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Sri Lanka's Rebirth

COLOMBO – Sri Lanka has been deservedly praised for the progress it has made since the end of the war against the separatist Tamil Tigers in 2009. The economy has grown at an average annual rate of 6.7%, and education and health statistics are impressive.

All developing countries face myriad challenges, but this is especially the case for a country that has suffered an intense 30-year civil war. The government will need to set priorities; but success will require a comprehensive approach.

Underlying wars such as the fight with the Tamil Tigers are, typically, social and economic grievances such as real or perceived discrimination, and the failure of government to address wealth and income disparities adequately. Thus, more than transitional justice is required in Sri Lanka (or, to take another example, in Colombia, where peace with the FARC guerillas seems increasingly likely). What is required is full integration of the Tamils, Sri Lanka's embittered minority, into the country's economic life.

Markets on their own won't solve this problem. Sri Lanka will need balanced affirmative-action programs that address the various dimensions of economic disparity and are

attuned to the inequalities *within* the Tamil population. It will do no good to give a leg up to Sri Lanka's many rich Tamils, while leaving poor, lower-caste Tamils further behind.

Economic integration of the northern Tamil region will require heavy public investment in infrastructure, education, technology, and much else. Indeed, such investments are needed for the entire country. And yet tax revenue as a share of GDP is only 11.6%, about one-third that of Brazil.

Like many other developing countries, Sri Lanka simply enjoyed the fruits of high commodity prices in recent years (tea and rubber account for 22% of exports). Sri Lanka *should* have used the commodity boom to diversify its export base; the previous government of Mahinda Rajapaksa did not. With export prices down, and with tourism likely to suffer from the global economic downturn, a balance-of-payments crisis looms.

Some suggest that Sri Lanka turn to the International Monetary Fund, promising belt tightening. That would be hugely unpopular. Too many countries have lost their economic sovereignty in IMF programs. Besides, the IMF would almost surely tell Sri Lankan officials not that they're spending too much, but that they're taxing too little.

Fortunately, there are many taxes that the authorities can impose that would increase efficiency, growth, and equity. Sri Lanka has abundant sunshine and wind; a carbon tax would raise considerable revenue, increase aggregate demand, move the country toward a green economy, and improve the balance of payments. A progressive property tax would encourage more resources to go into productive investments, while reducing inequality and, again, boosting revenues substantially. A tax on luxury goods, most of which are imported, would serve similar goals.

Some in the country, citing inadequate inflows of foreign direct investment (despite marked improvement in the business climate), argue for lower corporate taxes. But such tax concessions are relatively ineffective in bringing in the kind of long-term investment that Sri Lanka needs; so to embrace them would needlessly eviscerate the already weak tax base.

Likewise, another frequently proposed strategy, public-private partnerships, may not be as beneficial as advertised. Such partnerships usually entail the government bearing the risk, while the private sector takes the profits. Typically, the implicit cost of capital obtained in this way is very high. And while the private sector can, and frequently does, renege on its

contractual obligations (through bankruptcy) – or force a renegotiation under the threat of reneging – the government cannot, especially when an international investment agreement is in place.

Twenty-first century development strategies need to be different. They should be based on learning – learning to produce, learning to export, and learning to *learn*. There can be leapfrogging: in Sri Lanka's case, the benefits (apart from direct employment) to be gained from certain low-skilled manufacturing stages like garments may be limited. Given its education levels, Sri Lanka may be able to move directly into more technologically advanced sectors, high-productivity organic farming, and higher-end tourism.

But if Sri Lanka pursues such activities, it will need to ensure good environmental policies for the entire island. That will necessitate sound urban planning. Sri Lanka is fortunate to have a low level of urbanization today; but this is likely to change in the next two decades. This gives the country the opportunity to create model cities, based on the adequate provision of public services and sound public transport and attuned to the cost of carbon and climate change.

Sri Lanka, beautiful and ideally located in the Indian Ocean, is in a position to become an economic hub for the entire region – a financial center and a safe haven for investment in a geopolitically turbulent part of the world. But this won't happen by relying excessively on markets or underinvesting in public goods. Fortunately, with peace and the emergence of representative political institutions, Sri Lanka today has a better opportunity than ever to make the right choices.

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