Pathfinder Economic Flash

The Risky Business of Price Controls and Guaranteed Prices

The anticipated national elections have spawned a spate of misguided and unaffordable claims and counter claims. There have been calls for price controls for 'essential commodities' and a higher guaranteed price for paddy farmers as well as the introduction of a guaranteed price for fish. When considering such requests, it is important to learn from the mistakes of the past. Repeating policies, which have undermined the development of the country and ultimately imposed additional burdens on the people, would not serve anyone's interest, particularly those who need 'relief' the most. In this connection, it would be useful to examine why price controls and subsidizing 'essential commodities' was a failed policy in the past. There is also merit in considering what the best instrument is for providing relief and how it can be targeted to those most in need. Finally, one needs to understand how best to treat the causes rather than the symptoms of the 'cost of living problem' which are triggering the pressure for these distortionary policies.

Failed Policies

For thirty years from the dawn of independence, there was a food ration scheme which covered some 'essential items', including free rice. This was then converted into a Food Stamp Scheme, in 1978, when the food ration program became unaffordable due to the rise in prices and the increased population. The food ration was untargeted with even the wealthy being entitled to it. This contributed to its unaffordability as did the impact of inflation on the prices of the 'essential items'. The Food Stamp Scheme was targeted with eligibility being based on an income threshold with the stamps being used to purchase a specified list of 'essential items'. It was not index linked to inflation. Eventually, a combination of unaffordability due to poor targeting and the political blowback from the erosion in the real value of the food stamps through inflation led to the introduction of first the Janasaviya and then Samurdhi Programs. These sought to address the distortionary impact of price controls by replacing them with income transfers.

In considering whether there should be a return to subsidizing consumer items through the introduction of price controls, it is important to recall that these unaffordable subsidies led, in the past, to distortions which severely compromised the country's developmental prospects and imposed hardships on the people. Foreign producers were subsidized at the expense of local farmers. In the case of rice, the cost of subsidizing both production and consumption became enormous and absorbed a massive share of budgetary resources. The end results were: (1) mobilizing additional revenue through an increased tax burden on the people; and (2) expenditure cuts which starved infrastructure and other public goods of vital resources.

One may conclude that the country, in the price control era, was plagued by unsustainable levels of consumption expenditure at the expense of much needed investment. This inevitably led to low growth and higher unemployment. In addition, the supplies available at the guaranteed (controlled) prices were limited and a thriving black-market emerged in the commodities concerned. As a result, those who needed relief most were confronted with scarcities, queues and black-market prices, while the powerful were able to use their influence to make their purchases at the controlled prices.

These misguided price control measures clearly had very perverse outcomes. Those, who needed relief most, were subjected to scarcities and black-market prices. In addition, the lack of investment in infrastructure, human resources and wealth creation dragged down the prospects of the whole country. Sri Lanka, which was second to Japan at the time of independence and ahead of South Korea and Singapore in the 1960s, fell far behind these and other Asian countries. This may be attributed, in large measure, to such policies which led to a misallocation of resources and a stifling of incentives.

One may conclude, therefore, that any attempt to reintroduce price controls (subsidized consumer prices) would serve to undermine the government's much needed fiscal consolidation program and/or impose an additional tax burden on the people to finance the subsidies involved; fuel inflation; and divert resources from more productive activities, including infrastructure development, health and education.

There have also been calls to increase the guaranteed prices of certain varieties of rice. In addition, the EU fishing ban has prompted pressure for guaranteed prices for fisherman. The paddy sector currently benefits from free water, the fertilizer subsidy and guaranteed prices. These measures already impose an extremely heavy burden on society as a whole, including paddy farmers, because they have to be financed out of taxes and/or borrowing at commercial interest rates. A guaranteed price for fish would have to be financed by damaging the interest of consumers through higher prices and/or by casting an additional burden on tax payers. The underlying cause as to why advantage is being taken of the election campaign to seek assistance – low productivity- is discussed below.

Protecting the Poor and Vulnerable

While price controls based on subsidies or guaranteed producer prices have little economic/social value, there is an extremely strong case for designing a social protection program for the poor and vulnerable. However, Sri Lanka has graduated to lower middle-income-country status, with $3,280 per capita income (2013), with 8.9% of the population living below the poverty line, and still continues to provide income transfers for 40% of the population through the Samurdhi program. As a result, those who are really in need do not get the level of support they require. There is a case for increasing the relief offered to the poor and vulnerable by improving the targeting of the Samurdhi program.

Myths of Price Controls, Guaranteed Prices and Unrealistic Salary Increases

Price controls, guaranteed producer prices or even income transfers, treat the symptoms rather than the underlying causes of the problem. The current pressure for price controls and guaranteed producer prices stem more from low incomes rather than a high cost of living. Incomes are low because productivity is low. Increasing incomes without improving productivity will merely fuel inflation. This would, in turn, result in the increased incomes being eroded by higher prices. The key challenge, therefore, is to increase productivity. This is the way to increase incomes while maintaining price stability. Those, who are interested in providing relief for the people, should focus on ways and means of increasing productivity rather than resorting to policies which have failed in the past and will not be any more successful now because they do not address the underlying cause.

Low productivity is the root cause of the problem. As Pathfinder Foundation has pointed out previously, Sri Lanka has two large wells of low productivity: agriculture and the public service which serve to exert downward pressure on incomes across the economy.

Solution: Increasing Production for Unit of Labour, Land and Capital

Over 30% of the labour force works in the agriculture and fisheries sector and only produces 11% of GDP. Issues such as fragmentation of land holdings; land use/product mix; the role of commercial agriculture;

technology; and seed quality need to be addressed effectively to raise agricultural productivity. The fisheries sector needs to be modernized with investments in boats and the cold chain. Fishing techniques also need to be improved to avoid violation of EU guidelines.

The public service has increased from 600,000 (2005) to 1.4 million (2014). A little over a decade ago, a study revealed that the public service should number 400,000. Even when one allows for the build-up of the armed forces, which was necessary to prosecute the war successfully, the public service is probably twice as large as it needs to be. There has been a large scale creation of unproductive jobs. As a result, public service salaries have had to decline in real terms to accommodate the rising numbers. This was the only way to contain the adverse impact of an increasing salary bill on an already unsustainable budget deficit. Unsustainable public servant salary increases will only aggravate the problem. Without an increase in productivity, it will merely serve to fuel inflation.

Unrealistic promises, if implemented, will undoubtedly lead to sharply increased inflation and an additional tax burden on the people to pay for them. The other option would be to cut expenditure in sectors, such as infrastructure development, education and health. The opportunity costs would be high. This is even more of an issue in the current context of weak Government revenue performance.

Sustained Relief and Prosperity through 5 Hubs + Tourism Strategy

Ultimately, sustained relief for the people can only be provided by shifting from low to higher productivity economic activity so that incomes can rise to cope with the cost of living. The Government's 5 hubs + tourism strategy provides a framework for doing this. Priority should be attached to identify ways and means of implementing this strategy in order to create higher value employment and to educate/train the human resources required for this purpose. There is nothing to be gained and much to be lost by harking back to failed policies, such as price controls and guaranteed producer prices. Instead the focus must be on creating a conducive environment for generating productive jobs which can support income levels that are high enough to cope with the cost of living.

This is the Fifty Fourth Economic Flash published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org