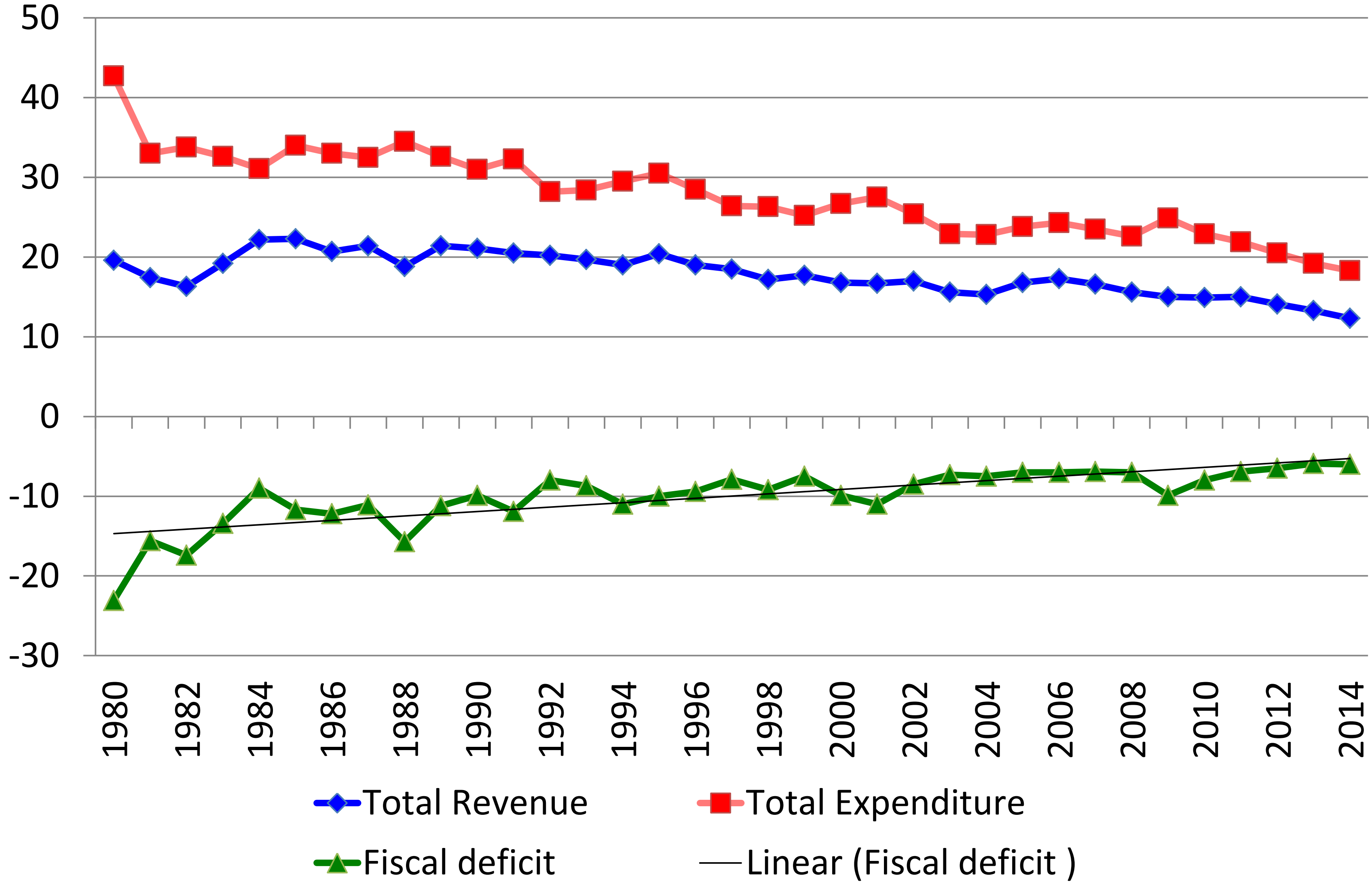
Public Debt and Importance of Taxation in Sri Lanka

Dr K.Amirthalingam
Senior Lecturer
Department of Economics
University of Colombo

Fiscal Deficit in Sri Lanka

Fiscal Deficit: fiscal deficit arises when total government expenditure exceeds total government revenues

Total Revenue, Total Expenditure and Fiscal Deficit (As % of GDP)



- What economics says about the prudent magnitude for a budget deficit?
- Economics recommends for countries

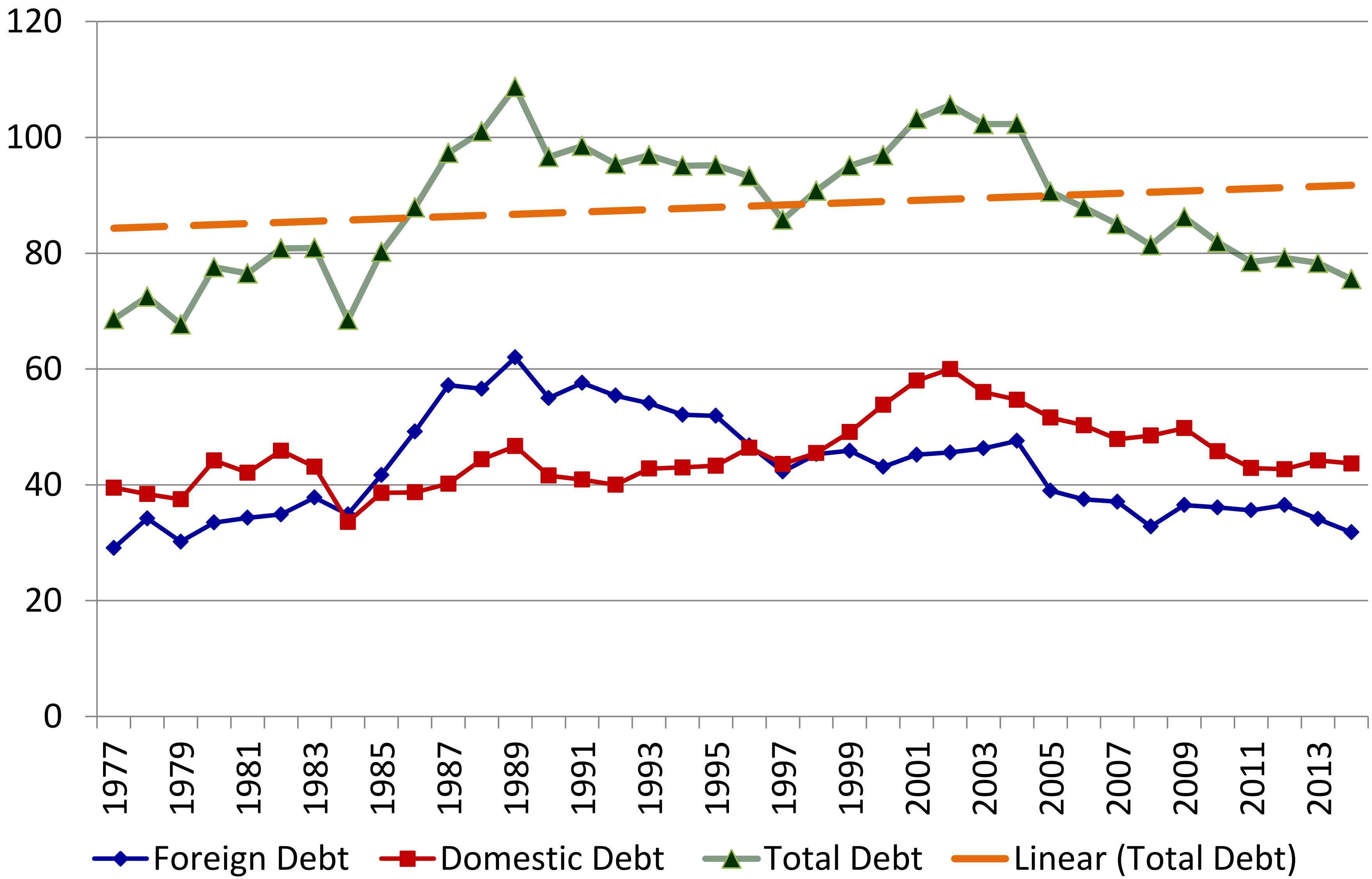
✓ A deficit budget during the a recession

✓ A surplus budget when the economy is operating at its maximum potential capacity.

✓ Any artificial expansion of aggregate demand will lead to **higher inflation** or **larger current account deficits** in the balance of payments **which requires more foreign borrowings.**

- How fiscal deficit is financed?
  - Debt
    - Domestic debt
    - Foreign debt
    - Our Focus is public Debt
  - Printing money
  - **Taxation**

Magnitude and Type of Public Debt (As a % of GDP)



Daily Mirror 2014-10-16

- Former Central Bank Governor once made that external borrowings are only the borrowings made by the Sri Lankan government directly and not the borrowings made by state institutions.
- Contingent liabilities??

Prudent fiscal measures needed: ‘Reform or Perish’

- The public debt has been kept at a slow growth rate by resorting to another imprudent fiscal policy measure.
- Instead of Government’s borrowing it has allowed govt entities to borrow from the market with the guarantees issued by the Government, known as ‘contingent liabilities of the Government’.
- These contingent liabilities have increased from a negligible 1% of GDP in 2006 to nearly 6% of GDP by 2014.
- Any meaningful risk management of the public debt should take into account both the direct borrowings and the contingent liabilities of the central government.
- Therefore, the country cannot be satisfied about the marginally declining debt to GDP ratio.

- Economics does not provide a prudent ratio for public debt.
- Ireland faced a financial debt repayment crisis in 2008/2009 with a debt ratio to GDP of 60%.
- It depends on the

✓ Composition of the foreign debt

✓ Rate of growth of the foreign debt

✓ Mobility of international capital flows

✓ Export proceeds plus foreign exchange Reserves

Debt

The government can either borrow from

- domestic sources

or

- foreign sources

or

- Both
- Their impacts on the economy are different

.

Domestic Debt

The government can borrow domestically from either banks or non-bank private sector or both.

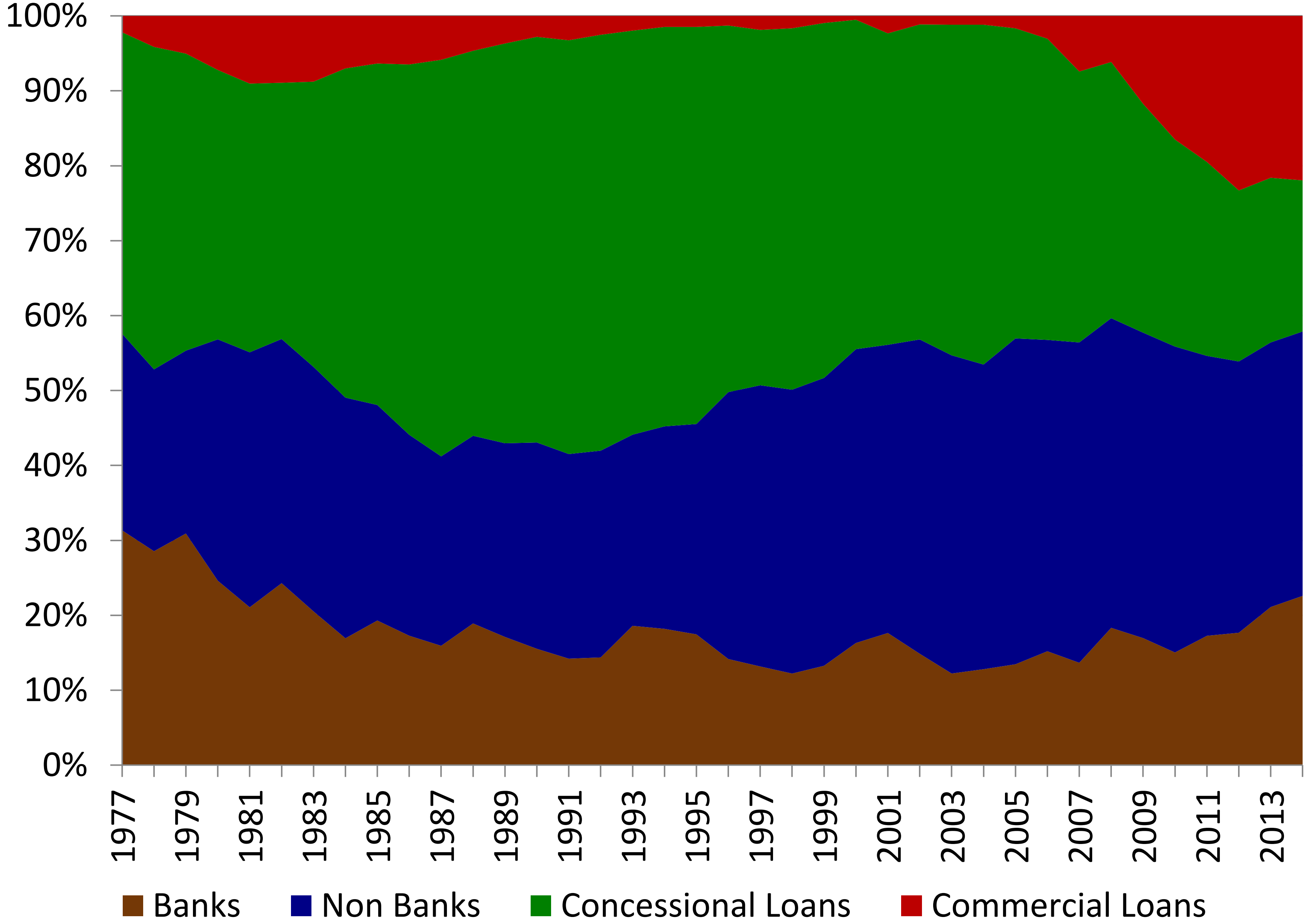
Foreign Debt

The government can borrow foreign loans in the forms of either concessional loans or commercial loans or both

Impact of debt

- Foreign debt will push up the foreign debt burden and increase **amortization and interest payments** of the country.
- Domestic debt will reduce the **domestic investment** if the government borrows from the **banking sector** and **non-bank private sector.**
- **Inflation** will soar if the government prints money

Sources of Debt (As a % of GDP)



- Sri Lanka is no longer a low income country
- Sri Lanka reached USD 2000 by 2008
- Therefore Sri Lanka is a lower middle income country
- So Sri Lanka should get more commercial loans at higher interest rate
- London Market will decide the rate
- Since the USA print money the interest rates are lower now

- Foreign –funded investment in infrastructure should generate goods and services that either save import expenditure or increase export earnings to ease repayment of debt.
- Expensive projects undertaken for political reasons have proved costly in many developing countries and resulted in economic crises.

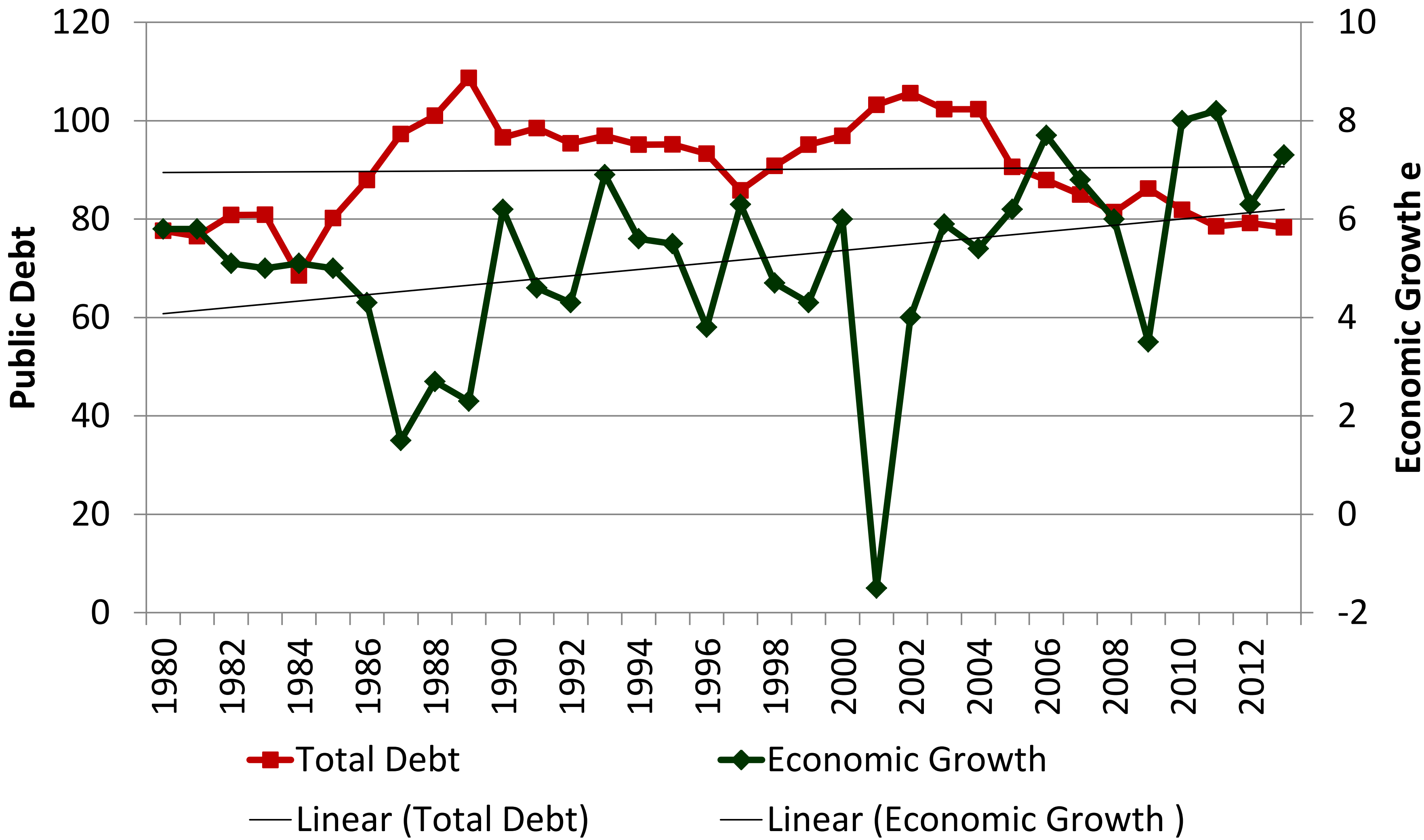
- The economic benefits of foreign borrowing for infrastructure would depend on several factors.
  - The terms and conditions of the loans
  - Interest rate
  - Pay back period
- Loans for infrastructure projects should be at **low interest rate** and the **repayment of capital and interest should be over a long period**.

Nexus between public debt and economic growth: Theory

- Ricardian Theory: the government debt is not a burden to the economy
- Keynes view: Positive consequences of budget deficit and debt finance on economic activities

- Neo-classical economists view: A negative correlation between debt and economic growth
- Economists and policy makers widely accepted the neoclassical view by suggesting that **high debt level is negatively correlated** with the **growth rate** of an economy
- Sri Lankan experience???

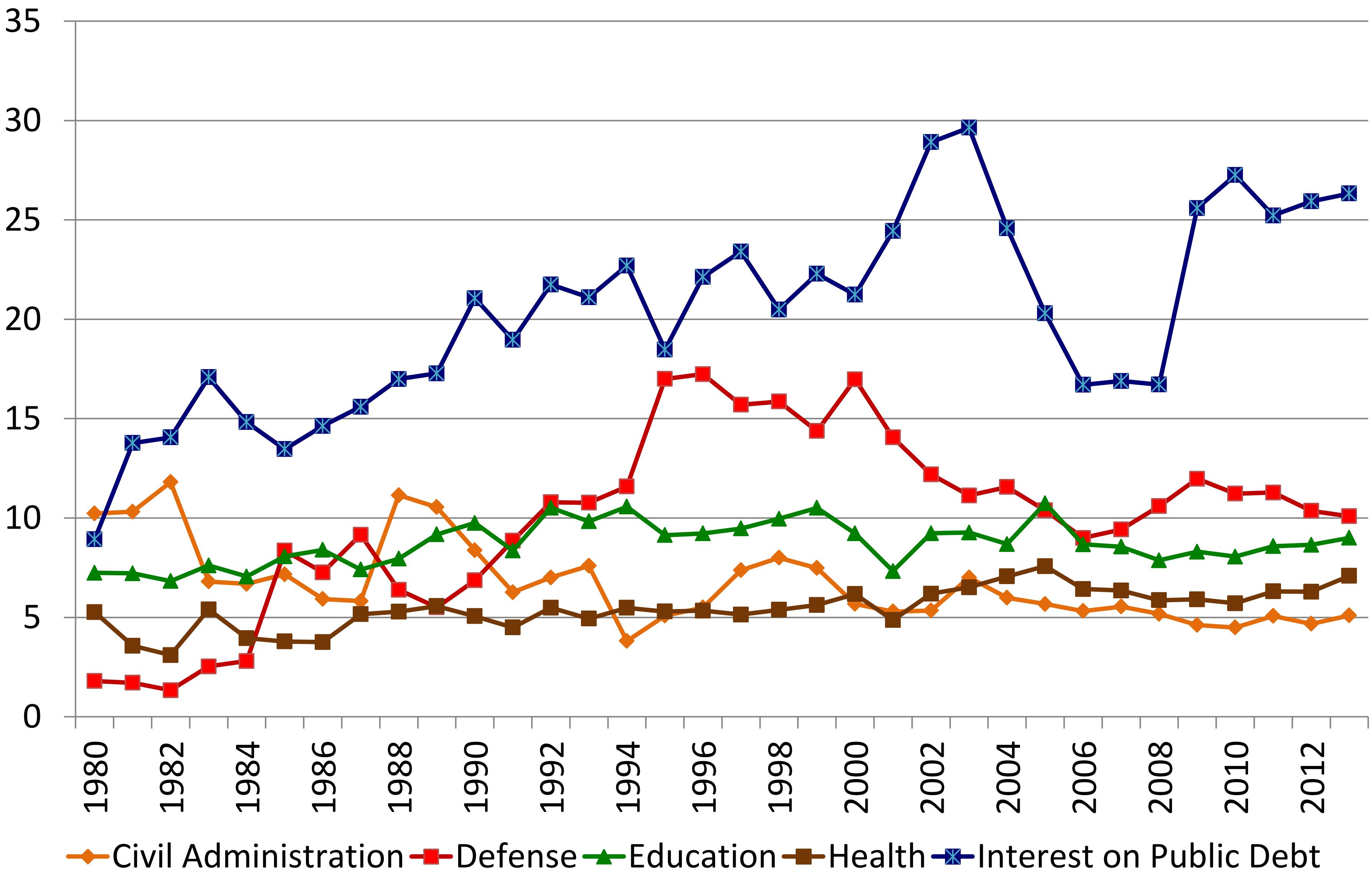
Public Debt (% of GDP) and Economic Growth Nexus



Financial debt and Social debt

- If the government continued to borrow, financial debt burden will increase.
- This will lead to reduction of budgetary allocation for Education, Health, housing etc.
- Then country will end up with poor education, deficient health facilities and bad housing.
- This is called "social debt" Are we heading towards social debt?

Expenditure on Certain Category (As a % of Total Expenditure)



Debt Sustainability

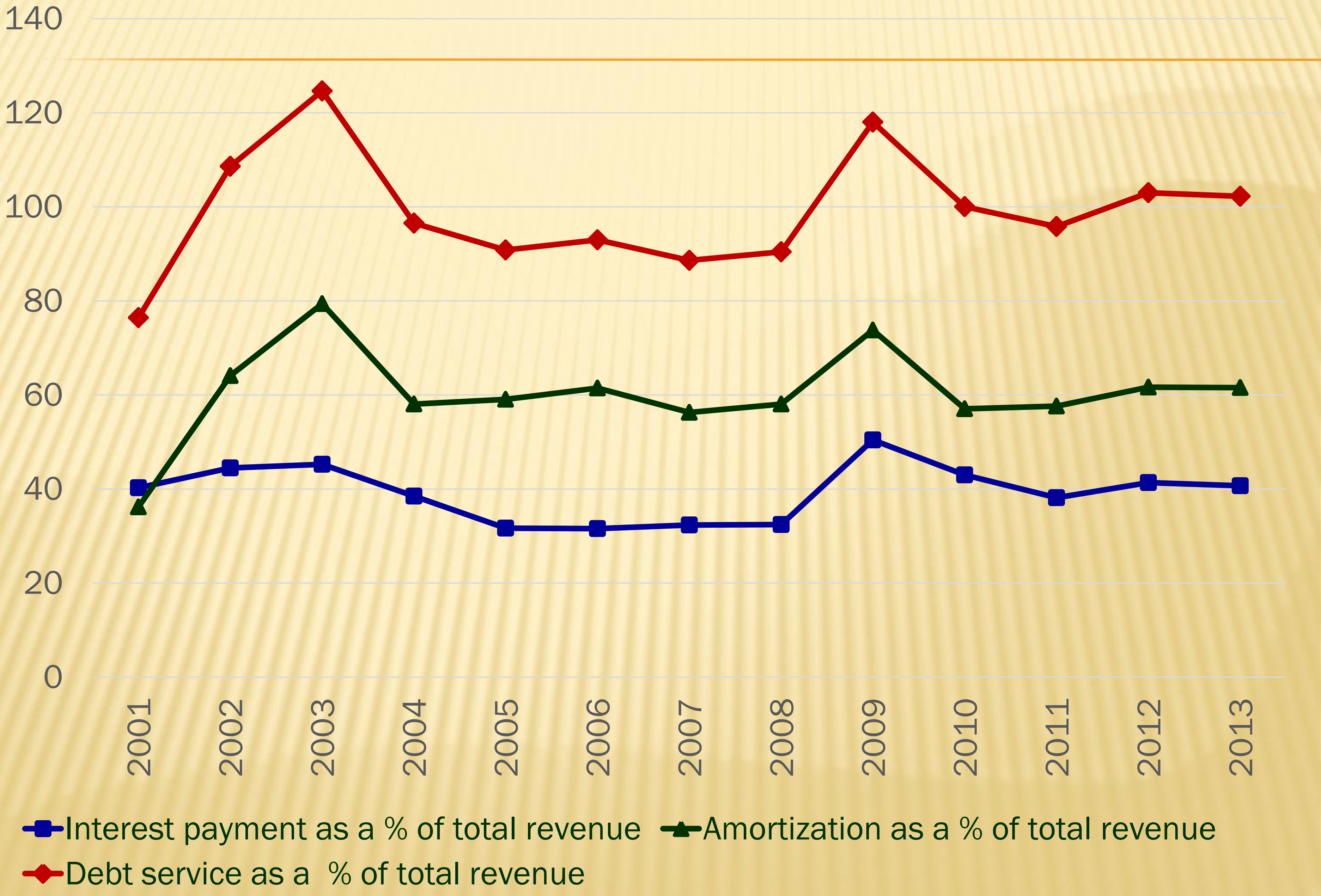
- External sustainability depends on
  - ability to generate foreign exchange

- Fiscal sustainability depends on
  - ability to increase or broaden the tax base to generate revenue

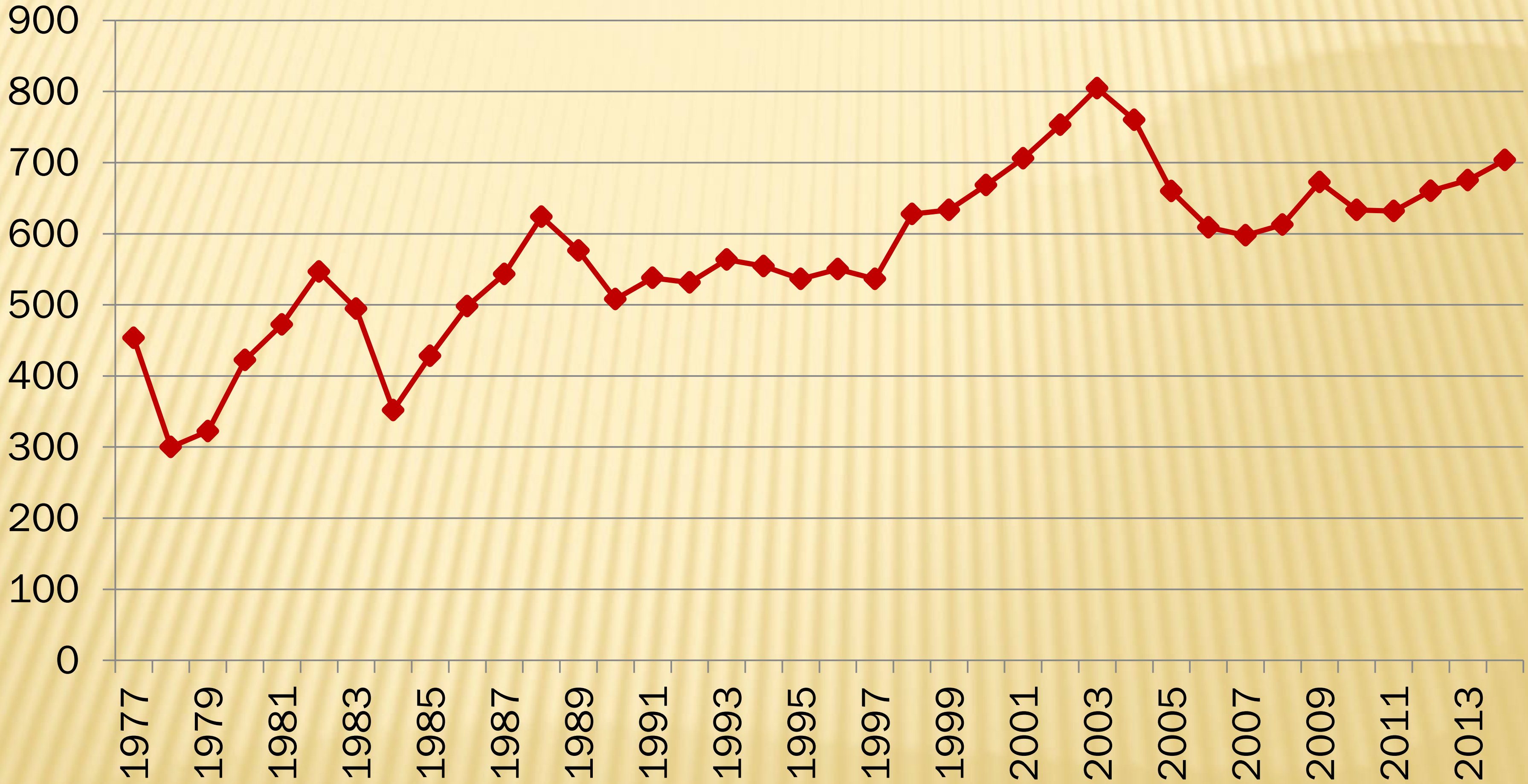
External Debt Indicators

- Standard external debt sustainability indicators:
  - Debt to GDP ratio
  - Debt to revenues ratio
  - Debt to export ratio
- Weaknesses of these indicators
  - These indicators are problematic if import growth outpaces export growth.
  - Unless the external debt is issued in domestic currency, the foreign exchange needed will only result from a current account surplus.
  - Not all types of debt carry the same risk features

DEBT INDICATORS



DEBT AS A % OF TAX REVENUE



- Since the total debt-servicing absorbs 95 per cent of government revenue, almost all other government expenditure has to be financed out of further borrowing.
- Or need to limit expenditure on other important sectors such as education, health etc
- In a fiscal situation where government revenue is spent entirely on debt servicing, investment would necessarily have to be by the private sector.
- Further commercial borrowing is limited with economic uncertainty in China and the possibility of US Federal Reserve Bank’s interest rate takeoff.

- Increasing government revenue is certainly important to reduce the deficit, but it is not sufficient.
- Reducing public expenditure through more prudent public expenditure on a basis of economic and social prioritization is also necessary.

Lose making Public sector 2012-2014

- This bad fiscal situation has been made worse by the gross losses made by key public sector enterprises.
- CEB - Rs. 49 billion,
- CPC -Rs. 95.8 billion
- SriLankan Airlines Rs. 84.6 billion.

Bastiat View

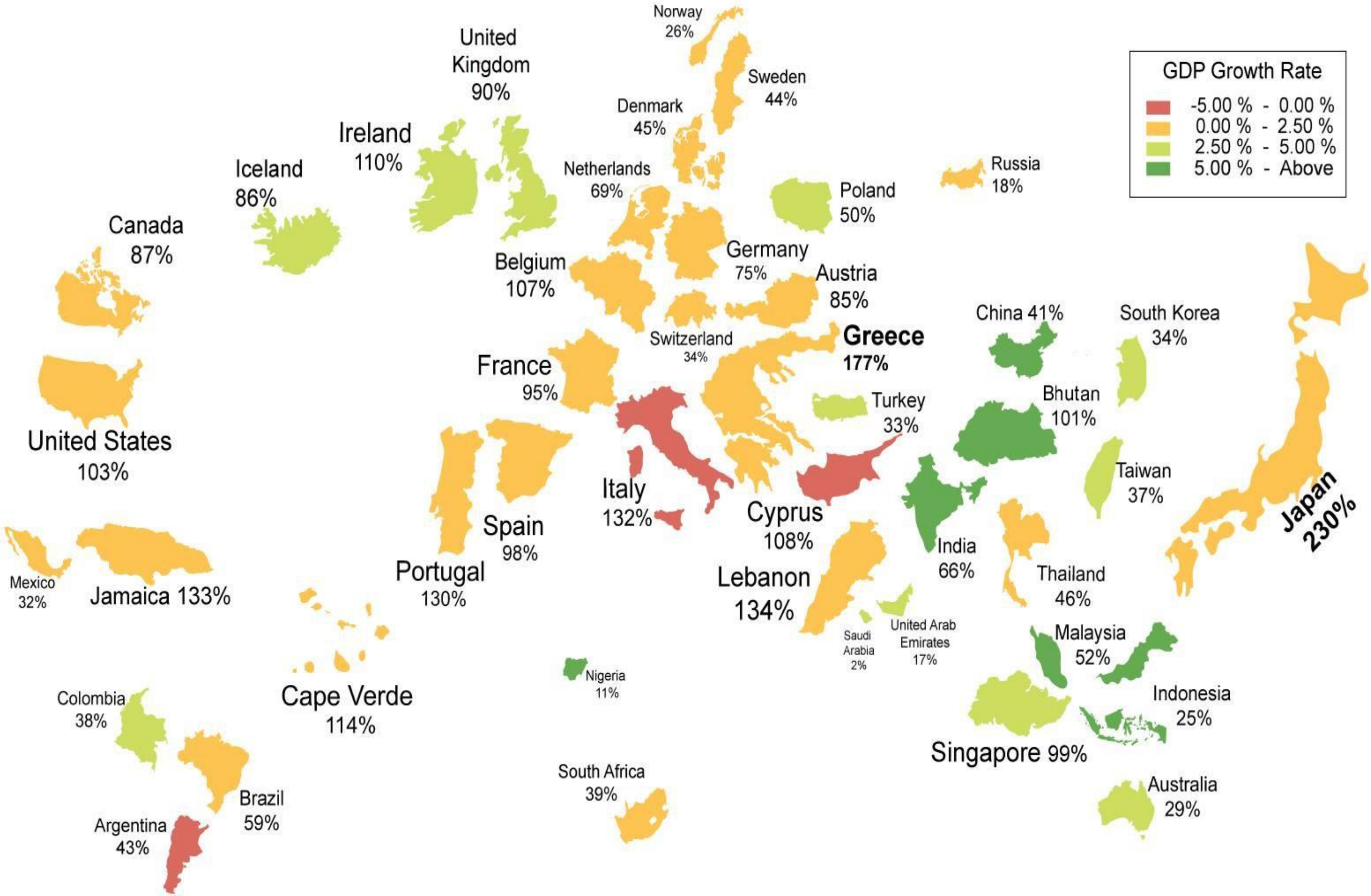
- A bad economist just looks at immediate benefits whereas a good economist would look at the costs and benefits of a policy over a foreseeable period in the future.

- Bringing down the public debt, foreign debt and fiscal deficit are short term imperatives for economic stabilisation and growth
- Focusing only on Debt/GDP ratio (74 per cent) without taking into account contingent liabilities is misleading

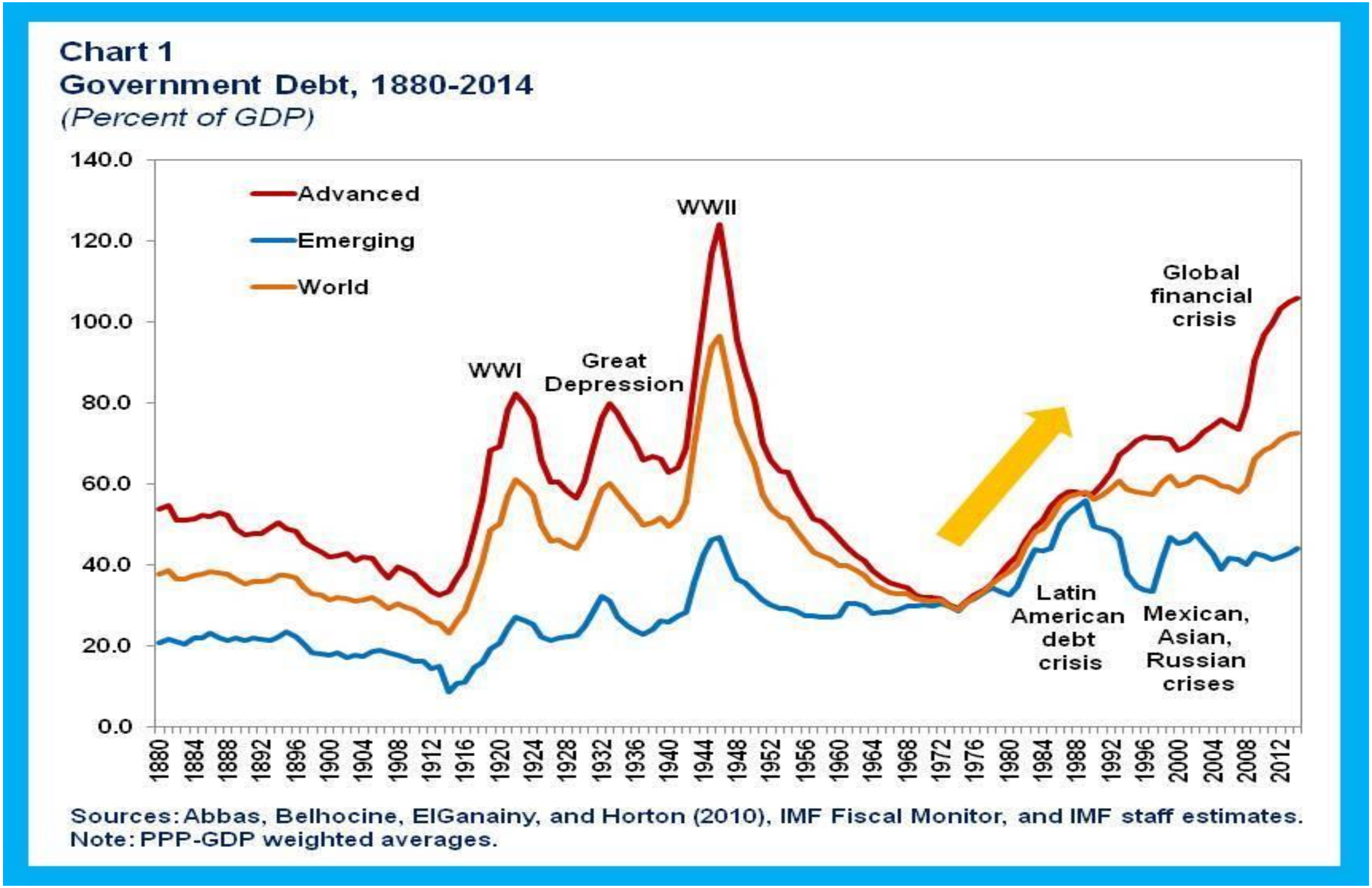
What if we were to redraw the world map based on the sustainability of national debt levels?

- Countries that are **smaller in size**, but that have **big debt loads**, would **stand out more**.
- If we used debt-to-GDP as scaling criteria, Japan would become the largest country on our new map. Japan holds 19.99% of all global debt despite only having about 6% of the world's economic production.
- Greece and Italy would be bigger than North America as a whole. The United States does hold an extreme amount of debt itself, equal to an astounding 29.05% of global debt.
- On the opposite side , there are large countries that have less debt – they disappear from the map almost completely. Australia, a giant land mass, is reduced to a tiny island with its load of 29% debt-to-GDP. Nigeria shrinks to a tiny speck on the map with an 11% ratio.

The World Map of Debt- 2015



How should Sri Lanka deal with sovereign debt crises?



An issue to be cautious about

- Macro issue: low interest rates encouraging consumption, imports and discouraging savings leading to widened savings-investment gap and exerting pressure for exchange rate to depreciate
- Tendency to correct one mistake with another mistake and finally ending up with a series of mistakes that cannot be easily corrected

Threfore

- IMF states that:
- Fiscal consolidation and debt reduction need to continue, but the burden of adjustment needs to shift decisively to **revenue generation"**
- Focus of current budget????

- **What is the situation in Sri Lanka?**

Total Public Debt and Tax Revenue (% of GDP)