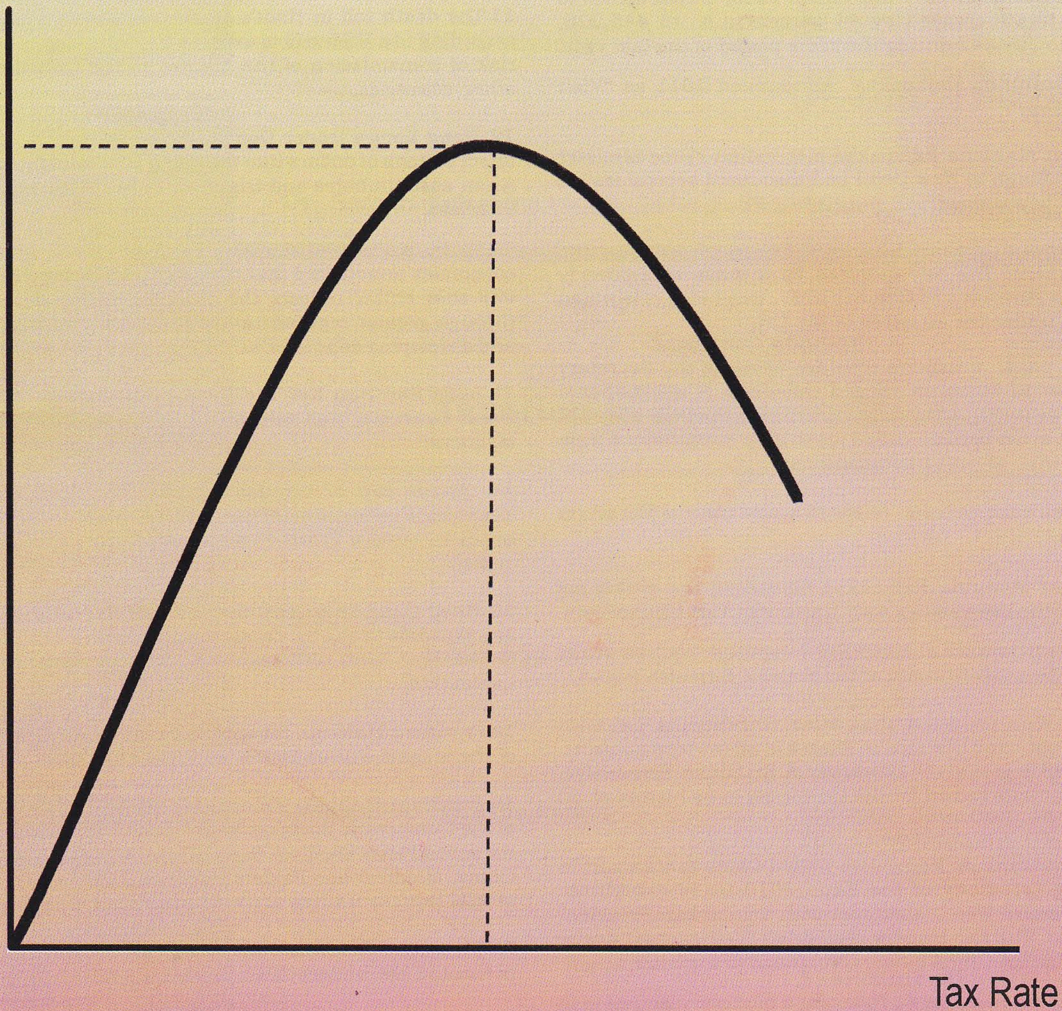
ECONOMIC REVIEW
Oct./Nov. 2010



Taxation in Economic Development

A People's Bank Publication

DIARY OF EVENTS

October

3-14 The 2010 Commonwealth Games, officially known as the 'XIX Commonwealth Games', were held in Delhi, India.

7 The Cabinet decided to takeover the Shell Gas Lanka Limited and the Shell Gas Terminal Limited at a cost of US$ 63 million.

10 Sri Lanka Tourism announced that, during the period of nine months from January-September 2010, tourist arrival to Sri Lanka has increased by 44 percent, i.e., to 445,228, compared to 309,142 during the same period of the last year.

President Mahinda Rajapaksa announced 2011 as "Visit Sri Lanka Year".

15 President Mahinda Rajapaksa met Indian Prime Minister Manmohan Singh in New Delhi and discussed several issues of bilateral importance.

17 The International day for eradication of poverty was commemorated. The day inspired by a mass anti-poverty gathering in Paris on 17th October 1987, was being celebrated since 1993 under the auspices of the UN.

21 The UN panel of experts who are advising the Secretary General Ban Ki Moon on alleged violations of international human rights and humanitarian law during the final stages of the conflict in Sri Lanka, called for written submissions from those who wish to make submissions.

22 The WikiLeaks website released a new trove of US secret documents.

25 President Mahinda Rajapaksa discussed the prevailing situation of the universities with University Vice Chancellors.

A powerful earthquake of about 7.5 magnitude(Richter scale) struck off the western coast of Indonesia's Sumatra island.

29 Lanka Web reported that Miss Chathurika Lakmini Dandeniya obtained Distinction Passes in all thirteen subjects for her MBBS degree at the University of Sri Lanka, Peradeniya, marking a unique record for the University in its history of 50 years.

31 President Mahinda Rajapaksa visited China to take part in the closing ceremony of the Expo 2010 trade exhibition. Chinese Premier Wen Jiabao met with Sri Lankan President in Shanghai. The two leaders reaffirmed their earnest desire to take Sri Lanka-China bilateral relations to a greater height.

Nepal President Ram Baran Yadav, at a bilateral discussion in Shanghai,China requested Sri Lanka President Mahinda Rajapaksa to channel his political and diplomatic goodwill and skill in the region in sustaining positive momentum in the current political process under way in Nepal.

November

1 World Prosperity Index announced that Sri Lanka was ranked 59 among 110 nations for the year 2010. India, Pakistan and Indonesia were ranked well below Sri Lanka.

3 The government bought 51% shares of Shell Gas Lanka Limited(SGLL) for US$ 63 million.The government also acquired 100 percent shares of the Shell Terminal Lanka Limited (STLL).

4 The 2010 Human Development Report indicated a progressive increase in Sri Lanka's Human Development Index from 0.513 in 1980 to 0.659 in 2010.

The Upper Kothmale tunnel was opened. This is the longest (12.9 km) tunnel in Sri Lanka.

8 The United States President Barack Obama, at his three-day State visit in India, declared support to India's candidature for a permanent seat in the United Nation's Security Council (UNSC).

9 The Department of Census and Statistics revealed Sri Lanka's unemployment rate fell to 5.4 percent in the second quarter 2010 (The survey was not conducted in the Northern Province).The unemployment rate in the second quarter 2009 was 6.5 percent.

11 The death toll in Haiti's Cholera epidemic raised to 800, according to a US medical expert who expressed concern about risk of transmission of the disease to the United States and other countries.

12 Hong Kong's leader Donald Tsand warned that a move to inject billions of dollars into the ailing US economy could inflate Asian asset bubbles and trigger a repeat of the region's 1997-98 crises.

G20, the summit of the leaders of advanced and emerging economies announced that they were delivering 'A modernised IMF that better reflects the changes in the world economy through greater representation of dynamic emerging markets and developing countries' at the summit in Seoul, South Korea.

13 Aung San Suu Kyi, the Burma's Opposition leader and a Nobel Laureate, was released from house arrest in Yangon, Myanmar.

14 At the end of two-day summit in Japan, Asia–Pacific Economic Cooperation (APEC) leaders agreed to transform their hopes to build a Trans-Pacific Trade Treaty into a more solid vision.

15 Shell Gas Lanka (Ltd) formally handed over all its assets and facilities to the Sri Lanka government. A new government-owned firm, Litro, will take over the operations of Shell Gas Lanka (Ltd).

18 President Mahinda Rajapaksa commissioned the first stage of the Magam Ruhunupura Mahinda Rajapaksa port.

19 President Mahinda Rajapaksa, the 5th Executive President of the Democratic Socialist Republic of Sri Lanka took oaths in his second term of office. Special representatives from Bhutan, China, Maldives and Pakistan were among the large number of official representatives arrived to participate in the ceremony.

22 President Mahinda Rajapaksa, as the Finance Minister, presented the budget-2011 in parliament.

23 The Central Bank of Sri Lanka introduced new foreign currency accounts for a number of vital sectors, including, tourism, gem and jewellery industry. This is following the arrangement made by the Central Bank to simplify foreign exchange controls to facilitate foreign exchange transaction.

North Korea fired artillery shells at a South Korean island, setting buildings on fire and prompting a return of fire by the South Korea.

25 The latest Open Budget Index published by Washington-based International Budget Partnership ranked Sri Lanka at 47th with 'some' degree of transparency among 94 countries surveyed.

27 Pakistan President Asif Ali Zardari visited Sri Lanka. His four–day State visit aimed at further strengthening bilateral relations between the two countries.

28 WikiLeaks began to publish 251,287 leaked United States embassy cables, the larger set of confidential documents ever to be released to the public domain.

ECONOMIC REVIEW

Vol. 36 Nos. 7 & 8 Oct./Nov. 2010

Published by :
Research Department,
People's Bank,
Head Office,
Sir Chittampalam A.
Gardiner Mawatha,
Colombo 02,
Sri Lanka.

ADVISORY BOARD

W. Karunajeewa
Chairman,
People's Bank

H. S. Dharmasiri
CEO/ General Manager
People's Bank

K. U. Pushpakumara
Director Research
People's Bank

CONSULTANT EDITOR

Dr. A. P. Keerthipala

CO-ORDINATOR

H. L. Hemachandra
Research Officer

THE ECONOMIC REVIEW is intended to promote knowledge and interest in the economy and economic development process by a many sided presentation of views and reportage, facts and debates. THE ECONOMIC REVIEW is a community service project of the People's Bank. Its contents however are the result of the editorial considerations only and do not necessarily reflect Bank Policies or the official viewpoint. Signed feature articles also are the personal views of the authors and do not represent the institutions to which they are attached. Similar contributions as well as comments and view points are welcome. THE ECONOMIC REVIEW is published bi-monthly and is available both on subcription and on direct sale.

*E-mail:*ecorev@peoplesbank.lk

CONTENTS

Features

Kenneth De Zilwa — 26 — Assembling Sri Lanka Inc.- Pragmatism over Ideology

Dr. R.H.S. Samarathunga — 34 — Problems in Regional Development in the Northern and Eastern Provinces of Sri Lanka

Dr. Saman Kelegama — 39 — Money, Inflation and Output

Special Report

Taxation in Economic Development

Deshamanya Prof. W. D. Lakshman — 03 — Taxation in the Process of Economic Development: A Discussion based on Sri Lankan Experience

Kopalapillai Amirthalingam — 11 — Indirect Taxation in Sri Lanka: The Development Challenge

Asoka Gunawardena — 16 — Provincial and Local-level Revenue Assignment in Fiscal Decentralisation in Sri Lanka

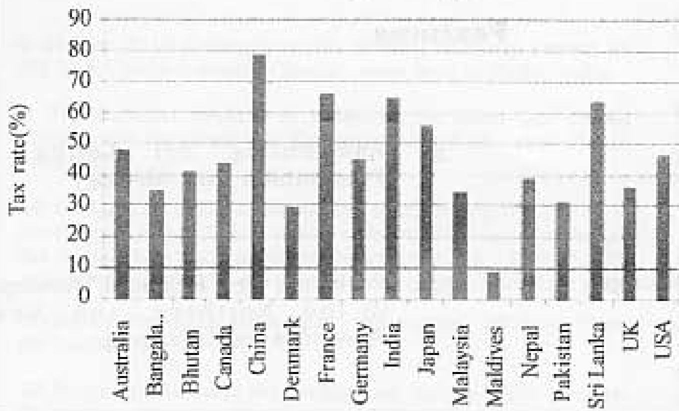
Dr.U. A. D. Prasanthi Gunawardena — 21 — Environmental Taxation

Next Issue

Budget – 2011

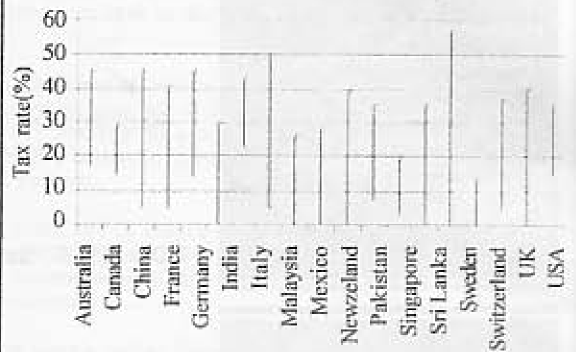
Printed at People's Bank, Printing Services Dept.

TAXATION
SOME HIGHLIGHTS

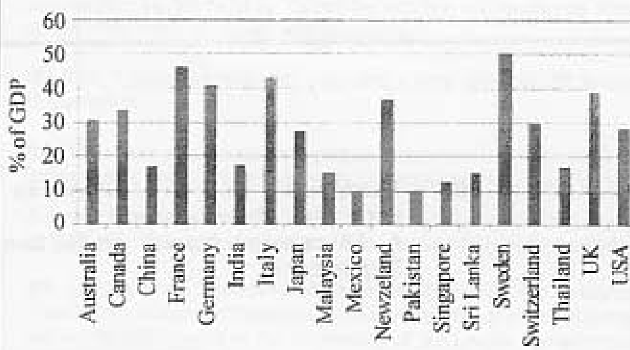


Source:http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/0,,pagePK:180619~theSitePK:136917,00.html.2010.12.08

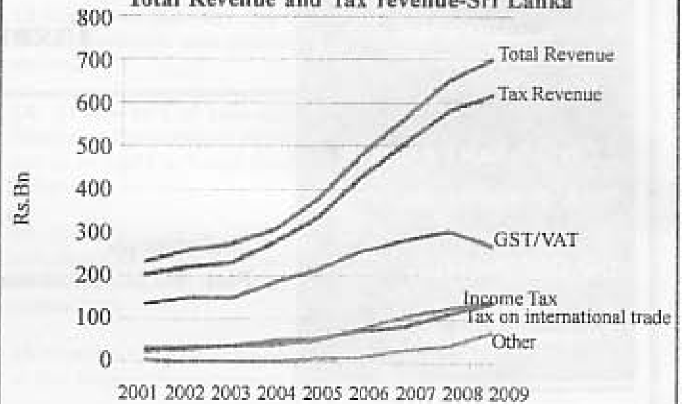
*Amount of taxes payable by businesses (except for labour taxes) after accounting for deductions and exemptions as a percentage of profit.



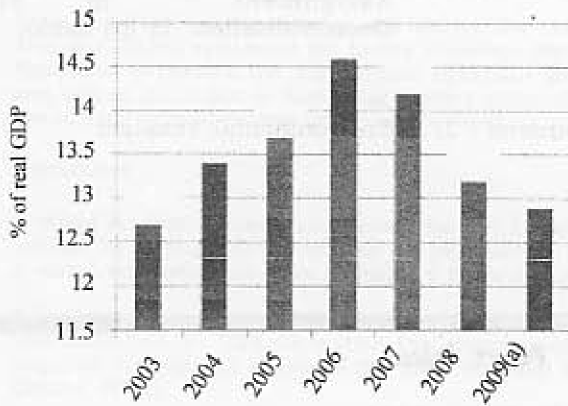
Source: www.wikipedia.com, www.creditloan.com & Central Bank of Sri Lanka



Source: www.wikipedia .com, www.creditloan.com & Central Bank of Sri Lanka

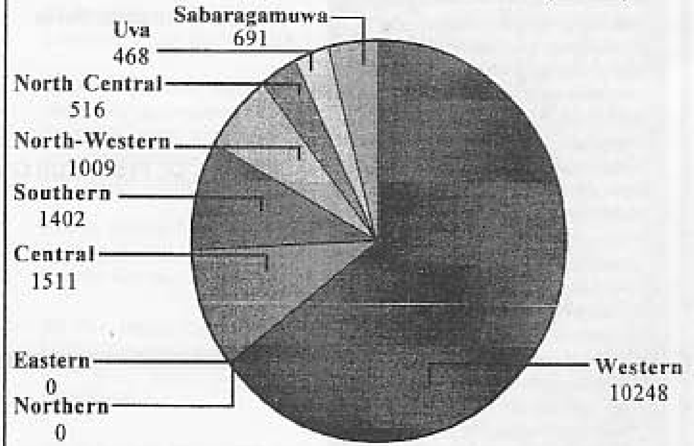


Source: Annual Reports, Central Bank of Sri Lanka



Source: Annual Reports of Central Bank of Sri Lanka
http://www.cbsl.gov.lk/pics_n_docs/10_pub/_docs/statistics/other/Pub_E&SS_2010.pdf

**Real values have been calculated by deflating current values by GDP deflator (base:2002=100)*



http://www.cbsl.gov.lk/pics_n_docs/10_pub/_docs/statistics/other/Pub_E&SS_2010.pdf

**Revenue earned by non-tax sources are excluded.*

Taxation in the Process of Economic Development: A Discussion based on Sri Lankan Experience

Deshamanya
Prof. W. D. Lakshman
Chairman,
Institute of Policy Studies of Sri Lanka.

Introduction

At the general conceptual level, taxation was seen half a century or so ago as the regrettable necessity arising from the need to finance government spending that was treated as wasteful. It is accepted nowadays, however, that taxation is functional in several important senses. Its stabilising role is widely accepted. In commodity exporting countries, for example, the manipulation of export taxes was an essential element among stabilisation measures adopted to address effects of fluctuating export prices. Historically, Sri Lanka had extensive experience of using export taxes as an important stabilisation measure during the time when commodity exports occupied a significant position in the national economy. In addition, the role of taxation in the promotion of economic growth and employment and improvement of income distribution patterns is widely recognised. Nicholas Kaldor (1963) argued that taxation raises two kinds of developmental issues, namely, those pertaining to

(i) investment incentives, and

(ii) investment resources, adding that of the two, the latter raises the more significant set of taxation-related issues. There is clearly agreement among economists today that taxation is a central element of development policy, although it has remained somewhat neglected in the literature. The goals of taxation presented in the form of 4Rs as shown below, summarise its development role:

- Revenue generation
- Redistribution
- Representation[1] and
- Re-pricing[2] of economic alternatives to influence individual and corporate citizens Policies of economic liberalisation – or the so-called "open economic policies" – in

Sri Lanka, since 1977, have gradually transformed into something very close to the prototype neo-liberal policy framework by the 1990s. This neo-liberal policy package remained strong, until important strategic policy changes were introduced after 2005. The post-2005 policy adjustments amounted to some distancing away from the neo-liberal framework. Economic policy and practice remained market-oriented, and offered freedom of enterprise, but assigned the State a stronger role in the economy and the market mechanism. During 1977-2005, the policy framework in place had transformed itself through several stages producing mixed socio-economic consequences.

Working through the 4Rs of taxation, we could examine how taxation influences the process of economic development of a country. This is done below using the Sri Lankan experience as the empirical base for the arguments presented. The essay has altogether six sections. Section II examines the role of taxation in the context of the expanded development role of the government since 2005. The next section examines how Sri Lankan taxation changed in structure over time, in line with gradual development of the country. Having examined in Section IV how taxation has been used to provide and strengthen investment incentives, the paper discusses in the next section how taxation is being used to guide market forces. The paper ends with a brief conclusion in the final section.

Expansion of Government's Developmental Role and Taxation

The conceptual basis of the decisive shift in the development policy framework since 2005 was initially publicised in the election manifesto, *Mahinda Chintanaya*, of the incumbent President during his presidential election campaign of 2005. In the 2010 Presidential elections, the manifesto titled *Mahinda Chintana - Vision for the Future* has articulated further the shift away from neo-liberalism.

The most important element of this policy shift from the point of view of this article is related to the respective roles assigned to private and public sectors of the economy under the two policy dispensations. The neo-liberal package was one of strong private sector orientation. Correspondingly, the State sector role in the market economy was to be gradually reduced. The accepted

ideology was one of "small government". As part of this policy of "small government", a number of privatisation programmes were carried out. Numbers in the public service were reduced and public sector investments contracted. Private sector involvement in infrastructure projects – which were traditionally considered in Sri Lanka as the preserve of the State sector – was promoted. Even after 2005, the market orientation of production and consumption activities continued, subject, of course, to necessary regulations and policy-based taxes or subsidies. At the same time, the State was made to acquire a greater leadership role in the economy, including the lead role in infrastructure development investments. Public employment programmes have been implemented to resolve the problem of unemployment in respect of politically critical labour force segments. Privatisation of State-owned enterprises was abandoned as a policy in clearly articulated announcements to that effect and in actual practice. The emphasis came to be placed on improving the performance of the existing public enterprises. In directly productive activity areas, however, private sector (both domestic and foreign) investments and close public-private participation are promoted. The five-fold global hub idea in *Mahinda Chintana - Vision for the Future* guides the thinking behind the mixed economy concept that is being promoted. A variety of infrastructure development initiatives is being undertaken throughout the country in power generation, transport, port and airport projects, road development and irrigation projects. Commercial services, Business Process Outsourcing (BPO), international banking, tourism projects and many other directly productive activity areas are being promoted among private enterprises. Petroleum exploration in the Sri Lankan sea bed is facilitated and initiatives were taken to develop educational facilities, ICT (information and communication technology) services, science and technology initiatives and so on. The above are only a few examples showing the critical role envisaged for the State within the planned mixed economy structure in which close public-private partnership is envisaged.

The extremely wide-ranging role of the government in the socio-economic system as briefly indicated above resulted in growing volumes of government expenditures, both recurrent and capital. At the time, the security forces were at war with LTTE terrorism, rising military expenditure was the main factor which pushed up government expenditures. After the termination of the war against terrorism in mid-2009, the regime has taken on what it calls the "economic development war". The objective of this economic war has been to initiate a process of acceleration of broad-based and holistic development, covering growth of production and productivity, creation of employment opportunities, alleviation of poverty, expansion of social service programmes and so on. Understandably, this involves high levels of recurrent and capital expenditures of the government.

High ratios of government expenditure to GDP (gross domestic product) were a familiar feature of Sri Lankan public finance for decades in the recent past. As Table 1 shows, for the period since 1978, the highest of these ratios were found during the late 1970s and the next highest in the 1980s. These were times when government revenue to GDP was also high at above 20 percent range. Still, the high expenditures of this period led to high budget deficits with adverse inflation implications. The trend in the ratio of government expenditure to GDP since 1990 was downwards. Several factors contributed to this falling trend. It was noted above that the policies of liberalisation in Sri Lanka have gradually transformed themselves into something very close to the prototype neo-liberal policy framework by the 1990s. The International Monetary Fund (IMF) was operating two structural adjustment facilities (the SAF [Structural Adjustment Facility] of 1989-91 and ESAF [Enhanced Structural Adjustment Facility] of 1992-94) in Sri Lanka during this period and therefore, its pressure to cut down government expenditure and to bring down budget deficits was strong. What was presented as the ideal target for the annual budget deficit was something close to 5 percent of GDP. Fiscal pressures to

Table 1: Revenue plus grants, expenditure and overall budget deficit of government, 1978-2009

Percent of GDP

	Revenue plus grants	Total expenditure	Budget surplus or deficit (-) after grants
1978-80	26.0	40.3	-11.1
1981-83	20.8	33.1	-13.5
1984-86	23.8	32.7	-10.2
1987-89	23.2	33.2	-10.0
1990-92	22.6	30.5	-9.0
1993-95	21.2	29.5	-8.2
1996-98	19.1	27.1	-8.3
1999-2001	17.5	26.5	-8.4
2002-04	16.0	23.7	-8.7
2005	16.8	23.8	-7.0
2006	17.3	24.3	-7.0
2007	16.6	23.5	-6.9
2008	15.6	22.6	-7.0
2009	15.1	24.9	-9.8

Source: Central Bank Annual Report 2009 (Special Statistical Appendix).

reduce government expenditures, which emanated from such deficit reduction targets, were further compounded by the contemporary decline in the revenue to GDP ratio. The latter ratio that was at over 20 per cent during the late 1980s and the early 1990s began a gradual decline. The neo-liberal policies, built up on an advocacy of "broad-based, low-rate" (BBLR) taxation for developing countries (Bird, 2010), did not work satisfactorily in Sri Lanka. As part of trade liberalisation, customs duties on imports were reduced and export duties almost totally eliminated. In respect of income taxes, tax holidays were offered extensively to incentivise investors, particularly the foreign direct investors. Public servants were exempted from income tax liability quite early (1979) after liberalisation and remained so for more than three decades until the budget 2011 announced that these officials are to be brought into the tax net. It is also suspected that there is fairly extensive tax evasion due to ineffectiveness of tax administration.

As a result of these reasons, among others, the tendency till about 2003-4 was for the ratio of government expenditure to GDP to fall. The policy stance, as noted above, since 2005, was to reject the neo-liberal policy framework and for government intervention in the economy to expand. Yet, government revenues fell from 20 to 15 percent of GDP during the last two decades. In this context of weakening revenue, the expansion of government's role in the economy, and therefore, public expenditures had to be undertaken with caution. Increasing public expenditures had to be financed in a non-inflationary manner. Fiscal and monetary authorities were aware of the fact that high rates of inflation went hand in hand with the sharp rise in public expenditures during 1978-89. The post-2005 government has taken up activities and roles in the economy, which are even more varied and extensive than those undertaken by the first government under the package of liberalisation during 1978-82. The ratio of government expenditure to GDP during 2005-09 showed a mildly increasing trend from the low levels it reached in 2002-04 but a significant degree of caution has been exercised by authorities, so that the budget deficit was kept around 7-8 percent. The 2011 budget statement shows that this caution will characterise government budgeting and fiscal management even after 2010.

Yet, the large public sector investments on planned and implemented infrastructure projects make the government to raise large loans. Having graduated to a "lower middle income" position in the well-known World Bank country classification, Sri Lanka does not any more have ready access to development assistance funds in the form of grants and cheap and easy-repayment loans from the donor community. Financing of the "economic war" is increasingly getting dependent on project-based funding from bilateral country sources among which neighbouring Asian countries have a more dominant presence than the Development Assistance Committee (DAC) countries in the Organisation for Economic Co-operation and Development (OECD). In addition, the government has developed the practice of raising funds in the international capital markets by means of sovereign bonds. As reported in the Central Bank Bulletin of July 2010, Sri Lanka's total outstanding debt stock at the end of April 2010 stood at Rs. 4,282.8 billion (90 percent of 2009 GDP), of which, domestic and foreign components were respectively Rs. 2504.8 billion and Rs. 1,778.1 billion. It has been reported that the average annual gross borrowing during the five years 2005-09 was Rs. 638 billion. As it happens in any debt management situation, part of the newly-raised loans is utilised to service the outstanding debt by making the due interest and amortisation payments. Debt service payments have been regular and on time.

The loans taken for recurrent and capital expenditures have to be repaid. The bulk of these loans are used to finance the public sector investment programme, and are therefore, expected to add to GDP and to government revenues in the time to come. It is clear that the repayment of past loans as well as funding annual recurrent expenditures requires buoyancy of tax and other revenues of the government. The downward trend in government revenues in general, and in tax revenues in particular, since 1990 has to be reversed. Certain changes in taxation introduced in June 2010 have produced favourable impacts in the revenue raising effort. Further improvement in revenues may be expected as a result of the future tax and tax administration reforms that are likely, whose initial steps have been already announced in the Budget 2011. The acceleration of GDP growth resulting from present-day investments is likely to help this revenue enhancement process as economic growth and revenue buoyancy generally go hand in hand.

Taxable capacity of developing countries is considered relatively weak. Sri Lanka's tax capacity, however, was strong enough two decade ago to raise as much as 20-25 percent of GDP in government revenues. With reforms in tax policy and tax administration, reaching that revenue level again without causing adverse repercussions on incentives, is within the domain of feasibility. In the Sri Lankan context, there is another significant favourable factor in this regard. If correct policy measures and management reforms are introduced using the current political strength of the government, Sri Lanka has a large public enterprise sector that can potentially contribute significantly to revenues. As a result of policy inaction for decades, this sector has now become a liability on

Table 2 : Tax and non-tax revenue, 2005-2009

Year	Tax revenue Rs. Bn.	Percent of GDP		Tax/Revenue (%)	Composition of tax revenue	
		Tax	Non-tax		Direct taxes	Indirect taxes
2005	337	13.7	1.8	89	15.6	84.4
2006	428	14.6	1.7	90	18.6	81.4
2007	509	14.2	1.6	90	21.1	78.9
2008	586	13.3	1.6	89	21.6	78.4
2009	619	12.8	1.7	88	22.5	77.5

Source: CBSL, *Annual Reports*.
Ministry of Finance and Planning, *Annual Reports*.

Table 3 : Structure of tax revenue, 2005-2009

Source	2005	2006	2007	2008	2009
Tax Revenue	**100**	**100**	**100**	**100**	**100**
Taxes on income	15.6	18.6	21.1	21.6	**22.5**
Personal	4.5	5.1	3.2	4.0	**4.6**
Corporate	7.4	8.7	10.9	10.9	**10.8**
Tax on interest	3.6	4.8	6.9	6.7	**7.2**
Taxes on production and expenditure	84.4	81.4	78.9	78.4	**77.5**
General sales tax & value-added tax	41.2	38.4	36.8	34.8	**27.7**
Selective sales taxes	22.9	21.8	19.0	17.2	**15.8**
Cigarettes	7.9	7.0	6.2	6.4	**6.1**
Liquor	4.8	4.8	4.7	4.7	**4.6**
Petroleum	5.4	4.3	3.4	3.2	**3.7**
Other	4.8	5.7	4.8	2.9	**1.4**
Import duties	13.5	12.3	11.0	10.9	**12.9**
Licence fees	0.5	0.4	0.4	0.3	**0.5**
Stamp duties/ Social responsibility levy	0.1	0.7	1.4	4.0	**13.3**
Tax on treasury bills/ Debit tax	1.7	1.5	1.4	1.4	**1.3**
Port and airport development levy/ RIDL	3.3	4.9	5.6	5.9	**6.0**
Export duty/ Cess levy	1.3	1.4	3.4	3.9	-

Source: Central Bank Annual Report

government finances. But, through effective corrective action and necessary management reform, most of these enterprises can be converted to at least break even conditions, and some to conditions of profitability. Those which offer neither option, which probably are very few in number, could be closed down with long-term benefits to all. Potential for improvement of the country's revenue capacity and actually collected revenues are thus significant. If this is done, the wider and more strategic economic role that the government has taken over will contribute significantly to the acceleration of socio-economic development.

Development and Structural Change in Taxation

Economic development in the framework of a market economy leads to certain changes in the composition of tax revenues. At low levels of development, the tax structure is bound to have a bias toward concentration in indirect taxes. Taxes charged on goods passing through the national border often occupy the dominant position among these indirect taxes. Prior to 1990, conditions in the pattern of taxation in Sri Lanka were of this nature. With GDP growth and corresponding institutional changes, the composition of taxation changed but certain patterns continue to operate even today.

Of total government revenue in Sri Lanka, 88-90 percent comes from taxation (Table 2). The dominant share of government tax revenue consists of indirect taxes, generating as much as three fourths of the tax total (Table 3). In the early part of the post-independence period, customs duties, more or less equally divided between export and import duties, formed the dominant share of these indirect taxes. The composition of indirect tax total has changed significantly over time. Customs duties and other foreign trade taxes are not at all insignificant even today, but they have lost their earlier dominant position in the total tax revenue. Dependence on export taxes was reduced in line with the export promotion policies after 1977, before export duties were almost totally abandoned in 1993. The process of trade liberalisation led to reduction in import duty rates, and correspondingly, import duty revenues as well. About 10 percent of Sri Lanka's tariff lines are at zero duty level and there are various schemes of Customs duty exemptions as well. In addition, a significant volume of revenue was foregone as a result four preferential trade agreements - Asia Pacific Trade Agreement (APTA), Indo-Sri Lanka Free Trade Agreement (ISFTA), Pakistan Sri Lanka Free Trade Agreement (PSFTA) and South-Asian Preferential Trade Agreement (SAPTA)/ SAARC Free Trade Area (SAFTA). All these contributed to the drop in the significance of foreign trade taxes in total tax revenue. Currently, the dominant position within indirect taxation is occupied by the value-added tax (VAT) and the excise duty. These two forms of tax yielded in 2009, 36 and 20 percent respectively of total indirect tax revenues. This pattern is likely to

remain until the relative significance of direct taxation improves in line with economic development.

The larger share of the volume of tax revenue in most of the developed countries in the world comes from direct taxes, that also predominantly from income taxation. Direct tax revenue in Sri Lanka – personal and corporate income tax and taxes on interest income – increased in absolute real terms since 1990. Direct taxes also grew relative to indirect taxes, so that direct tax revenue as a percentage of total tax revenue increased gradually from 12 percent in 1990 to 23 percent in 2009 (Table 3). Future buoyancy of tax revenues will depend significantly on further increase in the relative size of direct taxes.

Economic development, by increasing personal and corporate incomes, would expand the tax capacity of the economy. Mere economic development, with no action on the part of government in the spheres of tax policy and tax administration, however, is unlikely to enable the government to use this expanding tax capacity effectively. Even at present, the available tax capacity is under-utilised. Similarly, the increasing tax capacity created by any future income growth may continue to be under-utilised, if necessary reform action is not undertaken. Tax policy and tax administration reforms are needed, on the one hand, to improve voluntary compliance among tax-liable individuals and entities, and on the other hand, to enhance effectiveness and efficiency of enforcement mechanisms thereby minimising tax evasion and avoidance. The tax collection capacity of revenue authorities in Sri Lanka today is limited, and to increase their tax collection capacity, these agencies have to be modernised by infusing modern technology into them and improving their institutional and management conditions.

Taxation and Investment Incentives

The critical role, which capital formation, covering both physical and human capital, plays in economic development is uncontested. During the entire post-independence period in Sri Lanka, the elected governments in the country provided varied packages of incentives to promote capital formation. Policies like free education from primary school to university education, scholarship and bursary programmes for undergraduate and graduate education, part of the latter in foreign universities, maintenance of a system of technical education, support for a variety of research organisations and so on were an integral part of the structure of incentives created and maintained to support human capital formation for economic development. While recognising the significance of the structure of support measures and incentives for investment in human capital, this section of the essay focuses only on the structure of incentives maintained in respect of private sector investments in physical capital.

A multifaceted framework of incentives, provided by the government, were available in Sri Lanka to apply sometimes generally throughout the economy and sometimes, selectively in favour of priority sectors. General measures included public investment for infrastructure development, subsidisation of costs of production, establishment of development finance institutions, publicly-funded R&D (research and development) activities, import protection through tariffs and other measures, development of investment promotional institutions, numerous tax-based incentives and so on. At different times, these incentives promoted a variety of economic activities oriented toward import substitution or export promotion. General or selective investment incentives operated in regard to agriculture and fisheries, manufacturing industry, housing and various service activities including tourism, information technology and so on. The focus in this essay, however, is on investment incentives offered via tax holidays and exemptions as well as various other tax benefits under the Inland Revenue, Customs and Board of Investment (BOI) laws. Tax incentives have been the major form of investment incentive used widely after the policy reforms of 1977 to promote foreign direct investments (FDI) in the country. Under the Foreign Investment Advisory Committee (FIAC – prior to 1978) and the Greater Colombo Economic Commission (GCEC – 1978-92) regimes as well as, the BOI regime (since 1992) tax incentives of various forms have occupied a significant position in the incentive schemes articulated to promote FDI inflows. Tax incentives figured prominently in the incentive packages used to promote modern industry in rural regions remote from Colombo, e.g., the 200 Garment Factory Programme in the early 1990s.

Opinions vary on the subject of the efficacy of tax holidays and exemptions in the promotion of private investments in general and FDI in particular. In the present-day-globalising environment, there is tax competition among countries trying to attract multinational companies (MNC) which are constantly shifting business premises across national borders. Tax incentives in the form of lower tax rates, tax holidays, accelerated tax allowances for spending on capital assets, subsidies, relaxation of regulations, absence of withholding taxes and so on are playing a role in this tax-based competition among MNCs. Bribery and corruption also plays a role. There is tax evasion and tax avoidance among companies, and tax havens in different countries impose problems for countries without such tax havens. The weight of opinion in the global empirical literature as well as among policy circles, however,

appears to be in favour of the contention that, if the general investment climate is conducive to investment, then tax holidays and exemptions are of no critical value in an investment promotion package. Indeed, in the not so conducive investment climate in pre-2009 Sri Lanka, these tax measures may have played a role in attracting into the country whatever FDI that came in during that period. But in comparison to some countries in neighbouring Asia, Sri Lanka's performance as a location for FDI has been rather weak, in spite of attractive tax incentives.

In addition, the extensive use of tax holidays and exemptions had the undesirable effect of contributing to the drop in government revenues experienced in Sri Lanka since 1990. The developmental implications of this drop in revenue to GDP ratio were significant. In so far as extensive use of tax holidays and exemptions contributed significantly to this revenue drop, whatever benefits they produced in terms of promoting investments in a not-so-conducive environment in the past, must be netted against these ill effects of the revenue drop.

There is a clear policy redirection today as pronounced in the Budget Speech of 2011 presented to Parliament on November 19, 2010. In this Speech, the President mentions disapprovingly of "... what successive governments have done ... (in) offering costly tax concessions...." and provides the clear indication of the following policy re-thinking: "A skilled labour force, political stability, a low-tax regime and efficient government institutions to facilitate investment must be the basis of our investment promotion strategy".[3] In respect of taxation, then it would basically be a low-tax regime that would form an essential ingredient of the incentive regime in the time to come.

Guiding Market Forces through Taxation

Fiscal policy has been used at different times by governments in every country to influence sector-wise and regional patterns of distribution of production activity. Sri Lanka has been no exception to this rule. Fiscal policy action implies here, on the one hand, action involving government expenditures and transfers and on the other hand, action involving measures of taxation. In the process called "late development" every country in the world has used customs duties and other foreign trade taxes to provide protection to nascent domestic economic activity. Competition against domestic products coming from those of more developed countries was so brought under restraint and control. The method adopted here was to use foreign trade taxes in selective and differentiating manner in respect of different groups of imports. Almost every country in late development contexts has historically used this method to provide protection to infant industry. Import substitution in agriculture and industry has been practised widely in every initial spurt of development – in both developed and developing countries. Protection from competitive imports was part of such import substitution strategies. When used selectively, on a strictly time-bound basis and monitored against productivity growth of domestic industry, import substitution turned out to be a successful development strategy in many countries.

Historically in Sri Lanka, during the first decade or so of independence, the import substitution process was in food crops, mainly paddy. Fiscal policy measures most widely used here were current and capital expenditures of the government as well as transfers in the form of subsidies. It was in the post-1960 policy of import substitution in manufacturing that tariff measures (plus direct import controls) were widely used to provide protection to nascent domestic industry. While the overall results of this import substitution policy in manufacturing were discouraging, its contribution in the early stages of the economy's process of diversification – which provided the foundation for subsequent industrial and entrepreneurial growth – should not be underrated.

Policy thinking today is strongly influenced by the three decades-long experience of market-oriented policies since 1977 in which export orientation of economic activity has come to be valued to a great extent as the secret of developmental success. The country's unpleasant experiences of the process of import-substitution industrialisation in the 1960s and the 1970s also produce a significant influence on current policy thinking. Pressures of globalisation and policy influences of international organisations promoting free trade in the world – the World Trade Organisation (WTO), the IMF and the World Bank – are very strong. Free trade agreements signed with some important trading partners also militate against any practice of a policy of protective tariffs. The use of foreign trade taxes to protect domestic industry from competitive imports is not generally favoured today although there is evidence of the occasional use of these taxes for this purpose.

More abundant are the examples of foreign trade taxes used during the last five years to protect and support domestic market-oriented food crops like paddy, onions, potatoes and so on. Tariffs on competing imports were pushed up at domestic harvest times. Tariffs were pulled down when domestic products were in short supply, threatening large price increases in the domestic market. Such manipulations of foreign trade taxes have had the objectives of ensuring a fair and stable price to domestic crop producers. These tax manipulations were abundantly supported by many other measures,

which were perhaps more important than the tariff measures. Through all this, the government has been able to raise domestic production of non-export agricultural crops and also incomes of farmers and other workers engaged in these activities. As these crops became profitable, they began to attract the interest of the corporate agri-business as well. There was some expansion in large-scale cultivation of domestic market-oriented crops by corporate agri-businesses during this period.

Taxes can be and have been used to achieve other similar objectives as well. During different times, different sectors in the economy have become priority sectors in terms of government policy. More favourable tax treatment has been a widely-used method to promote such priority sectors. Many examples of differential use of taxation to promote identified sectors can be cited from the Budget Speech for 2011. In order to promote exports, the income tax rate on companies engaged in the production of goods for export has been kept at a lower level than the average corporate rate. Similarly, favourable tax treatment has been accorded to companies in other priority sectors like tourism. Fisheries industry has been exempted from income tax for a period of five years. Commodity exports in raw and semi-processed form were subjected to a cess and exports of finished goods only were made free from this cess. The intention here has been described as "to encourage value-added exports". Under the strategic investment law and income tax laws, special tax incentives were provided to large "strategic" investments and to investments in targeted priority sectors. Duties and taxes on machinery, equipment and raw materials were reduced to enable domestic enterprises to have affordable access to world-class technology. The Budget Speech for 2011, intending to set the environment for rapid economic development, is replete with many such examples of the intended use of taxation to guide market forces. Many similar cases can be cited from the past fiscal experience of Sri Lanka where differential tax rates were used to encourage the priority, and to discourage the non-priority activities in the economy. Not all these measures of the past produced the favourable results as desired and in future too, the results of tax measures introduced to guide market forces will be mixed. Still, everywhere in the world, differential taxation will continue to be part of the armoury of weapons available to policymakers to influence the process of a country's economic development.

Taxation has been used almost everywhere in the world to adjust income distribution patterns produced by market forces. As a country with long social democratic traditions, Sri Lanka has practised a system of progressive income taxation with the steepest progressivity found, perhaps, during the early 1970s. The country had indeed recorded a gradual decline in the degree of income inequality until 1973. Progressive income taxation was a major factor, among many others, behind this equalising tendency, which however got reversed during the post-1977 period of liberalised markets.

Perhaps, as part of the same social democratic tradition, there was also favoured-tax treatment of weaker producer segments of the economy. Over many years, Sri Lanka has practised a policy of promoting small and medium enterprises (SMEs) and self-employment activities, irrespective of what production sectors they belonged to. Many policy instruments have been used for this purpose – cheap credit through government-owned financial institutions or through Central Bank refinance schemes, technical assistance and market promotion programmes and so on. Most such fiscal programmes of promoting SMEs and self-employment activities involved targeted-government expenditures. Insofar as income tax measures were used for this purpose it was either tax exemption or lower taxes. Self-employment activities have generally been in the informal sector. Many of these units would not have reached tax-threshold level of income. In any case, tax authorities would encounter numerous difficulties in bringing the informal sector entities into the tax net. Thus, those in self-employment have not generally been in the practice of paying income taxes. In addition to income tax measures, the government has often manipulated foreign trade taxes to help the small sector of the economy.

Relatively lighter taxation of faster growing sectors of an economy may be justified when viewed from the growth promotion objective of tax policy. From the point of view of the revenue objective of taxation, however, such growing sectors of the economy ought to be subject to heavier taxation. The trade-off between the two objectives therefore, may have to be handled with caution. In the 1980s when Sri Lanka was promoting the garments sector for export, it was heavily tax-favoured. By the end of that decade, this sector had achieved a mature stage. The enterprises involved, particularly those with foreign direct investments, however, continued to be favoured in respect of Customs and income tax treatment. The government of any country which assists and promotes an industry in its growing stage would expect that industry to become a significant contributor to revenues at a later stage with maturity and high profits. The industry could thus compensate for the revenues, which the government had forgone at an earlier stage on its behalf. If this happens, the government could begin to identify and help new growth industries. There are cases of industries in Sri Lanka, which are

continuing to enjoy tax benefits, including generous tax holidays, for over decades. The original agreements these industries would have signed with authorities would have provided for tax benefits only over a short period like five years. Extension of their tax incentive periods, often without limit, cannot be justified on developmental arguments.

Another developmental aspect of tax policy is that it can be used to influence the level and distribution of production activities, employment and investment in different regions of the country. In countries with federal constitutions, the sub-national States enjoy some independent powers of taxation. In such countries, therefore, tax types and rates may vary from one State to another. The use of tax policy to influence the State-wise distribution of production and employment is therefore most widely practised in countries with such federal constitutions. In a country like Sri Lanka, the Provincial Councils, working in tandem with the central government within constitutional limits, might be able to create differential tax conditions in different Provinces, thereby, influencing the Provincial distribution of the aggregate investment that is taking place in a given period. Patterns of taxation can thus be used to make different regions differently attractive to investors. Although there is, today, some interest in promoting investment in some regions (for example, the north and the east) at a more rapid rate than in other regions, there is no significant evidence so far of actual use of tax policy for this purpose.

Conclusion

Tax policy of a democratic polity is guided by several socio-economic objectives – revenue collection, income redistribution, macroeconomic control, protection of industry, economic growth, restraining undesirable elements of consumption and so on. Similarly, there are several principles of taxation – e.g. equity, progressivity, simplicity, efficiency and so on. These objectives and principles of taxation are not always mutually compatible. If they were, the government's tax policy decisions would become simple and easy. In reality, however, when a tax measure is implemented with a given objective in mind, it will have adverse effects on other similarly-desired objectives. When tax holidays and exemptions are granted as investment incentives, the revenue objective and as a result, many other desirable government expenditures are sacrificed. The other difficulty is that although it is widely contended that close (positive or negative) relationships exist between taxation and certain micro or macro variables, the reality may not always support such contentions. Tax holidays, exemptions and other tax incentives appear significantly in any investment incentive package. An acceleration of national investment is the result of a multiplicity of factors described in terms like economic, political, social, cultural and so on. In such a scenario, tax-based investment incentives would not, by themselves, be able to produce the desired acceleration of investment and growth. Such complexities operate in regard to other objectives of taxation as well. This is what makes the political economy of taxation as complex as it is.

The choice of the system of taxation best suited to meet the demands of development is thus one of the most complex issues in politics. There is no one-size-fits-all framework here. It is also worth noting that, although a "good" tax system may not necessarily accelerate economic growth, a "bad" tax system is most likely to stifle it. Even the best tax policy is unlikely to yield much revenue in the absence of growth. If economic growth takes place in a sustainable manner, there will be expansion of government revenues, which can be used to provide many services, education, health, communication systems and so on, which would lead to development. Most such services, however, would not produce much government revenues. In a scenario of such complexity, the choice of a tax structure that is both development-friendly and revenue-productive and its successful administration would depend as much on good luck as on informed and clever decision making.

References:

Nicholas Kaldor (1963). "Taxation for Economic Development", *The Journal of Modern African Studies*, I:1, pp. 7-23

J.F.J Toye (ed.) (1978). *Taxation and Development*. London: Frank Cass

Alex Cobham (2005). *Taxation Policy and Development*. Oxford Council on Good Governance

Richard Bird (2010). *Taxation and Development*, World Bank

Footnotes:

[1] The American revolutionary slogan "no taxation without representation" implied that rulers tax citizens, and citizens demand accountability from their rulers.

[2] This also means that taxes are levied to address externalities. Tobacco is taxed, for example, to discourage smoking.

[3] Quotations from the Budget Speech 2011 are from the text of the speech published in the Internet at www.treasury.gov.lk/docs/budget2011/budgetspeech2011-eng.pdf

■

Indirect Taxation in Sri Lanka: The Development Challenge

Kopalapillai Amirthalingam[1]

Senior Lecturer, Department of Economics, University of Colombo.

Abstract

Sri Lanka is seeking rapid economic growth targeting at doubling per capita income by 2016. Nonetheless, inequality is at its historical highest and thus the development challenge is to ensure that rapid economic growth is achieved while better ensuring equitable income distribution. Since fiscal deficit is significantly high in Sri Lanka, taxation is crucial in generating government revenue because of the harmful macroeconomic repercussions of other means. However, tax ratio is on the decline and the decline is closely related to the decline of the indirect tax revenue. Therefore, enhancement of indirect taxation is vital. Efficiency and productivity of VAT should be improved while taking measures to ensure equity. This will be an important development challenge to the country.

Introduction

Development can be defined as economic progress shared by all, and is particularly so if one focuses on sustainable development. Sri Lanka is seeking a rapid economic growth after ending the thirty-year old civil war. The current target is to double per capita income from the current level of USD 2053 to USD 4106 by 2016. Inequality, as measured by the Gini coefficient however, is at its historical highest, 0.49 in 2006/2007, compared to 0.43, 0.46 and 0.48 in 1978/79, 1986/87, and 1996/97 respectively. Thus, the development challenge is to ensure that rapid economic growth is achieved while better ensuring equitable income distribution. Taxation, *inter alia*, can be used as a tool to ensure such income distribution across geographical demarcations and income deciles.

In the past three decades, a number of developing countries have experienced major episodes of financial crisis that were brought about by unsustainable fiscal deficits. As in the case of a number of other developing countries, the fiscal deficit in Sri Lanka too has been high for a long period. Though the fiscal deficit was at its peak at 23 per cent of GDP in 1980, it averaged 13 per cent during 1977-1991 and 9 per cent during 1992-2009 (Central Bank of Sri Lanka). However, even a 9 per cent deficit could be a dangerous phenomenon as it could act as a catalyst for financial instability in the country. For example, Brazil's financial crisis in 1999 was closely related to its high budget deficit, which was 8.4 per cent of its GDP (Woo, 2003). When government revenue is insufficient to offset expenditure, the country is forced to depend on foreign and domestic sources to bridge the fiscal deficit. As a result, government's debt as a percentage of GDP (Gross Domestic Product) rises. High levels of debt in turn will increase the pressure on the government's ability to meet its other commitments. This is of particular concern when these commitments involve essential and development-oriented expenditure. Government borrowing also tends to reduce the quantum of resources available to the private sector and results in higher interest rates in the domestic market. This will increase the cost of borrowing for the private sector, thereby crowding out private investment, adversely affecting the economic growth of the country. This situation necessitates comprehensive policy measures either to reduce expenditure or to increase the revenue base of the country, so that the government need not depend overwhelmingly on debt. However, given the security situation and the need for rapid development of the country, expenditure cuts could be harmful not only economically, but also politically.

Therefore, focusing on taxation is crucial since alternative ways of financing government expenditure, such as, money creation, mandating larger required reserves, domestic borrowing and foreign loans can have harmful macroeconomic repercussions. International empirical evidence on tax ratio (total tax revenue as a percentage of GDP) has 40 per cent, 25 per cent and 18 per cent as the average tax ratios for high-, middle- and low-income countries respectively (Gallagher, 2005). Nonetheless, tax ratio in Sri Lanka has been declining and remains well short of the average rate of developing countries. It is important to note that the tax ratio has declined from 21 per cent in 1979 to 12.8 per cent in 2009. Indirect tax as a percentage of GDP has declined from 15.7 per cent in 1980 to 9.9 per cent in 2009. During the same period, as a percentage of GDP, direct tax has also declined marginally, from 3.1 per cent to 2.9 percent (Central Bank of Sri Lanka). Here, we can notice that the decline

of tax ratio has been closely related to the decline of indirect taxes as a percentage of GDP.

Thus there is a need, as well as room to increase the tax ratio in Sri Lanka because increasing tax revenue as a percentage of GDP is vital for the economic development. Lewis (1984) argues that an increasing share of tax revenue in national income or in GDP is an instrumental objective of economic development policy. High-income countries have had rising shares of tax revenue and government expenditures to income as they have become more economically advanced. Similarly, comparison among countries at different levels of per capita income generally show higher shares of government expenditure and tax revenue in national income of higher-income countries than in poor countries. There appears to be a relative increase in the demand for government services as per capita income increases. At very low levels of per capita income, the principal needs are for "private" goods, such as food, clothing and shelter. The income elasticity of demand for those products falls as per capita income increases, and there is an increased demand for "public" goods at higher levels of income. The increased demand is for government services in the areas of transportation, communication and general government administration, to deal with increased complexities. Further, the demands for certain welfare services and transfer payments to various poorer sections of the population are felt much more strongly at higher levels of per capita income than at lower ones. All these pressures to increase the level of government expenditures and transfer payments generate a need to increase tax revenue to release real resources for the provision of these government services. In addition to general government consumption expenditure, the governments of developing countries usually wish to increase development-oriented services such as education and training, agricultural extension and research. Thus, government revenue may need to grow at a rate that exceeds the growth of national income to provide resources for recurrent government expenditure. As a result, countries are constantly trying to formulate a better tax policy and frequently reforming their tax structure with a view to increasing tax revenue.

Though the main target of a country is to increase total tax revenue, indirect and direct taxes play different roles in developing and developed countries. Developing countries tend to rely on indirect taxation as a revenue source, since such taxes are easier to administer in countries that have poorer income and asset recording systems. High direct taxes are also thought to discourage entrepreneurship and effort, and hence lower direct tax rates are proposed in a bid for greater economic growth. Thus clearly, the growth in tax revenue has to be largely through the expansion of indirect taxation. However, since indirect taxes act as regressive taxes in which the tax burden may fall on everyone equally, regardless of their income (or ability to pay), further enhancement of the indirect taxes might aggravate the equity concerns encompassed in the development objective. This necessitates indirect tax reforms to be sensitive both to equity and growth objectives in the country.

Defining Indirect Taxation

Indirect taxation is defined as taxation that may be imposed upon the persons other than those who are intended to bear the final burden. Unlike direct taxes, indirect taxes are the same for all, irrespective of the income level of the consumer and are therefore regressive. These taxes imposed on producers, can be shifted on to the consumers by way of increasing the price of goods and services. The most important single fact about indirect taxes in developing economies is the dominant role that they play in the revenue system of almost every country. Historically, indirect taxes have been an important element in stabilisation tax packages that aim at raising revenue in the short run in many countries.

Musgrave (1969) divided the period of economic development into two: the early period when an economy is relatively underdeveloped and the later period when the economy is developed. During the early period, there is limited scope for the use of direct taxes because the majority of the populace resides in rural areas and is engaged in subsistence agriculture, and therefore their incomes are difficult to be estimated. Therefore, indirect taxes play an important role during the early stage of economic development. The difference in direct and indirect tax shares in developed and developing countries confirms Musgrave's theory. He further states that the ratio of indirect taxes to total taxes is related inversely to per capita income, because the economic structure of low-income economies is not suited to the imposition of direct taxes. The following Table clearly shows the difference between Sri Lanka and some developed countries, such as, Canada, New Zealand and Australia and even some other developing countries with regard to the capacity for raising tax revenue through direct taxes (Taxes on income, profits and capital gains).

Table 1, shows that Sri Lanka has raised less revenue from direct taxes (taxes on income, profits and capital gains). This indicates that even in contrast to Thailand, Malaysia, India and Kenya, Sri Lanka has relied excessively on indirect taxation. Other countries have expanded their direct tax

Table 1: Taxes on income, profits and capital gains (% of total taxes) in selected countries

Country	1990	1992	1994	1996	1998	2000	2002	2004	2006	2007	2008
Sri Lanka	**12**	**14**	**15**	**16**	**14**	**15**	**17**	**15**	**19**	**21**	**21**
Canada	72	71	71	73	74	76	72	74	77	77	..
New Zealand	..	..	..	..	..	..	62	62	67	66	..
Australia	..	..	..	..	..	75	67	70	..	..	..
Thailand	..	..	..	..	..	..	..	39	44	45	48
Malaysia	43	47	44	46	60	55	62	..	..	..	..
Korea, Rep	40	40	39	37	41	38	37	41	44	46	..
India	19	23	29	30	32	36	38	43	47	51	52
Pakistan	13	18	21	20	29	28	31	28	28	38	37
Uganda	..	..	..	..	15	16	21	25	27	28	27
Kenya	..	29	33	40	38	33	33	36	39	40	42

Source: World Development Indicators—Not Available

revenue proportion over time significantly unlike Sri Lanka, which began from a lower base and has grown more slowly. Given the regressive nature of indirect taxation, the tax structure is likely to be detrimental to Sri Lanka's progress towards the achievement of social and economic justice. While a major development challenge is to shift the Sri Lankan tax system more towards direct taxation, given the current fiscal deficit problems, it is also important to focus on improving the earnings from indirect taxation in a manner that is least regressive.

Efficiency and productivity of the VAT

Value-Added Taxes (VAT) can be defined as a tax on the value that is added to goods and services by enterprises at each stage of the production and distribution process (Shoup, 1988). After the first adoption in France in 1954, VAT has indeed proved itself an effective form of taxation and its growth is unprecedented by any other concept in taxation (Keen, 2007; Ebrill *et al*, 2002; Keen and Lockwood, 2009). Moreover, the VAT has now become a central tool of tax policy in most countries, with the exception of the United States. The extent and pace of the spread of the VAT around the world has been one of the most striking international tax developments in recent history. Tax development in the world as well as the successful experience of other countries with different tax systems, induced Sri Lanka too to shift from Business Turnover Tax (BTT,1964-1981) to Turnover Tax (TT,1981-1998) to Goods and Services Tax (GST,1998-2002) and finally to Value-Added Tax (VAT, 2002). In Sri Lanka, the VAT involves a multiple rate structure. Apart from zero rate and exemption, there was a 10 per cent concessionary rate and a 20 per cent standard rate when the VAT was introduced in 2002. Subsequently, there were changes almost every year with regard to the rates. At present, VAT rates adopted in Sri Lanka are 20 per cent luxury rate, 12 per cent standard rate, 5 per cent optional rate, zero rates for exports and exemption for specific items (Government of Sri Lanka).

In Sri Lanka, the VAT has contributed 35.7 per cent to total indirect taxes in 2009. Since VAT plays a pivotal role in the entire indirect tax system, it is important to examine the efficiency and productivity of VAT.

VAT efficiency (sometimes called 'C-efficiency') and productivity are the two indicators used to measure the collection efficiency of VAT in many countries. The efficiency is the ratio of the VAT revenue to aggregate consumption, divided by the standard VAT rate. The productivity is the ratio of VAT revenue to GDP, divided by the standard VAT rate. The closer these ratios are to zero (one), the lower (higher) the collection efficiency of the VAT (Bird and Gendron, 2006; Aizenman and Jinjarak, 2008; Ebrill *et al.*, 2002 and Correia, 1999). The VAT could be the most productive source of revenue for developing countries. To achieve this objective, its efficiency and productivity must be high.

According to Table 2, the efficiency in Sri Lanka does not show a clear trend: it increased from 0.40 in 2003 to 0.61 in 2004 but after 2004

Table 2: Efficiency and productivity of VAT in Sri Lanka

Year	Efficiency	Productivity
2003	0.40	0.27
2004	0.61	0.38
2005	0.55	0.38
2006	0.55	0.37
2007	0.52	0.35
2008	0.44	0.31
2009	0.46	0.30

Central Bank of Sri Lanka (Various Annual Reports) and Government of Sri Lanka (publications with regard to Value Added Tax Act and subsequent amendments)

there has been significant decline till 2008 and then a slight improvement in 2009. The efficiency of the VAT in the world varies country to county. For example, it is very high in some countries (Jamaica: 0.93 and Canada: 0.67) and very low in others (Brazil: 0.16 and Argentina: 0.27) (Bird and Gendron, 2006).

VAT collection efficiency can be improved with the resources spent on enforcement, and with the efficiency of monitoring, collecting and processing information. Theory suggests that the enforceability of taxes is impacted by political economy considerations - greater polarisation and political instability would tend to reduce the efficiency of tax collection, reducing the resources devoted to tax enforcement. In addition, collection is impacted by structural factors that affect the ease of tax evasion, like the urbanisation level, the share of agriculture in GDP and trade openness (measured as the ratio of imports plus exports to GDP). Empirical studies on several countries show that both urbanisation and trade openness will be significantly and positively related to the tax collection efficiency but in contrast the share of agriculture in GDP will be negatively correlated to the tax collection efficiency. So with the prevailing peaceful situation in the country, it is necessary to have meaningful industrialisation and trade liberalisation with increased resources devoted to tax administration, efficient monitoring, and better usage of modern information technology (MIT) to enhance VAT collection efficiency in the coming years.

If we look at the productivity of VAT, not only is it relatively low, but it has been declining during the period 2004 and 2009 (Table 2). This figure presents the percentage of GDP that each percentage point of the standard VAT rate collects. Therefore, we can conclude that Sri Lanka has collected just 3.6 per cent of GDP in revenue from VAT. The revenue productivity of the VAT in the world is as high as 0.70 (for New Zealand) and as low as less than 0.20 for some countries. Within Latin America the range in productivity varies from around 0.20 (in Haiti, Mexico and Venezuela) about to 0.50 (for Chile and Ecuador) (Bird and Gendron, 2006). To improve the level of revenue productivity of the VAT, total revenue from VAT as a percentage of GDP should be increased. To achieve this goal, government can take many measures including;

i) more taxation on the growing economic sectors (e.g. - mobile phones),

ii) heavier taxation on income-elastic items (e.g. - vehicles, petroleum products),

iii) bringing informal economic activities into tax net, and

iv) heavier taxation on price-inelastic items (e.g. - alcoholic beverages and tobacco products).

If Sri Lanka manages to improve the productivity of VAT, it can ensure greater government expenditures for development objectives. However, the country faces challenges here too, because VAT has clearly not achieved its greater revenue-generating objective; this may be due to several reasons such as its complicated structure, administrative weaknesses, political influence, tax avoidance and evasion, complexities in the tax law, lack of application of modern information technology, etc. VAT, in fact, has performed worse than the previously adopted Business Turnover Tax in terms of revenue generation. However, compared to turnover taxes, VAT is an ideal tax to address the equity concern, because unlike turnover taxes, there is no cascading effect under VAT and zero rate and exemption of essential goods can be used effectively to achieve the distributional objective under VAT. Moreover, VAT is more equitable than turnover tax because under VAT, the tax rate is clearly specified and as a result there is no hidden element in tax.

Impacts on equity

Equity is, of course, a central issue in taxation almost everywhere. Equity in taxation implies that taxes should be imposed in accordance with the ability to pay. Equity normally has two dimensions: horizontal and vertical. Horizontal equity holds that taxpayers with equal income should pay equal taxes regardless of the source or nature of that income. Vertical equity means that taxpayers with greater ability to pay should pay more (Musgrave, 1976; Musgrave and Musgrave, 1989; Plotnick, 1982). A good tax system must be both equitable and efficient. It is widely recognised that these goals may conflict. Efficient taxes may be inequitable in their effect on the distribution of income. On the other hand, equitable taxes may not be efficient taxes. Efficiency demands that necessities should be taxed more heavily than luxuries. This is of course the opposite of what one would hope for from the equity point of view. Therefore, it is argued that distributive (equity) policies are implemented at a cost in efficiency in almost all countries.

Theory suggests that if a country does not have a well-developed, effective and optimally- adjusted income tax and transfer system to tackle equity concerns with the direct tax system, indirect taxes should be differentiated to incorporate the distributional consideration in addition to the usual efficiency concerns (Stern, 1987). That is why most countries tend to keep many essential goods and services - which are largely consumed by the poor disproportionate to their income - out of the tax net by the ways of zero rate or lower rate or exemption. Furthermore, there is a common

argument that equity could be improved by the greater use of food subsidies accompanied by much higher taxes on luxuries and alcoholic beverages and tobacco products. Indeed, alcoholic beverages and tobacco products are not beneficial for either their users or for society and could actually be harmful, especially for the consumer and the family, and therefore it is argued they could be heavily taxed with no ill effects. Further, since they have less elasticity, they provide a better basis for taxation than most other commodities. Therefore, in practice, different rates are imposed on different goods to ensure equity under VAT. With the view addressing equity concerns, higher tax rates are imposed on alcoholic beverages, tobacco products, petroleum products and other luxuries in Sri Lanka too.

According to the theory, the VAT provides a potentially more equitable and efficient means of taxation. In practice, under the VAT, different mechanisms are adopted to address the equity concern. Hossain (1995) notes that a selective VAT with some zero ratings (or exemptions) and additional excise is clearly preferable to a completely uniform VAT, if distributional issues are of dominant concern. Ahmad and Stern (1987) indicate, in a study in India, that a uniform VAT on all final goods is clearly regressive and undesirable. However, they conclude that a uniform VAT with exemptions or zero rates on certain items to allow for "distributional consideration" is much less regressive than a proportional VAT. Therefore, it is true that greater equity can be achieved under VAT using zero rating and exemption.

Conclusion

Even though the primary focus of Sri Lanka is to achieve a rapid economic growth rate in the coming years and to double per capita income by 2016, the country should take comprehensive measures to reduce the over dependency on indirect taxes in the long run and should continue to address the equity concern by way of zero rating and exemption under VAT. The major consumption basket (such as food, milk powder, pharmaceuticals, etc.) of low-income group should not be taxed even indirectly. At the same time, comprehensive measures should be taken to improve the efficiency and productivity of the VAT. Only then will the country be able to harness its indirect tax system as an instrument in attaining sustainable development. In fact, this will be an important development challenge to the country.

References:

Ahmad, E, and Stern, N., (1987). "Alternative sources of government Revenue: Illustration from India, 1979-80," in the theory of taxation for developing countries, ed. By David Newbery and Nicholas Stern, Oxford: Oxford University Press for the World Bank.

Aizenmana, Joshua and Jinjarak, Yothin, (2008). "The collection efficiency of the Value Added Tax: Theory and international evidence" The Journal of International Trade & Economic Development. 17(3): 391–410.

Bird, Richard M. and Gendron, Pierre-Pascal, (2006). "Is VAT the Best Way to Impose a General Consumption Tax in Developing Countries?" ITP Paper 0602, International Tax Program, Institute for International Business, Joseph L. Rotman School of Management, University of Toronto, Toronto, Ontario, Canada.

Central Bank of Sri Lanka (Various Issues), Annual Reports, Central Bank of Sri Lanka, Colombo.

Correia, Isabel H., (1999). "On the Efficiency and Equity Trade-Off", Journal of Monetary Economics, 44:581-603.

Ebrill, L., M. Keen, J-P. Bodin, and V. Summers, (2002). "The Allure of the Value-Added Tax". Finance and Development 39(2): 44-47.

Gallagher, M. (2005). 'Benchmarking Tax Systems'. Public Administration and Development 25:125-144.

Government of Sri Lanka (Various Issues) Publications with regard to Value Added Tax Act and subsequent amendments), Government Publication Bureau, Colombo.

Hossain, Shahabuddin M., (1995). "The Equity Impact of the Value-Added Tax in Bangladesh". Staff Papers-International Monetary Fund 42(2):411-430.

Keen, M. and Lockwood, B., (2009). "The Value Added Tax: Its Causes and Consequences". Journal of Development Economics Doi:10.1016/J.Jdeveco.2009.01.012

Keen, M., (2007). "VAT Attacks!". International Tax and Public Finance 14:365–381.

Lewis, S.R. (1984). Taxation for Development: Principles and Applications, Oxford University Press.

Musgrave, R. A. (1969). Fiscal System. New Haven: Yale.

Musgrave, R. A., (1976) "Optimal Taxation, Equitable Taxation and Second-Best Taxation". Journal of Public Economics 6: 3-16.

Musgrave, R.A and Musgrave, P. B., (1989) Public Finance in Theory and Practice, McGraw, Singapore.

Plotnick, Robert, (1982). "The Concept and Measurement of Horizontal Inequity". Journal of Public Economics 17: 373-391.

Shoup, Carl, (1988). "The Value Added Tax and Developing Countries". The World Bank Research Observer 3(2):139-156.

Stern, Nicholas, (1987). "The Theory of Optimal Commodity and Income Taxation: An Introduction," In The Theory of Taxation for Developing Countries, ed. by David Newbery and Nicholas Stern, Oxford University Press.

Woo, J. (2003). 'Economic, Political, and Institutional Determinants of Public Deficits'. Journal of Public Economics 87:387–426.

Contact Details:

K. Amirthalingam,
198 A, Wasala Road,
Kotahena, Colombo-13.
TP: 0777411547
Email:kamirthalingam@econ.cmb.ac.lk

Footnote:

[1] I am grateful for the constructive comments made by Prof. Amala de Silva.

Provincial and Local-level Revenue Assignment in Fiscal Decentralisation in Sri Lanka

Asoka Gunawardena

Formerly Chairman, Finance Commission.

Sri Lanka, in 1988 through a constitutional amendment, devolved responsibility for providing "public services" to Provincial Councils. While there existed a system of local government established by law providing public services at the local level, provincial councils constituted a radical departure in the provisioning of public services. They were hitherto, nationally defined, sectorally oriented, and delivered through local-level agents accountable to the centre. Creation of an intermediate tier of taxing and spending established a system of multi-level governance in Sri Lanka.

Assigning Revenues for Service Provision Responsibilities under Decentralisation

The case for devolution of power to sub-national levels rests on their ability to understand better and address more efficiently the differing needs of regions and communities on account of their proximity to them. This would thereby enable more responsive provision of public goods and services and foster greater efficiency in the allocation of resources. The matching of public functions with appropriate levels of decision-making power and responsibility for the provision of public services constitutes the framework for fiscal aspects of devolution. Then devolution provides the governance mechanism through which the delivery of public services can be designed to meet the needs of the people.

In a system of multi-level government, the assignment of subjects between the different tiers follows the simple principle[1] of which level is in a better position to carry them out in a more responsive and hence more efficient manner. Importantly, the principles of decentralisation also suggest that fiscal resources available to each level of sub-national government should be proportional to the share of the level in the public sector expenditure burden. The choice of the appropriate structure of fiscal resources (comprising a mix of taxes, user charges and transfers) should be open to choice depending upon the spending responsibilities of the tier of government.

Usually, the question of spending responsibilities precedes the question of how resources are to be generated to pay for spending. However, these decisions cannot be separated one from the other. It is generally argued that the financing of decentralisation should follow "benefit pricing" or benefit taxation.[2] The assignment of tax revenue in multi-level governments can follow three options, where local jurisdictions collect all taxes and transfer some revenue upwards for the national level to meet its spending responsibilities, national government collects all taxes and transfers revenues adequate to meet spending responsibilities at the local level, or assigning to the local level some taxing powers and complementing, if necessary, local revenue with grants transferred from the national government.

Revenue Assignment at Provincial and Local Levels

The purpose of local taxes is to finance locally-provided public services to local residents. Then the assignment of revenue to sub-national entities should enable each level of government and each entity within each level to finance its own budget independently on its own criteria, in packaging the bundle of public services to meet the needs and preferences of the citizens living within the jurisdiction. The principles of decentralisation assert that the assignment of public expenditure powers to provincial and local levels must be matched by adequate finances to meet such needs.

The financing of decentralisation takes place within the framework of the 13th Amendment to the constitution. The following are the core constitutional provisions:

i. Assignment of expenditure and revenue powers in terms of the Provincial List in the Ninth Schedule to the Constitution.

ii. Guarantee of the allocation of funds from the annual budget to meet the needs of the provinces.

iii. Apportionment of such funds between the Provinces on the basis of principles formulated by the Finance Commission in terms of

the following criteria set out in the constitution:

(a) The population of each province;

(b) The per capita income of each province;

(c) The need, progressively, to reduce social and economic disparities; and

(d) Progressively reduction of the differences between the per capita income of each Province and the highest per capita income among the Provinces".

Provincial Revenue Assignment

Provinces are assigned with a large number of tax and non-tax revenue sources shown in Box 1.

However, the provincial tax base is miniscule. It is noteworthy that the sources with any significant potential, such as, turnover taxes on wholesale and retail sales, motor vehicle licence fees, and taxes on mineral rights, are within such limits and exemptions as may be prescribed by law made by the parliament. Further, taxes on land and buildings including the property of the State and any other taxes within the province to raise revenue for provincial purposes are only to the extent permitted by the parliament. Thus, provinces can not act on the revenue powers assigned by the constitution without approval of the parliament. At the same time, provinces cannot introduce any new revenue measures. Thus, provinces are severely constrained in mobilising revenues.

Provincial revenue collections in 2004 and 2008 are shown in Table1.

Table 1: Provincial Revenue Collection (Rs millions) by Source in 2004 and 2008

Source	2004	%	2008	%
Business Turnover Tax	5,912	44.38	16,641	53.04
Motor Traffic Fees	1,668	12.53	2,812	8.96
Excise duty	259	1.95	467	1.53
Stamp Duty	3,761	28.23	6,023	19.19
Court Fines	579	4.35	1,054	3.35
Other	1,140	8.56	4,373	13.94
Total	13,319	100	31,370	100

Source: Finance Commission Annual Report, Ministry of Provincial Councils

Box 1: Tax and non-tax Revenue Sources of Provincial Governments

1. Tax	36.1 Turnover taxes on wholesale and retail sales 36.2 Betting taxes 36.5 Dealership licence taxes on drugs and other chemicals 36.17 Taxes on lands and buildings including property of the State to the extent permitted by Law 36.18 Taxes on mineral rights within limits and exemptions as prescribed by Law 36.20 Other taxation within the province in order to raise revenue for provincial purposes to the extent permitted by Law
2. Duties	36.6 Stamp duties
3. Fees and Charges	36.3 Toddy tapping licence fees and liquor licence fees 36.4 Motor vehicle licence fees within such limits and subject to such exemptions as may be prescribed by Law 36.8 Fines imposed by courts 36.9 Fees charged under the Medical Ordinance 36.10 Fees charged under the Motor Traffic Act 36.11 Departmental fees in respect of any of the matters specified in List I 36.12 Fees under the Fauna and Flora Protection Ordinance 36.13 Fees on lands alienated under Land Development Ordinance and Crown Lands Ordinance 36.14 Court fees, including stamp fees on documents produced in Court 36.15 Regulatory charges under the Weights and measures Ordinance 36.16 Land revenue, including the assessment and collection of revenues, and survey and maintenance of land records for revenue purposes 36.19 Licence fees on possession, transport, purchase and sale of intoxicating liquors
Non-Tax	
1. Rents	36.3 Arrack and toddy rents

Source: The 13th Ammendment to the Constitution:

While there are twenty items of revenue assigned to provinces, only three sources account for as much as ninety percent of total revenue. These are Business Turnover Tax on wholesale and retail sales, Motor Traffic Fees and Stamp Duty and Court Fines that are collected and transferred to local government authorities. While provincial revenue collections have improved significantly (by 30%) during the last five years, the respective shares of the provinces have remained relatively unchanged. Business Turnover Tax remains the main source of own revenue accounting for as much as half of all revenue collected. Therefore, despite the large number of sources assigned, the tax assignment to provinces under the Thirteenth Amendment is weak and ensuing revenues are low by any standards.

The provincial revenue structure has remained unchanged over the past two decades of fiscal devolution continuing to mobilise less than a fifth of expenditure needs at current levels of service delivery. Provinces collect less than 0.5% of GDP (gross domestic product) suggesting that the overall tax effort is inadequate. Provinces have been constrained in their tax operations by the limits of revenue assignment and inability to make any policy changes within those limits due to the failure on the part of the centre to have engaged the provinces in tax harmonisation.

Local revenue assignment

Local government bodies have a range of tax powers. The respective legislation establishing local government bodies; Municipal Councils, Urban Councils and *Pradeshiya Sabhas* empowers them to take necessary action to ensure that adequate revenue generation takes place to provide the services that they are required to provide. The revenues of local authorities are usually classified into own revenue and contributions and allocations of funds by government. Box 2 shows the sources of own revenue assigned to local authorities.

Box 2: Revenues Source of Local Government Authorities

1. Tax	Assessment Rates, Vehicles and animal tax, Entertainment tax
2. Duties	Stamp duties
3. Fees and Charges	Licence fees,Court fines,Public performance fees, Service charges, Warrant costs
Non-tax	
1. Rents	Rents
2. Miscellaneous	Tolls, Building application forms etc.

Source: Local Government Acts and Ordinances

The significance of the above sources of local revenues is different according to the type of local government body. Thus, for Municipal Councils and Urban Councils, the main source of revenue is the assessment rates or the property tax. For *Pradeshiya Sabhas*, 'the main source of revenues will be the rents on commercial stalls and *polas*. Local government authorities have greater control over their revenue in terms of the revision of rates. In fact, local government authorities must revise assessments and rates of levy on a regular basis to follow the appreciation of property values resulting from urbanisation through enhanced service provided. Further, *Pradeshiya Sabhas* are required to declare built-up areas to be able to levy property rates in order to generate revenues for further investment. The major complaint is that they do not do so.

Other sources of revenue include financial allocations received from central and provincial sources, especially the Decentralised Budget allocations of the Members of Parliament. The overall position in regard to the shares of the different sources of revenue of Local Authorities for 2003 and 2008 are set out in Table 2.

Table 2: Receipts (in Rs million) of Local Government Authorities in 2003 and 2008

Source	2003	%	2008	%
Rates	2,726	22.16	3,514	13.41
Other Revenue	3,351	27.25	6,650	25.40
Stamp Duty	1,261	10.26	3,842	14.67
Government Transfers	3,311	26.92	6,241	23.83
LLDF Borrowings	330	2.69	362	1.39
Other Receipts	1,319	10.72	5,578	21.30
Total	12,301	100	25,804	100

Source: Finance Commission Annual Report, 2004 and Provincial Councils.

(Data on revenue and expenditure for LAs are not available in a complete data set. Data for two years is presented for comparative purposes and 2003 and 2008 are years for which data is available)

Transfer of resources to meet imbalances

The design of the fiscal framework for devolution to provinces results in a significant shortfall in revenue over expenditure. The revenue-expenditure gaps at central, provincial and local levels are given in Table 3.

Thus, overall provincial revenue accounts for 22.7% of total expenditure. The revenue-expenditure gap varies from approximately 40% in Western Province to as much as 95% in North Central Province. This makes provinces heavily dependent on central government financial grants to meet their expenditure needs.

Table 3: Revenue-expenditure Gap in Rs millions in 2008

	Revenue	Expenditure	Gap	%
Central	699,388	945,247	245,859	26.1%
Provincial	23,915	101,173	77,258	77.3%
Local	14,020	23,894	9,874	41.4%
Total	736,603	1070,314	333,711	31.2%

Source: Government Budget Estimates and Ministry of Provincial Councils.

As already noted, the constitution guarantees the allocation of funds from the annual budget to meet the needs of the Provinces. The deficit is financed through transfer of resources from the centre through allocation of funds annually from the central government's budget (Box 3).

Financial transfers to provinces constitutes an annual cycle. The grants structure does not provide for equalisation of fiscal capacity between provinces making the Provinces dependent upon centre, thereby giving the Centre financial control over the Provinces. Nor is it designed to take account of provincial relativities either of norms or costs. The Criteria-based Grant alone incorporates socio-economic indicators that allow provincial disparities in development to be taken into account.

While the constitution guarantees allocation of funds to meet the needs of provinces, consultation and recommendation of the Finance Commission, as is constitutionally required, is not mandatory and the final decision rests with the Government, i.e., the Ministry of Finance. The decisions by the government regarding the allocation of funds from the annual budget have not been based on a sharing of service provision responsibilities and have followed imperatives of central requirements that are increasingly incorporating service delivery programmes in devolved subjects and functions.

The financial transfers to local government authorities are as follows (Box 4).

For most local government authorities, central government transfers (referred to as revenue grants) reimburse the costs of salaries and wages of staff, which is, on average, about 25% of their total income. For small local government authorities with limited revenue capacity, the share of central transfers can increase up to half of their total income. The other external sources of income, such as, allocations from Decentralised Budget (DCB) are also significant, especially for *Pradeshiya Sabhas*. They account for about 10 per cent of income of local government authorities.

External sources of finance thus become a significant factor in financing of local government authorities. Amounts vary from around 45% for Municipal Councils, 60% for Urban Councils and as much as 77% for *Pradeshiya Sabhas*. Borrowings do not figure

Box 3: Financial Transfers to Provinces

1. Block Grant	An un-conditional block transfer to meet assessed recurrent expenditure needs of Provinces. The need is estimated on the basis of the gap between the assessed recurrent expenditure for the Financial Year and revenue collection target set for the year.
2. Criteria-based Grant	A formula based block grant for development expenditures of Provinces. Provincial index is calculated on the basis of a set of indicators reflecting per capita income and socio-economic disparities and the population of each Province.
3. Matching Grant	A formula based block grant to reward revenue collection effort of Provinces. The grant is computed on the basis of the excess of actual collection of revenues in a given year against a "benchmark revenue" being revenue collected in a base year. (This grant has since been discontinued)
4. Province Specific Development Grant	A conditional grant to finance an infrastructure development programme in specified areas of provincial services.

Box 4: Financial Transfers to Local Government Authorities

1. Revenue Grant	Reimbursement of allowances of members and salaries and wages of all officials holding positions approved by the Department of Management Services.
2. Other receipts	Allocations to local authorities from programmes funded by the centre (especially the Decentralized Capital Budget) and province.

Source: Author's tabulation.

prominently in the finances of local government authorities. Thus, it is to be noted that local government authorities with a weak fiscal base are becoming increasingly dependent upon central government transfers for meeting the salaries and wages of staff and have little fiscal space to provide services in a meaningful scope and extent.

Borrowing Powers

Both, provincial councils and local government authorities are vested with borrowing powers. In the case of provincial councils, borrowing is subject to approval of the parliament and enabling legislation has not been passed. Local government authorities are vested with borrowing powers and borrow from the Local Loans and Development Fund (LLDF). As indicated in Table 2, borrowings constitute an insignificant source of local government authority financing.

Issues of Provincial and Local Tax Systems

Devolution of power under the 13th Amendment gives only limited autonomy to provinces in terms of setting rates, adopting comprehensive tax bases and establishing an efficient and credible revenue administration. On the other hand, the 13th Amendment guarantees the existing powers of local government authorities and thereby the powers in regard to taxation under the respective laws establishing them. There are several issues in regard to the provincial and local tax systems.

Issues of Design

In an efficient provincial and local tax system, the vertical transfers from the central government should be to supplement own resources for financing provincial and local public services. However, as indicated in Table 3, the revenue-expenditure gap of the provinces in 2008 stood at 77.3%. In 2003, the vertical gap stood at 82.5%. While the reduced gap reflects improvement in tax effort, it would seem that revenues are supplementing grants rather than the other way about. In the case of local government authorities, the revenue-expenditure gap has increased marginally from 40.4% in 2003 to 41.4% in 2008. (Finance Commission) The revenue situation in respect of local government institutions is better than that of the provincial councils.

There are several design issues in the system of fiscal decentralisation that account for the weaknesses in the revenue position of provinces and local authorities.

i. The meagre sources assigned, as far as provincial councils are concerned, provide a narrow tax base. As noted above, only four of the sources assigned to provincial councils yield substantial revenue. All the "other" sources accounted for approximately 14% of total provincial revenue, up from 8.5% in 2004.

ii. Absence of incentives for exploiting full potential. In the case of provincial councils the tax revenues are deducted from the Block Grant. The Matching Grant that was introduced incentivise revenue collection was never honoured fully by the government in the allocation of transfers to make any sense as an incentive to enhanced tax effort. In the case of local authorities grant for the reimbursement of allowances of members and salaries and wages of staff removes any incentive to enhanced tax effort. Indeed it can have perverse incentives.

iii. The exclusion of Business Turnover Tax (BTT)[3] did not make for good design of consumption tax implemented through Value Added Tax (VAT), making for discontinuity in the tax system. It made for a separation of manufacturing from wholesale and retail trade making for tax on tax as well as evasion. The exclusion of the wholesale and retail trade from VAT along with the long list of exemptions of many unconventional items results in substantial tax evasion and erosion of tax base. Thus, in addition to the list of items excluded from BTT, the exemption of a range of local goods and services, such as, tea, rubber, gems and tobacco, have prevented provinces from exploiting potential tax bases.

iv. Some of the revenue sources assigned to provinces do not accrue to them. Stamp duties and Court fines must be collected and passed on to local government authorities. It is important to note that stamp duty and Court fines constituted 20% of total collection in 2008.

v. There is considerable variation across provinces in the tax collection performance both in terms of per capita collections and as a percentage of GDP.[4] However there is no provision for equalisation in fiscal capacity.

Issues of Practice

i. *Low level of voluntary compliance:* At the provincial and local levels, there is a low credibility in the revenue departments due to low levels of voluntary tax compliance on the one hand and fewer cases being taken to the Courts system. There seem to be a system of agreed assessment wherein taxpayers generally escape payment of heavy penalties on detection of defaults. The system would tend to bring about collusion between the tax payers and tax officials.

ii. *Less efficient tax administration:* Yet, much of tax functions in the provinces are undertaken manually. Provinces are yet to introduce a meaningful threshold limits for registration and

Contd. on page 33

Environmental Taxation

Dr. U. A. D. Prasanthi Gunawardena

Department of Forestry and Environmental Science, University of Sri Jayewardenepura.

Introduction

The integration of environmental concerns into economic growth and development policies has emerged since the 1970s. During the 1970s and 1980s, environmental policies in many industrialised countries were based primarily on a system of regulations. During this period, however, it became increasingly evident that such regulatory environmental policies have little success in addressing new environmental pressures which demanded a shift in environmental policy and a search of new economic instruments.

Since the early 1990s, many European countries initiated widespread use of economic instruments in controlling pollution. Apart from the increasing levels of pollution, the political reform process that was driven with the aim of becoming more effective and efficient has lead to the widespread adoption of economic instruments. Environmental taxes can guarantee that efficiency objectives are achieved with least costs. The tax provides a price signal to consumers and producers to change their behaviour.

Rationale for Environmental Taxes

An environmental tax is defined as: "any compulsory, unrequited payment to government, levied on tax-bases deemed to be of particular environmental relevance", where the tax bases include energy products, motor vehicles, wastes, measured or estimated emissions, natural resources, etc. (OECD, 2006).

Conventional command and control instruments impose mandatory restrictions on the behaviour of polluting industries and individuals. However, environmental taxes incentivise individuals or industries to change their behaviour. Pollutants are by-products in the production of intended final output. The quantities and types of pollutants depend on many factors (such as type and quantity of goods, technology and inputs used), and taxes could be applied on any of such factors. The level of the environmental tax should reflect the cost of the environmental externality it intends to address (Pigou, 1932; Baumol, 1972).

A tax can alter a producer's pollution control strategy. Figure 1 shows the marginal cost (MC) and marginal benefits (MB) of pollution control.

Marginal cost curve is upward sloping since each incremental unit of pollution control costs more and more to achieve the next incremental level of environmental quality. Marginal benefit curve is downward sloping since each incremental unit of control provides fewer and fewer incremental benefits to the society. The socially optimal level of control is where the marginal cost equals the marginal benefit of control (point A). Usually, the producer has no incentive to invest in this optimal level of control since he is able to earn higher profits by setting the level of pollution control at zero. The producer's behaviour could be changed by imposing a pollution tax (a constant rate per unit emission) T = MB = MC.

Now the producer has two options:

1. to invest in pollution control where the total control cost is equal to area of OAP*

2. to pay the tax, where the total payment is equal to OTAP*

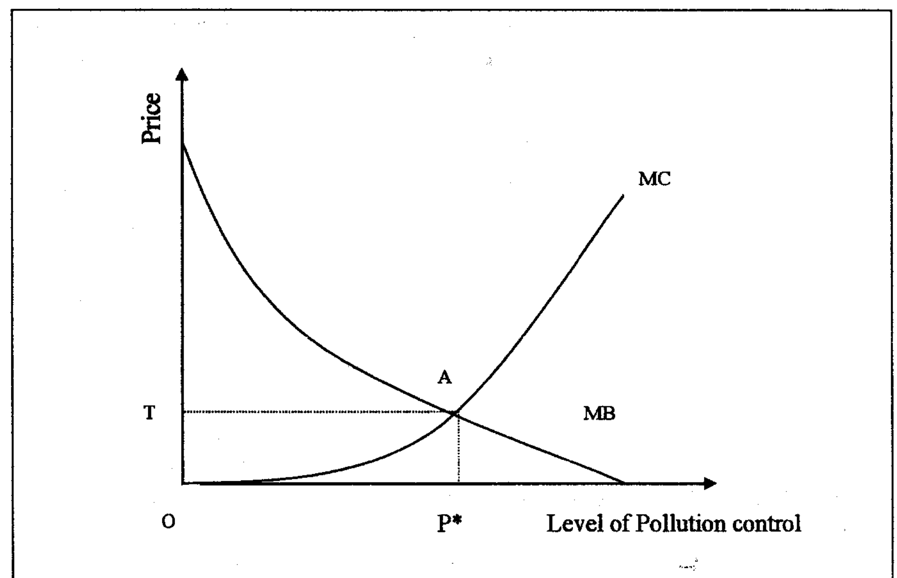


Figure 1: Socially optimal level of pollution control

Up to the point A, it is more profitable for the producer to invest in pollution control than to pay the tax. The tax provides the incentive for the producer to increase his level of pollution control until his privately optimal level of control equals the social optimum, MC = MB. Such optimal taxes are known as Pigovian taxes (Hanley *et al.*, 1997). The environmental tax 'internalises the externality' by inducing the pollution generator to behave as if pollution costs entered its private cost functions (Perman *et al.*, 2003).

There are several advantages of environmental taxes. Environmental taxes induce innovation among producers, since it pays them to develop new products and processes to reduce their tax liability, thus resulting economic as well as environmental benefits. The revenues from taxes can be used for either to improve the environment or to reduce other taxes or to correct undesirable distributional effects.

However, in practice, valuing complex environmental effects is quite difficult, and therefore, the estimation of marginal benefits of pollution control (or damage functions) and calculating the optimal tax levels also have been daunting tasks (Baumol, 1972). Alternative approaches, therefore, have been proposed which involves choosing environmental standards on the basis of their effects on environmental or human health, and then to bring levels of environmental damage down to the standards using environmental taxes on an iterative basis. Such environmental taxation could achieve the desired environmental improvement at minimum cost to the society (Ekins, 2009).

Classifying Environmental Taxes

There are different types of taxes; taxes that recover costs, incentive taxes and revenue- raising taxes. The level of a *cost-recovering tax* is determined by the service it is intended to deliver (for example treating the waste water) or the other purposes to which its revenues will be put (for example, general water treatment). *Incentive taxes* are levied purely with the intention of changing environment-damaging behaviour, and without any intention to raise revenues. The level of an incentive tax can be set at the optimal level where the marginal cost and benefit are equal. If it is not possible, tax can be used as an instrument to achieve environmental objectives set according to other criteria (for example, environmental sustainability. *Revenue-raising taxes may, in addition,* yield substantial revenues over and above those required for related environmental regulation. Such revenues may be used to shift the reliance on income. The latter approach is called an environmental or green tax reform (Ekins, 2009; Ekins & Speck, 2008).

Environmental Taxation in Sri Lanka

In managing natural resources, Sri Lankan government complements regulatory approaches with market-based instruments. The first example of environmental taxes in Sri Lanka was introduced through Environmental Conservation Levy Act No. 26 of 2008 which empowers the Minister of Environment and the Minister of Finance and Planning to impose taxes on specific commodities and services provided within Sri Lanka which are likely to have harmful impacts on the environment. The revenue generated under the Act is remitted to the Environmental Conservation Levy Account of the Consolidated Fund and to be invested on environmental management and conservation in Sri Lanka.

According to the provisions of the said Levy Act, environmental conservation levy was imposed on mobile phones due to the hazardous e-waste generated. The order No.03 of 2008 imposes a levy of 2% calculated on the value of the services supplied and to be supplied by the licensed cellular operators (for the use of a mobile phone) (Gazette of the Democratic Socialist Republic of Sri Lanka No. 1559/10 dated 22.07.2008). It is expected that the revenue generated from this tax has to be invested on e-waste management in the country.

Potential Applications of Environmental Taxes in Sri Lanka

It is possible to apply environmental taxes in many sectors related to environment and natural resources in Sri Lanka. The need for environmental taxation and a review of some studies that could guide environmental taxation in Sri Lanka are given below:

i. Taxes on renewable and non-renewable resources

Renewable and non-renewable resource products: Export taxes are being applied for many renewable and non-renewable resource products; Indonesia taxes palm oil exports; Madagascar applies tax on vanilla, coffee, pepper and cloves; Russia uses export taxes on petroleum, while Brazil imposed a 40% export tax on sugar in 1996. The EU imposed a $32 per tonne export tax on wheat in 1995 (Suranovic, 2009).

The need for taxing unsustainable resource harvesting is increasingly recognised. It has become evident that the majority of commercially-exploited fish stocks globally is fully exploited or overexploited (FAO, 2007). In addition, majority of fishery resources harvested is not subjected to any scientific monitoring. Flaaten and Schulz, (2010) investigated the applicability of policy instruments to mitigate fishery resource degradation within the framework of a two-sector

general equilibrium model and found that a positive export tax could increase both GDP and the resource stock. The study further confirms that externalities arising from aquaculture including the damage of mangrove forests and the aquatic pollution could also be reduced by an export tax also on such resource goods.

Taxed export of renewable resource goods could lead to higher domestic consumption and income than with free trade. For example, the increased GDP (due to exports) could facilitate the import of substitutes for the good, e.g., cheaper fish in place of expensive fish. This may give a distributional advantage for the poor (Flaaten and Schulz, 2010).

Fisheries and coastal resources: Coastal fishery in Sri Lanka accounts for 91 percent of the total fish production and contributes to about 2 percent to the GDP. However, fishery resource is subjected to over exploitation and the coastal fish catch has exceeded the maximum sustainable yield by 11,015 tonnes in year 2002 (MENR, 2008).

There are few charges that are operational in the fishery sector in Sri Lanka. The import of fish and other related articles of the fishery sector is subject to an import duty of 10 percent. River sand mining is one of the main reasons for coastal erosion which reduces the supply of sediment that stabilise the shoreline. An administration fee of Rs 50 per m^3 has to be paid for extracting sand.

Implementation of a tax system in the fishery sector has to be done with caution. Additional burden on the existing coastal fishing could lead to a gross reduction of the coastal fishery. Instead, an allocation system would be suitable to control the overexploitation beyond the sustainable capacity. It is proposed to establish a fishing limit for each region or fishing area on scientific basis at the community level. Any community that exceeds the limit could be charged a fee (MENR, 2008).

Resource extraction (renewable and non-renewable resources): In Sri Lanka, non-renewable resources, such as, rock phosphate and dolomite extraction presently requires a royalty payment. A similar scheme could be proposed for the renewable resources such as timber. Although the Geological Survey and Mines Bureau of Sri Lanka leases land for mining of various non-renewable resources, such as, mineral sands, mica, graphite, dolomite, limestone, silica and quartz, the revenues collected are very low. For example in year 2006, this value was about Rs 130 million. It is recommended, therefore, to increase such royalty payments to reflect the true resource costs both to present and future generations and the environmental damages resulting from the extraction operations (MENR, 2008).

ii. Taxing soil erosion

Soil erosion imposes substantial economic costs to many tropical developing countries in terms of both on-site effects in hilly lands and off-site effects on hydropower generation and irrigated agriculture. Off-site effects are typically externalities to the people who are generating soil erosion. It has been estimated that annual on-site losses range between 0.5 and 1.5% of GDP in countries such as Costa Rica, Malawi, Mali and Mexico (World Bank, 1992). Annual soil erosion-induced costs ranged between US$ 90—125 per hectare in Sri Lanka and the annual cost is about 1% of GDP (Somaratne, 1998 cited in Bandara *et al.*, 2001).

Bandara *et al.*, (2001) examined the impact of different instruments, such as, tax/subsidy measures on erosive/less erosive crops and land tax on the level of soil erosion using a Computable General equilibrium model for Sri Lanka. The results indicate that, although such instruments were capable of achieving significant soil erosion abatement, they may result in different impacts on other policy goals such as national income. The importance of taxing soil erosion, however, could not be ignored and the need to study this issue further is emphasised.

iii. Tax on land degradation

In Sri Lanka, agricultural and industrial activities, such as, tobacco cultivation, gem mining and construction activities lead to land degradation, including soil erosion, land slides, drainage and flooding problems. MENR (2008) proposes a cess on the export value of gems and a tax based on the square area of building under construction. It has been estimated that a cess on 3% of the value of gem exports could generate about Rs 250 million to recover the environmental damages. A similar tax on the square area of the buildings constructed could generate funds for compensating the damages.

In addition, tobacco cultivation in many areas in the country, including those in upland areas, causes land degradation. In addition, cigarette smoke contributes to air pollution, and increase health risks and medical treatment costs. If a cess is levied on the excise tax paid by tobacco producers, cigarette manufacturers and importers that could be used to mitigate the damages. The excise tax that was collected in 2006 was Rs 30 billion and 1% of that amount to Rs 300 million per year (MENR, 2008).

iv. Energy taxes

Carbon dioxide emitted by different fossil fuels differs considerably. For example, oil products emit less carbon per unit of energy than coal. Natural gas has the lowest carbon dioxide emissions. With a properly-

Table 1: Suggested Cess Rates for Hazardous Chemicals

Hazard level	Cess rate (as a percentage of CIF value)
Extremely hazardous (WHO Class IA)	100 percent
Highly hazardous (WHO Class IB)	80 percent
Moderately hazardous (WHO Class II)	60 percent
Slightly hazardous (WHO Class III)	50 percent

Source: MENR, 2008.

Table 2: Potential Revenue from Agro-chemicals Imported in 2007

Chemical Type	Revenue (Rs million)
Weedicides	2,380
Fungicides	269
Insecticides	1,377
Total	10,301

Source: Gunawardena, 2010

Table 3: National-level Taxes and Levies in the Tourism Sector of Sri Lanka

Type of charge	Rate	Proportion of revenue received by	
		Sri Lanka Tourist Board	Other agencies
Embarkation levy	US$ 15 /air ticket	US$ 5	Air port and aviation services (US$ 5) Treasury (US$5)
Tourism development levy	1 percent of turnover	100 percent	0 Percent
Registration, licence and inspection fees	Rs 500 to Rs 10,000	100 percent	0 Percent
Environmental Protection Licence fee	Rs 750	0 percent	100 percent to Central Environmental Authority

Source: MENR, 2008

designed energy tax, users (both businesses and households) can be incentivised to substitute fossil fuels with less carbon intensive energy sources. With the clear link between fossil fuel energy use and carbon emissions, the tax rate should be designed in such a way that the carbon content of fuels is taxed uniformly.

Siriwardena *et al.* (2007) studied the impact of economy-wide emissions of carbon and energy taxes levied for electricity generation in Sri Lanka. The study used an input–output decomposition technique and analysed four types of effects that contribute to the overall reduction in equivalent carbon, nitrogen oxide and sulphur dioxide emissions. These four effects are: fuel mix effect (i.e., the change in emissions due to variation of fuel mix), structural effect (i.e., change in emissions due to changes in technological coefficients with and without taxes), final demand effect (i.e., the change in emissions associated with changes in final demand) and joint effect (i.e., the interactive effect between or among the fuel mix, structural and final demand effects). The results indicated that the polluting-fuel sources and low-energy efficient technologies are less preferred under these tax regimes. Of the four effects, a change in fuel mix in thermal electricity generation and a change in final demand for electricity were found to be the main contributors in achieving economy-wide emission reductions. It was found in the analysis that a minimum of US$ 50 per tonne of Carbon tax or US$ 1.0/ MBtu (British thermal unit) of energy tax is required to have a significant impact on economy-wide emission reduction in the Sri Lankan context. This translates into an overall increase in electricity generation cost of approximately US$Cts 0.9 per kWh and US$Cts 0.6 per kWh under the carbon and energy tax regimes, respectively.

It was also found that, with the imposition of tax, coal-fired steam plants are replaced with cleaner technologies, such as, oil-fired combined cycle, IGCC (integrated gasification combined cycle), supercritical coal and renewable plants, such as, wind, mini-hydro and dendro-thermal (wood fuel-fired plants) in the future electricity generation plans. Also, the number of plants that are added for power generation is reduced due to the reduction in demand with increased taxes. This means, when a significant reduction in emissions is achieved, it leads to approximately 10–15% increase in average electricity prices. The study concluded that carbon taxes above $50/tC in the electricity sector cause a visible reduction in economy-wide emissions. This value is $1.0/MBtu in the case of energy taxes.

v. Taxes on pesticides

The present import tariff on pesticides in Sri Lanka is not based on any environmental consideration. MENR (2008) recommends classifying pesticides

according to environmental hazard class as defined by the World Health Organisation. Such differentiated tax has been able to reduce the consumption of pesticides and to shift pesticide consumption towards less harmful pesticides in Norway (NCM, 2006). Table 1 shows the suggested cess rates by MENR (2008) for hazardous chemicals in Sri Lanka.

The potential revenue from agro-chemicals imported in 2007 based on the cess rates shown in the Table1 is given in Table 2.

It is intended to achieve several objectives from such a scheme. Funds of such a scheme could be earmarked for integrated pest management activities which reduce the need for chemicals and for promotion of organic farming and eco-labelling programmes. Such programmes would not incur additional costs for the government.

vi. Taxes on Tourism

Table 3 summarises various types of taxes and levies applicable to tourism sector of Sri Lanka.

Tourism development levy is applicable to all private- and public-sector businesses, hotels, service providers, etc. The major part of the revenue of this tax is earmarked for expenditure on State-sponsored activities for tourism development. However, there are no clear guidelines on the utilisation of the funds.

However, a significant part of the revenues collected from the tourism sector goes to the treasury and collections made by the Tourism Board are utilised by the Board and it seems that they are not invested for conservation/protection of the natural resources concerned.

Potential for Environmental Tax Reforms

The concept of an environmental tax reform (ETR) involves shifting the taxes from conventional taxes, such as, those levied on capital, to environment-related activities, such as, taxes levied on resource use or environmental pollution. The main aim of implementing this policy instrument is to ensure that the tax is imposed more on 'bads' than 'goods' by guaranteeing that the price signals provide an incentive to consumers and producers to change their behaviour.

In addition, a tax-shifting programme also intends 'revenue neutrality' which means that the increase in one is balanced by the reduction of the other, guaranteeing that there is no change in the overall tax level at the national level. In addition, ETR is thought to be able to increase human well-being through both economic and environmental pathways –by reducing resource use and pollution, by increasing output, employment and resource productivity, and by stimulating innovation and the development of green technologies. This could be one area that Sri Lanka could investigate the potential application. The existing tax system is fairly outdated and needs revisions immediately.

ETR as promoted by OECD (Organisation for Economic Cooperation and Development) and the World Bank can be an appropriate tool in pursuing environmental goals. Although the underlying principle of an ETR is similar in both developed and developing countries, their actual design and policy goals planned to be achieved may differ widely (Speck and Datta, 2007).

Conclusion

Sri Lanka has many environmental issues which warrant application of environmental taxes. The lessons learnt from other countries and theoretical experiments done in Sri Lanka could guide the successful application of such taxes. Delays in application of resource taxes may lead to depletion of resources beyond their natural regeneration. It is usually accepted that environmental taxes need to be effective in terms of addressing the environmental concerns and raising the revenues. Environmental taxes are being applied in Sri Lanka in various forms at present. It will be important to recognise the various factors limiting the efficacy of environmental taxes in Sri Lanka and addressing them through appropriate institutional, administrative, regulatory and political adjustments.

References:

Bandara J. S. Anthony Chisholm, Anura Ekanayake, Sisira Jayasuriya (2001). Environmental cost of soil erosion in Sri Lanka: tax/subsidy policy options. Environmental Modelling & Software 16, 497–508.

Baumol, W. J. (1972). On taxation and the control of Externalities. American Economic Review, Vol. 62 (3).

Ekins, P. (2009). Theory and Practice of environmental taxation, *In* Green Tax Report, The Chartered Institute of Taxation, available at http://www.greentaxreport.co.uk/ accessed on 27 Oct 2010.

Ekins, P. and Speck, S. (2008). '*Environmental Tax Reform in Europe: Energy Tax Rates and Competitiveness*'. In: Chalifour, N., Milne, J., Ashiabor, H., Deketelaere, K. & Kreiser, L. (eds.) 2008 Critical Issues in Environmental Taxation, Vol.V, Oxford University Press, Oxford, pp.77-105.

FAO (2007). The State of World Fisheries and Aquaculture 2006, Food and Agriculture Organisation of the United Nations, Rome.

Flaaten, Ola and Carl Erik Schulz (2010). Triple win for trade in renewable resource goods by use of export taxes. Ecological Economics, 69, 1076–1082.

Contd. on page 38

Assembling Sri Lanka Inc. - Pragmatism over Ideology

Kenneth De Zilwa*

Abstract

This paper focuses on the current debate that has engulfed many of us in Sri Lanka, how should Sri Lanka Inc. be constituted in its path towards rapid industrialisation and economic prosperity? Many economists, financial market practitioners and theorists have shared their observations in this 'selection process', based on either their personal overseas exposure and experience in other economies, its ideological propositions or on conjunctional thoughts of both exposure and ideology. It is the intention of the author to argue in favour of a country specific 'value creation model' based on the existing ground realities. Doing so requires a sensitive ear and a sensible balance in implementing pragmatic set of policies. I will argue that assembling many economies into one model can be destabilising. Therefore, if we are to usher in a rapid development path, then we need to be pragmatic as opposed to be ideological.

1. Introduction

Adam Smith spoke of division labour in a pin factory, in his thought-provoking idea that took the form of a book, titled "Wealth of Nations" in 1776. The fundamental premise of his book was division of labour, Smith argued that, by dividing tasks into small parts, it would enable greater dexterity of labour and make the sum of the parts more efficient. Back in 1908-1915, Henry Ford pioneered his low-cost Model-T by the novelty of the 'auto assembly line philosophy'. His inspiration had been based on Smith's premise of division of labour in the manufacturing process, which, Ford inherited from studying the meat packaging industry of Chicago in 1867[1].

The idea was a simple but a revolutionary one, intended to speed up the production process and increase labour productivity, in an era of rapid industrialisation and social upheaval and economic transformation of the West. However, none of us would have thought that an assembly line-based concept for an economic model would be part of a country's economic fabric that would be woven into an economic model in the 21st century. The answer is not straightforward or as visible as the Ford model-T manufacturing process, nevertheless it seems an ironical, yes! How so?

The rapid development through industrialisation and integration of economies viz.-a-viz. globalisation, has meant that as we have been locked into a mindset of "West is Best". Whether we like it or not, globalisation of mindset has encroached and encapsulated all countries. There is no escaping the glaring reality! It has also made living without connectivity technically impossible! Access to information has created a borderless society and literally each of us has access to what Thomas Friedman, in his acclaimed book titled 'The World is Flat' (2006), alludes to "world at our fingertips"; by many ways, we have access to high technological apparatus and software, such as, i-pads, satellite phones, skype, face book, tweeter, google chat via wireless mobile web.

Whichever way we consider time and distance between places, cultures, economies or economic policy framework, we find that we are brought together in an instance by a single key stroke, to the reality of 'global inter-facing'. Therefore, globalisation has not only made the world seem flat, it has also been able to shrink its boarders down in size to a single economic manufacturing plant, where many processes[2] are seemingly interlinked.

It is in this context that we find our mindsets aptly conditioned toward adopting our lifestyles and economic behaviour similar to those of other economies. Many of us want our country's——Sri Lanka Inc.'s, new economy model to be based on, and, developed on the principles akin to a multi-model 'assembly line'. Assembling economic parts based on our first hand views, experience, exposures and ideological beliefs of democracy and governance of the US, lifestyles and economic policies of European nations, cost of living of Singapore, economic growth rates of China, per capita income of Hong Kong, and topped with low inflation of New Zealand. This is clearly an 'Alice in Wonderland' adventure.

Empirical experience of many other countries who have moved from 'third world to first world' status

* *Author is associated with Econsult International, an Economic and Financial Market think tank.*

have done so by adopting country-specific development models with a culmination of sound and pragmatic policy framework (Zilwa, 2010). The assembling line of the Ford model-T, is a case in point, as it would suggest that what Henry Ford assembled was 'one single car' with many inter-company contributory skills working in tandem to make Ford-T road worthy. Clearly, it would have not worked if the Ford-T was put together with other companies manufactured car parts. As such, a development model too cannot be based on, another countries-adopted economic policies, thoughts, aspiration, values, or impositions; the basis for a 'multi-nation model' cannot be adopted nor can it co-exist with its national industries and ground conditions. As the adding of many parts of various economic ideological parameters, and the assimilation of other countries policies in our path toward industrialisation, could lead to weak joints and eventual destruction of the vehicle (country) itself.

In order to set out ground conditions in answering this debate, it is important that the focus the central debate that has formed a centrifugal force,

(a) Who controls the World economy and what were their adopted policies?

(b) The paper will also briefly, deal with globalisation, in the context of development

(c) Finally it will argue that 'agriculture is the prerequisite for industrialisation'. By the end of this journey, it is highlighted and argued that "Assembling Sri Lanka Inc." is neither a desirable outcome nor should it be remotely considered. But what is needed for Sri Lanka Inc. is to keep its ear to the ground and "adopt a pragmatic approach to development over ideology".

2. Who Controls the World Economy

2.1 Control over Institutional Power

Since the industrial revolution, much of the world economic activity has been controlled by the western rich countries. Today, they account for more than 80% of world output, conducting 70% of international trade, while channelling nearly 70%-90% of Foreign Direct Investment (Chang, Bad Samaritians-The guilty secrets of rich nations & the threat to global prosperity, 2007). In doing so, the western developed countries have super imposed their economic policies of neo-liberalism, cultural well-being and fastidious lifestyles on less developed countries. One may argue vociferously with this statement, but empirical literature and anecdotal facts speak for itself, authors, such as, Ha-Joon Chang (2007), Joseph Stiglitz (2002), Joseph Stiglitz (2010), Howard Nicholas (2004), Lakshman (1985), and Lakshman (1987), have all highlighted the obvious and shed light on the deep-seated methodology used to break down barriers of developing countries, viz-a-viz 'Institutional Power'.

The institutional powers – International Monetary Fund (IMF), World Bank and World Trade Organisation (WTO) too played their unholy part in the Latin American, South Asia and the East-Asian crises under the pretext of helping out struggling developing countries to come out of macro imbalances (Rodrik, 2002). Many of these policies dished out to developing countries did not find consensus nor did they agree with domestic needs. Nonetheless, they were promoted on the grounds of unconditional global integration (Stiglitz, 2002). This club of 'Institutional Power' seemed to be further strengthened by aligning regional multilateral financial institutions, such as, the ADB (Asian Development Bank), IDB (Inter-American Development Bank) into their fold.

Mooting such skewed development policies through various straightjackets, one size fits all policies ensured domestic economies, and their livelihoods were gradually dismantled in order to promote their own "Free Market is Good" mantra (Stiglitz, 2010). Multilateral institutes also added insult to injury by ensuring that through their financial aid packages guised in the form of Structural Adjustment Programs [SAP], they could wield wider power over regulating government budgets, industrial policy regulation, agricultural pricing, labour markets, and eventually privatisation of domestic assets (Chang, Bad Samaritians-The guilty secrets of rich nations and the threat to global prosperity, 2007). Stiglitz, in his hard-hitting book titled "Globalization and its Discontents" refers to these policies as 'beggar-thy-neighbour policies'. Financial aid as a tool also proved extremely useful as it could influence governance, best practices, and democracy in favour of the financiers who made rules to benefit them (Chang, Bad Samaritians-The guilty secrets of rich nations and the threat to global prosperity, 2007).

It is in this context that we find Sri Lanka has been grappling with Structural Adjustment Program, Poverty Reduction and Growth Fund since 1977, 1989 through to 1993, mainly due to the above-mentioned skewed policies[3]. Dependency on aid for economic growth and financial stability had meant that Sri Lanka could not focus on its ambitious industrialisation plans in 1995. Neither could she find a voice to articulate her own destiny in terms of broader value addition propositions, or in terms of investing in its people or natural resources given the restrictive international trade practices and policies (Lakshman, 1994). The imposition of rules and regulations or covenants to financial transactions can be viewed as a 'necessary evil' to some. However, when a country is subtly forced into accepting retarding credit terms, it does not bring about desirable outcomes, as we have seen and it only serves the ambitions of the lending agency (Chang, 2007). Today China and India form an "Avatar Asian World". The rapidly changing tide in global power and the rise of China and India together with the re-balancing of strategic investment into Asia,

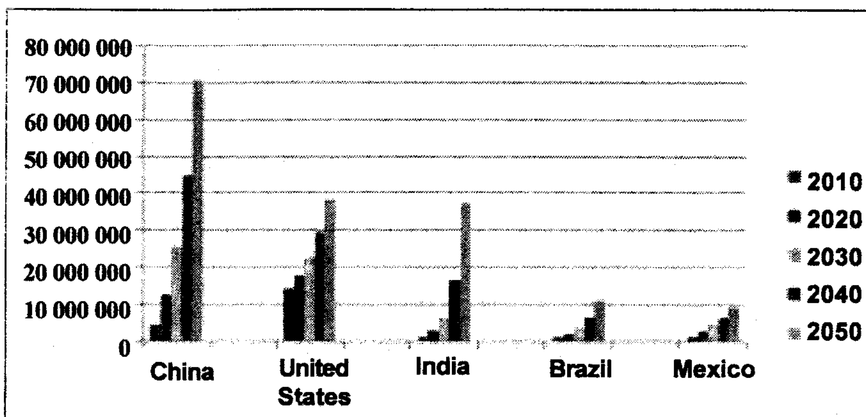


Figure 1: Five Largest Economies in the World by 2050, Measured by Nominal GDP (millions of USD)

Source: Goldman Sachs

dawns a new era in economic development for Sri Lanka Inc.. Figure-1 depicts the shift of economic power, in terms of nominal gross domestic product (GDP) from western countries to Asia. The current nominal GDP of China is USD 4.9 trillion, and is predicted to reach USD 70.6 trillion by 2050 surpassing that of the US, thereby reaching number one economic status. On the other hand, India's current nominal GDP is USD 1.2 trillion, which will become USD 37 trillion by that time and would be behind China[4]. This tectonic shift of 'economic power' and 'institutional power' will also open up brighter alternatives apart from the western frontiers. The perceived growth prospects within the Asian region together with an ever increasing middle class, places Sri Lanka Inc. in an unique position, for it has now an opportunity to reclaim its destiny with the gradual demise and wider acceptance of 'free market is not so good' ideology.

2.2 Interventionist and protectionist policies

What many of us are blinded or fail to realise is that economic history has pointed out that Western developed countries had adopted a variety of strategic interventions policies and also adopted protectionist policies,tariffs in order to give infant industrialist a chance to compete in mature markets. (Chang, Ha Joon, Ilene J. Grabel, 2004, & Chang, 2007). The US,UK, EU, and Japan themselves resorted to selective forms of undemocratic, protectionist, interventionist policies until their own entrepreneurs, farmers and industrialist were strong enough to compete with foreign companies (Stiglitz, 2002). A case in point is the former British Colony - the US. During the period of British rule, Britain banned US-manufacturing companies from using trade tariff to protect its domestic industries, and thus preventing any form of manufacturing or high-technology industries taking root in the US. The British Empire considered US as a mere supplier of raw materials to its thriving Empire and its path toward industrialisation. William Pitt, the UK's Prime Minister, captured this thought process in a statement in 1770 where he was quoted saying, "British Colonies should not be permitted to manufacture so much as a horseshoe nail" (Chang, 2007). The Japanese Government too literally kicked out US-based General Motors and Ford in 1939 and used its funds to bail out Toyota who was venturing into motor cars. Japanese cars, such as, Toyota, Honda, Nissan are today competing thanks to such interventionist and protective measures.

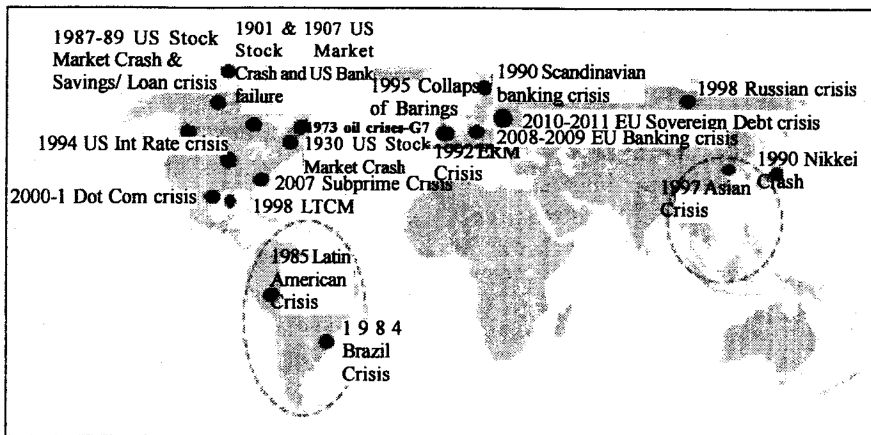
It also a commonly known and documented fact that many European countries, Germany, France, Sweden, Austria, and Finland banned capital flows, which was deemed to create extreme volatility in financial markets until the 1970 (Chang, 2003). Europe was in fear of hot volatile money-creating havoc and wreaking its currencies and fragile economies in their initial stage of industrial development (Stiglitz, 2002). In 1994, the US aluminium industry accused Russia of dumping. In fact, the fall in prices had nothing to do with Russia, nor did they ever engage in dumping. The aluminium cartel created a platform for the US government department of Commerce to impose a special duty keeping out foreign competition (Stjglitz, 2002). In 2005, the US government intervened in a commercial transaction, in what was called 'selling of strategic interest', despite it being deemed as a legitimate financial transaction that involved the changing hands of USD 18.0 billion between the US energy-based company Unocal Corp and Chinese National Offshore Oil Company, thus halting the takeover.

It should be evident that the western developed countries continue to hide behind interventionists and use protective barriers arbitrarily, thus following a "Do as I Wish Policy" to international trade, finance and corporate governance.

Therefore, we need to ask the question, why is that Sri Lanka Inc. is frowned upon for adopting a similar set of selective measure of strategic interventionism and protectionism to help its industrialists and local entrepreneurs launch themselves by setting up of value-added sectors. "Sri Lanka, the emerging wonder of Asia" policy document, which set out ambitious targets and outcome matrix, is step in the right direction.

2.3 Banking and Financial Markets

Banks and financial markets have been pivotal in promoting trade and investments, and bringing about innovation. It has also been instrumental in channelling and



Map 1: Global banking and financial market crises of the 20th & 21st century

Source: Citi Global Markets & Authors

assessing credit risk across the world. The Glass-Steagall Act, Basle-2, International Accounting standards, have all been put in place by the western developed countries to ensure that financial system functions in an acceptable manner.

Apart from this noble action, western banks have been seemingly instrumental in sharing best practices, encouraging financial transparency and promoting good governance across the globe and more so in developing countries. A set of key terms that is popular among many Sri Lankan foreign bankers, neo-liberal advocates and theorists.

As depicted in Map 1, during the 20th century, we have witnessed 17 financial crises, of which 15 (88% of the time) were associated with western financial markets or so acclaimed developed economies, while, the two 21st century crises have also been associated with the western financial markets[5]. In fact, the recent US, UK and EU banking crisis should have also flagged our minds, to this duplicity in the rhetoric for financial transparency and good governance structures. The repealing of the Glass-Steagall Act is a case in point, as it gave way to a mindset of 'too big to fail', thereby, creating a situation whereby investment banks would rely on government/tax payer support. Excessive risk taking and synthetic products, which paid hefty fees, were also the order of the day for big banks (Stiglitz, 2010).

Many of the so-called 'safety nets' and 'accounting standards' were also discontinued or frozen, London Inter Bank Offer Rate-LIBOR, used for pricing of global loans/deposits was manipulated[6], while international rating agencies, Bank of International Settlements and British Bankers' Association which are supposedly financial market watchdogs, played a passive role in highlighting such risky activity, fraud and irregularities. The IMF and World Bank too preferred to watch than comment, as they were indoctrinated and made to believe that free markets were supposed to solve all of humankind's problems (Stiglitz, 2010). Many foreign banks, which are synonymous for professing good governance, best practice, and financial accountability mantra, fell like dominos.

Today US, UK and EU governments have been literally pushed to use taxpayers funds to stabilise the volatile financial markets and reassure the public in a bid to shore up global and domestic confidence[7]. Notwithstanding, banks and clients themselves are embroiled in legal action for excessive risk taking, lack of transparency in financial dealings, partaking in pyramid/ponsi scandals and other such financial irregularities. The list of offences range from mis-selling of government bonds, non-transparent structuring of Mortgage-Backed Securities (MBS), slicing and dicing of Collateralised Debt Obligations (CDOs), front running of Credit Default Swaps (CDS), etc. (Stiglitz, 2010).

Therefore, we see that Sri Lanka Inc. has monumental task in reshaping its 'west is best' ideological predispositions, be it, cultural values, banking, financial markets and trading systems that have deep externalised roots, which over the years have been firmly planted in our domestic markets. It is in this backdrop that we need to reflect and ask ourselves if we need to follow the western industrialised methods of 'greed is good' banking or should we adopt a 'home-grown conservative' solutions to our domestic problems, be it banking, financial markets or trading habits? The answer needs to lay with pragmatism over ideology, thus listening to industrialist and entrepreneurial needs in developing a policy framework in the form of a policy document titled "Sri Lanka, Emerging wonder of Asia" is a starting point. Why should Sri Lanka Inc. not select a development model that would suit its own ground conditions, values, cultural attributes and financial system based on local needs? Clearly, there are merits in this methodology.

3. Dealing with Globalisation

Globalisation is a process where cultures, societies and economies become closely integrated. The conduit for integration is by way of trade, communication and transportation. The first wave of globalisation was recorded in 325 BC, however, the term globalisation found its vogue and deeper meaning in the world of industrial capitalism between 1750 and 1950[8]. Many argue that globalisation is an inevitable process, but why has it taken so long to reach many of us? What is the force that distributes globalisation? If technology

determines globalisation, then it would be difficult to explain why the world was less inter-connected since the 1960 and 1970s than today. The only explosion that has happened during this 50 years period is the internet revolution. Therefore, we can argue that it does not matter what shape or form technologies begets, what makes its wider distribution across continents possible is clearly within the realm of national policies and international agreements drawn out between global players.

The spirit of globalisation, was further epitomised by US President, Ronald Regan and UK Prime Minister Margret Thatcher, in the late 1980s, who were strong promoters of "what's not good for us is good for them" and pushed down the ideological sweetener of 'free markets are good', and called its dominance "There Is No Alternative" [TINA][9]. It is with this push that IMF and World Bank found its new missionary purpose in a formalised process toward imperialistic bartering of financial aid for increased market share and profit in developing countries, sighting the inevitable globalisation doctrine.

Today no country wants to be isolated from the juggernaut of globalisation; which parent wants to see their children suffer from any illness or disease when advancements in science and medicines are available and can help his child in a globalised world. Similarly, all of us want something from this global integration process, be it, to be surrounded by information of sports results, fashion, music, entertainment, international cuisine, weather, financial markets, and political developments etc.; we all want a piece of the action and to be part of this global community. Such want cannot be at whatever cost, as there must be some degree of subordination. Ironically, all such demands have been engulfing and have eventually developed into broader forum and permeates' into 'what is best me is best for our country'.

However, such a predisposition is clearly flawed, as history has shown us a selective approach to globalisation is not a new phenomenon (Chang, 2003). It also highlights the apprehension by which countries embraced globalisation- for the lack of alternative. Britain, in 1932, abandoned free trade due to the decline of its supreme statutes and re-introduced tariffs, when it had no choice given that other countries too turned inward, protecting their industries and preventing cheap imports into their countries (Chang, 2007). Post-second world war was considered a period of incomplete globalisation, as trade between rich western countries and United States thrived, due to lowering of trade barriers[10], however most developing countries did not embrace globalisation until the late 1980s -until the invention of Thatcherism. Historian of globalisation describe the post-war period as a period of economic disaster (Chang, Ha Joon, Ilene J. Grabel, 2004)

Therefore, the logical conclusion to globalisation argument is not say no to it or to kick it away, but to embrace it to an extent that would not compromise the overall policies and visionary framework that is being developed in order to the carve out a path toward industrialisation. For it is in our interest to enhance technological aspects of value creation and value addition, viz-a-viz trade, modern communications and efficient transportation. In doing so, Sri Lanka Inc. has a responsibility to strike the right balance between the vast majority of local farmers, industrialists and traders who seek state protection and timely interventionist policies, and its current domestic consumers whose changing life styles also needs consideration. Therefore, what is the balance?

The answer to this profane balance is not easy, nevertheless as a starting point, it can be found by looking at what resources (hard and soft) are needed to get from point A to B within the shortest period of 6 years-2016. This has been articulated by the Vision for Sri Lanka titled "Sri Lanka, the emerging wonder of Asia"[11]. Where it sets out policies and targets for:

(a) agriculture-feeding the nation,
(b) strengthening enterprises,
(c) networking and transportation
(d) knowledge in a modern e-society,
(e) satisfying lifestyles while also focusing on shared values.

Apart from adopting domesticated policies that are pragmatic to that of ideological in nature, adopting the right mindset to getting the 'job done' too can serve Sri Lanka well in this critical phase-1.

Many invaluable ideas of blending globalisation can be obtained by listening to local industrialist and to entrepreneurial needs. Thus developing a domesticated policy framework, whereby incorporating filtered thoughts into our economic model, is the preferred path. If I use this analogy, it is akin to Fords model-T assembly line of making one-brand-one-car. Therefore, why should Sri Lanka Inc. not select a development model that would suit its own ground conditions, values, cultural attributes and financial system? Clearly, there are merits in this methodology.

4. Agriculture is a Prerequisite for Industrialisation

Modern free trade doctrine is primarily based on Eli Heckscher and Bertil Ohlin, together with Paul Samuelson which was derived from David Ricardo. Its fundamental premise is that each country has a comparative advantage in producing some products or another by efficiently using its factor endowments. As the principle of the comparative advantage thesis revolved around the concept of products and not countries per se. Therefore, it was argued that developed countries, such as, UK, should engage in high tech capital

intensive products while developing countries, such as, Sri Lanka, make do with its labour surpluses by engaging in low-value agrarian products. In this context, the notion of free trade also suggests that factors of production can move freely without any incremental cost and adjust to changing consumer patterns. However, in reality, for any manufacturer or agricultural crop producer, this should intuitively come across as, not possible.

Needless to say that the western developed countries today continue to promote free trade ideology as the path toward greater economic integration, however, this is far from the truth (Myrdal, 1957). What is also striking about the rhetoric is that they continue to protect subsidies and pay close attention to agricultural production in their post-industrialisation phase. Why is this? The agricultural revolution which started in Great Britain during the early 1700-1800s was responsible for spurring the industrial revolution[12], it reached North America by the mid-1800's, and to this day, continues to be the backbone of economic growth. 200 years have lapsed since the agriculture and industrial revolution, today market based doctrine has taken centre stage in a globalised world, and yet, the US, UK and EU taxpayers continue to violate its principles, forking out funds to support and subsidise agriculture. Why is this so?

Clearly the extensive fiscal support extended to famers and agricultural industries is needed in order strike a balance between food security and food sustainability in developed countries. Therefore, governments across the world have understood this reality. According to Canada's trade consultant, Peter Clark, "the U.S. continues to provide massive - sometimes unreported to the World Trade Organisation - support at the federal, State and local government level to U.S. agriculture". He further states that US taxpayers spend annually USD 28.70 billion in total subsidies to its framers[13] despite agriculture only accounting for 1.2% of total US labour force (1.8 million of people live on the farms) while accounting for only 0.7 percent of US GDP[14]. As at 2010, UK agriculture sector accounted for 0.90% of GDP, while it employed 1.4% of UK total work force or 440,000 people, yet, UK fiscal spend on agriculture accounts for USD 76.0 billion or about 32% of total budgetary expenditure[15]. Over the past 50 years, the EU too has continued to support and subsidise the agriculture industry, despite the fact that only 5% of EU's population work on farms, while the farming sector is responsible for 1.6% of the GDP[16]. In fact, EU budgetary allocations toward agriculture in 2010 amounted to approximately 50% of the total EU budget - EUR 45-53 billion a year[17]. Why is this? Clearly, the thinking is to keep basic food supplies adequate and ensuring people have access to low-cost food (i.e., a basic need that needs to be satisfied first in each of our hierarchy of needs). This has been the paramount focus of policymakers in their path toward industrialisation. Analysis of economic history would also suggest that agriculture and industrial development go hand in hand. Therefore, it is argued that agricultural buoyancy has been the backbone of industrialisation since the early 19th century.

Sri Lanka Inc. is caught up today in a similar debate of service and manufacturing sectors subsidising the agricultural sector. Most argue that exchange of consumer goods should be based on free trade principles. Proponents of free the trade camp suggest that Sri Lanka Inc. import all, if not most, of its basic food requirements and trade apparels, primary commodities in a fair exchange of comparative advantage and based on the economies of scale ideology. This oblivion mindset clearly is destined to be doomed and so is the country. Why so? Agriculture sector was instrumental for development of industrial sector in developed countries and accounts for industrial development in most of the Asian countries. It is no doubt that agriculture is an engine of growth and has to form the backbone in the countries like Sri Lanka as well. Sri Lanka Inc. is an agrarian-based country endowed with fertile soil and favourable climatic conditions. At present, agriculture comprises of crop, fisheries and livestock, which contributes about 13% to the country's GDP. Agriculture also accounts for the livelihood of 65% of the population. It also employs 33% of its workforce or 2.7 million people, more importantly our food balance sheet also contains a significant content of consumer imports -from vegetables, sugar, wheat flour, lentils, dry fish, eggs, rice, fruits, canned fish, milk powder and products, confectionaries, chicken, garlic etc, exposing us to rapid changes in external price behaviour[18].

By analysing Sri Lanka Inc.'s 20-year annual average of total imports in two stages, namely, 1990 to 1999 and 2000 to 2008/09, we find that, during the 10 year period from 1990 to 1999, consumer food imports accounted for 23% of total imports. In the preceding nine years from 2000 to 2008, consumer food imports alone had reached a staggering 20% or USD 1.3 billion over the same period. In 2009, however, this figure eclipsed the historical average and stood at 25% of total imports, reaching USD 1.97 billion out of a total import bill of USD 10.2 billion[19]. Notwithstanding, trade figures, we also find that there is strong correlation between inflation and imported prices of consumer goods (Zilwa, 2009; Nicholas, 2004; Nicholas, 1990).

Therefore, it is about time we took our food balance sheet seriously! Ironically, in this instance, the "West is Best" has been overlooked by some neo-liberal theorists and free trade propagators, who have failed to realise or refuse to consider that as with western industrialisation, our path toward rapid industrialisation is dependent on a sound, and thriving, value added, superior agricultural base.

Thus, this strategy focused on agriculture not only ensuring domestic consumers with a steady supply of calories needed for industrialisation, but also catering to price stability and external macroeconomic soundness.

Therefore, why should Sri Lanka Inc. not select a development model that would suit its own ground conditions, values, cultural attributes? Clearly, there are merits in this methodology.

5. Summary and Conclusion

The paper focused on an attitudinal adjustment of why assembling Sri Lanka Inc. is not a viable solution. The main ideological predisposition that have formed the core of the arguments put forward by the liberals/free thinkers have been addressed and found to be wanting and at more times, hypocritical. Arguments been, west dominate world economy thus Sri Lanka Inc should not alienate ourselves from the west, Globalisation, and the need for importing of basic foods/ consumer imports; based on free trade and comparative advantage. In this paper, it has been firmly argued, substantiated with empirical examples and evidence of some of the duplicities and inconsistencies that exists in 'West is best' approach. In fact, today the 'Rise of Asia' is inevitable and Sri Lanka Inc. has a unique opportunity given the proximity to two of the world largest markets and economies, in China and India. Therefore, the dominance of the West since. the mid 1960 is gradually, if not steadily, declining, this also paves the way for a better balance in global power and re-shaping of institutional powers, while been Asia oriented. The paper also focuses on the topic of globalisation. Stiglitz (2006) has openly made his thoughts felt and voiced his unhappiness with this misconception in his revelation of book titled 'Globalization and its Discontents'.

Nevertheless, this paper argues that while globalisation is deemed today as a 'necessary evil' for the country, it is important that we extract some value for our economic development and prosperity while not being overreaching. Notwithstanding, our current polices articulated in the road map document "Sri Lanka, The Emerging Wonder of Asia" seems to be aligned and is based on what is best for Sri Lanka Inc.'s majority. Finally, the thought of Agriculture being a negative factor or a drag on the economy, supporting this argument has been importing food is better than saving a few unproductive farmers. Clearly, this is thought process is dumb founding and is wrapped with irrationality, over facts and sound understanding of development history. Empirical example sighted in this paper together with recent data supports and de-bunks this argument, as many western countries continue to support and subsidising farmers/ agriculture, despite being in the post-industrialisation phase.

Therefore in conclusion, the West is best policy attitude has shown us that "Assembling Sri Lanka Inc." is neither suitable nor desirable. Assembling an economic model on another country's or countries individual tastes, values, beliefs, expectations, and cultural exposure cannot bring a desirable outcome. We have seen positive results when a domesticated model, based on local industrial needs, culture, aspirations, knowledge, and values have been incorporated, as in the case of the mightily successful East-Asian Tiger economies to Western countries. Therefore, an economic product or model based on another country's economic model, values, financial market behaviour, predisposition, and attitudes could be dangerous and, in fact, be eventually destabilising. What Sri Lanka Inc. needs is a game changing set of pragmatic solutions over ideological misconceptions. Sri Lanka Inc. is not up for assembling its domestic oriented development model!

6. Bibliography

Chang, H. J. (2007). Bad Samaritians-The guilty secrets of rich nations & the threat to global prosperity. London-UK: Random House Business Books.

Chang, H. J. (2003). Globalisation, Economic Development, and the Role of the State. Lomdon,UK: Zed books and Third World Network.

Chang, Ha Joon, Ilene J. Grabel. (2004). Reclaiming Development-an alternative economic policy manual. Canada: Fernwood Publishing Ltd.

Friedman, T. L. (2006). The World Is Flat-The globalilzed world in the twenty-first centuary. London,UK: Penguin Books UK.

Lakshman, W. D. (1987). Active State Control Vs Market Guidance In a Dependent Capitalist Economy. Social Scientist-vol-15 , pp-10-44.

Lakshman, W. D. (1994). Market Oriented Policies & Poverty In Sri Lanka. Poverty. Colombo.

Lakshman, W. D. (1985). The IMF-World Bank Intervention in Sri Lankan Economic Policy: Historical Trends and Patterns.". Social Scientist-Vol-13 .

Myrdal, G. (1957). Economic Theory & Under-developed regions. Norwick-UK: Gerald Duckworth,UK.

Nicholas, H. (2004). Inflation in Sri Lanka-Ideology Vs Reality. ISS Working paper- .

Nicholas, H. V. (1990). "Inflation in Sri Lanka 1977-1987: A Preliminary Study" . Institute of Policy Studies, Sri Lanka. , Pages 1-68.

Planning, Department of National Planning & Ministry of Finance &. (2010). Sri Lanka-The Emerging Wonder of Asia. Ministry of Finance and Planning.

Rodrik, D. (2002). The Crisis That Was Not Prevented-Argentina Case For Globalisation Gone Too Far Or not Far Enough. The New Republic.

Stiglitz, J. (2010). FreeFall. London: Penguin Books, UK.

Stilitz, J. (2002). Globalisation and Its Discontents. New Delhi, India: Penguin Books.

Zilwa, K. G. (2009). Inflation In Sri Lanka- Importance of External Factors. Economic Journal of Sri Lanka .

Zilwa, K. G. (2010). Sri Lanka Inc-A Possible Reality. Association of Professional Bankers, Sri Lanka .

Footnotes:

[1] http://en.wikipedia.org/wiki Assembly_line

[2] Both in terms of physical and psychological, given national boarders have been breakdown. Therefore we are more inter-dependent than independent today than ever before.

[3] Excerpts of the by Gunnar Myrdal in his lecture to the memory of Alfred Nobel, March 17, 1975-" In the United States, where aid to underdeveloped countries has been continuously argued as being in "our country's best interest", with these interests more

and more specified as located in the military sphere, foreign aid has increasingly lost its popular appeal.The fact that the foreign policies supposedly served by this direction of aid has met defeat in Southeast Asia and also been less than successful in Latin America and other parts of the world, can only have made people in America ever more skeptical and adverse to foreign aid supposed to serve these purposes."

[4] Date accessed-20th Dec 2010-http://en.wikipedia.org/wiki/BRIC

[5] Date accessed 20th Dec 2010-http://en.wikipedia.org/wiki/Financial_crisis

[6] Data accessed on 20th Dec 2010 http://www.bloomberg.com/apps news?pid=newsarchive&sid=aZHPJf06Z5t8&refer=uk

[7] Cost to countries taxpayers due to excessive risk taking by banks- US-$2.5 trillion, UK- $ 1.2 trillion, EU-$ 962 billion Source- USA- http://www.independent.co.uk/news/world/americas/wall-street-rescue-23-trillion—the-cost-of-us-bank-bailout-1606328.html;UK- http://www.independent.co.uk/news/uk/politics/163850bn-official-cost-of-the-bank-bailout-1833830.html; EU-http://moneymorning.com/2010/05/10/eurozone-bailout/

[8] Date accessed-20th Dec,2010- http://www.sas.upenn.edu/~dludden/global1.htm

[9] Ha-Joon Chang-2007,Bad Samaritans, pg 38

[10] However most developed countries used other mean of adjusting for lower trade tariffs, countries continued to subsidies R&D and also provided financial support.

[11] Ministry of Finance and Planning (2010)

[12] http://en.wikipedia.org/wiki/British_Agricultural_Revolution

[13] Date accessed, 20th Dec 2010- http://www.theglobeandmail.com/report-on-business/economy/economy-lab/daily-mix/for-us-farmers-subsidies-the-best-cash-crop/article1813425//

[14] CIA World Factbook

[15] CIA World Factbook & http://www.ukpublicspending.co.uk/budget_ukgs.php (date accessed 20th Dec 2010)

[16] Euro Stat pocket book 2007- http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-ED-07-001/EN/KS-ED-07-001-EN.PDF

[17] Date accessed 20th Dec 2010-http://news.bbc.co.uk/2/hi/8036096.stm#start

[18] Date accessed 20th Dec-http://www.statistics.gov.lk/agriculture/FoodBalanceSheet/SumOfFBS.html

[19] Central Bank of Sri Lanka, Annual Data tables 2.3.2 ■

Contd. from page 20

assessment of turnover tax. Adequate staff is not available in many provinces for introducing functional specialisation in tax administration. Hence, provinces do not practice the in-depth assessment of selected high-risk taxpayers than a casual assessment of all taxpayers. The practice does not serve to enhance the credibility of the provincial tax department.

iii. Poor information base and absence of sharing information between the province and the centre. Inadequate adoption of information technology prevents provinces from establishing proper information bases. Further, there is no mechanism for sharing of information between central government tax agencies and provincial tax departments.

Issues of Capacity

Lack of adequate capacity at the provincial level: There is no proper system of improving technical skills for developing tax systems and enforcement strategies at the provincial level. There is no proper arrangement for training of provincial tax officials.

Assessing the Provincial and Local Tax Systems

The assessment of the performance of the provincial and local tax systems should be made in the context of the performance of fiscal decentralisation. Fiscal devolution has not brought about a meaningful allocation of resources to provincial and local levels. It has created a mis-match between public functions assigned to provincial/local bodies and fiscal capacity required by them for those functions.Though the fiscal devolution is precisely to enhance potential to better address the varying needs of different regions and therefore of communities, significant fiscal imbalances in provincial finance has imposed limitations on its capacity to provide services.

Thus, the fundamental issue of fiscal devolution in Sri Lanka is as to how provinces could be established in fact as efficient and accountable providers of public services instead of being merely enjoying constitutional status. An appropriate design by itself is not sufficient to ensure the success of fiscal devolution, a commitment to devolution is necessary to bring about the potential welfare gains of fiscal devolution. The operational experience of fiscal devolution in Sri Lanka raises fundamental questions about the ability of the system of intergovernmental transfers to lead to efficiency enhancing equalisation of fiscal capacity of the Provinces.

Conclusion

The foregoing analysis of the revenue assignment shows that the revenue raised from the sources assigned to provincial councils and local government authorities are not large enough to create significant fiscal autonomy and flexibility in service provision. The aggregate revenue raised by the provinces from own sources financed only a negligible proportion of their total revenues. There is no provision for equalisation of fiscal capacities to enable all provincial and local councils to provide services at a minimum level and standard. There is a need for a fundamental reform of the decentralised tax systems to enable the decentralisation to meaningfully perform service provision roles and responsibilities.

Footnotes:

[1] Referred to as the "principle of subsidiarity", it argues for a bottom-up arrangement in the location of responsibility for the provision of public services in terms of the relative efficiency of the different levels in their performance.

[2] The benefit rationale for local taxation argues that each (local) jurisdiction pay for its own benefits. For example pubic services enhance the value of local properties and therefore the owners of properties must pay for those benefits.

[3] BTT has been taken over by the Central government under the Budget Proposals for 2011.

[4] Making Decentralization Work for the Benefit of the People of Sri Lanka, NIPFP, Delhi, 2007. ■

Problems in Regional Development in the Northern and Eastern Provinces of Sri Lanka

R. H. S. Samaratunga

Formerly Deputy Secretary to the Treasury

Introduction

The Northern Province, with an extent of 8884 sq.km, covers 14 percent of the total land area of the country. It consists of 5 Districts, 30 Divisional Secretariat divisions, and 912 *Grama Niladhari* (GN) divisions. Approximately 40 percent of the sea coast of the island is in the Northern Province. The province is rich with fertile land, minerals, forests, wetlands and also picturesque beaches. On the other hand, the Eastern Province which consists of 3 Districts, 43 Divisional Secretariat divisions, and 1081 GN divisions, covers 9996 sq. km which is nearly of 15 percent of the total area of the country. Paddy fields, forests, scrub jungle, wetlands and lagoons are common sights in the province. Further, Trincomalee Harbour which has a very high potential for development and also the Oluvil harbour which is under construction are two natural resources of the province. The beaches of the Eastern Province being great attractions for the tourists have a vast potential for development.

The population in the Northern Province was estimated at about 1.2 million in 2009, which was 5.8 percent of the total population of Sri Lanka. Of the total population in the province, more than 95 percent comprises of Tamils. Comparatively, the Eastern Province in 2009 had a population of approximately 1.5 millions which was nearly 7.5 percent of the country's total population. All three communities - Sinhalese, Tamils and Muslims - live in this province roughly in equal proportions. In terms of land area, Northern and Eastern provinces rank second and third respectively. In 1901, the population in the Northern Province was 341,000 or 9.5 percent of the country's total population. After a century, the population in the province had trebled in absolute terms.[1] In contrast, the population in the Eastern Province was 173,000 in 1901 or 4.8 percent of the total population, and the number has increased by eight times by 2001. Except for the Jaffna District, all districts in both provinces have a comparatively very thin population density. Comparatively a sizable segment of population is live in largely under serviced locations. In this article, the economy of the two provinces is discussed briefly before analysing the problems of regional development, followed by concluding remarks.

Regional Economy in Brief

The contribution of the Northern Province to the National GDP (Gross Domestic Product) was as low as 3.3 percent in 2009. Among all provinces, the Northern Province made the lowest contribution to the national GDP in the recent past. Due to the armed conflicts that prevailed for more than 3 decades, the contribution of this province to the national economy has gradually declined, particularly so in the agricultural, fisheries and industrial sectors. Before the commencement of terrorist activities, the production of paddy, vegetables, chillies, tobacco, dairy products, fish products, and fruits were substantial in this province. There were many light engineering, apparel manufacturing and various other small industrial establishments also.

The Eastern Province contributed 5.8 percent to the national GDP in 2009. The economy of the province is based on the natural resources available in the region. Forests, agricultural lands, wetlands, lagoons, sea ports and attractive beaches are prominent among those natural resources. Above all, there had been a well-established ancient irrigation system in the province, which supported the full potential of agricultural production. At present, the majority of these systems are either destroyed or in a state of disrepair. The main agricultural crop is paddy. There is evidence to suggest that the Eastern province including Binthenna and Wellassa had supplied more than 50 percent of the national paddy production, before Sri Lanka came under British rule in 1815. At present, there are more than 130 tank-based major irrigation systems. Gal Oya, Maduru Oya, and Alla are the main irrigation schemes that provide water for agriculture in the province. Since the early '80s, while the terrorist activities increased in the region, agricultural production - particularly paddy and dairy

production – decreased. Prior to the intensification of the terrorist activities, fisheries sector of the Eastern Province made a substantial contribution to the national production, but since the '80s up to the recent past, it could not maintain those levels.

These two provinces belong to the dry zone of the country which gets rain from the north-east monsoon. Most of the crops grown in the dry zone are found in these two provinces, while paddy and coconut are the most common. The land area under coconut in the Northern Province was around 2 percent of the national total in 2002, but due to the conflict situation, the same may have decreased substantially. In the Eastern Province, land under coconut was about 2.7 percent of the national total in 2002.

Of the paddy cultivated lands of the country, 6.2 percent is in the Northern Province (2006). Of those, around 1/3 is cultivated under major irrigation schemes. In 1980, when the terrorist activities were not that intense, the Northern Province contributed about 10 percent to the national paddy production. It gradually declined to below 3 percent in the recent past. Besides, fisheries sector in the Northern Province contributed as much as 40 percent to the national production in 1980, but by the year 2000, it had declined to about 10 – 12 percent.

The Eastern Province is of critical importance to the country's paddy production. Of all the paddy lands irrigated by major irrigation schemes, 23.5 percent are in the Eastern Province (2006 *Maha* and *Yala*). Among the five districts that give the highest paddy production, two (Ampara and Batticaloa) are in the Eastern Province[2]. Since the conflicts in the province were confined to certain areas, the paddy production was not totally devastated here as it happened in the Northern Province. The Eastern Province contributes 20 percent to the national paddy production, and marginal improvements were seen during the three decades prior to the conclusion of the conflict situation in the province. All the dry zone crops, such as, chillies, maize, cowpea, green gram and gingerly, are cultivated in these two provinces, but those cultivations too have not had much progress during that period. Fisheries production is an important economic activity in the Eastern Province. In 1980, the Eastern Province contributed 16 percent to the national fisheries production. In 2004, it stood at 20 percent. The number of industrial establishments as well as the number of people employed in them is not substantial in the Northern Province. The situation is not better in the Eastern Province too. During the three decades of conflicts, many industries have become dysfunctional.

According to the available data, the poverty level in the Northern Province is higher than the national level. Labour Force Participation Rate[3] which was 36 percent in the Northern Province and 46 percent in the Eastern Province in 2004 were both lower than the national level which was 49 percent. The levels of unemployment in both these provinces are also higher than the overall unemployment level in the country. Income received in the form of transfer payments per spending unit is higher in both provinces and are similar to such levels in the Uva and Sabaragamuwa provinces. Total expenditure on food is 40 percent per spending unit, both in Northern and Eastern provinces and that level too is similar to those in Uva and Sabaragamuwa provinces only. There exists a wide gap in the consumption pattern compared with that in the Western Province, where the total expenditure on food is 27 percent. These statistics shed some light on the disparities in social and economic progress of these provinces.

Problems in Regional Development

The concept of comparative regional development was not an integral component in national planning before the '70s. During that period, certain geographical areas, such as, the dry zone (except Rajarata[4]) were not covered by many development programs, and as a result, there were many regional imbalances in the development of physical, social and economic infrastructure.

Since the '70s, the importance of decentralised resources allocation has been recognised and various mechanisms for that purpose have also been instituted.[5] Three main development programs begun in the late '70s – 'Accelerated Mahaweli Development', 'Urban and Housing Development' and 'Free Trade Zone' having substantial investments have had serious regional development implications. Further, direct benefits of those investments did not reach the regions which were not within those project areas. In order to minimise such regional imbalances, integrated rural development programs were implemented with the financial help from donor countries and multilateral agencies. These programs were launched in those districts which were not covered by the government's three major development programs. By 1990s, 19 districts were covered by these programs and they were very successful in certain districts. Even though the Northern and the Eastern Provinces too were included in these plans, when it came to implementation, it was not possible due to the unsettled law

and order situation then prevailed. Thus, the first attempt of regional development in these provinces since 1950s was hampered. The social and economic infrastructure that was built since the colonial days was also destroyed due to the prolonged armed conflict. Even the day-to-day activities of the people were severely curtailed. The brain drain that had taken place as a result of the above problems has created additional challenges for the new development thrust.

With the intensification of the conflict, the number of internally-displaced persons increased.[6] To provide the essential day-to-day requirements of these people, the government was compelled to meet substantially large expenses. The next challenge was the reconstruction and rehabilitation of the damaged houses and infrastructure. For the success of any government intervention, it has to be supplemented with people's participation. Therefore, the scarcity of human resources in the regions is a challenge for all regional development efforts. The number of IDPs was around 250,000 at the commencement and they have been successfully resettled in an orderly manner.[7]

Since the liberation of the Eastern Province in 2007, the government launched a three-year (2008-2010) accelerated development program. With a view to restoring the normalcy in civil life and economy, the "*Negenahira Navodaya*" (Re-awakening East) program was launched with a focus of six key areas:

i. Resettlement of IDPs

ii. Revival of the regional economy

iii. Development of economic infrastructure

iv. Strengthening of infrastructure for social development and services

v. Skills development

vi. Re - establishment of State institutions and productivity improvement

For this three-year regional development plan, the government has sought assistance from donor countries, multilateral agencies and non-governmental organisations. The estimated total expenditure was approximately Rs. 199 billions. This program has progressed satisfactorily since its commencement.

The democratic political institutions and leadership have been re-established in the East since 2008. The members for the provincial council and other institutions of local government have been democratically elected, and they are now firmly and actively integrated with the development process and due both to the positive political developments and development program being implemented, the civil life of the region has come to the complete normalcy. The infrastructure and the socio-economic conditions are being restored after years of destruction due to the terrorism. Agriculture, fisheries and State services are being revived expeditiously. Even though the progress has been satisfactorily implemented during the last several years, large additional investments are required for infrastructure projects in the fields of communication, highways and transport. The disparities in the regional development can be minimised only with such investments. This is however, common to several other regions as well.

The intensity of conflict was much higher in the Northern Province and hence the infrastructure and civil life had been much more devastated. Of the total population in the province, a higher percentage has migrated either to other regions of the country or to foreign countries. [8] Even though there are similarities in certain aspects, the regional development in the Northern Province is different from that of the Eastern Province. The problems of regional development in the Northern Province are comparatively much more challenging. Even prior to the commencement of terrorist activities, two distinct regions of development were evident within the Northern Province. They were:

i. District of Jaffna

ii. Wanni (Currently the districts of Vavuniya, Mullaithiev, Kilinochchi and Mannar)

Between these two regions, the District of Jaffna was far ahead of Wanni in terms of development. Social and economic infrastructure of both these regions were severely affected by terrorism, but more so in the Wanni. By the time the conflict was over in May 2009, nearly all the population in Wanni was internally displaced and more than 300,000 people were in temporary welfare centres. The day-to-day maintenance of these people was itself a monumental challenge. Therefore, tackling of the development needs of the region was a very difficult task. However, the government has successfully met the immediate requirements of those people.

The government has launched a multi-faceted program called "*Uthuru Wasanthaya*" for the development of the North. The program is expected to be completed in four years (2009 - 2012) and the estimated expenditure was about Rs 244 billion. Basically, this program covers five sectors as follows:

i. Social security and livelihood development

ii. Development of economic infrastructure

iii. Strengthening of social infrastructure facilities and restoration of the social services

iv. Revival of productivity

v. Development of human settlements

Of the total investment under this program, more than 50 percent is expected to be spent on development of economic infrastructure, such as, roads, transport, electricity, housing, water supply, agriculture and irrigation.

Both the "*Negenahira Navodaya*" in the East and the "*Uthuru Wasanthaya*" in the North aim at re-integration of the people of these two provinces with those of the mainstream by restoration and development of social and economic infrastructure, resettlement of IDPs and strengthening of livelihoods. As a result of that process, it is expected that the unemployment, poverty and social and economic inequalities prevailing in these regions would be brought down to some extent.

The devastation caused by the 2004 Tsunami was another factor that negatively affected these regions. The coastal areas in the districts of Ampara, Batticaloa, Trincomalee, Kilinochchi, Mullaithiev and Jaffna were seriously affected by the Tsunami. Post-tsunami rehabilitation in the East was successful to a certain extent, but it was not so in the North due to the conflicts that prevailed until mid 2009. Particularly, the districts of Kilinochchi and Mullaithivu were virtually inaccessible for post-tsunami rehabilitation work, due to the conflict situation. In the entire country, 98,525 houses were destroyed by the tsunami, and out of that, 10,253 (11 percent) was in the Northern Province and 50,460 (50percent) was in the Eastern Province. Around 150,000 livelihoods were destroyed in the two provinces. These two provinces used to contribute 60 percent to the national fisheries production. But, almost all the fishing equipment and infrastructure were destroyed as a result of the Tsunami. All the beach hotels too faced the same fate. Similarly, schools, medical facilities and State institutions in the coastal areas were also damaged, but could not be reconstructed soon due to the conflicts that prevailed at that time. As a result, the civil life of the regions was under tremendous pressure.

Concluding Remarks

The terrorism sprang up in the Northern and Eastern provinces at a time when the concept of balanced regional development was recognised in government policies, plans were drawn up and resources were allocated for that purpose. Thus, in terms of development, these provinces were denied of the opportunities to be in line with the other provinces of the country. The Tsunami in 2004 too caused considerable destruction for the life and resources of these provinces. Post-tsunami reconstruction too was extremely difficult in the area and almost impossible in the Mullaithiev and Kilinochchi districts due to the conflict situation that prevailed. Therefore, the problems of regional development in these two provinces have been quite challenging.

When considering the situation of regional development in the country, there are some exclusive problems in the North and East. More than 300,000 people became internally displaced in the North alone at the end of the conflict by the mid 2009. A section of people belonging to certain ethnic groups have been chased away from the area by the armed groups. Additionally, people in large numbers had temporarily migrated to other provinces with the expectation of returning after normalcy is restored. The IDPs have to be looked after until they are resettled. Security has to be ensured in the areas identified for resettlement by the completion of de-mining. The shelters and the livelihoods have to be restored for the resettled people. Similarly, the entire system of State sector services has to be re-established. Infrastructure in all the sectors has to be rebuilt. At the same time, the process of integration of the social and economic system of the North and East with that of the rest of the country has to be completed. All these are challenges for everyone involved in regional development. Indications are such that government has successfully dealt with all these aspects of development of these two provinces during the post-conflict period.

In meeting the needs of the displaced persons, an area of concern has been the mental trauma and stress caused by the prolonged conflict. Disrupted families, children who have lost one or both of their parents, under-age marriages and child bearing are some of the complex problems that need attention. While the physical development takes place, hostilities created by the conflict too have to be soothed. The sociological problems that may surface are new, large and complex in all of their dimensions.

In terms of development of social and economic infrastructure, the Northern and Eastern provinces lag behind the other provinces of the island. Therefore, different strategies and approaches are required by the planners of regional development. The government's approach is to bring normalcy to the people's life while developing the physical infrastructure facilities. For this purpose, the government has launched two broad programs with large quantum of investments - "*Negenahira Navodaya*" for the Eastern Province and "*Uthuru Wasanthaya*" for the Northern Province – encompassing all the aspects required for the restoration of economy and the civil life in

respective regions. The restoration of these two provincial economies will enhance their contribution to the national economy, thus paving the way for rapid integration with the rest of the country.

Footnotes:

1. The slower rate of population growth is due to the migration from the Northern Province.

2. The other three districts are; Kurunegala, Anuradhapura and Polonnaruwa.

3. Labour force participation rate = Labour force as a percentage of household population, aged 10 years and above.

4. Except for irrigation schemes and agricultural settlements, even Rajarata was lagging behind in development, compared to other provinces.

5. Examples are: Decentralised Budget, Divisional Development Councils, District Political Authority, District Ministries and District Development Councils.

6. The number of confrontations was comparatively low during 2002 – 2004.

7. At present, the re-settlement of IDPs is nearing completion.

8. Reliable data relating to the Northern Province were not available during the last three decades. Therefore, any analysis in respect of that province would be subject to that limitation until a comprehensive survey is undertaken in the future.

Bibliography:

1.Ministry of Finance and Planning (2005) Sri Lanka: New Development Strategy: Framework for Economic Development and Poverty Alleviation, May 2005, Colombo

2.Department of National Planning (2005) Re-building Sri Lanka: Post-Tsunami Recovery and Reconstruction Strategy, Colombo

3.Government of Sri Lanka (2005) Post-Tsunami recovery and Reconstruction, Government of Sri Lanka with Development Partners, December 2005. Colombo

4.World Bank (2006) Poverty Assessment for Sri Lanka: Engendering Growth with Equity: Opportunities and Challenges, Poverty Reduction and Economic Management Sector Unit, South Asia region, World Bank

5.Kelegama, Saman (2006) Development Country Stress: Sri Lanka Economy in Transition, Sage publications: New Delhi

■

Contd. from page 25

Gunawardena, U.A.D.P. (2010). Greening the National Accounts, Presidential address of Section F delivered during Annual Sessions of Sri Lanka Association of Advancement of Science, Dec 6-10, Colombo, Sri Lanka.

Hanley, N., Shogen J.F., and White B. (1997). Environmental Economics in Theory and Practice, Macmillan Press

MENR (2008). Development of Market Based Instruments for Environmental Management in Sri Lanka, Ministry of Environment and Natural Resources, May 2008

Nordic Council of Ministers (NCM) (2006). The use of economic instruments in Nordic and Baltic countries 2001-2005, TemaNord 2006:525, Copenhagen, Denmark.

Organisation for Economic Cooperation and Development (OECD) (2006). The political Economy of Environmentally related Taxes, Paris, France.

Perman, R., Ma, Y., McGilvray, J., and Common, M. (2003). Natural Resource and Environmental Economics, Pearson Education Ltd, UK.

Pigou (1932). The economics of Welfare, 4th edition, London.

Somaratne, W.G. (1998). Policy reforms and the environment: A general equilibrium analysis of land degradation in Sri Lanka. PhD Thesis, La Trobe University, Melbourne, Australia (unpublished).

Stefan, S. and Datta, A. (2007). EFR – differences and similarities between developed and developing countries, A case study of Sri Lanka, The Eighth Global Conference on Environmental Taxation, Paper presented at Environmental Fiscal Reform in Developing, Emerging and Transition Economies Special workshop, Munich, Germany.

Suranovic,S.M.(2009). International Trade Theory and Policy.http://internationalecon.com/Trade/Tch10/T10-4.php.

Siriwardena K., Wijayatunga, P.D.C., Fernando, W.J.L.S., Shrestha, R.M., and Attalage, R.A. (2007). Economy-wide emission impacts of carbon and energy tax in electricity supply industry: A case study on Sri Lanka. Energy Conversion and Management, 48, 19w5–1982.

World Bank (1992). International Trade and the Environment, World Bank Discussion Paper, No. 159. The World Bank, Washington DC.

■

Money, Inflation and Output

by Dr. H.N. Thenuwara,
Published by Global Policy Research Centre,
Colombo, 2010; pp. 238; Rs. 1500.

Reviewed by

Dr. Saman Kelegama

Executive Director,
Institute of Policy Studies of
Sri Lanka.

The book is the latest addition to economics literature in Sri Lanka. The basic thesis of the book is 'good money' creates wealth and growth while 'bad money' would retard this. This observation was made by Copernicus in 1529 AD and Thenuwara shows the validity of this observation in the modern world.

The book has 11 chapters. Some of the chapters explain basic economic concepts in the context of monetary policy while others show how monetary policy has worked and the prerequisites for positive results. The underlying theme of the book is the need for a Central Bank to conduct independent monetary policy and thereby keep inflation low, which is essential to achieve higher economic growth.

Inflation

When too much of money circulation is not matched by an increase in the supply of goods, the goods prices increase and creates inflation. Inflation inertia is created when past high inflation makes it difficult to control current and future inflation. When the public is used to a high rate of inflation, they incorporate high inflation rates to future economic plans — expectation causes the inflation to persist by way of self-fulfilling phenomenon. Thus to combat adverse expectations on inflation, Central Banks make an effort to sensitise the public on their plans to reduce inflation and provide forecasts of future inflation levels.

Core inflation is the extent of inflation that responds to demand management policies and usually excludes items that are very sensitive to supply side disturbances like food and energy. Headline inflation on the other hand, is the rate of increase of the price level of all goods and services included in the consumer basket. A comparison of the two indicators shows that in Sri Lanka, core inflation has been on the decline until late 2007 but headline inflation has been on the increase from mid-2006 to mid-2008. These trends basically show the lagged effect of excessive money printing and the influence of the escalation of food and energy prices, respectively. While presenting these trends, the author has a closer look at the revision of the Consumer Price Index (CPI) in 2007 to replace the outdated basket of currencies (based on the 1952 basket) that governed the earlier CPI, and expresses concern of alcohol receiving a zero weight, especially when a number of commentators have expressed that Sri Lanka is a very high alcohol consuming nation.

Demand for Money

Demand for money can be explained by the classical framework of the Quantity Theory of Money or Keynesian Framework or Friedman's framework - it is a complex subject. If demand for money is stable, a Central Bank can carry out monetary targeting (quantity of money) in its monetary policy to keep inflation at a low level. In the real world however, the demand for money is unstable. Thus, Central Banks adopt different monetary policy regimes at different times. It is left to the Central Bank to select the most efficient monetary policy instrument or a combination of instruments to reach the desired credit and money targets.

In monetary targeting, a Central Bank cannot directly hit at the final target, i.e., inflation, thus, it aims at operational and intermediate targets. First, the interest rate is used to hit at the operational targets such as high powered money and short-term interest rates. Then high-powered money and short-term interest rates impact on the intermediate targets of narrow money, broad money, and medium-term interest rates. Finally, narrow and broad money and interest rates impact on the aggregate demand and inflation.

Central Banks use several instruments to conduct monetary policy: interest rates, the statutory reserves, moral suasion, central bank communications, and administrative instruments to control aggregate demand. The book shows that the most effective and convenient instrument is the market-based instrument of interest rate for conduct of monetary policy. But the market players should be sensitive to the interest rates. If the government is a major borrower in the market, and does not change its demand for credit when changes occur in the interest rates, then monetary policy becomes ineffective.

Chapter 9 highlights the need for proper coordination between

monetary authorities and fiscal policy officials to obtain best results from monetary policy. When fiscal policy is excessively used and generates high budget deficits, monetary policy becomes accommodative and ineffective, leading to high inflation. Why politicians influence Central Banks and dilute their effectiveness is best captured by quoting the former Governor of the Reserve Bank of Australia; first, the tendency to push the economy to run faster than its capacity, and second, the temptation that governments have to incur budget deficits and fund these by borrowings from the Central Bank.

Global Economic Crisis

Chapters 5 and 6 deal with exchange rate management and the global economic crisis, respectively. Exchange rate management is closely linked to monetary policy. After heavy loss of international reserves during the recent global economic crisis, some Central Banks realised that defending the exchange rate (Sri Lanka spent over US$ 1 billion to defend the rupee), is not compatible with independent monetary policy and open capital account — known as the 'Impossible Trinity' (Sri Lanka had a partially open capital account). Either the Central Bank undertakes a devaluation or approaches a funding agency like the IMF for a loan to boost up the reserves, and there was no case for resisting both. It is by approaching the IMF that Sri Lanka created the space to pursue and sustain a more independent and relaxed monetary policy.

In the chapter on economic crisis and monetary policy, Thenuwara argues that the Central Banks have always been either part of the causes of the crisis or part of the solution to the crisis. He highlights the US experience of the economic crisis and how the then Fed Chairman, Alan Greenspan mis-read the economy and quotes Paul Krugman's observations on him: "Greenspan's story is also the story of how makers of economic policy convinced themselves that they had everything under control, only to learn, to their horror and the country's pain – that they did not" (p. 107).

Regulation has always lagged behind financial innovation, partly because financial innovation takes place at a rapid pace and partly because of the belief that financial markets are self-correcting. But when regulation is introduced especially after a financial crisis, it may be an interim measure which needs to be continuously updated to face the challenges of financial innovations. In regard to regulatory responses, Thenuwara highlights the shortcomings of Basel I and II and goes on to say "After resolution of the current crisis, international regulators, no doubt will introduce Basel III, and will fine tune it until the world is hit by a brand new crisis." (p. 124).

Effective Monetary Policy

Chapter 7 is perhaps the most important chapter in the book where the key theme is addressed. While money eliminates the cost of searching associated with the barter system (discussed in Chapter 1), excessive money growth does not cause any changes in the long-run growth of the economy. This phenomenon is called 'neutrality of money'. Excessive monetary growth, unless matched by equivalent increase in the supply of goods, will generate inflation. 'Highlighting the existing literature, the book shows that an inflation level of about 2% is the best to achieve high growth rates — completely dismissing an assertion by some commentators that having a little bit of inflation is like being a little bit pregnant that will grow to an uncontrollable level.

In Chapter 8, Thenuwara discusses inflation targeting (IT) and argues that "successful implementation of IT requires a country to meet several prerequisites: a mature financial system, monetary policy independence, fiscal discipline and transparency, accountability and good governance in the Central Bank" (p. 157). Due to the instability of the demand for money, many Central Banks have abandoned the monetary targeting framework in favour of IT. New Zealand pioneered IT and their strategy was that if the expected inflation was not realised, the Governor of the Central Bank would resign unless he could provide an explanation acceptable to the Parliament. Many countries (Canada, Australia, Chile, South Korea, Mexico, Israel, etc.) today use IT as a policy to bring down inflation. Sri Lanka is yet to create conditions for IT, although the subject has been discussed extensively. However, given the groundwork done so far, there are reasons to believe that IT will soon become the policy in Sri Lanka.

Independence of the Central Bank

The 10th Chapter is on the independence of the Central Bank. Thenuwara shows that unlike New Zealand and other inflation targeting nations, the Central Bank of Sri Lanka is both goal and target independent. Basically, the goal has to be identified from the broad objectives in the law governing the Monetary Board. The key duties of the Central Bank should be to ensure price stability and financial system stability. Some Central Banks are entrusted with a large number of other functions unrelated to the key objectives. For instance, the Central Bank of Sri Lanka is encumbered with management of government funds – EPF and management of public debt, and these have conflicting interests with the key objectives of the bank. "..Central Banks have realised that they do not have instruments and ways and means to achieve multiple objectives. The only task they could accomplish well is maintaining price stability.." (p.19).

The independence of the Central Bank of Sri Lanka is then discussed, first highlighting that the Central Bank has no legal identity and it is only the Monetary Board that has a legal identity; thus, what matters is the independence of the Monetary Board. The book highlights four areas which have contributed to the dilution of the independence of the Monetary Board: (1) Section 89 of the Monetary Law Act permits the Central Bank to grant provisional advances to the Treasury up to 10% of the estimated revenue. In the past, the Treasury has always availed of this facility fully, thus preventing the Central Bank from controlling this injection of money to the economy, (2) the Central Bank is the agent for the government in raising public debt – thus making it vulnerable to subscribe to the public debt, (3) the Central Bank is the banker to the government – thus causing difficulties in controlling money supply, and (4) the Secretary to the Treasury being a member of the Board (ex-officio) may influence the Board to accommodate the fiscal needs of the political establishment. The book argues that the Central Bank should be made independent by law (this was also the recommendation of the Final Report of the Presidential Commission on Finance and Banking, Vol. II, 1992, pp. 266-267), to make monetary policy more effective.

What should be the attitude of a Central Banker? Always pessimistic – always look for risks to the stability of the economy. Quoting another Central Bank Governor, the author argues that this attitude should permeate from bottom to top in a Central Bank: "when my Minister is elated about high economic growth, I worry about overheating of the economy, when he talks about high foreign inflows, I worry about external stability, and when he beams with appreciating currency, I worry about competitiveness of the country" (p. 215-216).

Looking Beyond

There are a few areas in the book where some questions could be raised. First, in the final chapter, the book argues the case for a regional Monetary Integration for bringing more binding commitment to monetary discipline than perhaps an independent Central Bank that will be difficult to create due to the political economy. This idea of course requires harmonising of macroeconomic policies – which would be difficult given the fiscal indiscipline in the regional members of South Asia.

Second is the re-emergence of Keynesian economic policy after the recent global economic crisis where a fiscal stimulus was injected by many countries (that had fiscal space) to rejuvenate their economies, rather than sticking to the monetarist doctrine of inaction. The latter is based on the belief that self-adjustment of the economy is sufficiently fast, while government action may cause undue harmful effects on the economy, which could have in any case reach its equilibrium before any government action takes effect. The rapid global recovery – at least at present – shows that the Keynesian formula has worked with reasonable control over inflation.

The book says: "..when governments resort to Keynesian policies of active engagement, countries may recover, but may cause other long-term problems of high budget deficits and high debt levels" (p. 121). The author presents the case where the monetary formula did not work when Japan was on a 'liquidity trap' in the 1990s and how it resorted to a fiscal stimulus to revive the economy resulting in budget deficits. This issue needs elaboration and Paul Krugman today advocates a 4% GDP fiscal stimulus package to the US economy instead of the current 1% GDP stimulus package of the Obama administration. Krugman believes that at a time when credit markets are frozen, producers are closing factories, and consumers are not spending, there are unused resources that could be put into effective work via a Keynesian stimulus and argues that any adverse consequences of such a policy could be effectively managed (see *The Return of Depression Economics and the Crisis of 2008* by Paul Krugman, Norton, 2008). This area should have received more attention in the book where better harmony could be worked out between fiscal policy and monetary accommodation to minimise the adverse consequences of a fiscal stimulus after a crisis.

Reflections

The book is written in very simple language without using much mathematical jargon. One needs not be an Economist to read and understand the book as all key concepts and terms are well explained. The book draws examples from various countries and is not confined to the Sri Lankan scenario alone.

It is very clear from the book that the author had a deep understanding of Central Banking and monetary policy. Although he is no longer serving the Central Bank, he has shared his experience and made a significant contribution to understanding monetary policy. The book will be useful for Central Bankers, policymakers and economists in Sri Lanka and it is an essential reading for anyone interested in the subject. ■

Registered in the Department of Posts of Sri Lanka under No. QD/35/News 2010

ECONOMIC REVIEW

The *Economic Review* published uninterruptedly since 1975 by the Research Department of the People's Bank provides a forum for indepth analysis and discussion of contemporary socio-economic issues and development related subjects. The recent issues of this journal cover the following important topics:

- *Education for Knowledge Economy, Growth & Development*
- *Ports & Shipping Sri Lanka as a shipping hub*
- *Indigenous Agricultural Knowledge in Sri Lanka*
- *Development of North & East of Sri Lanka*
- *IMF and its Recent Facility to Sri Lanka*
- *Peace in North & East of Sri Lanka*
- *International Trade & Some Issues of Sri Lanka*

Interested readers could purchase copies of this journal from our publications Sales Centre located at Head Office Premises, Leading Bookshops and selected People's Bank Branches. Few back issues are also available for sale at our Sales Centre.

Subscription	**Local-12 issues**	**Rs 540/-**
	Foreign-12 issues	**US$ 50**

Subcription could be remitted by Cheque/ Money Order along with a request letter. Cash payments are accepted at our Sales Centre.

Cheques/ Money Orders should be drawn in favour of
People's Bank - Economic Review and forwarded to

Director of Research, Research Department
People's Bank, Head Office, Colombo 02
Sri Lanka.

Phone: 2481428, 2436940
Fax: 2434526
e-mail: ersales@peoplesbank.lk

Economic Review
A community Service Project of the People's Bank

A Publication of the Research Department of People's Bank.
The contents of Economic Review may be quoted or reproduced with the acknowledgement.
ISSN No: 0259/9779

Price per copy: Rs 45/-