Issues and Challenges for the Sri Lankan Economy in 2013

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Overview of the Sri Lankan Economy

- Growth decelerated from an average 8 % during 2010-2011 to 6.4 % in 2012 due to stabilization policies enacted in early 2012 (global economic downturn also contributed)
- Euphoria of the war victory and IMF SBP in 2009 made Sri Lanka to relax its fiscal and monetary policies for growth stimulation
- Monetary relaxation and slow tightening of fiscal policy facilitated the growth process for two years but could not be sustained due to structural problems in the economy

Stabilization Package

- February 2012: a much delayed stabilization package with flexible exchange rate and higher interest rates capped by higher tariffs for a number of consumer durables came into effect
- Stabilization policies managed to reduce the current account deficit of the BOP from 7.8% GDP in 2011 to 6.6% GDP in 2012 and fiscal deficit from 7% GDP to 6.4% GDP for the same period
- Despite depreciation of currency after Feb 2012, higher interest rates and imposition/enhancing of import tariffs on certain items the current account deficit did not reduce significantly due to the unsatisfactory performance of exports
- Imports declined by 5.8% but exports declined even more by 7.3%; thus despite increased remittance inflows (US$ 6 bn) and tourist earnings (US$ 1 bn) the current account deficit of the BOP was 6.6% GDP in 2012

Structural Deficiencies in the Economy need to be addressed

- Gross reserves of US$ 6.9 bn by end 2012 was composed of borrowed funds and not net earnings
- Given this scenario, there is limited room for relaxing monetary policy
- By relaxation of monetary policy – bringing down interest rates -- a boost to the economy could be given and enhance growth, but it will not be sustainable without structural reforms
- For sustainable growth, major structural deficiencies of the economy have to be addressed that will bring more manageable imbalances both in the external and internal deficits
- Improve competitiveness of exports; increase productivity of the agriculture sector and the public sector; and so on
- The fact that despite investment being little more than 30% of GDP in 2012 and yet growth being below 6.5% shows that the efficiency in the economy – if measured by the incremental-capital output ration – is above 4.5, when it should have been about 4 – a clear indication of the problems of productivity
- Macroeconomic policy space is currently limited to reorient to more inclusive and sustainable growth

Composition of Expenditure

- ESCAP Report says: There has to be greater emphasis on the quality and composition of public expenditure, rather than aggregate budget deficits and public debt
- Current expenditure is lopsided with interest payments (5.4% GDP), wages and salaries (4.6% GDP) and Transfers and Subsidies (3.1% GDP) accounting for 13.1 % GDP – same as the overall revenue in 2012
- That is the reason why Sri Lanka has not been able to show a surplus in the current account of the budget deficit for the last several years
- For instance, in 2012 the deficit in the current account of the budget was 1.4% GDP compared to 1.1% GDP in 2011
- Surplus in the current account is always helpful to maintain capital expenditure at a high level of close to 6% of GDP (a must in the absence of PPPs for infrastructure projects)

Expenditure Reprioritization Required

	Sri Lanka	Korea	Malaysia	Mauritius	Singapore	Thailand
Education	2.3	3.2	6.7	3.8	3.9	4.2

Table above provides the expenditure allocation as a percentage of GDP on education on a country sample, where Sri Lanka features as the lowest. Clearly, restructuring of public expenditure is required to produce better quality output

Nearly 3% GDP expenditure allocated to cover losses of SOEs –CPC losses : 1.2% GDP, CEB losses: 0.9% GDP, Sri Lankan and Mihin losses: 0.3%, etc.

Had these losses not been there, at least an additional 1% of GDP could have been allocated to education expenditure to be par with Korea

The decline of the budget deficit from 6.9% GDP in 2011 to 6.4% GDP in 2012 has been brought about mainly by cutting capital expenditure which was 5.5% of GDP in 2011 to 4.9% GDP in 2012 – from the long term growth perspective this is not a desirable policy

Development Role of Macroeconomic Policy

- ESCAP Report emphasizes the developmental role of macroeconomic policies, in particular, distributive and developmental role of fiscal policy
- Elaborates social and environmental pillars of sustainable development: (1) 100 day job guarantee programme for informal sector workers; (2) universal pensions; (3) disability benefits for all disabled; (4) universal health coverage by 2030; (5)universal access to basic schooling by 2030; and (6) universal access to energy services by 2020 – will cost 5-8% GDP
- Sri Lanka is close to achieving many of these goals – the key challenge for Sri Lanka is quite different; although funding constraints prevail

Sri Lanka’s Priority

- Sri Lanka’s social security programmes are widespread and coverage varies but highly fragmented with several Ministries, Departments, and Provincial Councils carrying out different programmes often leading to duplications and coordination difficulties among the institutions
- The challenge is to improve targeting in programmes like Samurdhi and use of limited available resources for the benefit of the most needy
- Integrating and consolidating existing social welfare programmes is crucial for maximum impact on the poor.

Gaps and Weaknesses of the Social Security System in Sri Lanka

- Coverage, benefits, targeting and sustainability of the existing social security programmes
- Old aged benefits are largely confined to the formal sector while the coverage of the informal sector is low
- Assistance for elderly and disabled persons – limited coverage owing to budgetary constraints
- Samurdhi – high coverage but targeting errors and low benefit amounts
- Programmes for school children such as school textbooks, uniform, and subsidised transport - universal coverage

Contd.

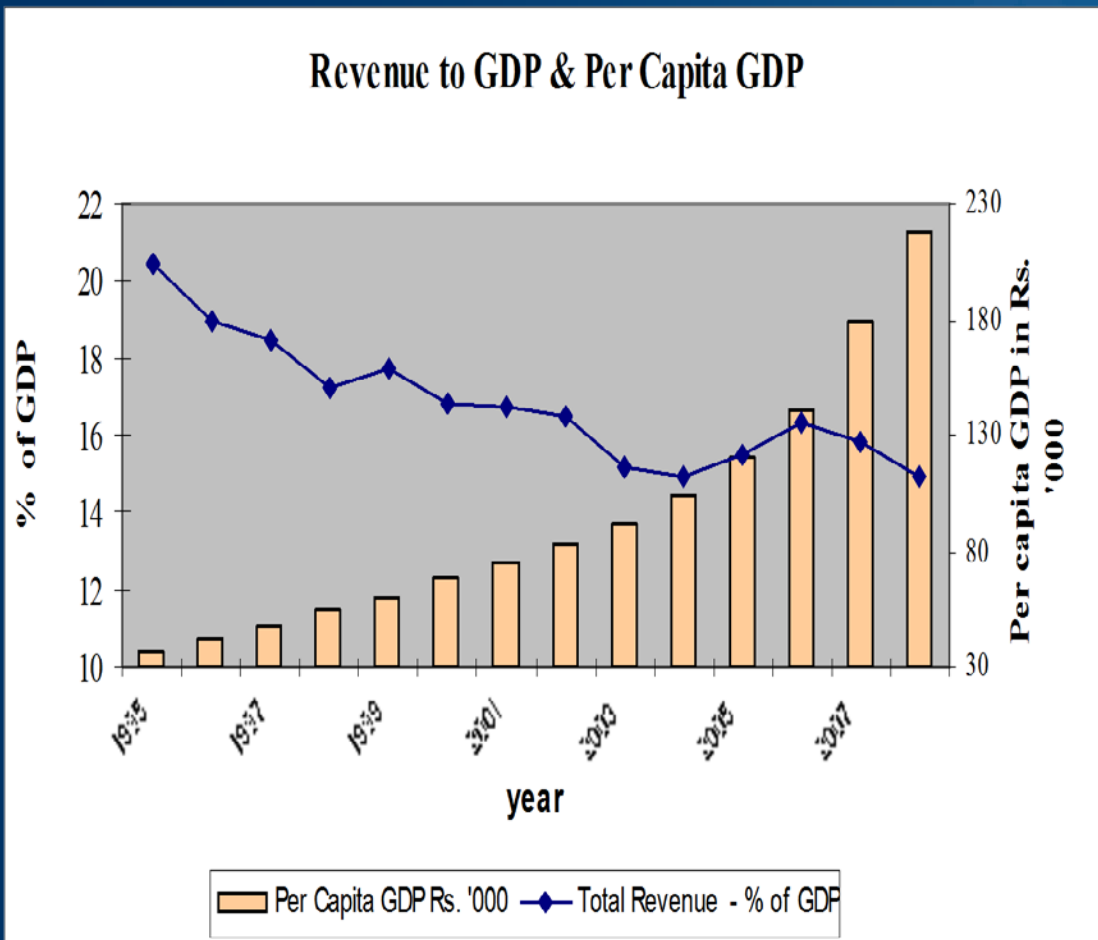
- Benefit amounts remain low across all transfer programmes (Samurdhi, assistance for elderly) and pensions for the informal sector
- Sustainability of non-contributory programmes like the Public Sector Pension Scheme
- Highly dispersed social security system:

  Several institutions → duplication of programmes and coordination problems
- These problems have to be fixed before allocating more financial resources for social security programmes

Social Security for the Informal Sector

- Accounts for 62% of the labour force in the country
- Many in the sector are not beneficiaries of social security programmes, although attempts have been made to cover some specific sectors of the informal labour force such as farmers and fishermen via insurance schemes
- The informal sector accounts for a significant contribution to the economy and its strengths and weaknesses should be assessed by a comprehensive study so that its contribution to the overall economic growth could be enhanced
- IPS did a couple of studies in 2003, and they contributed in one way or another to introducing insurance schemes for farmers and fishermen
- Any comprehensive study of this sector needs wide-scale stake-holder participation and cannot be done in isolation
- Indian appointed a Commission to study this sector; likewise, Sri Lanka should also initiate a study under a Presidential Commission – this will facilitate effective policy formulation for the informal sector

Inadequate Revenue to Support Development -- Revenue to GDP Declining while Per Capita Income is Increasing



- Tax elasticity, which measures the extent to which the tax structure generates revenues in response to increases in income without a change in statutory rates, is less than one.
- Tax base has not broadened in line with increase in income or economic activities.
  - The reasons for this situation may be :
    - Rampant tax evasion
    - Poor tax administration
    - Plethora of tax exemptions
    - Many discretionary measures being prevalent

Lop Sided and Declining Revenue

	Sri Lanka	Indonesia	Korea	Malaysia	Thailand	Vietnam
Individual	0.6	1.7	3.2	2.5	2.0	0.5
Corporate	1.8	3.0	3.3	8.1	4.7	7.7
Total	2.4	4.7	6.5	10.6	6.7	8.2

Table above provides Income Tax as a percentage of GDP for the period 2003-2007 (average)

In 2012, revenue declined to 13% of GDP from 14.3% of GDP in 2011, mainly due to tax revenue declining from 12.4% in 2011 to 11.1% in 2012

Revenue from VAT declined by 0.8% of GDP in 2012 compared to 2011 (3.5% to 2.7% of GDP), mainly due to many exemptions or zero ratings

Income tax declined from 2.4% GDP in 2011 to 2.3% of GDP in 2012 due to rate adjustment not being matched by broadening the tax base in 2012

PTC Report Recommendations

- The ratio for direct : indirect taxation in Sri Lanka is close to 20:80
- As long as the revenue from direct taxation remains low, this ratio will prevail and this in turn means that the bulk of the burden of indirect taxation will be felt by the poor people
- At a time when public debt per GDP is 79% and Sri Lanka is depending on a debt roll over strategy for settling maturing debt and a time when infrastructure development is taking place rapidly it is all the more important to enhance domestic resource mobilization, i.e., enhancing revenue
- Recognizing this, the Presidential Taxation Commission (PTC) was appointed and its recommendations were submitted in October 2010
- Some of its recommendations have been implemented but there are many more to be implemented and they have to be done soon if the revenue levels are to be enhanced close to 20% of GDP

Summing Up: Challenges Ahead

- Addressing structural issues in the economy to increase the competitiveness, productivity, and efficiency of the economy in order to have manageable imbalances in both the domestic and external accounts
- Prioritization of expenditures
- Integrating and consolidating existing social security programmes
- Comprehensive study of the Informal Sector before extending social security schemes to the sector
- Enhancing revenue to meet debt obligations and sustain developmental activities

Growth Prospects for 2013

- ESCAP Report predicts a growth rate of 6.5% for 2013
- ADB Asian Development Outlook 2013 forecast of growth for 2013 is 6.8%
- Recently released IMF World Economic Outlook 2013 forecast is 6.3% (p.153). (The IMF has cut the global economic growth for 2013 from 3.5% to 3.3% due to sharp government expenditure cuts in US and prolonged recession in EU)
- These outlooks indicate that Sri Lanka needs more time to stabilizing the economy and addressing structural imbalances before steering the economy on a sustainable growth path
- An average 6.5% growth for 2013 is good compared to other South Asian countries (other than Bhutan, all others will show a growth rate below 6.5%), indicating that if the existing challenges are effectively met, getting back to a higher 8% growth path will not be a problem

Thank You

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