Pathfinder Foundation Economic Alert

Fulfilling Budget 2013’s Aspirations: Lets Walk the Talk Regarding Reforms

Key Targets

It is encouraging that the Budget Speech 2013 sets out a fiscal framework that seeks to continue the trajectory of much-needed fiscal consolidation. If successful, it will address a perennial problem that has plagued macroeconomic management in Sri Lanka for over four decades. The budget also announced several measures to strengthen the supply-side of the economy (i.e. boost domestic production) in relation to SMEs, agriculture, other import substitutes and capital markets. The capital account of the balance of payments was also liberalized further. Despite these measures, the prospects of achieving the following two outcomes that are built into the budgetary framework are likely to prove extremely challenging:

1. The overall budget deficit of 5.8% of GDP

2. The growth target of 7.5%

These two targets are inter-linked as higher growth will make it easier to achieve the desired budget deficit through its impact on revenue and fiscal consolidation is a crucial element of a growth-friendly macroeconomic environment.

Challenge 1: A Budget Deficit of 5.8% of GDP

It is noteworthy that this year’s budget (2012) has come under severe pressure due to a revenue shortfall arising from the sharp slowdown in growth. The budget deficit for the period January to August 2012 was 6% as against a target for the whole year of 6.2%. As a result, it has become necessary to cut expenditure, particularly capital expenditure, drastically in the last four months of the year. It is likely that there will be the same pressures on revenue and ultimately the budget deficit next year, if one assumes that the budget has been framed on the basis of an unlikely 7.5% growth rate for 2013 (see below for discussion of growth prospects in 2013).

This raises the question as to what can be done by way of a mid-course correction during the course of 2013 to improve the prospects of meeting the deficit target of 5.8% of GDP. The options are:

1. Cut recurrent expenditure

2. Reduce capital expenditure

3. Increase revenue

4. A combination of the above.

There is considerable rigidity downwards built into the government's recurrent expenditure. Almost 90% is accounted for by:

1. Interest payments on public debt (35%)

2. Public service emoluments (33%)

3. Subsidies and transfers (21%)

Interest payments cannot be reduced as they are payable on debt that has already being incurred. In fact, they can increase as monetary conditions could tighten further, in 2013, as the Budget has announced a significant increase in borrowing from domestic non-bank sources to finance the deficit. This will inevitably exert upward pressure on interest rates (see below). In addition, public service emoluments can only be reduced through either a reduction in the number of public servants or cuts in their pay and/or pensions. Such a course of action is politically challenging, particularly for a government whose development framework has seen the public service grow from 600,000 to 1.3 mn during its stewardship. Furthermore, cuts in transfers and subsidies are also politically very difficult, particularly if major elections are to be held in **early** 2014 as permitted by the Constitution.

This leaves some combination of revenue increases and capital expenditure cuts as the means for achieving the desired outcomes in respect of fiscal consolidation. However, both these options will have a contractionary impact on the economy through their restrictive implications for aggregate demand. They would be strongly pro-cyclical at a time when there is an increasing growth deficit. Here again, lessons can be drawn from this year's mid-course fiscal adjustment that is being characterized by severe cuts in capital expenditure (about 30%) during the last four months of 2012. A repetition of this cycle of events (a revenue shortfall, rigidity in recurrent expenditure, and significant cuts in capital expenditure), in 2013, would serve to stifle growth impulses even further in a context where the growth target (7.5%) is likely to be elusive even without further fiscal tightening.

Challenge 2: Achieving 7.5% Growth

Growth, which was 7.9% in 1Q 2012, is unlikely to be much above 5.5% in the last quarter of this year in the wake of the much needed robust stabilization measures introduced in February/March 2012. It had already decelerated to 6.5% in 2Q 2012. Since then the kicking-in of the credit ceiling and the sharp reduction in Government capital expenditure would have squeezed growth even further.

The Budget 2013 has been framed on the basis of 7.5% growth next year. This assumes a sharp acceleration in growth from the figure recorded in 4Q 2012. The prospects of achieving the growth target in the Budget will be determined by whether the supply-side measures introduced in the Budget 2013 are sufficient to off-set the powerful contractionary effects that will emanate from the macroeconomic policy stance which will have to be adopted during the course of next year. There is little scope to relax fiscal and monetary policies over the next 6-12 months at least.

The fiscal consolidation anticipated in the Budget is necessary. However, it will have a negative impact on growth, particularly as capital expenditure is being reduced from the 6.6% of GDP allocated in 2012 to 5.8% next year. If growth is significantly below 7.5%, one is likely to see a repetition of this year's fiscal cycle with a revenue shortfall and further cuts in expenditure, particularly capital expenditure, with its concomitant stifling of growth.

As mentioned above, the prospects for relaxing monetary policy have been significantly reduced by the increased recourse to domestic non-bank financing to fund the budget deficit next year. It is encouraging that the government will not be undertaking any further foreign commercial borrowing, given the negative net external gross reserve position and the concerning trend in the debt service ratio. However, the anticipated increase in borrowing from domestic non-bank sources will tighten monetary conditions and reduce significantly the prospects of a reduction in interest rates from current levels. The scope for reducing interest rates will also be constrained by the price increases which will stem from budgetary measures, such as the increase in the guaranteed price of rice, changes in tariffs to promote import substitution (cheaper imported goods will no longer be competitive) and the increases in VAT and Nation Building Tax on large retailers (which constitutes a positive step in widening the tax base by). These measures will be limited to a one-off effect on the price level unless they result in wage rises which would then trigger the secondary effects of boosting inflationary pressures in the economy. This would call for a further tightening of the already restrictive monetary policy stance.

How To Walk the Talk

One may conclude that monetary and fiscal policies will have to continue to exert contractionary pressures on the economy. The trends in the current account of the balance of payments and inflation do not, as yet, provide any room to maneuver on the macroeconomic policy front. It is unlikely that the supply-side measures introduced in the Budget 2013 will be sufficient to override the powerful effects of continued restrictive monetary and fiscal policies. Developments in the world economy are also likely to mean that external demand will continue to be muted though one is beginning to see an upturn in China, India and the US. All this implies that a wave of more fundamental reforms is necessary to strengthen the overall growth framework (particularly for export expansion) if the country is to achieve the growth target in the Budget. This is even more important for attaining 8% growth in the medium to long-term. These reforms could include, inter alia, the following: SOE reforms (CPC and CEB operating at breakeven point would eliminate their losses from the balance sheets of the state banks and serve to mitigate the liquidity squeeze generated by increased government borrowing from non-bank sources); PPPs for maintaining the momentum of infrastructure development; further implementation of the recommendations of the Tax Reform Commission; better design and targeting of subsidies and transfers; land and labour market reforms; tariff reform; further improvements in the investment climate; and confidence-building regarding the consistency and predictability of policies, including the sanctity of contracts and the rule of law in the commercial sphere.

It would be wholly inadvisable to opt for short-cuts by relaxing the restrictive macroeconomic policy stance before the economy achieves its equilibrium, particularly on the balance of payments front. Premature easing would merely trigger another round of stop-go policies. It should be noted that the next cycle would start from a more unsustainable external position (current account deficit and debt) and the risks would, therefore, be significantly greater of there being a major Greece-like payments crisis. The Pathfinder Foundation reiterates that there can be no shortcuts for putting the economy on a higher-growth trajectory. It is not possible without more ambitious structural reforms, particularly those that shift the overall incentive regime in favour of exports. The supply-side measures in the budget have tended to shift the balance in favour of import substitution in an economy with a market of only 20 million.

Finally, it is important to reiterate that it is easier to achieve the fiscal deficit targets with higher growth. Equally, accelerated growth on a sustained basis cannot be achieved without fiscal balance.

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