Pathfinder Economic Alert

Relief Delivered: Fiscal Sustainability in Question.

The Pathfinder Foundation (PF) has been consistent in its call for prudent fiscal management and market oriented policies. In Economic Alert no: 67 titled 'The Election Manifestos: An Auction of Non-existent Resources and Beyond', it highlighted the populist nature of the manifestos of the two main candidates and the need for fiscal discipline. The subsequent Economic Flash 57 titled 'Economics of the 100 day program: Word of Caution on Populist Measures' developed upon the same theme. This piece seeks to assess the Interim Budget presented by the new government last week, from both a short and medium-term macroeconomic perspective.

The PF is undertaking a more detailed analysis of the Budget proposals. The findings will be published shortly.

Sri Lankan Populism or Opportunism?

The first bid in the auctions that characterise election campaigns came in the Budget Speech delivered in November 2014. This was followed by the manifestos of the two main candidates, the 100-day program and now the Interim Budget. Fiscal pump-priming, or offering pre-election giveaways, has happened in Sri Lanka since the 1950s. However, it is more important than ever before to have a strong commitment to fiscal sustainability in the medium-term as Sri Lanka is now a lower-middle-income country and is no longer eligible to concessional assistance.

A wide-ranging package of relief measures was the centre-piece of the Interim Budget. This article seeks to explore whether there is any rationale for these relief measures and whether they can be financed without undermining macroeconomic stability and the medium-term growth prospects of the country.

One can put forward both a political/social and economic rationale in support of the relief package, from a short-term perspective.

Is there a political/social/economic rationale for the relief package?

Though the country has achieved relatively high growth rates (even after allowing for the contestation regarding the official figures), household incomes/expenditure have increased by only 0.5% per annum, since the end of the conflict. This has been the overall average. Hence, a significant share of households would have experienced a decline in their real incomes.

Sri Lanka is an aspirational society which is increasingly impatient about material advancement. It is also a country which has recently experienced serious fault lines in terms of ethnicity, religion and class. In such a context, if people's frustrations are allowed to fester, an environment can be created that is conducive for the growth of various forms of extremism. There is, therefore, a political and social rationale for the relief package. These measures were also in the 100-day program which received a democratic mandate through the outcome of the Presidential Elections.

There is also an economic argument that can be advanced in support of the relief measures. The non-tradable sector has expanded over the last decade. Domestic demand has been the key driver of growth. This is clearly the wrong growth model for a country with a domestic market of only 21 million people. However, this is where the economy currently is. Therefore, there is a case for pumping up domestic demand in the short-run while implementing structural reforms to transition to an export-led growth model in the medium-term. There is currently macroeconomic space to do this. Inflation is subdued and global commodity price movements, particularly oil, are having a positive impact on the balance of payments.

However, the PF cautions that the solutions in the Interim Budget should not be allowed to aggravate the problems being addressed.

Has the Interim Budget maintained macroeconomic stability?

Has the Interim Budget undermined macroeconomic stability? Measures have been introduced to fund the relief package. The overall budget deficit is expected to decline from 4.6% of GDP in the November 2014 Budget to 4.4%. This implies that there will be no excess demand infused into the system to fuel inflation through price pressures and/or de-stabilize the external account as a result of leakages into exports.

There are, however, two issues which need attention. First, one can raise questions about the way in which the incremental expenditure has been financed. It is commendable that the revenue mobilization efforts have focused upon direct taxes. Sri Lanka has a highly regressive tax system with indirect taxes accounting for over 75% of total tax revenue. Recourse to indirect taxes on this occasion would have also diluted the impact of the relief measures from the very outset. The Interim Budget has opted for a series of discrete and specific revenue measures based on assumptions made regarding the capacity to pay (e.g. the super gains and mansion taxes as well as the levies on specific business sectors). An alternative would have been to increase overall rates of individual and/or corporate taxes. A case can be made that the latter would have been a less distortionary means of raising the required revenue.

The second issue relates to revenue underperformance. In recent years, there has been difficulty in meeting revenue targets. This could happen again, particularly as challenges are likely to emerge in implementing some of the revenue proposals. If there are revenue shortfalls and/or expenditure overruns, there would be a slippage in the overall budget deficit. The resulting increase in aggregate demand would trigger an overheating of the economy (i.e. inflation and/or balance of payments pressure). This would require adjustments to interest and/or exchange rates. It is important that there is sound fiscal/monetary policy coordination to avoid overheating. In this respect, it should be noted that inflation and depreciation of the currency have an adverse impact on the poor and can thereby reverse the benefits of the relief package.

Another point to be noted is that the Budget has redistributed resources from the wealthy to those who are not as well off. Different income/wealth groups have different patterns of savings and consumption. This can have an impact on domestic prices and the import intensity of expenditures. Hence, even if there is no slippage in the budget deficit it would be important to monitor carefully trends in both inflation and the current account of the balance of payments.

The upshot is that it is necessary to be vigilant and use all available macroeconomic tools (monetary, exchange rate and fiscal policies) to address any inflationary and/or balance of payments pressures that may emerge. In this connection, early and decisive action can minimize the costs of adjustment (i.e. the painful effects of austerity/contractionary measures to contain excess aggregate demand). It is important to learn from the experience in 2011/12 when delayed action resulted in the need to impose a tough stabilization (austerity) package. The effects of these measures on the lives of the people were felt for some time. This is one of the explanatory factors for the very low growth in real household incomes which was one of the factors which influenced the outcome of the Presidential election.

Above all, it is important to introduce a package of structural reforms to improve the competitiveness of the economy in order to achieve sustained accelerated growth. This would also serve to promote medium-term fiscal sustainability**.**

Towards medium-term fiscal sustainability

The combination of a democratic mandate and political/social compulsions can be used in support of the Interim Budget in the short-term. It should also be recognized that the budget was prepared in 20 days and was designed as part of a 100- day program. However, from a medium-term perspective, it is imperative to address, inter alia, the following challenges:

1. Structural problems on the revenue side
2. Achieving fiscal sustainability through strengthening the growth framework
3. More efficient and effective social safety net

1. *Improving revenue performance* – revenue has declined to about 14% of GDP. It tends to be 18% - 20% of GDP in countries which are in Sri Lanka's peer group. Furthermore, as mentioned above, there has been an undershooting of revenue targets in recent years. The Interim Budget has exacerbated the structural problem on the

revenue front. Streams of increased recurrent expenditure (eg increases in salaries, pensions and Samurdhi payments) have been introduced. However, a significant share of the incremental funding has been mobilized through one-off measures. High priority needs to be attached to strengthening revenue performance through, inter alia, the following:

a. Publication and implementation of the Tax Reform Commission Report, including further streamlining of the tax structure.
b. Strengthening tax administration.
c. Sale and/or listing of minority stakes (e.g. 10%-20%) of commercial SOEs. For instance, listing of 10% of the State Bank of India yielded a transformative impact. The sale of SOEs (or minority stakes in them) would mobilize much needed resources for the public coffers. A proportion of the proceeds could be earmarked for the workers of the SOEs concerned. In addition, the disclosure requirements associated with listing would serve to improve corporate governance.

2. *Strengthening the growth framework* – the PF's Blueprint for Reform, 'Charting the Way forward: Prosperity for All', sets out ways and means of strengthening the growth framework of the economy. It encompasses a wide-ranging program covering macroeconomic stability; improving the business climate; reform of factor markets (land, labour and capital); exports and FDI; SME's; increasing agricultural productivity; education, skills and training; reforms of SOEs; and efficient public service delivery (including downsizing the bloated public service). Of these, it is arguable that improving the business climate is the most important issue to be addressed. Investment has been the most disappointing aspect of the post-conflict narrative. Growth in domestic investment has been sluggish and FDI was only $1 billion in 2014. Countries like Malaysia and Vietnam have attracted six or seven times this.

   The PF Blueprint recommends a number of actions for improving the business climate. Of these, predictability and consistency of policies, based on consultation with stakeholders, is the most important. In this connection, it is important to take into account the concerns which have been expressed about retrospective taxation. It introduces an element of uncertainty which has a negative impact on investor sentiment, both domestic and foreign; and sets a dangerous precedent. The Vodafone case in India provides a good example of the negative effects of such taxation. Entity-based taxes also send negative signals which undermine business confidence. The same applies to amending agreements, which have already been signed and projects launched, unless laws have been violated, procedures not followed and/or there is clear evidence of malfeasance.

   The overall message is that growth-friendly policies, based on a robust business climate, can result in more diversified and expanded economic activity which widens the tax base and promotes medium-term fiscal sustainability provided tax holidays are contained. The need for such concessions has been reduced significantly now that there is no war-risk premium attached to the economy.

3. *More effective and efficient social protection* – at present, social protection is offered through a complicated network of administered prices, subsidies and transfer payments. It is poorly targeted, inefficient and involves very high administration costs. There is a strong case for moving to a well-designed and targeted income transfer scheme to afford protection to those who need it. In addition, the combination of the national identity card scheme, the extremely high mobile telephone penetration and the extensive banking network provides a good framework for establishing an efficient on-line system for delivering transfer payments. The government's proposal for each person to have a bank account would further facilitate this. India is in the process of rolling out the Aadhaar scheme, which could yield useful lessons in this respect.

Postscript: from an entitlement mentality to productivity/competitiveness

It is welcome that greater transparency has been introduced regarding the terms of the Government's foreign borrowing and contingency liabilities. The commitment to bear down on waste is also welcome. It is important that there is effective follow-through on this.

The Interim Budget has delivered considerable relief for the people on the basis of the democratic mandate received in support of the 100-day program. Attention would now need to be paid to accommodate these measures in a fiscally sustainable way in the medium-term. Simplifying and improving the tax system and strengthening the growth framework would be important for achieving this. It is also important that the tax system should not introduce distortions which undermine business confidence. One must also reiterate that the accelerated growth and diversification of the economy necessary for medium-term fiscal sustainability cannot be achieved without a package of structural reforms, once the anticipated General Elections are out of the way.

In the medium-term, politicians, thought leaders, businessmen and society as a whole should also work towards changing the entitlement mentality which is pervasive in Sri Lanka. We need to move to a more productivity focused and entrepreneurial culture. It is important, for instance, to move away from non-productivity based salary increases.

The country's debt dynamics are such that we cannot afford to live beyond our means. As mentioned above Sri Lanka is no longer eligible for highly concessional loans and grants. It is increasingly exposed to the harsh discipline imposed by rating agencies and international capital markets. At some point, we need to smell the coffee!

This is the Sixty Ninth Economic Alert of Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org