1960. Besides dominating new industrial investment, the government took over control of all mining, utilities, communications, banking and insurance, transportation, wholesale and foreign trade, and construction. Price controls were greatly expanded during the 1960s to cover all the major sectors of the economy. They were implemented with the stated objectives of social welfare and resource mobilization. Minimum wages were also raised significantly during the period.

Foreign trade and payments were under the complete control of the government through its State Trading Corporations. Various mechanisms were used including import licensing, triangular payment transactions, bilateral payments agreements, and direct foreign exchange allocations through a formal Foreign Exchange Budget. The exchange rate was fixed and significantly over-valued during most of the 1960s and early 1970s. [10/]

In the area of money and banking, ceilings on interest rates and high taxes on interest payments discouraged private savings. In addition, the state-controlled banks gave preferential allocations and terms of credit to public sector companies. Credit for the private sector during the 1960s and early 1970s was virtually non-existent. 11/

Government reforms in the social welfare area included legislation more favorable to labor, greatly increased expenditures on health and education, and the use of the government payroll as an employer of last resort. Subsidized prices for food, housing, and clothing protected the standard of living of the poor.

Ideology does not appear to have been the driving force behind the progressive government domination of the economy after 1952. The term "Arab Socialism" was only adopted by Nasser in 1962, ten years after the Revolution. From 1952-56, the private sector was not seriously threatened. The growing government intervention from 1957-60 was referred to by Nasser as "controlled capitalistic economy". 12/ Hansen aptly described the situation in Egypt during this period where "ideology was clearly lagging behind factual change." 13/ He further makes the interesting point that "this makes it easier to understand how Sadat a decade later could play down Arab Socialism so easily." 14/ The driving forces behind increasing government intervention appear rather to have been a strong nationalism combined with a desire to redress the inequitable income distribution.

The impact of the extended period of government intervention can be divided into its effect on social welfare and its impact on economic growth. The impact on social welfare was substantial.

Greater equity in the distribution of wealth and income was achieved by the land reform (before the reform the top 6 percent of owners held 65 percent of the land, and after the reform the same 6 percent only held 43 percent of the land), the nationalization of large industrial enterprises which then adopted employment policies with social welfare objectives, and more favorable legislation for labor. Large increases in government expenditures for education helped to increase the literacy rate from 26 percent to 44 percent. Food subsidies and increased government expenditures for health helped to raise life expectancy at birth from 46 to 54 and bring virtually every Egyptian physically within reach of at least minimal health services. Fertility rates dropped significantly over the period, but death rates likewise dropped so that the annual rate of population growth remained at around 2.3 - 2.5 percent over the period. Open unemployment declined over the period from almost 6 percent to less than 2 percent, but disguised unemployment in the public sector undoubtedly increased significantly with its guaranteed employment policy. It could be said, therefore, that as unemployment was diminishing as a social problem, it was at the same time worsening as an economic problem.

The impact of government intervention on economic growth was uneven over the period, with fairly rapid growth over the period 1955-65 but a steady decline thereafter. The rapid growth of 1955-65 was primarily due to the large public investment program, much of it financed by external aid from the United States and the U.S.S.R. Domestic savings rates did not increase along with the investment rates, however, and with the decline in external assistance after 1965 investment and economic growth also declined. The Yemen war and the Arab-Israeli war of 1967 placed additional severe strains on the economy.

Government controls, particularly price controls, and public sector domination of investment almost certainly resulted in a serious misallocation of resources. Hansen estimated that about 8 percent of total crop acreage was planted with the wrong crops due to price distortions. 15/ He also showed that domestic resource costs for many public sector industries were high and increasing over the 1960s, a clear indication of the declining competitiveness of Egyptian industry over this period. 16/

The government subsidy burden due to price controls and social services, however, did not become overly burdensome until the mid-1970s with the sharp increase in the international prices of energy and food grains. During the 1960s the cost of social services and subsidies accounted for about 20 percent of total government expenditures compared to over 40 percent after 1974. Compared to Sri Lanka, therefore, the private sector in Egypt was preempted relatively more by public sector investment in industry and infrastructure rather than by social services.

2. <u>The Process of Economic Liberalization</u>: In April, 1974, President Sadat in his <u>October Working Paper</u> presented a new "Open Door" policy to the People's Assembly. 17/ The document was approved by a national referendum in May. Addressing an economic situation that had been deteriorating since the mid-1960s, the "Open Door" policy introduced a new framework for economic policy. In order to re-establish strong economic growth in Egypt, the new policy framework would open the economy to world markets, adopt an "outward-looking" economic policy, redirect policies to favor the private sector rather than the public sector, and rely increasingly on external resource inflows for capital formation.

Unlike the comprehensive policy package introduced in Sri Lanka in 1977, however, the <u>October Working Paper</u> was a more general paper that did not propose specific legislation but merely set the stage for more detailed actions which would presumably come later. In fact, the process of economic liberalization has been very gradual and has occurred in an <u>ad hoc</u> manner. This may have been partly due to the exceptionally difficult economic situation that Egypt faced at the inception of the "Open Door" policy, especially in the external account with sharply deteriorating terms of trade, a heavy debt burden, and lags in committed aid disbursements. These conditions can be compared to Sri Lanka which faced buoyant world tea prices and strong aid commitments in 1977.

Although the difficult economic conditions discouraged certain liberalization actions (e.g., reducing subsidies), they encouraged rather swift policy changes designed to improve the foreign exchange situation. Most important was a devaluation of the official exchange rate in 1973 and the establishment of a parallel exchange rate for non-traditional exports, tourism, and workers' remittances from abroad. In addition, in 1974 an "own-exchange" market was introduced whereby Egyptians were authorized to hold foreign exchange accounts and use them in an unrestricted way for imports. This "own-exchange" market was a further inducement for remittances from abroad. In 1975 state trading companies, which had monopolized foreign trade, were abolished and the private sector was encouraged to participate in foreign trade. Egypt's bilateral trade agreements with more than 30 countries in 1973 were gradually eliminated until only 10 remained in 1978. Finally, free trade zones were established in the canal cities and near Cairo and Alexandria.

Regarding money and banking, liberalization has been much slower. The 7 percent ceiling on interest rates was finally raised in 1976 and the withholding tax on interest earnings eliminated. The interest ceiling on deposits was gradually raised over the 1970s to a level of 12 percent in 1980. Since the rate of inflation also increased over this period to a level of around 25 percent in the late 1970s, real interest rates remained negative and the incentives for domestic savings low. Moreover, the state-controlled banks continue to administer loans with a complex system of preferential allocations and terms usually favorable to the public sector companies.

Progress in the area of price controls and subsidies has been even slower and, in fact, a retrogression has occurred in the subsidy situation due to the substantial divergence of domestic and international prices of energy and food since 1974. The share of subsidies in total government expenditures increased to around 20 percent by 1976 from a level of around 4 percent in the early 1970s. Subsidy levels per ton of most items increased dramatically in real terms from 1973 to 1978, by 50 percent for wheat, 80 percent for flour, 150 percent for lentils, 170 percent for edible oils, 540 percent for foods and fats, and over 100 percent for frozen fish. [18/] Subsidies on food and energy now account for almost half of household expenditures in the lowest income groups. [19/] The only serious effort to reduce these subsidies in January, 1977, was met with serious social unrest to which the government responded by relenting and giving up the effort for the time being.

Even aside from energy and food commodities, progress in reducing price controls has been slow. Although from 1974 to 1980 some commodities were freed from price controls (primarily goods produced by private sector companies) and some *ad hoc* increases in prices of public sector commodities occurred, the great majority of goods produced in Egypt remain subject to a significant amount of price control. Indeed, one of the first measures taken by the new cabinet in May 1980 was a price rollback on several hundred items produced by public sector companies. This was seen as a major element of Sadat's "War on Prices" which he declared upon assuming the role of Prime Minister in May, 1980. The issue of reducing subsidies and price controls continues to be actively debated in Egypt, but there is considerable political opposition. A major problem is that a piecemeal approach is not workable because of the complex interrelationship among the broad range of price controls, but a comprehensive approach would be extremely difficult to pass politically.

A basic obstacle to the liberalization of prices and interest rates is the continued dominance of the public sector companies in the economy. Although their share of industrial output has dropped from over 80 percent in 1974 to around 70 percent in 1980, this has been achieved primarily by growth in the private sector and not by a reduction of the public sector. Public sector firms still account for about 75 percent of new investment. The reluctance of public sector firms to favor price decontrol may at first seem puzzling, since they might view it as a way to improve their financial condition. If the state petroleum and Suez Canal companies are excluded, the remaining public sector companies as a group are a net drain on the government budget. Yet, the many years of protection and subsidization probably cause them to be apprehensive about being exposed to a more free market and competitive environment.

The government has never taken the position that it would reduce or eliminate public sector firms. It has stated that the private sector would be favored for new investment, but this policy is extremely difficult to implement when the major productive agents continue to be public. Rather than a reduction of public sector enterprises, the most that can be hoped for is an improvement in the efficiency of existing firms through price decontrol, breaking up larger enterprises into smaller units, and more management autonomy. Progress in these areas has been and probably will continue to be slow.

3. Assessment of the "Open Door" Policy: The impact of the "Open Door" policy has been uneven, just as its articulation in terms of legislation has been incomplete and *ad hoc*. In two important areas, restoring economic growth and a healthy balance of payments, the government's policies since 1974 appear to have achieved remarkable success. From 1974-1979 GNP grew at an average annual real rate of growth of almost 9 percent, and strong growth in exports, workers remittances, and foreign aid improved the balance of payments. These successes, however, are only partly due to liberalization policies.

The "Open Door" policy, as explained earlier, has not been a comprehensive liberalization program. It has rather been a combination of selected liberalization actions in a few areas and a redirection of government emphasis and resources toward new priority areas. It has also depended heavily on improved relations with the West generating large increases in external aid flows.

The part of the "Open Door" policy that has not necessarily been related to economic liberalization policies has been the effort to encourage more foreign aid from the West and the effort to exploit more effectively Egypt's natural resources for earning foreign exchange, primarily the Suez Canal and petroleum. All of these efforts have been quite successful over the 1970s, but have not been the direct results of economic liberalization policies.

The liberalization of international trade and exchange policies has certainly had some significant favorable effects. The remarkable increase in workers' remittances during the 1970s, which now is second only to oil as a source of foreign exchange, was surely influenced by the changes in the exchange system. The "own exchange" market has encouraged increased private sector activity and investment because of the availability of imported inputs. From 1974 to 1979, the private sector's annual average rate of increase in industrial production was 22 percent and in investment was 44 percent, far exceeding the public sector rates of 14 percent and 28 percent respectively. Because of the private sector's small base, however, the public sector shares of total output and investment declined only modestly.

Although the parallel exchange market was gradually broadened over the 1970s to cover virtually all export commodities, the response of non-traditional exports has been disappointing. Egypt continues to depend heavily on petroleum, the Suez Canal, worker remittances, and tourism for its foreign exchange resources.

The failure of interest rate increases to keep up with inflation has resulted in a disappointing performance of private savings. Most of the impressive gains in investment have been financed by capital inflows and public savings. The allocation of domestic credit has also continued to be dominated by the public sector.

The slow progress in liberalizing prices and subsidies on the one hand and reducing the dominance of the public sector on the other are closely related. Public sector firms, for the reasons discussed above, have resisted price and subsidy liberalization. Since these public sector firms are not being reduced and do constitute a significant political force, price liberalization will probably continue to be slow and on an *ad hoc* basis.

The reasons for the slow progress of liberalization in Egypt are both economic and political. President Sadat made a political decision to re-establish close relations with the West. Although this decision was partly motivated by the prospect of improving the economy with better aid, trade, and investment ties with the West, it was not encouraged by a strong popular movement against government controls and intervention as in Sri Lanka. The popular support was more motivated by the devastating effects on Egypt of the conflict with Israel and a desire to liberate the economy from this crushing burden.

The liberalization of international trade and exchange policies is the only area where significant decontrol of the economy has been established. Of all the possible areas of liberalization, trade and exchange policies were probably seen as the most necessary politically for economic re-integration with the West. Without these reforms, trade and investment with the West would have been severely hampered. In addition, the large increases in workers' remittances probably could not have been achieved.

Regarding internal domestic liberalization, however, much more serious political opposition existed without a compensating political or economic payoff with the West. Although President Sadat could mobilize widespread support to improve economic and political relations with the West, he did not have a mandate (as did the newly elected government of Sri Lanka in 1977) to reform the well-entrenched domestic systems of price controls, subsidies, and public sector ownership of productive assets. Even if a mandate did exist, dismantling the complex system of price controls and subsidies and state-owned enterprises would be a formidable task in view of the economic and social disruption and administrative difficulties that would be encountered.

In some developing countries, the combination of external capital requirements and the policy conditions attached by Western donors are sufficient to overcome the domestic political constraints. Until 1978, the International Monetary Fund (IMF) was applying this kind of pressure, but with only limited success except in the area of trade and exchange policies. Partly due to Egypt's resistance to IMF pressure and also to a greatly improved balance of payments situation, the IMF has not been involved in Egypt since 1978. Although bilateral donors, particularly the United States, continue a dialogue with the government on domestic policy reforms, Middle East political-strategic policies are often overriding.

In summary, Egypt's "Open Door" policy has never constituted a comprehensive economic liberalization program. The only significant area of liberalization, international trade and exchange policies, was achieved because it was a necessary element to re-establishing economic ties with the West and improving the critical balance of payments situation in 1974. Progress in domestic economic liberalization has been slow and ad hoc due to the following factors:

(1) strong political opposition to the reduction of consumer subsidies because their prolonged existence over several decades had resulted in such subsidies accounting for large shares in real household expenditures, particularly for the poor;

(2) strong political opposition to the liberalization of price controls and producer subsidies due primarily to public sector firms which continue to dominate industrial production;

(3) employment in the public sector continues to be used as a major instrument for achieving welfare and income distribution objectives;

(4) the lack of effective pressure by the Western donor community for domestic economic policy reform;

(5) the ability of Egypt, at least in the short to medium term, to rely on its natural resources for strong economic growth.

C. The Sudan

1. The Control Regime: The Sudan's long experience with a government control approach to economic management had as its major purpose the development of the country's agricultural and water resources. The infrastructural needs required by the country's size, and the strategy to develop agriculture via irrigation called for lumpy investment that only governmental institutions could undertake. The heavy participation of government in economic management lasted from the time of colonial rule to the present. 20/ Such participation was reinforced by the need to have a strong and centralized government in a country fraught with ethnic divisions.

Under British rule, the first attempt was made at large scale irrigation, through the initiation of the Gezira irrigation scheme in the 1920s. The objective was the large scale production of long staple cotton for export. Political independence in 1956 brought the transfer of the two major schemes (Gezira and White Nile) as well as the plans for others to the newly established government. The control of these schemes remained with the new government which had to negotiate bilateral treaties with Egypt regarding the future use of the Nile. This meant that the government managed the majority of export crops. Government control was exercised through a tenancy agreement, where services, inputs and acreage distribution for various crops was provided by the government in exchange for a share of proceeds from largely government-marketed exports.

The first formal development plan was introduced to cover the 1960/61-1970/71 period. Two chief objectives were the diversification of the structure of production through mostly public investment and the maintenance of a stable price level. By 1974, the government's share in gross domestic capital formation had reached 77 percent, as new agricultural irrigation schemes, the mechanization 21/ of rain-fed crops, the formation of industrial enterprises, and the provision of infrastructure and social services were well underway. In fact, actual expenditures surpassed planned expenditures for the first three years of the plan. The initial years of the plan also saw an increasing budget deficit, reaching approximately £S 29 million in 1963/64, almost doubling the 1961/62 level. Such high budget deficits and a dramatic drop in foreign reserves contributed to a 1964 coup d'etat.

The 1965-69 period saw two elections and continuous internal political turmoil. As a result little attention was paid to the economy which was characterized by moderate growth of about 3 percent per annum. Foreign exchange reserves continued to dwindle and unemployment rose. These developments led to a 1969 coup d'etat by the current president, General Nimeiri. 22/

During the first year of the Nimeiri regime, domestic politics were greatly influenced by the so-called "Arab socialism" being established in neighboring Lybia and Egypt. As a result and following the Egyptian model, all banks and foreign property were nationalized, assets of large landholders and businesses were expropriated, and relations with the U.S. were severed in 1971. National economic management was characterized by the "scientific and socialist" principle, resulting in the almost total government domination of economic activities. A new Ten Year (1970/71-1980/81) Plan was drafted with an emphasis on output expansion in agriculture and industry through the provision of heavy infrastructure and a parallel emphasis on expansion of social services.

While the plan suggested the participation of the private sector, there were very few mechanisms that could elicit their participation. In fact, market mechanisms were tampered with to the extent of discouraging private investment decisions. By 1973, the control regime permeated almost every aspect of economic activity. The major instruments included:

(1) state enterprises in agriculture and industry;

(2) monopolist financial intermediation;

(3) public construction of physical infrastructure such as roads and dams;

(4) the control of pricing of consumption goods, raw materials, capital goods, and some labor segments. The measures used included marketing monopolies, taxes/subsidies on international transactions, and subsidies on consumption items through controlled prices.

(5) controls on external trade through a fixed exchange rate and import licensing.

Throughout the period of increasing government intervention (1960-1973), the country's economic performance was mixed. Real GDP grew at an average rate of 3-4 percent per annum. The major force behind such growth was the sustained growth of agricultural output which averaged nearly 5 percent per annum for the same period. The expansion of area under cultivation in both the irrigated, mechanized and the traditional sectors account for the agricultural sector's growth. In effect, the government's objective of output expansion via irrigation had been met.

The impact on the agricultural labor force was not as large as output growth figures might suggest. Two factors account for this:

(1) Capital intensive methods were utilized in much of the new areas brought under cultivation and

(2) acreage expansion was concentrated mostly in the east-central and western regions.

These characteristics of agricultural expansion resulted in more than half of the population remaining in subsistence activities.

Social services were also concentrated in the east-central region. The main beneficiaries of health and education services were those whose income had increased as a result of the agricultural expansion. This reinforced the geographically biased pattern of growth.

In fact, the excessive concentration of economic activity and social services in the Khartoum and surrounding areas has attracted most of the internal migrants. For the 1955/56-1972/73 period, urban population growth was estimated at 7.4 percent, in contrast to the estimated 1.5 percent for the rural areas.

The balance of payments consistently showed signs of strains with large current account deficits and growing amounts of long and short term commercial debt. The deficits resulted from deteriorating terms of trade at an average of 1-2 percent for the 1960-73 period, even with a fairly rapid expansion of export volume.

2. Economic Liberalization: The political stability of the Nimeiri regime began to deteriorate in the early 1970s. In mid-1971 a left-wing coup attempt almost toppled the regime. The coup attempt had a profound effect on the surviving government both in terms of domestic and foreign policies. Shortly thereafter Nimeiri announced a rapproachment with the West, and shifted development efforts toward an emphasis on participation and more aid from western donors.

The rapproachment with the West gave new directions to the Sudanese development strategy which can be characterized as an economic liberalization program. This represented a bold shift in policy when it is remembered that Sudan's socialist tradition had been as old as the country itself and that its irrigation schemes, mechanized farms, and infrastructural needs still called for the heavy participation of government in investment.

The initial liberalization measures reversed previous actions taken to nationalize foreign industry and expropriate large landholders. By mid-1973, several industrial enterprises were returned to former owners, and plans were made to formalize a new policy for industrial development, encouraging the participation of private domestic and foreign investors. These events were followed by the enactment of the 1974 Development of Encouragement of Industrial Investment Act, comprised of measures mainly in the areas of fiscal incentives, allocation of foreign exchange, and ex-factory pricing designed to encourage increased private sector industrial investment and output.

The government undertook a massive investment program in the first half of the 1970s, with expenditures increasing from $76.3 in 1970/71 to $305.4 million in 1974/75. The government's share of gross capital formation remained above the 50 percent mark. The plan maintained its order of priorities: agriculture, infrastructure, services, and industry. Expenditure rates were fueled by expectations of funding from Arab oil exporting countries. Foreign and domestic debt were acquired almost indiscriminately, as every ministry had its own borrowing authority.

The intensive pursuit of these policies led to severe balance of payments problems that resulted in further efforts to liberalize the economy. [24/] The trade deficit increased dramatically from $66 million in 1973 to $710 million in 1978. The quadrupling of oil prices and the pace of public investment (high in import content) accounted for high import growth. On the export side, cotton exports continued their sharp decline that had begun in the mid-1970s.

The heavy acquisition of debt on unfavorable terms over the decade, the expected high debt service payments and the slowdown in foreign loan disbursements led to the rapid accumulation of arrears, jeopardizing the country's relationship with creditors. By the end of 1978, total external debt had reached almost $3.5 billion. The debt service ratio for that year stood at approximately 18 percent. This figure is misleading as large external arrears were accumulated.

Foreign debt had been acquired in order to finance not only development expenditure, but the growing deficits of highly inefficient public enterprises in agriculture as well as industry. These suffered from poor management, the lack of spare parts and controlled output prices.

The concomitant credit expansion led to rapid growth in liquidity which in turn affected the prices of basic consumption items. The subsidies resulting from controlled prices worsened the fiscal position of the government, whose deficits had reached about £S 167 million in 1978, almost double the amount in 1975.

The alarming dimensions of the external imbalances forced debt rescheduling and a request for IMF assistance. Thus in mid-1978 the government initiated another set of liberalization measures designed primarily to improve the external account. Two main measures were taken: (1) an exchange tax/subsidy scheme constituted a de facto 20 percent devaluation for all exports, bringing the rate from $2.50 to $2.00 for Sfl. (2) The preferential rate of exchange for remittances was devalued 14 percent, bringing it to $1.50 for Sfl. These measures can be construed as being rather cautious and uncontroversial. For a government that had been threatened by at least three coup attempts, the taking of measures with extensive impact on the population seemed an unpalatable proposition which might be more acceptable under the auspices of the IMF-EFF agreement that was soon to be signed. Thus, another phase of liberalization starts with the signing of the Extended Fund Facility (EFF). The EFF called for reform in four areas:

(1) Restructuring the government/tenant production and cost/price relationships in agriculture, making government enterprises and its tenants more responsive to market conditions.
(2) Improving the physical infrastructure in agriculture.
(3) The pursuit of financial policies that decrease budgetary deficits.
(4) The pursuit of more rational external policies regarding the exchange rate, external debt acquisition and the rescheduling of outstanding debts and arrears.

A number of policy measures have been adopted since the signing of the agreement. A parallel market for foreign exchange was created at $1.25 for Sf1, equivalent to a 50 percent devaluation. All non-cotton exports and non-essential imports were incorporated gradually into the parallel market. However, export duties on non-cotton products were raised between 15 and 30 percent, and all cotton export taxes were eliminated.

Foreign exchange controls were lifted and transactions authority was granted to commercial banks. Other foreign exchange dealers were to operate under licensing.

Preferential treatment granted to the Sudanese working abroad was eliminated. They were permitted, however, to maintain foreign currency deposits in commercial banks.

The new production and cost/price relationships between tenants and government enterprises was introduced whereby prices paid to tenant farmers and allocation of acreage to different crops was to be determined by market forces. The implementation of this scheme has been slow as changing long-established relationships has proved difficult.

Public corporations have also been affected by new measures. Four public corporations have been dissolved, but many of their components were reorganized into other public entities. Another measure was the transference of management to private firms on a contract basis.

Controlled prices were allowed to increase for critical subsidized items such as sugar, wheat, petroleum and bread. The subsidies, however, were only partially reduced. Import taxes were raised for consumption items like tobacco, spirits, and automobiles. These measures were somewhat offset for the urban population by a S£200 raise in the taxable income exemption and increasing the transportation allowance for government workers.

The interest rate was adjusted upwardly 2 percentage points for borrowing and lending. The average lending rate stands at approximately 15 percent, while the average borrowing rate is approximately 9 percent. Public borrowing authority has been centralized and implemented under strict scrutiny.

3. Assessment of Economic Liberalization Policies: The liberalization policies adopted by the Sudan Government, as those of Egypt, have been largely *ad hoc*. The measures have been responses to "crises" e.g., possible suspension of the EFF. The absence of an integrated and comprehensive approach is perhaps the reason for the mixed and unimpressive results.

Cotton production has declined from 1.01 million bales in 1977/78 to 585 thousand bales in 1979/80. While there have been technical reasons for the drop in cotton production (e.g., flooding and white fly infestation, shortages of labor and other inputs), the fact remains that financial incentives still discriminate against cotton. In the areas in the new scheme where incentives allow responses to market conditions, cotton production has actually increased. The production record of other export crops such as groundnuts, dura, and gum arabic -- where the traditional sector is involved -- has been quite responsive to market conditions.

Industrial production has hovered at 30 percent capacity for the 1978/81 period. The major technical constraints are the unavailability of electricity, poor labor supply, and lack of spare parts. The economic constraints are credit rationing policies that favor public enterprises, the unavailability of foreign exchange for spare parts, and inflation trends that encourage speculative as opposed to long term investment. A key unimplemented component of the credit reform package is the upward readjustment of the interest rates, as current rates are negative in real terms.

Commercial services have remained as healthy as they have always been, as traders and other marketers have been able to extract very large rents from the differential between the controlled purchase prices (ex-factory, etc.) and the prices at which they sell traded goods. For the 1974/75-1977/78 period, the private services sector (excluding financial) grew at an average rate of 35 percent in nominal terms. The growth of this sector perhaps best illustrates the limitations of a controlled approach to economic management with limited administrative resources. Although there are restrictions on distributive margins, these are largely unenforceable.

Price decontrol has been difficult for the Sudanese Government. The prices of several major consumption items (sugar, wheat, bread) remain below their shadow prices. Although the consumables component of the cost of living index (60 percent weight) has almost doubled between 1978 and 1980, subsidies on items like sugar and wheat still account for about 6 percent of public current expenditures. The need to maintain a political base throughout a liberalization process is underlined by the cautious Sudanese approach to price decontrol. The threat of strikes and other social disturbances in response to drops in the standard of living is ever present. In this light, the presidential speeches in (September 1979/October 1980) on new economic policies with regard to public enterprises, and the adoption of the semblance of a liberalization plan by the SSU in February 1981, ought to be seen as necessary steps in the evolving liberalization process.

In the public enterprise area, the progress is reasonable when one considers the historical context of public entrepreneurship and the fact many of these enterprises will remain under government control. The problem has been recognized and steps taken so far indicate a commitment towards improvement in their operation.

Perhaps, with the recent party approval of an economic recovery plan and a more active role by the President himself, Sudanese efforts to liberalize can become more coordinated. The mixed performance and results achieved so far underline the need of such an approach.

III. Conclusions and Policy Implications

The processes of economic liberalization in the three country case studies started from different base situations, although with many similarities, and were characterized by different objectives regarding the extent and pace of the intended liberalization. Although it is difficult to generalize even within the three-country context, some of the lessons learned from these experiences may be useful to other countries pursuing liberalization strategies.

All three countries initiated economic liberalization after extended periods of heavy government control and participation in their economies. Political opposition to liberalization, therefore, was well-entrenched in all three countries. The political situations in the three countries, however, varied considerably. The new government of Sri Lanka in 1977 was elected by a large margin with a platform for strong economic liberalization. In Egypt the Sadat Government in 1974 had strong popular support and was relatively stable politically. The strong political support, however, was more for Sadat's reconciliation with the West and repudiation of war than for a program of economic liberalization. The Nimeiri Government, on the other hand, has had a delicately balanced political base. After taking over as part of a military coup in 1969, Nimeiri survived a number of threats to his control over the 1970s. These events have not allowed the undertaking of bold economic programs in the late seventies.

The economic situations of the three countries upon embarking on liberalization also varied. Egypt was in the most difficult economic situation as it was in the midst of a serious balance of payments crisis. Sri Lanka was experiencing slow economic growth, but was not in a crisis situation. Sudan also started during a slow growth period with rather modest measures, accelerating its efforts when its balance of payments deficit reached alarming proportions.

All three countries were relatively poor when they started economic liberalization, with GNP per capita of $190 (1977) for Sri Lanka, $250 (1974) for Egypt, and $130 (1973) for Sudan. Egypt was relatively more industrialized, with 27 percent of GDP originating in industry, compared to 20 percent for Sri Lanka and 8 percent for Sudan. Egypt was also relatively more urbanized, with 42 percent of its population living in urban areas compared to 22 percent for Sri Lanka and 12 percent for Sudan.

The stage of development and economic/political situation of each of the countries certainly influenced the objectives and scope of the economic liberalization effort. The popular dissatisfaction with poor economic performance from 1970-76 and the election mandate for economic liberalization in 1977 gave the Government of Sri Lanka the advantage in being able to propose a far-reaching program that could be implemented rapidly. In Egypt, the only area of economic liberalization that Sadat could push rapidly was in international trade and exchange policies because these reforms were seen as necessary to address the country's severe balance of payments situation and to re-integrate Egypt into a trade/investment relationship with the West. Sadat had no domestic support to liberalize other areas of the economy and, in fact, has encountered serious political opposition to such attempts. In Sudan, the delicate political balance prevented rapid liberalization in any area. Only when the economic situation deteriorated after 1975 was the government compelled to initiate significant changes in spite of potential political problems.

In Sri Lanka the pace of economic liberalization was more rapid and the scope of its coverage broader than in Egypt or Sudan. This was partly due to Sri Lanka's more favorable political situation as discussed above, but credit should also be given to the government's careful and comprehensive planning and implementation of the liberalization measures. Sri Lanka avoided the imbalance problems of a piecemeal approach with its broad coverage of policy reforms, and particularly sensitive liberalization measures were either ameliorated by compensating actions or implemented in phases to cushion their impact.

It should be noted that in some respects economic liberalization in Sri Lanka required less of an adjustment by those affected than in Egypt or Sudan. For example, food subsidies accounted for 14 percent of the average household budget in Sri Lanka compared to 28.5 percent in Egypt. In addition, the private sector still played an important, although diminished, role in

Sri Lanka, whereas the industrial private sector had been all but eliminated in Egypt and Sudan.

In none of the three countries did political ideology seem to be an obstacle to economic liberalization. Although the term "socialism" had been employed by previous governments, the masses of the population were more influenced by traditional values, such as the strong Buddhist value favoring equity in Sri Lanka. Indeed, all three countries had strong traditions favoring equity and these had to be respected in any liberalization program. Although complaints have been voiced in these countries that the rich are benefitting disproportionately from economic liberalization, it should be noted that the governments in all three cases have been sensitive in varying degrees to the impact of liberalization measures on equity.

The existence or absence of outside pressure for economic policy reforms was a factor influencing the pace and extent of liberalization. Although the Sri Lanka Government initiated the liberalization effort on its own, the presence of IMF conditions tied to certain aspects of the liberalization package provided additional incentives to persist with the reforms in the face of political opposition. The fact that Egypt has not had to depend on the IMF since 1978 may be part of the reason why the liberalization there has been so slow. With a rather healthy balance of payments situation and substantial foreign assistance from other donors, Egypt has not needed to draw on resources from the IMF in recent years. In Sudan, some of the most significant liberalization measures have occurred under economic crisis conditions and IMF pressure.

In terms of the relative difficulty of achieving the various elements of economic liberalization, it appears that international trade and exchange policies have encountered the least difficulty. All three countries were able to achieve at least a certain degree of progress in this area. In Egypt, these reforms were seen as necessary to integrate the economy with the West regarding trade and investment. Another more general reason is that with trade policy reforms there are both winners and losers. The losers are typically previously favored importers and domestic producers. Although these importers are probably economically and politically strong, their interests may be outweighed by the benefits to the winners. The winners are generally exporters, who are also often economically and politically strong, and a wide range of private sector importers who gain access to imports. Although with any policy reform there are winners and losers, with trade policy liberalization the winners may be particularly visible and possess political influence, although this is certainly not always the case, especially in countries where the export sector is largely state-owned and private exporters are not strong. A more important reason for the apparent relative success of trade liberalization over other areas of liberalization may be that a substantial body of economic literature has accumulated to demonstrate the benefits of trade liberalization, several outstanding country success stories have demonstrated the potential effectiveness of trade liberalization, and international organizations and donors have tended to stress trade liberalization relative to other areas in their dealings with developing countries.

The most difficult element of economic liberalization appears to be public sector enterprises. Only Sudan has been able to diminish the absolute level of public ownership of productive assets and services. Although one of the reasons for the difficulty in transferring assets to the private sector may be the large size of most public enterprises, there is substantial evidence that many of these enterprises would not be financially viable in the private sector. The most that can realistically be done, therefore, is to gradually work to improve the management and efficiency of public sector enterprises and to favor the private sector for new investment. Improving the efficiency of public sector enterprises is a difficult task that is being addressed only slowly in the three countries. Avoiding new public sector investment is also quite difficult when, as in Egypt's case, almost all the major industries are publicly owned.

Next to public sector enterprises, price controls and subsidies have been a very difficult element to liberalize. Sri Lanka has been the most successful in this area, mainly due to its comprehensive and sensitive approach to this delicate problem and the relatively favorable political climate. In Egypt, even those who would appear to benefit from price decontrol (e.g., public enterprises) have resisted, probably because they fear being exposed to a more competitive environment. The lack of domestic support for price and subsidy liberalization in Egypt and Sudan will probably continue to constitute a significant obstacle to reform in this area.

Although many of the positive lessons of liberalization are associated with Sri Lanka, an important negative lesson from its experience is the danger of combining the liberalization effort with an ambitious government spending program. While the development spending program was probably seen as helping to compensate for the unpopular aspects of liberalization, if taken too far this kind of program can overextend the government and destabilize the economy. If the government is then forced into a posture of restraint and stabilization, as has happened in Sri Lanka, the program can backfire by requiring even more unpopular measures than included in the liberalization package. The political consequences of such a situation are obviously undesirable.

The lessons to be learned from the three country case studies can be summarized by recognizing that, while significant political and economic obstacles must be overcome in any liberalization effort, progress can be achieved with comprehensive and sensitive planning of the measures to be undertaken. The most serious limits to potential progress are probably in most cases related to the impact on domestic interests and the political opposition that this generates.

In terms of useful future research in this area, application of the economic theory of "second-best" to the tactical issues of liberalization would be appropriate. It is obvious from the case studies just covered that economic liberalization programs will probably always fall short of the ideal program that would be dictated by economic theory. Political pressures and economic realities will make gradual, piecemeal approaches the rule rather than the exception. It is possible in some cases that a second-best liberalization measure would not even be desirable. For example, in Egypt merely liberalizing electricity tariffs without adjusting other input and retail prices may worsen financial distortions rather than improve them. A thoughtful application of second-best analysis could be quite helpful in achieving a better understanding of appropriate and feasible approaches to economic liberalization.

Finally, some important lessons and policy implications for international organizations and bilateral donors can be derived from these case studies. Since it is not unusual for international organizations and bilateral donors to try to influence the policies of host countries in the direction of economic liberalization, it is important that they take into account the tactical issues and peculiar constraints that exist in individual countries. For example, the timing of certain measures may have to be adjusted for election pressures, or the long history and extensive nature of certain controls may dictate the necessity of a more gradual approach than normal. Second-best approaches will be the most that can be encouraged realistically, and certain areas of liberalization will be easier to support initially than others.

It is also extremely important that the various institutions involved coordinate their activities so as to avoid crossed signals and achieve to the extent possible mutually reinforcing support. The participation of different institutions will vary according to their respective roles and status vis-a-vis the host country. For example, with respect to certain sensitive liberalization issues, an international organization may be better able to encourage the required difficult measures, and a bilateral donor's appropriate role may be "back-seat" support of the international organization in the form of timely commodity aid in support of the particular measures. In another case involving liberalization measures within a specific sector, such as the liberalization of prices and subsidies in the agriculture sector, a bilateral donor heavily involved in that sector may be in the best position to carry on an effective dialogue with the host government.

Further, it is important that donors recognize the implications of their programs and projects for the economic liberalization prospects of host countries. For example, the provision of increased food aid to compensate for reduced domestic production caused by the disincentive effects of controlled low food prices will merely allow the postponement of the price liberalization that is necessary to stimulate increased production. In another case, it may be appropriate for a donor to shift from project aid to fast-disbursing, non-project aid to support more effectively an economic liberalization program.

Liberalizing a previously heavily controlled economy is a difficult and sensitive process. Complex economic, social, and political factors must all be taken into account not only by the government, but also by particpating international organizations and bilateral donors. Careful interdisciplinary research should be focused on the relatively new process of economic liberalization that is occurring in an increasing number of developing countries.

FOOTNOTES

1 R. Prebisch, The Economic Development of Latin America and Its Principal Problems (New York: United Nations, 1950); and R. Prebisch, Toward a New Trade Policy for Development (Geneva: United Nations, 1964).

2 For example, see A. Gantt and G. Dutto, "Financial Performance of Government-Owned Corporations in Less Developed Countries", IMF Staff Papers, 25:102-142; and A. Choksi, "State Intervention in the Industrialization of Developing Countries: Selected Issues", World Bank Staff Working Paper No. 341, July, 1979. Choksi summarizes the results of 12 separate studies in tabular form on page 16 which show overwhelming poor performance of public sector enterprises in developing countries.

3 See Choksi (1979), pp. 88-94; and I. Little, T. Scitovsky, and M. Scott, Industry and Trade in Some Developing Countries: A Comparative Study (London: Oxford University Press, 1970).

4 See A.O. Krueger, Liberalization Attempts and Consequences, National Bureau of Economic Research (Cambridge, Mass.: Bullinger, 1978). This study by Krueger is a volume that summarizes a series of other NBER volumes on individual country case studies: Turkey, Ghana, Israel, Egypt, Philippines, India, South Korea, Chile, and Colombia.

5 The November, 1980 issue of World Development is a special issue devoted to stabilization programs in Latin America. See also the proceedings on a Brookings Institution conference on Stabilization Programs in Developing Countries, 1979.

6 P. Isenman, "Basic Needs: The Case of Sri Lanka", World Development, Vol. 8 (March 1980), p. 238.

7 Extrapolated from the Land and Labor Utilization Survey, 1975 (see Isenman, p. 255).

8 See Isenman (1980), p. 247; E. Lee, "Rural Poverty in Sri Lanka 1963-1973" in ILO, Poverty and Landlessness in Rural Asia (Geneva: ILO, 1977); and D. Morawetz, "Economic Lessons from Some Small Socialist Developing Countries," World Development, Vol. 8, (May/June 1980).

9 A. Wilson, Politics in Sri Lanka 1947-1973 (London: Macmillan, 1974).

10 For further details, see B. Hansen and K. Nashashibi, Foreign Trade Regimes and Economic Development: Egypt, NBER (New York: Columbia University Press, 1975).

FOOTNOTES (continued)

11 K. Ikram, Egypt: Economic Management in a Period of Transition (Baltimore: Johns Hopkins University Press, 1980)

12 P. O'Brien, The Revolution in Egypt's Economic System (London: Oxford University Press, 1966), see p. 85.

13 See B. Hansen, "Arab Socialism in Egypt," World Development, Vol. 3, No. 4 (April 1975), pp. 201-211.

14 Ibid., p. 202.

15 Ibid., p. 207.

16 Ibid., p. 209.

17 President Anwar el-Sadat, The October Working Paper (Cairo: Arab Republic of Egypt, Ministry of Information, May 1974.

18 See Ikram, p. 329.

19 See U.S. Agency for International Development, Country Development Strategy Statement, 1982-1986, Annex XIII: Egypt's Food and Energy Subsidies, pp. 3-5.

20 For an interesting and brief description of the early Sudanese economy, see Osman, O. and Suleiman, A.A. "The Economy of Sudan", in Robson, P. and Lury D. The Economies of Africa (Evanston; Northwestern University Press, 1969).

21 The most complete series on early economic data can be found in the Ministry of Planning's Economic Survey, published every year since 1956.

22 See, Bechtold, P.K. Politics in the Sudan: Parliamentary and Military Rule in an Emerging African Nation (New York; Praeger; 1976).

23 A brief history of the Sudan can be found in, Conte, C. The Sudan as a Nation (Varese, Giuffre Editore; 1976).

24 For a complete and solid study on the Sudanese economy of the early seventies, see ILO, Growth, Employment and Equity (New York; ILO; 1975)