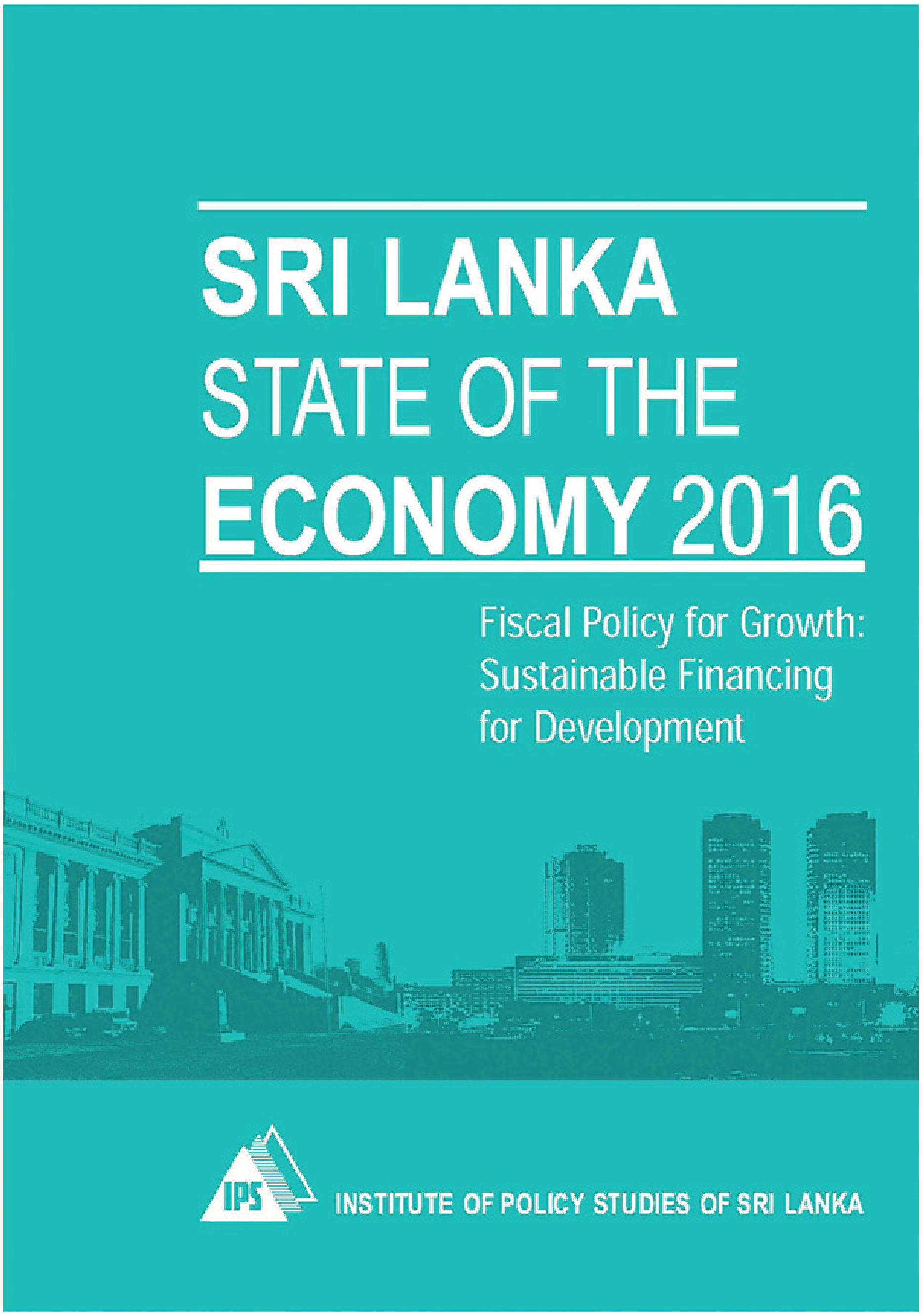
Fiscal policy for growth: Sustainable financing for development

2016-10-26 00:00:57



In 2015, the Sri Lankan economy grew at a modest 4.8 percent, capping a year of socio-political transformation in which electoral politics dominated the headlines.

In the midst of the socio-political transition, the economy received little attention despite worrying signs of a deteriorating economic environment, particularly in the arena of
public finances.

With a fiscal deficit of 7.4 percent of GDP and public debt of 76 percent of GDP in 2015, fiscal consolidation is necessary to ensure macroeconomic stability, a fundamental prerequisite for growth. Fiscal policy also has impacts on growth at the micro level through tax and spending policies across economic activities.

Interrelated problems

In this context, the 'IPS' Sri Lanka: State of the Economy 2016' report focuses on the many interrelated problems constraining investment and productivity across the Sri Lankan economy owing to weak public finance management.

For instance, Sri Lanka has witnessed a sharp increase in para-tariffs that not only distorts the import duty structure but also leads to policy inconsistency. Conversely, Sri Lanka has granted significant tax exemptions to attract FDI, which has contributed to weakening the country's tax base and tax compliance. Exports have continued to decline as a share of GDP, hitting a new low of 14 percent in 2015, and with export earnings continuing to contract by 6 per cent in the first half of 2016.Similarly, Sri Lanka has failed to raise its FDI beyond 1.5 percent of GDP even following the post-war economic euphoria. FDI inflows fell by 30 percent in 2015; they have fallen by a further 53 percent in the first half of 2016.

Fiscal incentives also matter in raising investment and productivity in labour markets. Despite a relatively low unemployment rate of 4.6 per cent in 2015 – albeit up steadily from 4 per cent in 2012 – Sri Lanka's labour market indicates significantly high educated youth unemployment as well as a low level of female labour force participation.

So far, well-meaning intentions to generate one million jobs and improve living standards of workers have been spelt out in the government's Economic Policy Statement, but without much guidance on the precise direction or the urgency with which it will be implemented. If one million jobs are to be generated, Sri Lanka will have to rely on those who are economically inactive, particularly females and youth and devise appropriate incentives to get them into the workforce.

Labour force participation

Increasing the labour force participation of youth is intrinsically connected to the quality and relevance of education that equip workers with evolving skills demanded in a more globalized world. Sri Lanka has relied heavily on public sector financed general education and tertiary education systems, including other measures such as the distribution of free textbooks, scholarships for disadvantaged students, free uniforms, and subsidized transport facilities, etc., to ensure high education outcomes.

However, even with public spending on education set to increase further, the resource gap to meet quality and equity issues in the education sector will of necessity require incentivizing private sector participation, particularly in the tertiary education system.

Heavy presence of private participation

Private participation – as both providers and consumers of services is already more heavily present in Sri Lanka's health sector. The current total expenditure on health of 3-4 per cent of GDP falls short of comparable global averages even at present, and is set to increase with the country's rapid demographic and epidemiological transition.

Out-of-pocket expenses by households on health care is rising, raising issues of affordability and equity. Thus, improving allocative efficiency of healthcare expenditures and finding alternative sources of finance are high on the agenda to address improved health outcomes in the country.

Sri Lanka's demographic transition also holds important implications for fiscal policy reforms, including the provision of adequate social protection systems and social safety nets. Efforts to reform the country's non-funded public sector pension schemes – as outlined in the 2016 budget proposal – have fallen by the wayside in the face of stiff opposition. Sri Lanka also provides an array of social safety nets. The cost-efficiency and effectiveness of current poverty reduction programmes – primarily, the Samurdhi/Divinegumaprogramme – is doubtful in view of poor targeting and other implementation weaknesses. Although Sri Lanka has made progress in tackling poverty at the national level, the presence of significant pockets of poverty and rising inequality within the country means that considerable attention needs to be paid to bridging such disparities in the coming years.

Population disparities

Targeted efforts to narrow disparities between population groups especially between urban and rural sectors of the economy need to accompany Sri Lanka's renewed efforts to fast-track the development of cities. The growing demand for urban lifestyles as incomes rise and the economic arguments for urban agglomeration make a compelling case for planned large-scale developments. Sri Lanka has already launched an ambitious US$ 40 billion Western Megapolis project that will require significant new sources of funding.

While such infrastructure-reliant projects can have an immediate and more long-term impact on growth, they can also lead to fiscal and broader macroeconomic stress unless financing aspects are managed effectively.

If large-scale urban development initiatives are not managed well, they can also have strong negative impacts on a country's natural resources and environment. Air pollution and urban slums are common undesirable outcomes of ill-planned big projects. With the renewed global emphasis on sustainable development, managing the environment is at the centre of economic policy. In Sri Lanka, environment policy has been dominated by command-and-control instruments based on regulations and standards.

However, owing to their limited effectiveness, high cost of implementation, low economic efficiency, and problems of sustainability, market-based instruments have been gaining ground. Such economic instruments, a shift from penalties for non-compliance to payments or adjustments in the systems of ownership rights offer countries like Sri Lanka a more fiscally effective means of environment management.

Indeed, the lack of user charges for irrigation for instance, has long been identified as reason for over-use of scarce water supply. The development and maintenance of irrigation facilities, however, is an onerous fiscal burden on the government. Similarly, the government spends considerable amounts on other producer subsidies such as fertilizer – a programme, which has often been criticized for lack of effectiveness. The sale of subsidized fertilizer and its over-usage that has led to other health related problems are some of the drawbacks. Sri Lanka's growing consumer demand for food and inadequate incomes to farmers do not support the country'smoves towards food security and poverty reduction efforts. Thus, Sri Lanka needs to re-examine economic incentives to leverage the existing resources in a more fiscally efficient way to support agriculture sector development in the country.

Beyond macro to micro

Thus, Sri Lanka's needed fiscal reforms are not only about attaining macroeconomic stability, although it is a prerequisite. The reforms go beyond the macro to the micro – and will be the more effective if they are self-reinforcing.

Progress towards meeting such a broader fiscal reform agenda has been facilitated with financial and technical support from Sri Lanka's IMF package lending from other multilateral and bilateral agencies.

The big hurdle for the government is to ensure political and social consensus for a successful reform initiative. In government, the reality of hard choices is being felt; tax increases on VAT is bringing widespread strikes by traders; consumers will also be disaffected by rising prices amidst tighter economic conditions. The government's efforts to foster public support for reforms, including effective communication have fallen short.

The lack of clarity on the direction of economic policy is perhaps not a surprise in the initial settling down period of a coalition government. The immediate task is to instill confidence that the fiscal consolidation process instigated under the IMF arrangement will be pursued. While the IMF deal is not a panacea for all Sri Lanka's economic ills, it can be leveraged as a confidence restoring measure and generates imulative benefits. Once a semblance of fiscal control has been restored, the impact of such austerity on the country's growth outlook can be reversed with an easing of monetary policy. Sri Lanka has already lost time in preparing the details of a complementary medium term structural reform agenda to promote growth. That too is a priority to set clear direction on the economic policy front.

With the announcement that the unity government will continue for a further three years till the end of the current Parliamentary term, there is still time in between for the benefits of reforms to be felt before going for fresh polls. The transition period will test the government's political acumen and dexterityin instilling confidence that it has a firm hand on steering the economy, and delivering a better economic future for all Sri Lankans.

(This article is based on the comprehensive chapter on "Policy Perspectives" in the 'Sri Lanka: State of the Economy 2016 Report' - the flagship publication of the Institute of Policy Studies of Sri Lanka (IPS). The complete report will be available for purchase from the publications section of the IPS)