Going Forward: The Forgotten Need for Incentive Reforms in Sri Lanka

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1. *Prologue*

Much of the discussion on Sri Lanka's economic policies for the medium term and beyond seems to center on the importance of raising savings and investment and addressing infrastructure, reconstruction and similar "hardware" needs. Incentive reforms (reforms that induce higher profits, gains or inducements for economic agents to behave in a particular way) that raise the returns to investments have been forgotten, since 2004, at least. This has important consequences for the efficiency of investments, the GDP growth rate and the reduction of poverty. For, the returns to all these current efforts, investment in infrastructure and reconstruction would depend on incentive reforms.

The paper is structured as follows: after section 1, the prologue, section 2 discuses growth and incentive reform scenarios. Section 3 examines the case for incentive reforms and section 4 surveys the state of incentive reforms in Sri Lanka in three areas-foreign trade, the regulatory framework and the financial sector. Section 5 gives the conclusions.

2. *Growth and incentive reform scenarios*

Research and experience elsewhere show that with the neglect of incentive reforms, returns to investment fall significantly. In fact, with no incentive reforms to speak of in the last 7-8 years, Sri Lanka is in danger of wasting a significant amount of investment. The cost of this neglect is the forgone returns that result from poor incentives. At a very general level, the 4 percent growth rate of GDP in the last 10 years was associated with an investment rate of 18% of GDP, financed both by domestic savings and foreign funds. This suggests an incremental capital-output ratio (ICOR) of around 4.5 per cent. For example, with a 25 per cent improvement in productivity (or a decline in the ICOR to 3.0 per cent) would give an output growth rate of 6 per cent with a savings rate of 18 per cent, using the Harrod-Domar model based identity. This would raise GDP per capita to $ 3226 at the end of 2020 (assuming a 1.1 per cent population growth), had incentive reforms were undertaken in 2010. Thus Sri Lanka would lose $ 3226-$ 2661= $ 565 per capita in the tenth year having cumulated the losses every year over the period due to greater inefficiency reflected in the 4.5 per cent ICOR at the same rate of savings. If for example we could raise the savings rate (that is domestic savings and foreign aid) by 25 per cent, then our per

capita income in 2020 would be $ 3649 instead of $ 2661. Or we could have raised our per capita income by $ 988 in the tenth year. The Government was talking about doubling per capita income in six years, namely by year 2016. But for that to happen, GDP must grow by 10.1 per cent per year (i.e. 9 per cent a year in GDP growth plus 1.1 per cent to take into account population growth).

Such a growth rate is not feasible with no incentive reforms in most circumstances and an attempt to do it could lead to macroeconomic problems[1]. If the Government has to rely on money creation to finance that level of investment, it would lead to inflation. An investment of 45.0 per cent of GDP would be needed (10.1 GDP growth times the ICOR of 4.5). Some have referred to raising savings to that level but such an increase in savings is not feasible. If we were to borrow it, it will create foreign debt payment problems. In the past, the civil war prevented the Government from focusing on reforms. The war effort required large resources. And, its commitment to incentive reforms was absent. Now there is a chance to grow faster but it must be consistent with realistic goals and depend on incentive reforms to a large extent. However, there is no strong commitment to reform in the Government. It is not well disposed towards the private sector and seems to believe that the public sector can continue to do more.

Mainstream economists know that at current rates of saving and the ICOR, we could not reach the doubling of per capita income in six years from 2010 to 2016 as the government claims. In the more realistic ten year horizon, the "cost of forgotten incentive reforms" is reflected in the lower GDP per capita by $ 988 per person in the tenth year. When Government economists speak they seem to obfuscate the issue between nominal and real GDP. Of course nominal GDP can double with a good dose of inflation, but that would not improve the standard of living. The opposite would happen[2].

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[1] We say "most circumstances" in the absence of a huge windfall that enhances domestic savings considerably.

[2] World Bank (2011). During the 2004 – 2009 period, real GDP growth was 6 per cent per annum with the population growth rate at 1 percent, implying per capita growth of 5 percent per year. Yet dollar per capita GDP grew at a huge 15 percent per year. Assuming 2 percent US inflation, the big driver of the dollar GDP per capita growth was a rapidly appreciating bilateral real exchange rate, recording an annual average appreciation of 7.5 percent. If per capita GDP was estimated at competitive (non-appreciated exchange rate), then per capita GDP would have grown by much less. The fault lies partly with the World Bank Atlas method of estimating GDP per

Some would claim that this mechanical approach to scenario playing which assumes a fixed ICOR is not only unrealistic but does not accord with economic theory. Robert Solow in a 1956 paper showed that sustained economic growth is the result of technological progress, not increased investments[3]. As a theoretical position this is correct, since there is no fixed relationship of investment to growth. Thus if investment (machinery or capital) is increased keeping labor constant, then diminishing returns begin to occur. Only technological progress in which the aggregate production function shifts upward continuously would lead to sustained growth. But later it was discovered that human capital could contribute significantly to sustained growth. Education not only helps to accelerate technological progress but also helps to adopt technological change taking place elsewhere through capital imports, technology purchases and foreign direct investment (FDI). Thus total investment (both physical and human capital) pays a crucial role even though it is not in a fixed relationship to output. For instance, without investment (or addition of new capital), technology is not incorporated into the aggregate production function. Equally, it is the incentives in place that induce investment. If the returns are low, less investment takes place and consequently, technological progress is limited.

Another qualification is that while it is claimed that Solow type models of growth can only deal with exogenous growth or once and for all growth gains, with no on-going growth accelerations. However, the impact of once and for all growth impacts can last for long periods. Models of endogenous growth on the other hand show that economic growth can be policy driven with long lasting continuing effects until countries reach the world technological frontier[4]. All this means that policy reforms can raise the growth rate. This in turn would help to reduce poverty. For without growth, poverty reduction cannot be achieved on a sustained basis. While growth is necessary it is not sufficient without some specific interventions to address pockets of poverty. But for all this to happen, incentive reforms must take place.

A more reliable framework to assess the contribution of savings and investments to growth is to use total factor productivity (TFP). Output growth is explained by growth in labor, capital raw material

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capita at official exchange rates which are not competitive rates. The appreciation of the bilateral rate was due to domestic inflation.

[3] Solow, Robert (1956)

[4] Mankiw, Gregory, David Romer and David Weil (1992)

and an unexplained part by traditional inputs which are in fact due to the growth of TFP. The growth of traditional inputs, can only explain less than half of the growth of output. TFP growth together with factor augmentation that allows for offsetting diminishing marginal productivity of capital (as against Harrod-Domar model which assumes a constant ICOR) shows that over time, total productivity must increase in order to sustain economic growth. For instance, over the last 30 years, the average TFP growth in Sri Lanka has been around 1.0 per cent. Doubling TFP growth to 2 per cent poses an enormous challenge. In fact a 1.75 per cent TFP growth was achieved by only 2.5 per cent of the countries in a worldwide sample[5]. It is noteworthy though that Sri Lanka did achieve higher TFP growth immediately following the 1977 reforms[6]. Some partial evidence is available with respect to total manufacturing. Comparison of TFP growth in total manufacturing during 1966-1974 with 1977-81 and 1981-1993 is revealing. In the first period prior to reform, TFP was negative 2.99 per cent. After the incentive reforms, during 1977-81 TFP growth became less negative and was 0.78 percent. For the whole period, 1981-93 TFP growth was 4.47 per cent. Two conclusions can be drawn from these results. TFP growth responds to policy reforms after a lag and it can reach a high level with sufficient time allowed for the reforms to work through. Unfortunately the reforms effort wavered after the initial strong effort undertaken in 1977. Macroeconomic imbalances, declining enthusiasm for reform in the governing party led to lower GDP growth, with reduced TFP growth. [7]

3. *The case for Incentive Reforms*

Estimates of GDP growth rates done for large samples of countries indicate that the contribution to growth from improvements in efficiency is better than the contribution from investments alone. This raises the issue of what incentive reforms are needed to raise efficiency or productivity (or reduce the ICORs as argued above). What is needed is an increase in TFP growth that is associated with improved resource allocation as well as good access to technology. For this to happen, three areas would prove to be crucial for Sri Lanka. These are: foreign trade, regulatory and financial sector reforms. Trade reforms can lead to a better allocation of resources and raise productivity by leading to good decisions at the

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[5] Hevia, Constantino and Norman Loyayza (2011) Unfortunately, the paper uses exogenous values for TFP growth to simulate savings and growth links. It is well known that high savings rates are more difficult to achieve in the short and medium terms, putting greater onus on TFP growth.

[6] Athukorala, Prema-Chandra and Sarath Rajapatirana (2000)

[7] Lal, Deepak and Sarath Rajapatirana (1989)

margin, as what to produce domestically and what to import and what to export and what is to be consumed domestically. Trade reform is not simply import liberalization as the popular press seems to believe. It is allowing prices to allocate resources between domestic and foreign markets. Such an allocation improves efficiency. Regulatory reforms will help to foster competition and keep monopolies and oligopolies from creating excess profits and rents for enterprises at the expense of the consumer. Financial sector reforms will lead to greater financialization of savings and an increase in domestic savings, replacing foreign savings to some extent and make a contribution to higher income growth.

Incentive reforms are intended mainly to get the private sector moving and make its contribution to higher growth. Incentive reforms to induce private sector behavior to raise productivity work well, when they are accompanied by public sector reforms that will help to raise rates of return on private investments. This happens when public investment is complementary to private investment. In addition a better allocation of public investment through evaluation, control and monitoring of public investment would ensure that they are complements to private investments and not substitutes. The best allocation is when the rates of return to private and properly evaluated public sector investment are equal so that no other allocation can raise the overall rates of return which in the aggregate is equivalent to the rate of growth of GDP. So if GDP is the sum of the rates of return to private and public activities weighted by their optimum shares, then public investments can make a crucial difference to the growth outcome. Of course, the public shares should have room for public goods which would be under-produced if only the market mechanism were to be allowed to allocate resources. This is why a proper evaluation of public investment is needed to make sure adequate public goods are produced taking into externalities. It is not an accident that most of the sustained fast growing economies have efficient public sectors.

Another mode that is being used in many countries is public-private sector partnerships. They can also contribute to better economic performance under a set of credible and effective conditions in a proper regulatory environment. Thus private and public sector participation with clearly defined boundaries could raise productivity overall. China and India have been able to achieve very high growth of 10 per cent and 7.5 per cent respectively in the 10 years prior to the Global Financial crisis that began in 2008. Such growth rates are within our reach with good incentive reforms. These countries have eschewed old style planning, pervasive public control of economic activities, and reformed their incentive regimes in far reaching ways. China has more liberal trade and foreign investment regimes akin

to those in the developed world and a far more open economy than most of the developing countries. India, has also loosened its "iron grip" of bureaucratic controls, liberalized the trade regime to a large extent compared to the past and reformed regulatory environment[8]. Vietnam is another example of a highly controlled economy that undertook incentive reforms and improved economic performance all around.

4. *State of Incentive Reforms in Sri Lanka*

Foreign Trade

Since 1995 there has not been an important trade reform. What was done in June 2010 was partial, reversible and subject to uncertainty. It was not a proper liberalization in that effective protection rates may have increased as nominal tariffs on intermediate inputs were reduced by a larger proportion than those on the final goods. Remarkably, the WTO's trade policy review of 2010 completely missed this point as it only took into account only standard tariffs[9] . High tariffs, some as high as 40-50 per cent that had helped to finance the war effort have been replaced by across the board 15 per cent tariff but many other high rates persist. Thus total tariffs including both standard tariffs and para-tariffs (the tariff equivalent of many charges and taxes that are imposed on imports) raise the level of protection. The trade regime has become more protectionist compared to the 1989-2004 period[10].

Pursell and Ahsan (2011) have noted that trade policies became restrictive during 2001-2004 period following the LTTE attack on Katunayake when a 40% import surcharge was imposed[11]. Many import cesses and para tariffs were introduced to help finance the war. Protectionist trends expanded and became stronger during 2007-09. There was an ideological commitment to protection, supported by many Sri Lankan economists, known for their Left leanings. They conveniently ignored the trade liberalization of East Asia and later by China (starting in 1979 under Deng Xiau Peng) and India (1990) responding to a macroeconomic crisis. The Indian trade liberalization was led by Dr. Manmohan Singh

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[8] Indian growth rate has faltered recently and most analysts agree that it is due to the slowing down of the reforms that started in the early 1990s.

[9] WTO (2010)

[10] Athukorala, Prema-Chandra (2012)

[11] Pursell, G and F.M.Z. Ahsan (2011)

but it retained tariffs on consumer goods imports. That was challenged by the US in the WTO and India agreed to not to seek protection for balance of payments purposes, particularly through quantitative restrictions. According to Pursell and Ahsan, in 2011, Sri Lanka and Bangladesh are the most protectionist countries in South Asia. As noted above, a modest relaxation of trade controls took place in June 2010 in Sri Lanka when surcharges were reduced to 15% across the board. Earlier there was the VAT, Social Responsibility Levy, Nation Building Tax and Excise duties. Then there was a special commodity levy on 22 essential imports. Consequently, agriculture remains the most protected sector with high tariffs and input subsidies[12]. Valdes (2012) found that effective rates of protection (ERPs) were high for some importables. Those for paddy were 111 per cent, for fresh milk was 907 per cent and for paddy 111.71 per cent calculated for 2010/2011[13]. For exportables during the same year, ERPs were negative 31.4 per cent for coconuts and negative 4.24 per cent for made tea. Not only are ERPs high, they also have wide variance which leads to resource misallocation problems.

Today, para-tariffs and various charges have remained in place. The present tariff regime is unpredictable. Many ad hoc changes are introduced particularly in the import of food, fuel and motor vehicles to name a few. For instance, car tariffs were reduced in 2010 but were increased later. Car assembly where value added at international prices exceed value added at domestic prices is one piece of evidence that the trade regime as presently constituted does not help to increase competitiveness and productivity. To make matters worse, the Government exempted domestic car assembly firms from the excise taxes making them earn even higher rents than before.

There were many para tariffs leading to similar protective and revenue effects that created a bias against exports. In 2010 para tariffs were reduced from 39.9 % of all tariff lines (total 6520 tariff lines) to 27 %. However, the total protection rate has increased compared to the pre- 2001 period, many types of tariff- like devices came to be used and the trade regime became complex and unpredictable with many changes especially in agricultural imports. Again, the case of motor cars imports is revealing. After reducing tariffs from 300% in June 2010, many rates were re-instituted.

[12] Valdes, Alberto (2012).

[13] Effective Rates of protection is protection accorded to domestic valued added taking into account tariffs and other trade measures effecting input and output prices as a proportion of international value added at free trade prices of inputs and outputs.

A study by the International Trade Center (ITC) found that Non-tariff measures (NTM) have created formidable barriers to export and imports, much to the detriment of efficiency[14]. A NTM survey done by the ITC found that Sri Lanka is among the most affected countries by these measures.

First, nearly 70 per cent of exporters complain about the NTMs. There are many procedural obstacles, clearances needed from Plantations and Forestry ministries and other authorities. Bribery is rampant. Exporters complain that domestic barriers are severe compared to foreign barriers, with respect to certification, meeting rules of origin among other requirements. The largest proportion of reported NTMs referred to are technical regulations and conformity assessments. In the case of imports, a cluster of charges, taxes and other para-tariff measures were also mentioned as formidable impediments to trade.

Second, obstacles are caused by inspections at Customs. Complaints referred to very long delays, especially if several government agencies are involved, and sometimes damage to cargo due to manual examinations rather than using X-ray machines. An initiative that requires all relevant agencies to be represented at the same time for a “single inspection”, combined with general training of officials, may alleviate frictions at Customs and Ports.

Finally, there are problems with respect to rules of origin, i.e. non-technical import requirements by importing countries. To benefit from preferential trade agreements in large market like the European Union, under the Generalized System of Preferences (GSP) and Special Incentive Arrangement for Sustainable Development and Good Governance (GSP+), require certificates of origin that many exporters find hard to obtain. Especially in the clothing sector, the rules of origin certificates are more of a burden than other requirements relating to technical matters.

Looking at the trade regime over 1994-2003 has not helped to raise TFP growth. First, the rise in import protection and its wide dispersion leads to greater resource misallocation. This misallocation comes from resources flowing to import substitution and non-tradable goods. Second, the corollary to it is that there is a bias against exports while the share of Sri Lanka’s exports in world trade and in the country’s GDP has fallen. Third, due to the emphasis on import substitution as a policy pursued by the Government, there is a greater tendency for the real exchange rate to appreciate, making non-tradable

[14] International Trade Center (2011)

goods more profitable compared to tradable goods. Such activities do not contribute to raising TRP growth. Finally even more disconcerting is the Government's avowed goal to pursue import substitution into the future. [15]

Regulatory Framework

Regulatory reforms are needed to give greater freedom to individual enterprises to hire and fire personnel and manage their affairs within a credible system of entry, exit and rules of conduct. Certain restrictions continue, despite changes in Governments. For example, even with the strong liberalization of the trade regime in 1977 (in contrast to the dirigiste regime that prevailed in the seven years before), the UNP did not dismantle the public enterprise apparatus. It served to maintain political patronage despite their very poor record in contributing to the national treasury or providing complementary investment to raise private sector returns. Simply changing staff without changing ownership is guaranteed to keep state owned enterprises (SOE) inefficient and a burden on the Government's budget and society. Given this situation, it is a huge mistake not to privatize. Privatizations were given a bad name by earlier governments. And, it also suites the ideological make-up the present Government.

Sri Lanka had a rank of 83 out of 189 countries for doing in the Ease of Business in 2013[16]. High cost of doing business inhibits better use of resources. . Public investment, to support development must be based on sound rates of return analysis and requires strong parliamentary oversight of public expenditures, which has broken down. The other aspect of the regulatory reform is the need for independent regulatory bodies to restore the reputational capital of many regulatory institutions to make them credible and more affective. At most times, good regulation comes about by review and doing away with regulatory rules and practices that inhibit rather than promote specific activities. In the literature on regulation, the analogy of an umpire is more apt than being a player.

[15] Ministry of Finance (2012) Annual Report. It proposed direct import substitution in subsidiary food crops and import competing manufacturing industries to increase the domestic content of export product. The latter policy is counterproductive to promoting efficient exports that have suffered from a decline in competitiveness, as evidenced by the falling share of Sri Lanka's exports in the world market. Both these policies increase the bias against exports.

[16] World Bank (2013)

Labor market problems persist today due to inappropriate regulation. The Termination of Employment of Workers Act 1971 is a case in point. It reduces labor market flexibility and employment. The Revival of Under Performing Enterprises of Under Utilized Assets Act No: 43 of 2011, has an inhibitive effect with respect to capital and entrepreneurship. It enables the arbitrary takeover of businesses, claiming them to be under- underutilizing their capacity and having under-performing assets. It does not lead to a healthy investment climate and a vibrant private sector led economy. One reason for the low levels of FDI to Sri Lanka is the poor regulatory framework in place. Compared to countries like Thailand, Vietnam and Indonesia, the inflow of FDI is small, even after the end of the war against terrorism.

Government must desist from arbitrary interventions in the private sector such as proposing salaries with no relationship to productivity and mandating private pension schemes as it has attempted to do recently. Some of the problems of the incentive system with respect to the public sector related the regulatory reform is the following:

First, state owned enterprises (SOE) are not subject to the same codes of conduct as private firms. They have privileged access to state owned banks, better time at clearing goods at customs and easier access to getting certifications with respect to exports and imports. Of course few of them can export since they are not internationally competitive. Any time a SOE product is exported it entails a subsidy to the foreign importer given the hidden subsidies to these enterprises from their very establishment.

Second, they have a stranglehold on domestic businesses since they dominate crucial services like electricity, water, petroleum, products, gas and air transport among others. In fact their hold on the economy has been increasing since 2004. Many activities have been re-nationalized; witness the Lankan airline, petrol distribution (Shell takeover) among others. And, regulatory takeovers such as the creation of a new Government owned airline, Mihin Air and acquiring shares of few major commercial banks with Employers Provident Fund resources.

Finally, there is no effective parliamentary control of SOEs. The parliamentary Committee on Public Expenditure (COPE) tries to bring control over SOE but their efforts are limited through lack of support for the committee by the majority party in parliament. Public enterprises can behave badly with impunity with no consequences to their management since the system of political patronage

protects them. Witness the losses from hedging by the Ceylon Petroleum Corporation, or the huge loss of money by the management appointed by the Government to the various public enterprises. With all these large losses the country suffers not only in financial losses but more damaging is the loss of competitiveness and future prospects to grow faster. The recent news that the financial performances of the CPC and Ceylon Electricity Board have improved is encouraging. However, if they are achieved by raising prices (rather than reducing costs), it means that the improvement in performance is not due to improved competition but getting consumers to pay for the continuing inefficiency of these enterprises.

Financial Sector issues

Much of the incentive related reforms in the banking system have been done in the early 1990s. The issues that remain are those related to the non-banking sector especially with respect to leasing, investment banking, non-bank deposit taking institutions and the capital market regulations.

As long as the state banks dominate the banking system in this country, privately owned banks make a large profits because they have lower intermediation margins compared to the state banks that determine interest rates, and financial charges. Foreign banks are even more profitable because they are run as businesses with close international connections. Hence their role in underwriting many large transactions from bond issues to the hedging fiasco where these banks played a role to make money from a not so wise management of the Ceylon Petroleum Corporation.

An area which needs strong reform is with respect to financial houses that have taken large deposits and have basically stolen funds while the Central Bank and the regulatory authorities were 'sleeping at the wheel'- a term now being used frequently with respect to the Federal Reserve System in the US under Allan Greenspan in 2008 when the housing credit crisis in the US which began and spread to the rest of the world. A better supervision and regulatory system is needed to prevent what has happened few times in the Sri Lankan financial market. Regulating and keeping a watch on non-bank intermediaries should be a priority for the Government. In many countries, the regulations governing such firms are implemented by a separate entity other than the Central Bank which can concentrate its efforts on the banking institutions.

With respect to the capital market much reform is needed to regulate mergers and acquisitions and how they are treated by the share market agents and not end up as insider trading. Moreover, there have been frequent changes in the management of the Securities and Exchange Commission of Sri

Lanka. Even if the laws and regulations governing the market are well designed, much depends upon implementation that relies on good management.

Finally, that the heads of the two state banks (which public enterprises) change with every government change is a resounding indictment of the banking system which remains as the most important part of the financial system. Being publicly owned, they have become a part of the political patronage system where those supporting the party in power get access to large loans and other accommodations.

5. Conclusions

The Incentive framework is deficient: major reforms are needed in trade, regulatory and the non-bank financial sector framework to bring about efficiency. The high annual growth rates projected by the Central Bank and other Government agencies will not be realized without incentive reforms, even that would require a 10-12 year time horizon and more committed and effective policy actions. The key focus should be on TFP growth. A higher TFP growth allows the country to reach higher GDP growth rates with enhanced rates of domestic savings. And, reduced variances in TFP growth are at the activity and sector levels would lead to improved resource allocation which is by itself growth enhancing.

Unfortunately reforms in the three areas identified are not generally attractive to the run of the mill politicians. They are usually carried out by strong leaders who are prepared to take strong actions when there are no immediate political gains. Good leadership combined with macroeconomic stability is essential to initiate incentive reforms.

Institutional changes are needed to increase efficiency such as increasing credibility of the leading institutions , be it the Ministry of Finance or the Central Bank; neutral regulatory agencies and getting rid of restrictive labor laws such as the Termination of Employment of Workers Act of 1971 and the Revival of Under Performing Enterprises of Under Utilized Assets Act No: 43 of 2011 would prove to be crucial not only to improve efficiency but also to give a signal, that the country takes private sector led growth as a primary goal. Reinstituting privatization as a public policy would not only help to raise efficiency, it will also limit a system of patronage in the SOEs. Sri Lanka needs to learn from China, India, Vietnam and other rapidly growing Asian countries.

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