

Informal Economy in the Conflict Affected Region of Sri Lanka

An Exploration

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Introduction

The conflict-affected region in Sri Lanka comprises two provinces, namely Eastern and Northern provinces, and the adjacent areas in the North Central, North Western, Uva, and Southern provinces. However, for the purpose of this paper only the Eastern and Northern provinces are taken as the conflict-affected region. In conflict regions and countries the functioning of government administration and justice system are very weak, which naturally leads to economic activities and transactions that are beyond the margins of the law and hence qualifies as the informal sector/economy (as opposed to the formal sector/economy). Informal economy is defined as all economic activities or transactions that are not captured in the official national income accounts.

Informal economy is also referred to as unofficial, hidden, parallel, black, shadow, second, underground, alternate, subterranean, and complementary economy (Alessandrini and Dallago, 1987; Gaertner and Wenig, 1985; Harding and Jenkins, 1989; Sarvananthan, 2001; Tanzi, 1982; World Development, 1989). A distinction is made between informal/unofficial and black/illicit goods and services or economy. Transactions in (or distribution of) some goods and services could become informal/unofficial because of non-registration or non-accounting of such transactions, non-payment of taxes, etc, but production of such goods and services are perfectly legal (aka 'goods'). These are usually referred to as informal or parallel economy. On the other hand, there are some goods (such as narcotics) and services (such as prostitution) whose production itself is prohibited and therefore illegal (aka 'bads'). These are usually referred to as black or underground economy. The welfare implications of informal/parallel economy and black/underground economy are different (Sarvananthan, 2001: chapter 8).

However, for the purpose of this paper both the foregoing categories are regarded as part of the informal economy. The objective of this paper is to study the nature, extent, and causes of the informal economy in the conflict-affected region of Sri Lanka and propose policy measures to combat or reduce such informal economic activities.

Provincial GDP

The Northern province has the lowest Provincial Gross Domestic Product (PGDP) in Sri Lanka, which is followed by North Central and Uva provinces. Eastern province has the fourth lowest PGDP after Northern, North Central, and Uva provinces. Western province is the largest contributor to the national economy of Sri Lanka, which contributes around 50% of the national GDP.

The PGDP of the Eastern province almost doubled during the six years between 1999 and 2004 (the latest available) from LKR 50 billion to LKR 98 billion. The share of Eastern Province in the national GDP fluctuated between 4.5% in 2000 (lowest) to 6.1% in 2003 (highest) during the same period. Similarly, the PGDP of the Northern province more than doubled between 1999 and 2004 from LKR 25 billion to LKR 52 billion. The share of Northern province in the national GDP fluctuated between 2.2% in 2000 (lowest) to 2.9% in 2004 (highest) during the same period (Table 1). Besides, the PGDP of the Eastern Province has been almost double that of the Northern Province during the period 1999 and 2004.

PGDP of both the East and North have improved during the time of ceasefire, i.e. between 2001 (year prior to the ceasefire) and 2004. The Eastern PGDP increased from LKR 62 billion in 2001 to LKR 98 billion in 2004 denoting a rise of almost 60%. In the same way the Northern PGDP increased from LKR 29 billion in 2001 to LKR 52 billion in 2004 denoting a rise of almost 80% (Table 1). The higher rate of increase of PGDP in the North during the three years of ceasefire is understandable because it was the worst affected province due to the conflict, and as the province with lowest PGDP it was the greatest beneficiary of the ceasefire.

There are two reasons for the lowest PGDP by the Northern province and one of the lowest by the Eastern province. One reason is that because of the civil conflict, naturally, economic activities in the N&E province were severely hampered. Second reason, often ignored, is that because of the conflict environment the unaccounted economic activities (informal economy) in the N&E are much higher than in the rest of the country.

Table 1: Provincial Gross Domestic Product (PGDP at current factor cost prices) 1999 - 2004

LKR billion	1999	2000	2001	2002	2003	2004
East	50 (5.0)	51 (4.5)	62 (5.0)	69 (4.9)	96 (6.1)	98 (5.4)
North	25 (2.5)	24 (2.2)	29 (2.4)	37 (2.7)	43 (2.8)	52 (2.9)
East&North	75 (7.5)	75 (6.7)	91 (7.4)	106 (7.6)	139 (8.9)	150 (8.3)
Sri Lanka	995 (100)	1,125 (100)	1,246 (100)	1,403 (100)	1,563 (100)	1,801 (100)

Source: Central Bank of Sri Lanka, *Annual Report 2005*, Statistical Appendix Table 4.

Note: Numbers in the parenthesis are percentages of the total (last row).

Sectoral composition of PGDP

The sectoral composition of PGDP in the N&E is also different from the sectoral composition of the GDP at the national level. While at the national level agriculture sector's contribution to the GDP has been progressively declining overtime it has been increasing in the N&E. Agriculture sector¹ contributed over 30% of the national GDP by around 1980, which declined to 21% in 1999 and further to 18% in 2004. On the other hand, in the East agriculture sector contributed 31% of the PGDP in 1999, which increased marginally to 33% in 2004. In the North agriculture's share of the PGDP was 27% in 1999, which increased marginally to 28% in 2004. In the combined N&E, agriculture sector contributed 27% to the PGDP in 1999, which increased to 31% in 2004 (Table 2). As a corollary, the gap between agriculture's contribution to the national GDP and PGDP of the N&E has been widening overtime.

¹ Agriculture sector incorporates crop agriculture, livestock, forestry, and fishing.

The industrial sector's contribution to the national GDP and PGDP has not changed much overtime between 1999 and 2004². At the national level industrial sector's contribution to the GDP was 27% in 1999 and remained the same in 2004. In the N&E industrial sector contributed 22% to the PGDP in 1999, which declined marginally to 21% in 2004. In the East industrial sector contributed 29% to the PGDP in 1999, which declined marginally to 28% in 2004. Similarly, in the North industrial sector contributed 8% to PGDP in 1999, which declined marginally to 7% in 2004 (Table 2). The foregoing figures reveal that industrial sector's contribution to the national GDP and to the PGDP in the Eastern province is more or less the same. However, industrial sector's contribution to the PGDP in the Northern province (7%) is only about one-fourth that of the Eastern province (circa 28%) and the country as a whole (circa 27%).

The contribution of the services sector to the national GDP has been marginally increasing from 52% in 1999 to 55% in 2004³. However, in the N&E, services sector's contribution to PGDP decreased from 51% in 1999 to 48% in 2004. In the East, contribution of the services sector declined marginally from 40% in 1999 to 39% in 2004. Greatest drop in the contribution of the services sector to the PGDP was in the North where it declined from 73% in 1999 to 65% in 2004 (Table 2). While the services sector's contribution to the PGDP in the East was considerably lower than services sector's contribution to the national GDP, the services sector's contribution to the PGDP in the North was considerably higher than services sector's contribution to the national GDP.

Table 2 reveals that the Northern economy is overwhelmingly dependent on the service sector (around 70% in recent times). This is also an indication of huge informal economy in the North because it is a common knowledge that the informal economy is greatest in the services sector both in developed and developing countries. Services sector, generally, is dominated by self-employed micro and small enterprises. Because of its huge number the services sector has intense competition,

² Industrial sector comprises manufacturing, construction, mining & quarrying, and electricity & water.

³ Services sector includes wholesale & retail trade, hotels & restaurants, transport, posts& communications, financial services, public, government, defence, social & community services, etc.

which in turn leads to bending of rules, regulations, and laws. Enterprises operating beyond the margins of law become the informal sector.

Table 2: Provincial Gross Domestic Product by Sector (at current factor cost prices)
1999 – 2004

LKR billion	Year	East	North	East&North	Sri Lanka
Agriculture	1999	15 (31.0)	5 (19.0)	20 (27.0)	206 (21.0)
	2000	15 (30.0)	5 (19.0)	20 (27.0)	218 (19.0)
	2001	22 (35.0)	6 (21.0)	28 (30.0)	250 (20.0)
	2002	26 (37.0)	10 (26.0)	36 (34.0)	288 (21.0)
	2003	35 (36.0)	12 (28.0)	47 (34.0)	297 (19.0)
	2004	33 (33)	14 (28)	47 (31)	321 (18.0)
Industry	1999	15 (29.0)	2 (8.0)	17 (22.0)	271 (27.0)
	2000	13 (25.0)	2 (7.0)	15 (19.0)	307 (27.0)
	2001	16 (26.0)	2 (7.0)	18 (20.0)	334 (27.0)
	2002	16 (23.0)	2 (6.0)	18 (17.0)	369 (26.0)
	2003	29 (30.0)	3 (7.0)	32 (23.0)	413 (26.0)
	2004	27.5 (28.0)	3.5 (7.0)	31 (21.0)	482 (27.0)
Services	1999	20 (40.0)	18 (73.0)	38 (51.0)	518 (52.0)
	2000	23 (45.0)	18 (74.0)	41 (54.0)	600 (53.0)
	2001	25 (39.0)	21 (72.0)	46 (50.0)	662 (53.0)
	2002	27 (40.0)	25 (67.0)	52 (49.0)	747 (53.0)
	2003	32 (34.0)	28 (65.0)	57 (43.0)	853 (55.0)
	2004	38 (39.0)	33 (65.0)	71 (48.0)	998 (55.0)

Source: Central Bank of Sri Lanka, *Annual Report 2005*, Statistical Appendix Table 4.

Note: Numbers in the parenthesis are percentages of the regional and national (last column) totals.

One of the main reasons for the informal economy is the evasion of direct and indirect taxes due to the state. Therefore, level of tax revenue could also be an indicator of the extent of informal economy. The following table reveals that the lowest contributor to the provincial revenue is the North&East province while the highest contributor is the Western province. That is, the N&E contributed only 1% to the total provincial revenue in 2004 (latest available) whereas the Western province contributed almost 67%. All the provinces (bar Western province) contributed lesser share to the provincial revenue than their share of contribution to the national GDP. The Western province contributed 51% to the national GDP in 2004 while it contributed almost 67% to the total provincial revenue. On the other extreme, N&E province contributed over 8% to the national GDP while contributing just 1% to the total provincial revenue. Greatest gap between the share in the national GDP and share in the provincial revenue was in the N&E province.

The share of provincial revenue of each province need not necessarily be proportionate to the share of national GDP because different provinces have different types and rates of direct and indirect taxes. Further, it would also vary depending on the sectoral composition of the provincial economy. For example, agriculture sector would have the lowest taxation, because by and large it is exempted from taxation. Moreover, provincial tax revenue collection would also depend on the administrative capacity of individual provinces to collect the dues effectively. Different provinces would have varying capacity to realise the due tax revenues.

Nevertheless, negligible share of the N&E province in the total provincial revenue is a strong indicator of high level of informal economy in the province, which is contributed by very weak administrative capacity and governance structures in the province. In fact, about 20% of the provincial population and about 44% of the land area of the N&E province is out of bounds for law enforcement agencies and the judicial system of the GoSL. In this circumstance it is understandable that informal economy is greatest in the N&E province in comparison to other provinces.

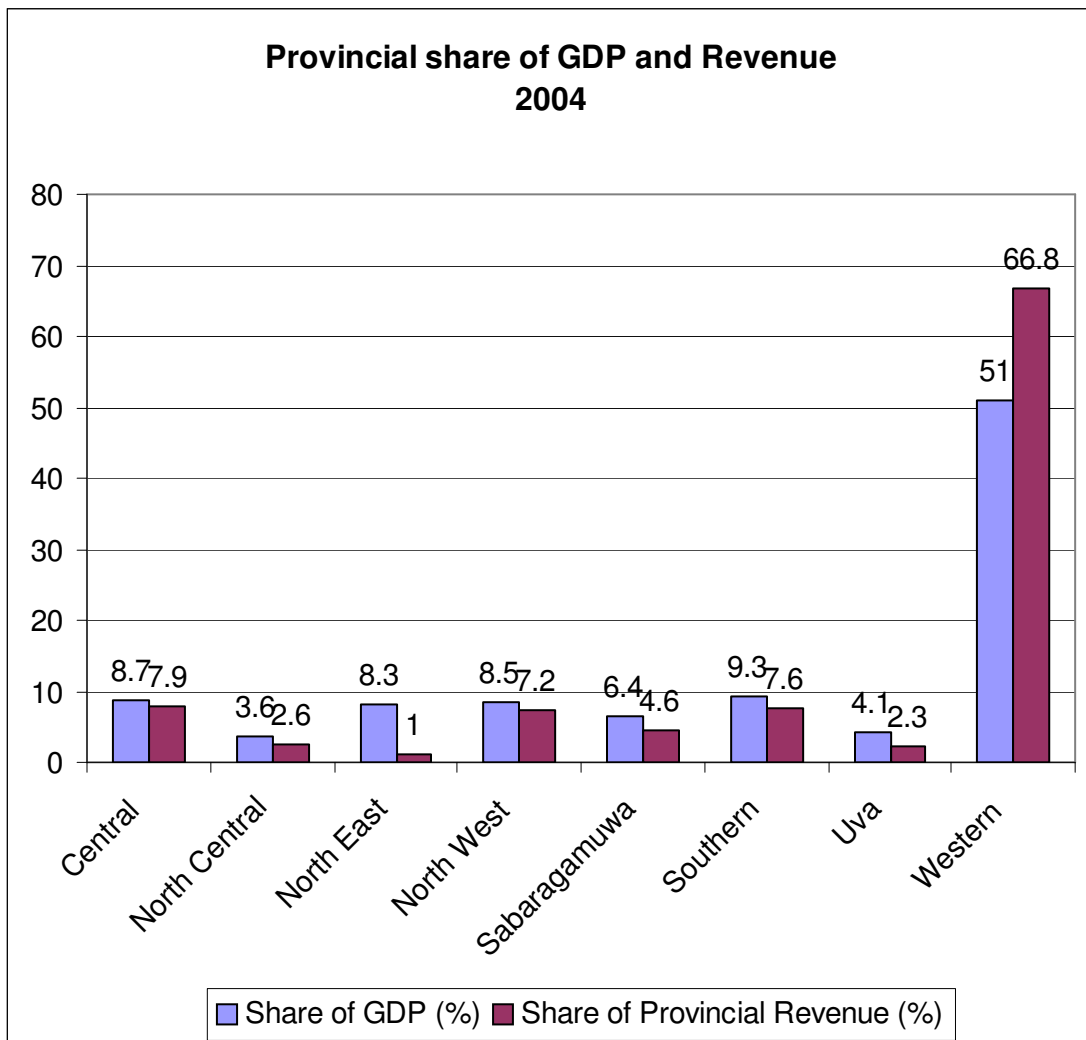
The Western province collects a greater share of the provincial revenue than its contribution to the national GDP because the industrial sector in the composition of

its provincial economy is much higher than the other provinces and compliance and enforcement is much more effective.

Table 3: Shares of GDP and Provincial Revenue by Province 2003 & 2004

Province	2003		2004	
	Share of GDP (%)	Share of Provincial Revenue (%)	Share of GDP (%)	Share of Provincial Revenue (%)
Central	8.9	8.4	8.7	7.9
North Central	3.9	2.7	3.6	2.6
North East	8.2	0.6	8.3	1.0
North West	9.4	7.5	8.5	7.2
Sabaragamuwa	6.0	3.9	6.4	4.6
Southern	9.8	7.1	9.3	7.6
Uva	4.4	2.5	4.1	2.3
Western	49.4	67.2	51.0	66.8

Source: Waidyasekera, D.D.M. (2005), *Decentralization and Provincial Finance in Sri Lanka: 2004 – An Update*, November, Institute of Policy Studies, Colombo.



Extent of Informal Economy

There are two distinct elements to the informal economy in the conflict-affected region of Sri Lanka. One is in the government-controlled areas and the other is in the LTTE-controlled areas of the N&E. The former is the legitimate economy of the Sri Lankan government and the latter is the illegitimate economy of the LTTE. Some could argue that the LTTE's income and expenditures should not be construed as part of the informal economy because it is an alternative formal economy amidst the absence of the Sri Lankan state in certain parts of the country. However, according to the definition used for the purpose of this paper all income and expenditures unaccounted for in the national income/expenditure accounts of Sri Lanka are regarded as part of the informal economy. Since LTTE's income/expenditure falls outside the margins of law and unaccounted for by the national income accounts it is part of the informal economy in the conflict-affected region of Sri Lanka.

Informal economy would incorporate both legal and illegal economic activities. Some legal economic activities could become informal because of non-payment (tax evasion) or underpayment (tax avoidance) of taxes. Illegal activities include narcotic drug dealing, armaments trade, extortion, theft & burglary, prostitution, etc. The welfare implication of the informal economy differs depending on legal or illegal economic activities. While illegal economic activities of the informal economy has negative impact on welfare, the welfare implication of legal economic activities would not be always negative⁴.

Hence, the estimation of the informal economy in the conflict-affected region is undertaken from the legitimate economy of the N&E and the illegitimate economy of the LTTE. Theoretically, there are three ways of compiling national income accounts, namely by the income method, expenditure method, and the value added method. Income and the expenditure methods are used in order to crosscheck the results of one by the other, because usually people tend to underestimate their income in order to avoid or minimise payment of taxes or to avail of government welfare payments. Therefore, expenditure data would be more reliable.

⁴ For theoretical discussions on these issues see Sarvanathan, 2001: Chapter 8.

Usually, incomes of households are reported lower than expenditures. That is, people are generally reluctant to reveal their total income while they may reveal their expenditures without hesitation. Therefore, the difference between total income and total expenditure could be a reasonable proxy for the extent of informal economy⁵. We applied this method to estimate the informal economy in the government-controlled areas of the N&E by using both the Household Income and Expenditure Survey (HIES) data and the Consumer Finances and Socio Economic Survey (CFSES) data.

According to the HIES, the N&E province had an informal economy to the tune of over LKR 16 billion (circa USD 160 million) per annum. This is worked out from the difference between expenditure and income multiplied by the number of households in each province. The difference between expenditure and income per household per annum was about LKR 37,500 in the East and LKR 17,500 in the North. Thus, the size of informal economy in the East (LKR 12 billion) was three times that in the North (LKR 4 billion). This result is the reverse of that obtained in Table 2 where it was inferred that North has greater informal economy than the East.

According to the CFSES, the N&E had an informal economy to the tune of almost LKR 5 billion (circa USD 50 million) per annum. The difference between expenditure and income per household per annum was nearly LKR 13,000 in the East and LKR 3,000 in the North. Thus, the size of the informal economy in the East (LKR 4,157 million) was almost seven times higher than in the North (LKR 624 million). This again is the reverse of that obtained in Table 2 where it was inferred that North has greater informal economy than the East.

There is a huge gap between the estimates of the informal economy in the N&E by way of the HIES and the CFSES. That is, according to the HIES the informal economy in the government-controlled N&E is over LKR 16 billion (circa USD 160

⁵ There are direct and indirect methods of estimating the informal economy. Direct methods involve undertaking sample surveys (small in-depth samples or large questionnaire-based samples) and extrapolating to the whole economy. Indirect methods involve analysing the money supply data and estimating the discrepancy between income and expenditure (Schneider, 2002; Kumar, 1999: Chapter 3; Gupta, 1992: Chapter 5; Harding & Jenkins, 1989: Chapter 5).

million) per annum, but according to the CFSES it is nearly LKR 5 billion (circa USD 50 million) per annum. Thus, estimate based on HIES is 3.4 times higher than based on CFSES. It is also interesting to note that the informal economy in the rest of the country (Sri Lanka *minus* N&E) in terms of the HIES is over LKR 18 billion (circa USD 180 million) per annum while in terms of the CFSES there appears to be no informal economy (at least according to the definition used here).

The informal economy in the government-controlled N&E in terms of the HIES (LKR 16 billion) is only about 12% of the official PGDP of the N&E in 2003 (LKR 139 billion). The informal economy in the government-controlled N&E in terms of the CFSES (LKR 5 billion) is only about 3% of the official PGDP of the N&E in 2004 (LKR 150 billion).

**Table 4: Difference between Income and Expenditure in the East&North
2002/03 & 2003/04**

	East	North	East&North	Sri Lanka
Household Income and Expenditure Survey 2002/03				
Total population	1,500,000	1,100,000	2,600,000	19,000,000
Total number of households	325,000 (4.62 per household)	232,000 (4.74 per household)	557,000	4,408,353 (4.31 per household)
Average annual income per household (LKR)	91,680	97,860		153,636 (excluding N&E)
Average annual expenditure per household (LKR)	129,228	115,368		157,764 (excluding N&E)
Expenditure- Income per household (LKR)	37,548	17,508		4,128 (excluding N&E)
Total Expenditure- Income per annum LKR	12,203,100,000	4,061,856,000	16,264,956,000	18,197,681,184 (excluding N&E)
Consumer Finances and Socio Economic Survey 2003/04				
Average annual income per household (LKR)	160,740	182,412		205,308 (including N&E)
Average annual expenditure per household (LKR)	173,532	185,100		203,688 (including N&E)
Expenditure- Income per household (LKR)	12,792	2,688		(-) 1,620 (including N&E)
Total Expenditure- Income per annum (LKR)	4,157,400,000	623,616,000	4,781,016,000	(-) 7,141,531,860 (including N&E)

Sources: Central Bank of Sri Lanka, *The Consumer Finances and Socio Economic Survey Report 2003/04* Part I, Colombo. Department of Census and Statistics, *Results of the Household Income and Expenditure Survey in the Northern and Eastern Province 2002/03*, Colombo.

LTTE's Income

Now let us look at the income of the LTTE that would serve as a proxy for the informal economy in the LTTE-controlled areas in the N&E. Income and expenditure of the LTTE is not known openly for obvious reasons. However, incomes are relatively easier to guesstimate than its expenditures, because the people both here and abroad pay LTTE's incomes. Expenditure data could only be obtained from the LTTE, which will not be forthcoming. Hence, we can only guesstimate LTTE's income.

The LTTE has various sources of income. Firstly, it taxes people living in areas under its control and in government-controlled areas of the N&E. These taxes involve both direct and indirect taxes. Direct taxes are imposed as a percentage of the monthly income or in kind as share of the produce of farmers and fisherpersons. Indirect taxes are imposed on most of the items/goods taken into LTTE-controlled areas and via LTTE controlled areas to government-controlled areas both for personal consumption and commercial purposes. Besides, direct taxes are also imposed on sale of real estate. Likewise, indirect taxes are also imposed on personal and private vehicles plying in and plying via LTTE-controlled areas.

For example, government officers are asked to pay 8% of their wages and salaries both in LTTE-controlled and government-controlled areas of the N&E. Similarly, fisherpersons and farmers are required to pay in kind part of their produce or percentage of their daily income. Passenger transport vehicles have to either pay an annual fee to obtain a route pass or pay-as-you-go every time they pass through LTTE-controlled area. Construction contractors have to pay a percentage of each contract of work they undertake. Businesses, shopkeepers, hotels and restaurants have to pay a percentage of their turnover. The rates vary from business to business but minimum is 5%. In addition to these illegitimate taxes LTTE also demands ransom (or protection money) from businesses and wealthy private individuals, particularly in government-controlled areas (both in the N&E and Colombo & suburbs).

Secondly, LTTE runs numerous businesses in the areas under its control, in government-controlled areas (both in the N&E and Colombo & suburbs), and abroad

where there is a significant Tamil Diaspora. Most of the trade in essential goods in areas under its control is monopolised / monopsonised by the LTTE. In addition, most of the wholesale and retail trade, hotels and restaurants, personal services such as laundrettes and hairdressers, telecommunication and transport services are owned by the LTTE. It also produces bakery products, sweets, soft drinks, ice cream, and alcoholic beverages. In government-controlled areas (both in the N&E and Colombo & suburbs) LTTE operates telecommunication centres, Internet cafes, hairdressing saloons, jewellery shops, moneychangers, mini supermarkets, hotels & restaurants, etc. In foreign countries LTTE owns grocery shops, mini supermarkets, telecommunication centres, jewellery shops, newsagents, wine shops, shipping companies, money transfers, Hindu temples, etc.

For example, LTTE monopolises the wholesale trade in wheat and cement to the North beyond Omanthai and Uyilankulam checkpoints. Needless to say, LTTE makes huge profits out of these businesses, because both of these are essential goods (cement is an essential good because of massive reconstruction works undertaken in the aftermath of the ceasefire and tsunami). At certain opportunities the LTTE artificially creates shortages in order to make super profits. For instance, after the attempt on the life of the Army Commander on 25th April 2006 the A9 highway (linking North & South) was shut for more than one whole day. Immediately, the LTTE began hoarding essential commodities in the Vanni⁶ so as to create artificial shortage and make super profits.

Thirdly, LTTE also has several front non-governmental organisations (NGOs) both in Sri Lanka and abroad. Most prominent one is the Tamils' Rehabilitation Organisation (TRO), headquartered in the capital of LTTE-controlled Vanni region, namely Kilinochchi, which is an international non-governmental organisation (INGO) having branches in many countries where there is significant Tamil Diaspora. TRO is also the largest and wealthiest NGO in the N&E and one of the largest and wealthiest in the country. This is the only NGO of the LTTE that is registered with the GoSL and thereby has some semblance of legitimacy. However, there are several other NGOs

⁶ Vanni is the generic term for four (Kilinochchi, Mannar, Mullaitivu, and Vavuniya) out of five districts of the Northern Province.

that are humanitarian fronts of the LTTE, which attract significant donor funds, within N&E and abroad.

Fourthly, LTTE is also reported to be involved in narcotic drug trafficking across the world in order to finance purchase of armaments. It is said to be involved in trafficking heroin from the golden triangle (Afghanistan, Iran, and Myanmar) to Sri Lanka (via India & Pakistan) and Europe. Sri Lanka has emerged as a major transit point for narcotics, especially heroin. There have been several arrests of LTTE sympathisers/supporters in several countries on charges of drug trafficking. Sri Lanka has emerged as a major transit country for trafficking of Heroin from the golden triangle via India & Pakistan to Europe. Heroin is trafficked by land up to South India (particularly Tamilnadu) and then airlifted to Colombo or sent via sea (through fishing boats) to North Western, Western and South Western coasts of Sri Lanka. In addition to narcotic drugs trafficking LTTE supporters/sympathizers are involved in credit card frauds, currency counterfeiting, and other criminal activities that are of transnational character. These are by and large concentrated in European countries.

Fifthly, LTTE also collects donations from the Tamil Diaspora living in various countries. These collections are both voluntary and involuntary. That is, Tamils in the Diaspora willingly make donations to the LTTE and they are also intimidated to contribute in case not sufficient funds are forthcoming by way of voluntary contributions. Recent Human Rights Watch (HRW) report provided graphic details of intimidation used by the LTTE supporters and sympathizers in Canada and European countries to mobilise financial resources for what is termed as the “final war”⁷ (see also La, 2004). LTTE organises various fund raising events in Europe, North America, Australasia, Malaysia, Singapore, South Africa, and Middle Eastern countries where considerable Tamils from India & Sri Lanka live. These fund raising events would coincide with its annual martyrs week in November or with annual festivals (feasts) of Hindu temples in respective countries. Mobilising donations takes two forms: One is by way of obtaining standing orders from the Tamil Diaspora for regular monthly contributions. Second is by approaching the Diaspora on and off for lump sum donations. These could be for general purpose or for specific purpose.

⁷ <http://hrw.org/reports/2006/lte0306/>

Quantitative estimation of informal economy is always fraught with problems, because of its hidden nature. However best we try to estimate it would be conjectural rather than precise. Irrespective of the methodology used estimations of informal economy are largely guesstimates. Ideally, survey method would be relatively more reliable than other methods. However, scope of the present study does not allow us to undertake a survey. With this caveat let us now estimate the proximate income of the LTTE through various sources as elaborated above. These estimates are drawn from Byman and Chalk, et al, 2001; Chalk, 2000; Mackenzie Institute, 2000; Manoharan, 2004; Peiris, 2001; Sarvananthan, 2003b).

According to informed sources, domestic tax revenue including income tax, custom duties, turnover tax, tax in kind, ransom, extortion, etc, is estimated to be about LKR 10 million per day. Therefore, annually it works out to be LKR 3,650 million (Sarvananthan, 2003b). Profits from legitimate businesses locally, nationally, and globally also guesstimated to be LKR 10 million per day, which is LKR 3,650 million per annum. Profit from local and international humanitarian front organisations is estimated to be about LKR 5,000 million per annum. This is over and above the cost of goods and services provided to affected/needy people as well as the wages and salaries, and other administrative costs of such humanitarian front organisations. This source of revenue leaped to a high in the aftermath of the tsunami when LTTE and its proxies mobilised huge amount of resources (monetary as well as in kind) locally and internationally. Profits from narcotic drug trafficking, credit card frauds, and counterfeiting are guesstimated by the author to be in the order of LKR 7,500 million. Though Chalk (2000) estimated that LTTE's income from narcotic drugs is about 25,000 million (USD 250 million) per annum, the author feels it is overestimation. Further, revenue from voluntary and involuntary donations from the Diaspora is estimated to be LKR 7,500 million per annum. The last two categories of revenue are the largest sources of income of the LTTE.

Table 5: LTTE's Income

Source		Annual Income (LKR million)	Total Income (LKR million)
Taxation	LKR 10 million (x) 365days	3,650 (USD 36.5 million)	
Profits from goods & services (local + national + international)	LKR 10 million (x) 365 days	3,650 (USD 36.5 million)	
Profits from humanitarian services		5,000 (USD 50 million)	
Narcotic drugs trafficking, credit card frauds, counterfeiting, human smuggling, other transnational criminal activities		7,500 (USD 75 million)	
Voluntary & involuntary donations from the Diaspora		7,500 (USD 75 million)	
Total		27,300 (USD 273 million)	

Source: Author's estimation based on Byman and Chalk, et al, 2001; Chalk, 2000; Mackenzie Institute, 2000; Manoharan, 2004; Peiris, 2001; Sarvananthan, 2003b.

In total LTTE's annual income is guesstimated to be over LKR 27,000 million (or USD 270 million) per annum (Table 5). If we add the informal economy of the government-controlled N&E (LKR 16 billion in terms of HIES) the grand total of informal economy in the conflict-affected region (N&E) is about LKR 43 billion (USD 430 million). This is nearly 30% of the PGDP of the N&E province in 2004, which was LKR 150 billion (see Table 1). According to an econometric study undertaken by Schneider (2002: 8-9) Sri Lanka's total informal economy was almost 45% of the Gross National Product (GNP)⁸ in 1999/2000. However, some have cast aspersions on the MIMIC model used by Schneider to calculate the informal economy (Chattopadhyay, 2005).

Causes of Informal Economy

There are several causes for the inception, existence, and growth of the informal economy in general, and specifically under conditions of internal conflict. Multiple & high taxes, excessive rules & regulations, intense competition, barriers to market access, shortages, lack of legal access to markets, etc, lead to informal economy (see for example, Gaertner and Wenig, 1985; Gupta, 1992: chapters 3&4; Kumar, 1999: chapter 5; Schneider, 2002). These general causes are compounded at times of

⁸ There is not much difference between GDP and GNP of Sri Lanka.

conflict and civil war due to security restrictions on economic activities inter alia (see, for example, MacGaffey, 1991).

During the civil war in Sri Lanka government administration in the North&East province was very weak or non-existent (in certain parts). Particularly law enforcement arms of the state, viz. police and judiciary, were non-existent in the LTTE-controlled areas. This has naturally promoted informality in polity, economy and society. There are two major sources of the informal economy in the conflict-affected N&E region.

Firstly, because of lack of government administration, law enforcement, and judicial services, informality has become the norm in the conflict region. For example, business registration in Sri Lanka is centralised at the Registrar of Companies Department in Colombo. During the time of war travel to Colombo from the N&E was a Herculean task. That is, people had to obtain travel passes from both the security forces and the LTTE (for people living in areas under LTTE control) and undergo stringent security checks. Because of these physical barriers to mobility businesses in the N&E have remained unregistered during the time of conflict. Thus, bulk of the micro, small, and medium enterprises that were established in the N&E since about the mid-1980s remain unregistered. Besides, almost the entire businesses in the LTTE-controlled areas are unregistered. It is important to note that almost all the businesses that are of any significance (in terms of size and turnover) in the LTTE-controlled areas are owned directly or indirectly by the LTTE, and therefore by definition informal.

In addition to the physical difficulty in registering businesses there was another reason for non-registration with the GoSL, i.e. the taxes imposed by the LTTE. Businesses in the N&E cannot avoid LTTE taxes even if they avoid government taxes, because punishment for non-payment of LTTE-taxes is often fatal. At the same time, micro, small, and medium businesses cannot survive in the conflict region by paying taxes to two authorities, viz. GoSL and the LTTE. Therefore, they opt not to register with the GoSL and thereby remain informal (Sarvananthan, 2003b).

Secondly, since 1990 the government imposed an economic embargo on LTTE-controlled areas. Further, there were restrictions on supply of goods to certain parts of government-controlled areas as well (for example, to Jaffna). This economic embargo and supply constraint resulted in shortages of goods that were affected by these restrictive practice. Shortages inevitably result in black markets for such goods. Though the economic embargo was unilaterally lifted in January 2002, restrictions on the movement of certain items (building materials – cement, steel, timber, concrete, etc) were re-imposed because of upsurge in violence since January 2006.

In the present globalised world informal economy is transnational and hence causes of informal economies are also transnational. With the growth in information technology, massive movements of goods, services, and people across the globe, and raging civil conflicts around the world, causes of informal economy are not confined to national boundaries, rather they trespass on nation states (MacGaffey, 2001; Naim, 2005; Schendel and Abraham, 2006). Countries inflicted by civil strife spur economic crimes in far away countries where there are Diasporas who had fled their home countries because of civil strife. These economic crimes in countries of asylum in turn fuel conflicts back home. Thus, there is a vicious circle of internal conflicts fuelling globalised informal economies and vice versa.

Policies to combat informal economy

In the forgoing circumstances, policies to combat or reduce informal economy in the conflict region of Sri Lanka should be transnational in nature. Some causes of the informal economy in the N&E can be addressed through domestic policy measures. For example, registration of businesses should be devolved to the sub-district (divisional secretariat) level in order to make it convenient amidst transport bottlenecks and insecurity at times of civil war. Similarly, informal economy spurred by shortages and black markets can be arrested by allowing flow of goods unimpeded by quantitative restrictions or outright prohibition, i.e. by lifting the economic embargo. Further, informal financial transactions could be curbed by providing mobile financial services in areas of conflict, which are devoid of regular financial services. These policy prescriptions are easier said than done because of competing interests of security phobia and humanitarian imperatives.

As noted above, several internal conflicts around the world (including Sri Lankan conflict) are intertwined with narcotic drugs trafficking, transnational criminal syndicates, mafia, and money laundering networks. Policy measures to combat such globalised informal economies require transnational or global cooperation and effort, which is very limited at the moment. This is because, while globalisation has made most markets (for both 'goods' and 'bads') global, governments remain national (Naim, 2005). It is this anomaly that makes policies to combat transnational informal economies very difficult or even impossible. However, Vito Tanzi (1999) argues that international organisations could fulfill the role of global governments in combating informal economies.

Usually, policies to combat informal economies are concentrated on the supply side of the informal goods and services market. That is, through rules, regulations, legislation, and law enforcement mechanisms governments tend to curtail supplies of informal goods and services to the market. However, Naim (2005) argues for the case of involving demand side of the informal economy as well in addressing the problem. That is, by making the formal sector efficient, competitive, and user friendly along with lesser transaction cost (in terms of money and time), the demand for informal goods and services could be reduced. Hence, it is argued that policies to combat or reduce the informal economy need to address both the demand and supply side causes of it.

According to Tengez and Klump (2005) corruption and inequality breeds informal economic activities. Corruption is, according to Tengez and Klump (2005: 26), "discretionary application of laws by bureaucrats and politicians that seriously undermines the ability of the state to enforce rule of law and provide effective public services to its citizens". In countries where corruption is rife, stringent law enforcement or increasing penalties for wrong doings would have little impact on arresting informal economic activities. Therefore, policy makers have to concentrate more on combating corruption in the first place. In societies where income inequality is high, removal of rules and regulations would have little impact because of the inability to people to pay for the participation in the formal sector. That is, policy makers have to ensure that people have the means and abilities to comply with the

law. It is also very important to note that corruption and inequality affects the poorer segments of society more than the higher echelons of society.

Corrupt bureaucracies deny a level-playing field for economic actors in general, and producers and suppliers of goods and services in particular. Because of the subversion of competitive markets through bribery and corruption more and more economic actors, particularly smaller and poorer ones may resort to informal economic activities. Therefore, combating corruption would be an important policy measure to combat or reduce informal economy. This requires strong and efficient law enforcement through the judicial system. However, in conflict situations like in the North-East Sri Lanka there could be an absence of judiciary, or the rule of law may be subverted by way of inordinate delays, security threats, etc.

In these circumstances breach of law and informal economy becomes the norm. Any revolt against the state undermines the legitimacy of the state and its institutions (including law enforcement) and thereby breeds informal activities including economic activities. This is what has happened in the conflict region. Deviant behaviour in general and informal economic activities in particular has become part of the popular culture in the North East. For example, power pirating (illegal tapping of electricity) has become widespread in the Northern Province where even quite well to do households and learned people are involved in this illegal activity. The author is aware of several senior bureaucrats, school principals and teachers, justices of peace, and attorneys at law are involved in power pirating. It has become so common that people openly acknowledge doing it and do not feel shame about it. How did this situation arise among the traditionally law abiding northern society?

With the eruption of the civil war in the mid-1980s Sri Lankan armed forces set up large number of camps (of different size) in vacant buildings and land owned by both the state and the private sector/households throughout the North. On top of it, numerous sentry points at main junctions of the Jaffna peninsula (for example) were setup. These irregular camps setup in vacant lands and sentry points at junctions required electricity, which was illegally tapped from nearby power lines by the armed forces. Such nakedly illegal activities of the guardians of law and order were the origin of the deviant behaviour of the society at large.

Therefore, policy makers confronting the informal economy in the atmosphere of civil conflict should attempt to obliterate such deviant behaviour by both the guardians of law and order and the society at large by way of persuasion and prosecution. Appropriate strategies could include naming and shaming, public awareness campaigns, imparting civic consciousness among school children, etc. A positive argument for complaint behaviour (as opposed to deviant behaviour) should be inculcated to the people from the very early age.

There is not much divergence of opinion among policy makers about the need to combat or reduce corruption and inequality as a precondition to combating or reducing informal economic activities. However, there is divergence of opinion on how (or what policy measures are required) to combat or reduce corruption and inequality. This is the critical challenge faced by policy makers addressing informal economic activities. Corruption also fuels inequality in terms of income, access to justice and fair play, access to public services, equitable distribution of public goods, etc. Corruption and inequality in turn promotes informal economic activities. Hence, combating corruption and inequality are prerequisites for formalisation of informal economic activities. One way of doing this is through legal empowerment of the poor. That is, by way of empowering the poor to access justice & fair play, and legal empowerment of the poor to resources and assets, corruption and inequality could be confronted. This in turn has the potential to reduce informal economic activities.

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