Keynote Speech

by Mr. K M Mahinda Siriwardana, Secretary to the Treasury and Secretary to the Ministry of Finance, Economic Stabilisation, and National Policies[1] at the Seminar on Macroeconomic Management, organised by the Institute of Policy Studies - 25 October 2022

Theme: *Economic crises and policy adjustments for stabilization*

As we all are aware, Sri Lanka is going through an extremely difficult, unprecedented and critical period. As we all are feeling and experiencing it in our daily life, I don't have to elaborate on the characteristics of it.

As Dr. Weerakoon provided a comprehensive analysis on the recent developments in the Sri Lankan economy, I am not going to repeat the same. Instead, I thought of concentrating my speech on the ongoing crisis, lessons that could be learnt from it and broad policies to stabilize the economy, with the emphasis on the first two matters.

I thought of doing so because today's gathering in this room is full of well experienced policy makers and academics, professionals, and private sector representatives, as well as young and budding individuals who would be the future leaders in economic policy making and advising. I expect that sharing these thoughts with them would be beneficial for all of us going forward.

Ongoing Crisis

Although the task at hands today as a country is to find solutions to the critical economic issues, it is important to have a glimpse of what happened to the Sri Lankan economy to come to this dire situation.

As we know, successive governments have made various efforts to develop the economy. One common factor that could be seen is the overreliance of borrowings as against the generation of savings as the basis for investment.

[1] The views expressed in this speech are my personal and should not by any means be interpreted as the official position of the General Treasury or the Ministry of Finance, Economic Stabilisation and National Policies.

That resulted in a situation where Sri Lanka has been living beyond its means over many years. The fiscal operations were characterized by low revenues and high expenditures leading to high budget deficits, thus creating high borrowings and eventually an unsustainable level of debt. Naturally this was mirrored on the external account as forex outflows consistently exceeding foreign exchange inflows resulting in persistent current account deficits, requiring foreign borrowings to balance it out.

The post COVID-19 adverse economic situation since March 2020 exploded in the second quarter of 2022. The public frustration created by the lack of forex liquidity and the resultant scarcity of essential items, including fuel, LP gas, medicine and other essentials, issues in the provision of uninterrupted electricity, lack of fiscal space and resultant issues, and high and increasing inflation culminated as an eruption of street protests. This resulted in a resignation of the key officials who were involved in economic policy making/advising while ultimately leading to the change of the country's administration.

The above developments teach several lessons to any economic policy maker. Particularly the importance of being humble enough to accept reality, and not allowing ego to get in the way of rational, timely decision making. The crisis has also shown us the importance of evidence based policy making, underpinned by sound analysis, accurate data, and objective judgment. Policy advice must be informed by appropriate risk assessments considering prospective developments and global factors, and most importantly such advice should not be clouded by ideological considerations.

The current critical economic conditions did not occur overnight in an unpredictable manner. If it were an earthquake, a Tsunami, or a flood, the context is completely different. But the gradual deterioration of the economic conditions and potential social unrest was to a great extent predictable and apparent.

The question is whether enough analysis and attention was paid to the unfolding macroeconomic situation in the post COVID-19 period. Whether there were alternative courses of action is another important question. I do not intend to elaborate more on this here, but these are certainly important questions to deliberate upon when trying to find solutions to stabilize the economy and move forward.

It is also important to carefully understand the gravity and the criticality of the ongoing situation. High inflation of around 70 percent, a significant currency depreciation, revenue to GDP ratio of around 8.2 percent of GDP, budget deficit of around 10 per cent of GDP, scarcity of essential items and raw material inputs, all have resulted in a serious contraction in the economy of around 8 per cent in 2022, which will potentially be continued to the next year as well, albeit at a lower rate. The social uprising that took place in the second quarter of the year was a culmination of all the adversities faced by the economy and the public.

As far as the government fiscal operations are considered, the Treasury is struggling to manage resources to meet mandatory payments i.e., salaries, pension payments, Samurdhi and other social welfare expenditures. Almost the entire government revenue has to be allocated just for these mandatory payments, leaving very little for other expenses. Hence, for all other expenditures, including debt service and capital expenditure, the Treasury has to borrow. But, given the lack of market access for foreign borrowings there has been negative net external financing of the budget. The domestic market is also limited in its ability to finance the entire budget deficit of the government. As a result, the Treasury is compelled to seek the Central Bank financing as the last resort, adding to inflationary pressures.

This situation is clearly unsustainable. Furthermore, many important sectors are adversely affected due to the Treasury's inability to provide required financing. This has resulted in outstanding bills of around Rs. 200 billion accruing for many sectors, including construction, fertilizer, health, rations etc., creating knock-on impacts for the whole economy. Given the lack of fiscal space, the government's capital expenditure has virtually come to a halt, creating further implications for current and future economic growth.

Addressing the Issue

Remedying the current issue is not an easy task as it is a deep and complex operation. Solutions must encompass various aspects including economic, political, social, as well as international facets, warranting careful navigation of these varied challenges.

Political will and the readiness to take unpopular decisions is also essential. In the past, political considerations have often dominated the economic decisions to a significant extent, contributing to the unsustainable macroeconomic structure we find ourselves in. Of course, when it comes to economic management, one could not totally ignore the "political economy considerations". For Sri Lanka to emerge from this crisis, it requires economic priorities to take the foremost position, even if such measures are politically unpopular in the short term. This applies to the necessary fiscal and monetary stabilization measures undertaken in the last 6 months. A failure to see through these critical stabilization measures risks putting the economy into a deeper and long-term paralysis.

In implementing challenging economic reforms, getting consensus of the majority in the society in economic decisions is very important. This is no doubt a difficult task, but reading, understanding, and engaging the behaviour of market participants is necessary in order to ensure the longevity of the reform programme.

Measures to Stabilize the Economy

In order to emerge from this crisis, Sri Lanka needs to rebuild foreign exchange reserves, first to enable a regular supply of essential imports to support economic activity and basic consumption needs and then restore the normal life gradually. This mainly requires the following;

1) Immediate: Restructuring the debt and obtaining bridge financing from development partners
2) Short Term: Implementing fiscal, monetary and structural reforms to put the economy on correct the path while aiming the possibility of regaining access to global capital markets as early as possible

3) Medium Term: Improvement in non-debt creating inflows (exports, tourism, remittances, asset divestments where foreign sources will also participate)
4) Long Term: Consistently implementing appropriate fiscal/monetary policies that result in stable current account balance and generates macroeconomic stability to attract sustainable long term capital inflows

The first step in achieving these objectives was to establish an IMF programme without which it is impossible to obtain bridge financing from multilateral and bilateral partners. In parallel, it was necessary to commence the process of debt restructuring, since the IMF is unable to provide financing without Sri Lanka demonstrating credible progress towards making its debt sustainable.

The programme agreed between Sri Lankan authorities and the IMF staff includes measures that address the fundamental drivers of instability in the Sri Lankan economy and putting in place a policy environment to support sustainable and equitable growth, going forward.

It involves following key areas.

1) Primarily revenue based fiscal consolidation
2) Cost-recovery based pricing of fuel and electricity and SOE reforms
3) Ensuring sufficient spending on social protection
4) Restoring price stability, including phasing out of monetary financing (money printing)
5) Rebuilding foreign exchange reserves
6) Ensuring financial system stability through modern legislative and regulatory frameworks
7) Reducing corruption vulnerabilities through improved fiscal transparency and public financial management

Fiscal Consolidation

I will elaborate primarily on the first of these objectives since the revenue measures announced by the government have received significant public attention. As mentioned at the outset, a primary cause of this crisis has been the widening budget deficit due to government revenues declining to historic and global lows of 8.2% of GDP in 2021. This caused escalation of debt, credit rating downgrades, and the requirement of inflationary monetary financing. Therefore, in order to mitigate the crisis, it is essential to reduce the budget deficit.

Revenue

Sri Lanka's **tax structure** has long been highly regressive with primary reliance on indirect taxes (77% of tax revenue in 2021) on goods and services which have a disproportionate impact on the poor. It would be unfair to make the poor take on the greater burden of taxation. Therefore, it is necessary to shift that burden to progressive direct taxes such as corporate tax and personal income taxes.

With regard to corporate income tax, Sri Lanka's proposed standard rate of 30% is comparable to regional peers such as India (25% to 40%), Pakistan (29% to 35%), and Bangladesh (25% to 32.5%). However, due to numerous exemptions and concessionary rates, the contribution from corporate tax is low at 1.5% of GDP in Sri Lanka compared to the broader Asia Pacific region which collects between 3% and 4% of GDP from corporate tax. Therefore, it has been proposed to eliminate exemptions and concessionary rates and create a level playing field with a uniform rate of 30% that is paid by all companies across all sectors. Since this is a tax based on profit, it is not expected to burden loss making entities that are challenged by prevailing economic conditions.

The government will take every effort to reduce the cost of setting up and expanding a business, making it easier to make profits, however once a company is established and profitable, it would be expected to contribute its fair share in taxation.

Personal income tax collection at 0.5% in Sri Lanka is also exceptionally low compared to regional peers which collect over 2% of GDP from personal income tax. The new personal income tax structure is designed to protect the most poor and vulnerable segments of society. The top rate of personal income tax is proposed to be increased to 36%, bringing Sri Lanka in line with regional peers, including Pakistan, Thailand, Philippines, Viet Nam (35%). The tax-free threshold of Rs. 100,000 per month is approximately 2 times the estimated median national income[2]. The effective tax on total personal income for an individual earning monthly income of Rs. 250,000 is less than 10%. The top personal income tax rate of 36% kicks in at approximately 7 times the median national income and 1.67 times the median income of the top decile.

The new tax proposals do not only focus on tax rates but also introduce numerous measures to expand the tax base. Mandatory withholding tax on employment income (APIT), interest income, and services are re-introduced, immediately improving the collection process. Several other technological interventions, institutional, and regulatory measures will be deployed to ensure that a broader tax net will share the burden of taxation.

Expenditure

This is also not to say that expenditure control measures have been ignored. In fact, here have been questions as to why the government is focusing on raising revenue instead of **reducing public expenditure**. At present, the bulk of Sri Lanka's government expenditure comprises mandatory or statutory payments which must be honoured. Obligations for wages (4.8% of GDP), interest payments (5.9% of GDP), welfare transfers such as Samurdhi and pensions (3.9% of GDP) {2021 numbers} cannot be deferred, and these alone are equivalent to almost double the government's revenue in 2021.

On the 26th of April 2022 the Treasury issued a circular that imposed strict limitations on new recruitments, controls on overtime and other payments to government employees, strict monitoring of the usage of vehicles, and

[2] Median national income can be estimated at Rs. 51,806 per month and is measured using household income earner's income as presented in the HIES 2019 and adjusted for prices as at September 2022.

restrictions on expenditure for functions and ceremonies. Furthermore, measures were taken to halt all non-essential capital expenditure and funds earmarked for capital expenditure have been diverted to essential social protection measures. In parallel, ongoing technological interventions such as the expansion of e-Procurement and management information systems such as ITMIS are being fast tracked in order to bring further discipline to public expenditure management. It is expected that these measures will collectively help Sri Lanka reach the target primary surplus of 2.3% of GDP in the next 3 years.

In the meantime, the government is in the process of streamlining expenditures and improving fiscal discipline by introducing new legislations such as the New Public Financial Management Act with binding fiscal rules. Measures are also being taken to restructure state owned enterprises (SOEs) to reduce the pressure on the government budget.

Setting the Stage for Recovery and Growth

In parallel to the measures that are being introduced to stabilise the economy, measures are being put in place to set the stage to enable economic recovery and growth. Accordingly, measures are being taken to free up land for economic activity. The high cost of energy is seen as a key impediment to growth and steps are being taken to facilitate greater investment in low-cost renewable energy. Measures are being taken to improve labour force participation, particularly female labour force participation, which remains low at under 34%. Steps are being taken to revamp the investment climate in the country and re-integrate Sri Lanka with global markets by engaging in key trade agreements that will provide market access for Sri Lankan exports.

Conclusion

It is well understood that the difficult reform measures create significant challenges for the entire country. However, the alternative to these fiscal and monetary measures is a situation where the budget deficit remains high and monetary finance continues, creating risks of hyperinflation. Failure to restructure debt and regain access to capital markets would lead to continued lack of foreign exchange, shortages of critical imports, fuel queues, and increased power outages. Such conditions have persisted for years in some countries that have gone through sovereign default and failed to implement necessary reforms. In Sri Lanka’s context, if we are able to carry through this reform process over the next couple of years, the economy will stabilize and will return to a path of growth. But to enable this, **there is a lot of sacrifice that we all must make in the short term** as we share the burden of these necessary adjustments. If we can stay the course and fulfil this agenda, I am confident that we will leave a better country for the future generations.