Pathfinder Economic Alert

The Choices for Voters: Forthcoming Parliamentary Elections
Getting out of or continue to be in the vicious circle?

Introduction

Every election in Sri Lanka has been contested by all parties on populist policies. Every government formed after the elections implemented unviable promises during their first few months. They hoped that they could find revenue and cut expenditure by eliminating waste and corruption. Invariably, they later faced hard realities within the domestic as well as the global setting and were compelled to reverse actions taken to fulfill election promises. This democratic process has ended up with fiscal deficits annually and has resulted in high levels of both domestic and foreign debt. This, in turn, demands high debt servicing from the annual budget. The government deficit increases aggregate demand in the economy. This pushes up demand for both imports and domestic goods and services which, in turn, creates inflation as well as exchange rate depreciation. The government borrowings also reduce available credit to private individuals and businesses and hence push interest rates up. These domestic macroeconomic trends are becoming increasingly played out in a context where countries are integrated to global trade, tourism, and labour markets as well as capital movements and financial transactions. This means that national economic sovereignty is becoming increasingly diluted in the modern global economy. This increases the importance of disciplined economic management as countries become more exposed to international markets.

The 2015 Presidential Election was fought on a governance platform. Sri Lanka advanced from a US$ 600 per capita income or a low - income economy in 1994 to a US$ 3,600 per capita income or US$ 70 billion middle-income economy; bringing down unemployment, inflation and poverty from double digit to single digit levels; ending the 30 year terrorist war; and entering a phase of modern infrastructure development that accelerated growth. Despite this, the 2015 Presidential election proved that the way forward cannot be sustained without addressing governance failures.

The governance failures were obvious. The incumbent government could not address international concerns on human rights and regional politics of India and China. Domestically, indiscipline among ministers and top bureaucrats brought about discredit. Politicians engaged in the illegal businesses of liquor and drugs. The family of the President engaged in business and politics. Appointments to top positions and diplomatic posts were not credible. Corruption charges were ignored. Independent agencies did not live up to public expectations. The President did not take serious action to fire anyone. Arm's length transactions were expanding around influential people. The government, security forces and state agencies got into commercial businesses- all unwarranted. The President lost the election surprising many.

President Rajapaksa left a strong legacy behind. He gave uncompromisingly bold leadership to end the conflict. He embarked on a massive infrastructure development drive and he tapped every possible funding source to realize it. Progress was made in macroeconomic management by committing to a lower fiscal deficit. The President left the country with a 5 percent fiscal deficit and lower inflation. Above all he conducted regular elections, including the provincial council elections in the former conflict affected provinces, in spite of the opposition from some of the Ministers. And finally, he conducted the Presidential election two years in advance and conceded defeat even before results were announced. This has given his successor and his followers the opportunity to take the country forward rapidly. The barriers to development are now only political. However, if Sri Lankan politicians get back to historical rhetoric and narrow minded political attacks on their opponents, the golden opportunity that the country has got to move forward with governance centric reforms will be lost. The legacy of President Sirisena should be vision driven and not a repetition of history.

Although the new Government has delivered everything that it promised during the election campaign to provide the usual relief and wage hike to public servants, they must understand voters rejected only the poor governance. For instance, voters expected a transparent formula for pricing fuel and electricity. Instead, the government has reduced administered prices like the previous Government. Similarly, people expect more efficient public service delivery rather than guaranteed pricing as in the past. Equally, a reduction in the budget deficit is expected not by cutting public investment on infrastructure but by eliminating corruption. That means getting procurements and related public sector governance right. This article invites concerned citizens of Sri Lanka, business chambers, intellectuals, corporate leaders, trade unions, academic community, retired senior public servants and media to engage in a non political debate to enlighten political parties as they prepare their manifestos for the general elections. One of which will become the National Development Strategy depending on voter choice. Each manifesto must present the budgetary impact of the measures contained in it.

Some lessons from recent history

Food subsidies have dominated elections since independence. Every successive government has attempted to remove subsidies while every opposition has attempted to promote subsidies. The two major parties in the 67 years of post-independent politics, in that sense, have not been successful in mobilizing the population on a clearly defined national political economy agenda. Instead the focus has been on subsidies and handouts.

This should not be the case in 2015. First, the incumbent Parliament has representation from all parties for securing the required constitutional reforms. This may be the last parliament that can get strong support from the opposition for the Government, as the

President is the Chairman of the main opposition party that commands over 125 members of parliament. Second, the country is a middle- income economy ready for take-off. The barrier was family politics and poor governance. This has now been removed. Third, regionally the country has gained investor appetite as tourism and FDI have gained momentum. The peaceful democratic transition of power should be marketed well overseas instead of downplaying it with local politics.

The nation has two serious choices to be made at least for the future.

1. Mobilize the population around two major parties or give leadership through the formation of two grand alliances by recognizing ethnic and religious concerns on the principles of equality of democratic rights of the people. The trade-offs in center left or center right politics should be discussed on election platforms for people to make choices.
2. Present a well thought out national economic development agenda, within the relevant political ideology, recognizing global economic realities. People could then make economic choices at the election to maintain necessary checks and balances.

Avoiding unrealistic promises

Auctioning of the costly rice subsidy came to an end in the1977 election. The Government of President J R Jayawardena came into power in that election based on the promise of 8 pounds of cereals. In practice, its reforms resulted in the market being liberalized enabling consumers to have access to buy any quantity of their individual choices. Thereafter the voters experienced four landmark promises. The first was President R. Premadasa promising a cash grant of Rs. 2,500 per family. As delivery was costly, only half of that promise (Rs. 1,250) was to be given in 12 staggered rounds. It was short lived.

The second was the promise by President Chandrika Bandaranaike to give a loaf of bread at Rs. 3.50. One year later it was discontinued as the annual subsidy cost exceeded Rs. 7,000 million; the same as thetotal cost at that time to build the Colombo-Katunaike Expressway. Third, was the promise of fertilizer at Rs. 350/50 kg per bag by President Mahinda Rajapaksa. It continues to date but at an annual budgetary cost of Rs. 40 billion. The last, was the Rs. 10,000 wage hike to public servants, among many other subsidies and concessions, by President Maithreepala Sirisena. It was granted with the support of all except one MP in the parliament but its sustainability is yet to be seen. So promises to deliver what is not feasible is a common characteristic of the political economy in this country. Therefore, everybody knowingly or unknowingly has become a stakeholder of debt, which is nothing but an accumulated outcome of successive fiscal deficits. This is how economic governance failures have cropped up. The 1978 constitution, which has got further complicated with 18 amendments so far, has generated constitutional failures as well. So the focusing on a governance agenda is timely. However, there is also need to address fundamental budgetary issues as well.

An Agenda for a Discussion

Historical experience is that all political parties have auctioned non-existent resources. This is reflected in the National Budget. The following issues need to be considered and the questions addressed in a non-political manner with a view to attaining fiscal sustainability in the medium and long term.

Salary Expenditure

The Government sector employs around 1.3 million people. Semi-government institutions make this number higher. The wage bill of this segment, in 2016, is likely to be Rs. 700 billion.

The pensioners of around 550,000 will cost nearly Rs. 200 billion.

Questions

A. Is this affordable? Do the voters need a public service of this size in terms of numbers and expenditure?

B. If acceptable, who pays for it? And what from? Personal income tax including PAYEE, Corporate tax, VAT, Excise, Customs duties or user fees?

C. If not acceptable, how would an affordable wage structure be designed taking into account professional needs of the public service I.e. on the occupational classification of public servants?

D. Is a VRS the answer?

Household Transfers

1. The government provides about Rs. 250 billion on household transfers. There are about 1.8 million Samurdi families (about 5 million people). In addition, there are about 4 million school children who get a variety of welfare assistance such as free uniforms, meals and transport. Pregnant and lactating women numbering approximately 1.7 million also receive assistance. Elderly people numbering approximately 300,000 and disabled persons too get government cash assistance. Ranawiru parents of around 1 million get a Rs. 1,000 monthly cash allowance. There is bound to be duplication through these programs as many line agencies, provincial councils and local authorities, are involved in implementation.

Questions

1. What should be the free/subsidized goods? Should they include pharmaceutical drugs, fertilizer, school uniforms, text books, school children and government servant season tickets and subsidized transport?
2. Should these be targeted to make them more effective, and efficient?
3. Should the multiplicity of household transfers, such as Samurdi payments, allowances for the elderly pregnant mothers, parents of tri-services, police and civil security personnel be consolidated and granted only for those below a poverty line?
4. Should be the income cut-off for the national poverty line and will that include income in kind?
5. Should semi-government institutions like BOI, EDB, Agrarian research, UDA, Tea Board, Rubber control Department, Coconut board, SME authority etc. be independent of the Budget and become self-financing?

Public Investment?

There is a general acceptance that the Government must maintain reasonably high public investment to develop public infrastructure which is necessary to make private investment viable, including those that can be done on a Public Private Partnership (PPP) or BOT basis. Currently it is around 5 - 6 percent of GDP.

Questions?

1. How much budgetary financing should be allocated to Public Investments? If it is below 6 percent of GDP, what are the investments which should be opened to the Private sector to compensate for this: expressways; airports;, power generation and distribution;, railway infrastructure;, aviation business; and petroleum industry upstream and downstream?
2. What are the plans for the two departmental enterprises, namely Postal services and Railways? Both are heavily unionized and may have outlived their usefulness.
3. What is the feasible degree of fiscal and power devolution to provincial councils? Do we need activities such as primary agriculture; poor relief and social welfare; cooperatives; primary schools and health facilities; low income housing etc. to be handled by ministries at the National Level?

Public Expenditure on Health and Education

There have been calls to raise expenditure on health to 3 percent and education to 6 percent. This is more than doubling the present annual budget allocation. Even if this level is to be realized over a 5 - year period, the present nominal outlay must increase by over 20 percent annually. One needs reforms to improve educational outcomes as additional money alone will be insufficient to obtain the desired outcomes. In addition, one needs to determine which areas should be targeted for expansion.

1. What would be the implications for other expenditure if 9% of GDP is allocated to health and education?

2. Should defense and national security be cut below 3 percent of GDP?
3. Should the civil service salaries and overheads be reduced below 1 percent of GDP?
4. Should the subsidies and current transfers to household be reduced below 1.5 percent of GDP?
5. Can the interest expenditure be reduced below 3 percent of GDP?
6. Should the public investments on public infrastructure be contained below 3 percent of GDP?

Unless there is a cut back in other expenditure, total public expenditure will be a minimum of 20 percent of GDP over the medium term. In this context, the government would need to plan for revenue in excess of 15 percent of GDP in order to achieve a fiscal deficit below 5 percent of GDP. Therefore, it is necessary to look at tax and non-tax revenue sources which are not one off measures.

Taxation as of 2015

The tax revenue in the 2015 amended Budget has been projected at Rs. 1,337 billion. Once corrected for the impact of one off revenue measures, over estimation and the general elasticity in the country's tax system, a more realistic figure could be projected at Rs. 1,000 billion or about 9 percent of GDP. The challenge is to move this in excess of 13 percent of GDP? This can be done on the principles of a broad based low tax rate structure or on a progressive sliding scale system?

About Rs. 250 billion is generated from income taxes. This is little over 2 percent of GDP.

Questions

How do we make this a bigger revenue source?
Is it possible to double this in terms of GDP?
Should Sri Lanka raise its tax rates or consolidate the low rates currently in place and remove all exemptions and concessions built into income taxation?
Should we combine low rates on income or profit with a percentage tax on gross income and collect whichever is higher?
With regard to personal income taxation should we do away with individual income and move back to family income with a prescribed threshold for the family and not individual, as adopted in 1978.

The answers depend on political will. Growing global trends in the movement of people and income should also be taken into account. In the growing services sectors in the Middle East and Asia, which are our direct competitors people employed in IT, medicine, engineering, legal services, tourism, aviation, shipping etc. are paid high salaries are liable to lower taxes.

Turning to **indirect taxes**, the country has equally low external trade based taxes, which account for about Rs. 250 billion. Prospects for protective customs duties are not helpful, particularly if one is serious about removing the anti-export bias in the overall incentive structure. Simplification is unavoidable. The main sources of customs taxation could be motor vehicles and petroleum through excise taxation.

VAT/NBT on goods and services, both at domestic retail level and at the point of imports for final consumption, are the main sources of tax revenue. The revenue from these sources is around Rs. 550 billion. This is at the rate of 11 percent VAT and 2 percent NBT with a wide range of exemptions such as fertilizer, pharmaceuticals, electricity, water, transport etc. The revenue from this could be raised and made more elastic to GDP if all exemptions are removed and this tax is imposed above a monthly turnover of about Rs. 50 million on domestic sales. In addition, liquor, cigarettes and petroleum products, including LP gas, are taxed through excise taxation. Exports anyway will need to be subject to zero rated tax for international competiveness. Alternatively, an old fashioned turnover tax of around 9 percent, without refund could be considered but this is not the practice of many countries.

Non- Tax revenue

The main sources include government fees and charges, social security charges on survival benefits for public servants and profits and dividends of state enterprises. The services provided by the government agencies must be on a cost recovery basis. This means that the importance of proper costing for salaries, operational costs and capital must be recognized. In the context of rising pension liabilities the current charge of 7 percent on basic salary is inadequate. It could be on a higher rate and on gross salaries to support a non-contributory pension system. The total wage bill of around Rs. 600 billion this year would generate Rs. 60 billion if a 10 percent rate is applied on gross salaries. This would finance 40 percent of pension outlays. Large state enterprises other than banks and insurance do not pay a return on investments to the government. Hence they must adopt commercial pricing based on a full cost service delivery to make them truly profitable. This requires fundamental reforms in enterprises such as electricity, petroleum, water, railway, airports, ports etc.

Conclusion

It is clear from the foregoing observations that Sri Lanka needs revenue efforts over 15 percent of GDP to keep its public expenditure on a sustainable basis over the next 5 years. This requires more reforms than its people, politicians and professionals currently envisage. Failure to do so and attempting to promote populist policies will not break the past track record of deficits, debt and credibility gaps in fiscal policy.

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