Pathfinder Economic Flash

Forthcoming Budget: Not an Annual Bargain Sale of handouts but Pronouncement of Direction and Priorities of Economic Policy

The Budget Speech has become a major landmark in the nation's calendar. It is much more than the government's income and expenditure statement for the forthcoming fiscal year. It is much more important as an indication of the direction and priorities of government economic policy. As such, a Budget Speech becomes an important determinant of investor confidence, both domestic and foreign. In the modern world, where the domestic and international economic landscapes change very quickly, economic management is a continuous task. It is not uncommon for fiscal measures to be introduced at various times of the year to stabilize or boost the economy.

Commendable Fiscal Consolidation

In recent years, there has been commendable progress made towards fiscal consolidation. Recurrent expenditure as a percent of GDP has been curtailed and the losses of the CEB and CPC have been reduced significantly through courageous but necessary electricity and fuel tariff increases. However, the agenda is still clearly unfinished and this budget provides an opportunity to build on the gains made so far.

A Challenging Legacy

In the lead up to this year's Budget Speech, it would be useful to take a historical perspective of fiscal performance since the liberalization of the economy in 1977. The budget deficit has been the main source of macroeconomic instability over the last three decades. It has meant that Sri Lanka has tended to be a high fiscal deficit; high inflation; high nominal interest rate; and over-valued/volatile exchange rate economy. This is diametrically opposed to the experience of the successful economies of East and South East Asia which have maintained robust fiscal outcomes; low inflation; low nominal interest rates; and undervalued/stable exchange rates. In East/South East Asia, macroeconomic stability facilitated accelerated development in a way it has not in Sri Lanka.

Systemic Effects of an Unsustainable Budget Deficit – Back to Basics

An unsustainable budget deficit pumps money into the economy which results in more money chasing the goods and services available in the economy. This has two effects: it raises prices of goods and services (inflation) and draws in additional imports thereby exerting pressure on the balance of payments. It must also be recognized that high inflation is tantamount to an implicit very regressive tax on the poor. The value of the assets that belong to the rich increases with inflation and acts as a hedge against the pernicious impact on them. However, the poor have no such hedge as they own little or no assets.

High inflation, in turn, exerts upward pressure on interest rates. This results in an increase in the cost of financing and acts as a drag on growth.

In addition, high inflation differentials between Sri Lanka and its competitors and trading partners result in local exports losing competitiveness as their prices rise faster. As there is a limit to adjusting for this through increased productivity, pressure on the exchange rate becomes inevitable in order to restore competitiveness. However, depreciating the currency is politically very challenging as Sri Lanka's basic consumption bundle has a high import component (oil, wheat, sugar, milk products, pharmaceuticals, etc) and weakening the currency results in increased prices of these items. Consequently, the exchange rate has tended to be over-valued for much of the time over the last three decades. This is one of the important causal factors explaining Sri Lanka's inability to replicate the export-led growth successes of East/South East Asia. The consequence has been a significantly weaker growth performance in this country.

Achievements Despite Structural Budget Deficit

Sri Lanka has experienced a structural deficit in its budget for almost the whole of the post-liberalization era. In every year since 1988, current expenditure has exceeded revenue i.e. Sri Lanka has had to borrow to meet even some of its current expenditure. Such a fiscal framework is fundamentally different from those of the successful Asian countries. One can argue that this is unsurprising due to: (i) an adversarial and highly competitive political system; and (ii) the need to accommodate a high level of defense expenditure over the last 30 years. It is noteworthy that India, with its competitive polity and high defense expenditure due to perceived threats on its Northern borders, is also afflicted with a structural budget deficit. In such a context, it is commendable that recurrent expenditure as a percentage of GDP has been reduced in recent years. However, this improvement has been largely offset by the weak revenue performance.

The New Paradigm – Risks and Opportunities

Sri Lanka has been able to "live beyond its means" over the last 30 years, largely due to generous amounts of foreign aid (grants and highly concessional loans). These inflows have tended to amount to about 5% of GDP and served to fill the structural gap between revenue and expenditure in a less burdensome manner. They also helped to finance the deficit in the current account of the balance of payments on very easy terms. Paradoxically, they have also helped Sri Lanka to postpone making the difficult decisions necessary to achieve a sustainable fiscal framework.

As the Pathfinder Foundation has repeatedly mentioned Sri Lanka's graduation to lower-middle-income country status has introduced a new paradigm for fiscal management. In recent years, the government has been able to substitute foreign commercial borrowing for the declining ODA. However, the headroom to do so has now become limited because of the burden of servicing such debt. This is reflected in the government's decision not to undertake any foreign commercial borrowing to finance the budget deficit in 2013. The decline in the headroom for commercial external borrowing by the government is now being compensated for by encouraging banks and corporates to borrow abroad. This has served to increase the country's headroom for such borrowing. It is important that this is done prudently on the basis of the strength of the balance sheets of these entities and a rigorous assessment of exchange rate risks. The need for prudence will become even more important going forward as the terms and conditions of international borrowing become tighter with the inevitable tapering of the US Fed's QE3 programme. In this respect, it is important to recognize that the East Asian crisis commenced due to the unsustainable foreign borrowing of the private banking sector in Thailand and not due to unsustainable sovereign debt.

It is important to strive for a significant increase in non-debt creating inflows in the form of exports of goods and services, FDI and portfolio flows into the stock market. This would increase the capacity to fund growth in a more sustainable manner and service the current debt. Fiscal consolidation will be an important prerequisite for creating a conducive enabling environment for sustainable debt management.

The priority given to fiscal consolidation in recent years is, therefore, very welcome. It recognizes that the country has shifted to a new paradigm of fiscal management. While there is a full understanding of these issues within the Treasury, there seems to be a major need to raise awareness regarding the new fiscal reality among politicians and the people at large.

Some Ideas for Consideration

Widening the Tax Base

Fiscal consolidation can be achieved through a mix of increased revenue, reduced recurrent expenditure and moderated public investment. Sri Lanka's revenue performance is disappointing by international standards. There is a strong case for widening the tax base and improving tax administration.

Public Expenditure Review

As mentioned above, recurrent expenditure has been reduced in recent years. 90% of the remaining recurrent expenditure is accounted for by interest payments (35%), public service emoluments (32%) and subsidies and transfers (21%). There is limited flexibility for reducing debt servicing in the short-term and the other two items are extremely sensitive politically. They can only be addressed at the beginning of a political cycle. In the meantime, there is a case for undertaking a rigorous public expenditure review to establish priorities and identify areas where there is scope for cuts.

Public-Private Partnership Unit

Given the shrinking fiscal space, the current momentum of much needed infrastructure development can only be maintained through increased recourse to PPPs, while protecting public expenditures in key sectors like education and health. There is a strong case for establishing an upgraded PPP unit under the Ministry of Finance. However, it is important to recognize that PPPs are difficult to get right. It will be useful to draw on the experience of countries which already have a track record in this area (e.g. Malaysia).

Expenditure Rationalization

The path of fiscal consolidation already embarked upon by the government and the progress made so far are commendable. However, structural issues remain. These are more likely to be addressed at the beginning of the next political cycle. These include: the size of the public service; better targeting of subsidies and transfers (e.g. the untargeted fertilizer subsidy and Samurdhi payments to 35% of households when the official poverty rate is 6.4%); and SOE reforms (including stock market listing of minority stakes).

Aiming At Key Economic Reforms: Next Political Cycle

The challenge of adjusting to a new fiscal framework, in a context of sharply declining ODA and reduced headroom for external commercial borrowing, will inevitably require hard political decisions. However, it is also important to recognize that the budget deficit has been the main source of instability in the system. Without macroeconomic stability, it will not be possible to put the economy on a trajectory of accelerated growth and development. The progress made so far needs to be consolidated and built upon in the forthcoming Budget Speech. There is a strong case for laying the foundation for a major advance at the beginning of the next political cycle.

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