Public Debt and Importance of Taxation in Sri Lanka

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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)

- Total Revenue
- Total Expenditure
- Fiscal deficit
- Linear (Fiscal deficit)
• 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)

- Foreign Debt
- Domestic Debt
- Total Debt
- Linear (Total Debt)
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.
• 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???
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?
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

- Interest payment as a % of total revenue
- Amortization as a % of total revenue
- Debt service as a % of total 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

GDP Growth Rate:
-5.00% - 0.00%
0.00% - 2.50%
2.50% - 5.00%
5.00% - Above
How should Sri Lanka deal with sovereign debt crises?

Chart 1: Government Debt, 1880-2014 (Percent of GDP)

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
Therefore

• 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)