Editorial

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FT View

Unfair taxation

SRI Lanka's quest for an equitable and simple tax policy is a long one and perhaps the reason for this is that the people who guide such policies are not honest in their intentions to reduce the inequality seen in society. This was further underscored by Wednesday's tax increases that focused on daily products and vehicle spare parts.

The Finance Ministry defended the move by insisting it was protecting the domestic diary industry but disregarded the fact that average families do not have access to locally produced milk. Moreover, products such as cheese are not only of lower quality than premier international cheeses but are also priced higher than average due to protectionist policies.

Senior Minister of Human Resources and Chairman Parliamentary Committee on Public Enterprises (COPE) D.E.W. Gunasekara recently warned of Sri Lanka's continued inattention to providing a tax system that efficiently takes from the rich to give to the poor, rather than a system where the rich get richer (with the help of offshore bank accounts if recent revelations are to be believed) while the poor are taxed heavily.

Speaking at the Central Bank's Annual Report launch, he told the gathering that included President Mahinda Rajapaksa, that borrowing for infrastructure development has overshadowed improvement of living standards and insisted that numbers of high growth and low inflation are not actually felt by the masses.

He recalled that the tax-to-GDP ratio is the lowest since independence and non-direct taxes account for the bulk of the government's tax receipts. This, the Minister stressed, shows that income disparity is huge. Intimating that the best solution is a comprehensive taxation policy, Gunasekara went on to call for the restructuring of Customs, Excise and Inland Revenue Departments as the three "houses" that bring in the bulk of public expenditure.

The problems that Gunasekara referred have been articulated by top economists in the country and organisations such as the International Monetary Fund (IMF). Reports have indicated that the ratio for direct and in-direct taxation in Sri Lanka is close to 20:80 whereas the number should ideally be 60:40.

In 2012, revenue declined to 13% of GDP from 14.3% of GDP in 2011, mainly due to tax revenue declining from 12.4% of GDP in 2011 to 11.1% in 2012. Revenue from VAT declined by 0.8% of GDP in 2012 compared to 2011 (3.5% to 2.7% of GDP), mainly due to many exemptions or zero ratings. Income tax declined from 2.4% GDP in 2011 to 2.3% of GDP in 2012 due to rate adjustments not being matched by broadening the tax base in 2012.

The IMF has repeatedly called on the Government to revamp their tax policy and increase the efficiency of their tax collection system. During their last visit to Sri Lanka, the delegation noted that other countries gain higher revenue for each percentage of tax that is imposed. Not only does this mean that income for public services such as healthcare and education are lower it also places high tax burdens on legitimate businesses. Therefore, instead of creating a culture that rewards taxpayers, it encourages tax evaders.

This is clearly a phenomenon that gains mileage on a daily basis. Take, for example, the logic of the Government introducing casinos, arguing that they would increase tax gains but in reality, handing out 10-year tax holidays to the projects. The carrot of tax concessions is not essential if the investment environment is efficient and corruption-free but rather than addressing these concerns, policymakers prefer to heap more misery on the masses.

Strengthening direct taxation, launching investigations into as many as 30 Sri Lankans holding accounts in tax havens and implementing a simplified and equitable tax policy is arguably the biggest development challenge faced by the Government.

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Asia and the middle-income trap

My View
Global Economics
By Razeen Sally

WILL Asian emerging markets follow Latin America and the Middle East into the middle-income trap? Having enjoyed fast catch-up growth, will they now get stuck, unable to graduate to high-income levels? These are live policy and research questions, most recently brought up in the IMF's Spring Regional Outlook for Asia and the Pacific.

This IMF report identifies middle-income countries in East and South Asia as those with per-capita incomes of US$ 2,000-15,000. Its reading of the evidence is that there is indeed a middle-income trap, and Asian countries need to reform policies and institutions to get out of it.

Let's probe deeper. Most of the evidence on the middle-income trap comes from Latin America and the Middle East. These are regions abundant in land and natural resources. They have had growth spurts during commodity booms, often followed by growth crashes when commodity prices plummet.

In Latin America, from the 1950s to the 1970s, extra growth came from import-substitution policies that favoured urban, import-competing manufacturing industries. However, the inefficiencies these policies bred caused growth to taper off, come to a halt and even end up in macroeconomic crises.

In contrast, much of East and South Asia is abundant in labour. The East Asian Tigers started their catch-up growth by putting armies of initially unskilled labour to work. They shifted rapidly from agriculture to export-oriented manufacturing. Then they moved up the value chain in 'flying-geese' pattern. From the 1980s and '90s, they inserted themselves in global value chains (GVCs). Growth has been higher and more sustainable, with benefits more widely shared, than in Latin America and the Middle East.

Until the 1980s, South Asia, unlike East Asia, had Latin American-style import-substitution policies that restricted growth – and without a commodities bonanza. But then the sub-continent opened up and integrated with the global economy. Growth rates shot up accordingly.

The comparative lesson is clear: labour abundance has helped 'globalising Asia' to achieve faster catch-up growth, particularly with export-oriented industrialisation in East Asia. That puts the region in a better starting position than Latin America and the Middle East to avoid the middle-income trap.

Now let's differentiate middle-income Asia. There are eight countries that stand out in East and South Asia: the ASEAN-5 (Malaysia, Thailand, Indonesia, Philippines and Vietnam), China, India and Sri Lanka. But they are at very different levels of development. So let's first divide them into 'high middle-income' and 'low middle-income' brackets. Malaysia is at the top of the high middle-income bracket. Indonesia, Philippines, Vietnam, India and Sri Lanka are in the low middle-income bracket. China and Thailand are roughly in the middle with per-capita incomes of about US$ 8,000.

Now let's make a further subdivision, this time within China and India. Both have vast sub-continental reach, with sub-regions that differ widely in terms of economic development. The 10 coastal provinces of China are clearly in the high middle-income bracket, close to Malaysia. But the interior provinces are low middle-income.

The more advanced Indian states, mainly in the south and the west, are low middle-income, but India's 'cow belt' in the north-centre, and its northern and eastern states, are low-income. Much of India, like Pakistan, Bangladesh, Nepal, Cambodia, Laos and Myanmar – not to mention East Timor, Papua New Guinea and North Korea – has yet to escape the low-income trap.

This twofold differentiation of middle-income Asia is important, for it affects conclusions on policy and institutional reforms to get out of growth traps.

So far, only five Asian countries have escaped the middle-income trap: Japan, South Korea, Taiwan, Hong Kong and Singapore. What do the rest need to do to follow them?

To answer this question, it is useful to go back to the World Bank's landmark report, The East Asian Miracle, published in 1993. It analysed the catch-up growth of the East Asian Tigers, but some of its conclusions are relevant to the middle-income trap. Its foremost conclusion was that it is vital to 'get the basics right': macroeconomic stability, relatively low distortions to domestic competition, openness to external trade, flexible labour markets, and investment in hard infrastructure as well as education. Pace the 'revisionist' school of thought, these "horizontal", economy-wide policies are far more important than 'vertical' industrial policies to promote favoured sectors and national champions.

Getting the basics right must still be the top priority for low-income Asia – including the less developed states in India. These countries and regions should be in the business of catch-up growth, which comes from maximum mobilisation of capital and labour inputs, and large productivity gains from efficient resource reallocation. This is what Paul Krugman calls growth through 'perspiration'.

At the other extreme, high-income Asia, from Japan down to Singapore, has to rely on 'output-led,' productivity- and innovation-based growth. This is what Prof. Krugman calls growth through 'inspiration'. Getting the basics right is still important – note that Japan is hurtling in the opposite direction with wildly profligate fiscal and monetary policies. But this has to be complemented with more sophisticated structural and institutional reforms.

These 'second-generation' reforms have to go beyond liberalisation of product markets to encompass deregulation of factor markets (for land, labour and capital). They must also include opening up of services sectors, upgrading 'soft infrastructure' (such as higher education and skills), and improving the quality of public administration, regulatory agencies and judicial systems.

What about middle-income countries 'in between'? They need a mix of getting the basics right and second-generation reforms. But the balance should differ as between high middle-income and low middle-income countries. High middle-income countries need to crack on with structural and institutional reforms for productivity-based growth. This applies to Malaysia, Thailand and China (especially its coastal provinces).

Reforms to the Bumiputera policy and government-linked companies in Malaysia, the financial sector, state-owned enterprises and the hukou system (that restricts labour movement) in China, and property rights and the rule of law in all three countries, come to mind.

Low middle-income countries still have to go farther with getting the basics right, just as they have more room for catch-up growth. But they must also embark on the simpler, less institutionally demanding second-generation reforms. That applies to India (especially its more advanced states), Sri Lanka, Indonesia, Philippines and Vietnam.

The middle-income trap is also as much about politics as it is about economics. Second-generation reforms are politically more sensitive than first-generation reforms, for they get closer to the heart of vested interests and political systems. That is why factor-market deregulation generally lags far behind product-market liberalisation.

To make middle-income trap issues more concrete, let's look at one policy cluster: trade and global value chains (GVCs). The latter fragment production across borders. Simultaneously, trade in parts and components, and complex logistics systems, knit production networks together to serve global markets. Trade in GVCs is the fastest growing part of international trade, and a critical driver of productivity, growth and employment in both developed and developing countries. East Asia, alongside NAFTA and the EU, is a production hub for GVCs.

How can GVCs help countries to escape growth traps? For low-income and low middle-income countries, the challenge is to insert themselves into labour-intensive segments of GVCs, particularly in manufacturing. This is a proven recipe for fast catch-up growth. It applies to South Asia, the poorer ASEAN countries and the interior provinces of China. High-income and high middle-income countries need to specialise in more capital-, knowledge- and skill-intensive segments of GVCs, in manufacturing and increasingly in services.

Finally, what policies best ensure gains from GVCs? First, get the basics right with macroeconomic stability, competitive product markets, low levels of red tape, and openness to trade and foreign direct investment (FDI). Second, focus on taking down more complex regulatory barriers, especially in services, FDI and border administration. And third, avoid industrial policy of the 'picking winners' variety.

Discriminatory policies, e.g. local-content and technology-transfer requirements, FDI and public-procurement restrictions, lax intellectual-property protection, trade-distorting subsidies, disrupt the seamless cross-border flow of goods and services that is the essence of GVCs.

(The author is Visiting Associate Professor at the Lee Kuan Yew School of Public Policy, National University of Singapore.)

Letters to the Editor

email: editor@ft.lk

Let northern voters choose chief minister

THE UPFA Government has categorically stated that it will not nominate candidates as chief minister candidates in the provinces where they are contesting. This shows that they are allowing the people of the respective provinces to elect persons of their choice as the chief ministers through their preferential votes. This is a highly democratic process and is one which should be emulated by other political parties as well.

In that regard, the TNA would do well to follow suit and give the opportunity to the voters of the Northern Province to choose the chief minister of the Northern Provincial Council. In such a situation, certain leaders of the TNA who have worked hard for the people of that area would definitely be more popular than Justice C.V. Wigneswaran, who has not done anything for the people of that area, or even sacrificed one day's service towards the north.

It is therefore hoped that the leadership of the TNA would respect the wishes of the people, who for 25 years were deprived of the opportunity of electing a chief minister of their choice, to do so at this important moment in the nation's history.

V. Thirunavakarasu
Point Pedro

Entry of C.V. Wigneswaran

C.V. Wigneswaran

IT was sweet music in the ear, hearing of the entry of C.V. Wigneswaran to the political arena, even though only at provincial level. It is fervently hoped that his rather late 'quick march' on to the political parade ground will be seen as a march 'on the double' (he was the Senior Sergeant of the Royal College Senior Cadet Platoon) to national politics.

Considering the present political climate of Sri Lanka, the entry of C.V. Wigneswaran is viewed as a panacea by all right-minded patriotic citizens of all hues. A mature legal luminary with unimpeachable professional conduct will undoubtedly be seen in the images of those of the calibre of Sir Ponnambalam Arunachalam, Sir Ponnambalam Ramanathan and a more recent figure of Lakshman Kadirgamar.

He has stepped in as the Chief Ministerial Candidate of the TNA. This automatically labels him a 'Tamil' politician, which is unfortunate as he should rise as a national figure, surpassing sectarian interest, upholding and bearing the national interest foremost.

This celebrated personality was seen speaking in his mother tongue, on being welcomed as a Judge of the Supreme Court. This indeed is a rare gesture by any standard, in this day and age. If one can be proud of and respect his mother tongue, and even demonstrate it at the highest echelon, then he has shown his mettle and proven his ability to respect his motherland and its people.

It would do well for him to remember certain antecedents of a constituent of the TNA; the 'Federal' Party of S.J.V. Chelvanayakam – Federal in English sounds innocent, but to the Tamil speaking, it was 'Thamil Arasu Kachhi,' meaning 'Tamil Government Party' – a different connotation altogether! A government should be national and cannot be either Tamil or Sinhalese. Such misleads have been made on both sides of the divide, obviously for short term gain, but to the eventual detriment of the country, as witnessed umpteen number of times in recent history.

As of today, we see bunches of bigots being used by influential elements to stoke the flames of racial hatred and religious intolerance, with sinister attempts to take the country back to the dark eras, for the advantage of a few. Unless this is nipped in the bud, the country's future will be bleak. It is in this back drop that entry of C.V. Wigneswaran is viewed with delight. It is hoped many more of the educated and mature patriotic fraternity, of all hues, will follow suit, and not leave C.V. Wigneswaran in isolation; as a last ditch they should come forward to save our motherland, and embark on a political role, effectively displacing hoodlums and thugs currently occupying the hallowed precincts of our national body politic.

Good luck C.V. Wigneswaran!

A Professional