Spotlight: Econ Op-eds in Summary

Week ended 20th May '20

In Summary

The underneath contains summaries of the articles given above, including key extracts from these articles.

1. Constrained fiscal space for post-COVID-19 reconstruction: Consider postponing costly tax reforms
By: W. A. Wijewardena

- The large economic damage caused by the Covid-19 outbreak in Sri Lanka has been met primarily with Central Bank action in the form of monetary support. While such artificial propping up of demand can protect output in the immediate term, it isn't backed up by real output beyond this. Continuing this action can therefore lead to inflationary depression.

- In order to support the recovery of the economy without facing such issues, the government will need to get involved with fiscal action. However, recent tax reforms have meant that the government will have very low fiscal space to do this. Revenue losses could reach up to Rs. 9 bn monthly, and combined with weaknesses in the current account, could further worsen in the midst of the pandemic.

- Therefore, in the absence of tax increases, any recovery of the economy will have to depend on foreign borrowings, which would be very risky at a time like this. Unless the government is able to increase tax revenue through increased taxes, the alternative would be to return to the previous tax regime for the short term so as to be able to spend into the economy, so as to see Sri Lanka recover.

The destructive COVID-19 pandemic

COVID-19 disrupted the normal supply chain that had been developed for internal trade within Sri Lanka and for external trade outside Sri Lanka. That prevented the local products from reaching markets here or outside efficiently and effectively. Large corporates, hitherto considered invincible giants in industry and commerce, were brought to their knees pleading for government support for lack of markets, liquid cash and resources to sustain continuity. As for medium, small, mezza, micro and self-employed who make the largest sub-component of the economy, it was fatal beyond redemption.

A flattened-out U shaped recovery

By all accounts, all Sri Lankans have been made poorer needing external support for surviving, sustaining and prospering. Since modern science has so far not come up with an effective anti-virus vaccination, all we can expect is that COVID-19 could be brought under control but not totally eradicated. Hence, the economic recovery from the pandemic cannot be rapid, known as V shaped, but prolonged, taking the shape of a flattened-out U, causing innumerable hardships to people and the economy in the interim before it would recover to original levels.

Limited fiscal space for the government

The Coomaraswamy report had justified the government's visible hand in tackling COVID-19 pandemic issues because the government needed to work 'big' to act effectively to bring a massive disaster of that proportion under control. But it had highlighted that the government's capacity to do so has been constrained by lack of space due to restricted budgetary environment it had been facing. Hence, the government had relied on central bank's unelected power to print money to provide immediate relief to the economy.

But as I had argued in my previous article in this series (available at: http://www.ft.lk/columns/Use-of-Central-Bank-s-unelected-taxation-power-to-fill-it-will-bring-cheers-today-tears-tomorrow/4-699956), it would bring about a worse outcome in the form of inflationary depression making central bank action totally ineffective.

B.R. Shenoy: It is real sacrifices and not imaginary sacrifices that matter

Voluntary savings are real sacrifices made by people by curtailing real consumption and made available for investors for use in real investments. For instance, if a man produces 100 kg of rice and consumes only 80 kg, he makes a voluntary saving of 20 kg of rice in real terms. This is made available to investors to produce, according to Shenoy, higher order goods which economists call investment goods.

These investment goods will produce more consumption goods in the future, increasing the real income of people thus facilitating them to consume more consumption goods. It therefore leads to a change in the economic structure and thereby generation of long-term economic prosperity.

Involuntary savings don't work in the long-run

Involuntary savings are those savings created out of the artificial credit and deposit creation by banks with the support of money printed by the central bank. These savings are imaginary savings arising from imaginary assets of financial institutions as against the real savings made by people by curtailing real consumption. Shenoy says that at first such imaginary involuntary savings can increase output but cannot sustain it since they are not backed by real production of investment goods.

Hence, it leads to disaster. As such, relying on central bank's unelected power to finance COVID-19 rescue package in the immediate term is justified. But to rely on it continuously will bring disaster to an economy since it leads, as I have argued in the present case, to the generation of inflationary depression.

Avoid inflationary depression

Though this [Central Bank action] has been the global normalcy today, it has a limit. The imaginary involuntary savings they make cannot sustain economic prosperity in the long-run and prevent the consequential inflationary depression within the economy. Hence, central banks should hand over the baton of leading the economy to the visible hand of the government.

A handicapped government

Sri Lanka's government has been handicapped not only by an emerging constitutional crisis but also by the distortions it had introduced to the tax collection system. The government had introduced a series of generous income tax and Value Added Tax or VAT reforms at the beginning of the year in fulfilment of one of its presidential election promises. Though the objective of these reforms had been to catch more people into the tax net and increase the revenue yield in the long run, in the immediate time period, it has been extremely costly to its revenue collection processes.

Short to medium term costs of tax reforms

The Central Bank Annual Report for 2019 has estimated that in 2020, the total revenue of the government would be at 9.8% of GDP amounting to Rs. 1,560 billion. If the government had been successful in maintaining the same revenue to GDP ratio of 12.6% which it had attained in 2019 in 2020 as well, the likely revenue in the latter year would have been Rs. 2006 billion. This means a loss in the revenue amounting to at least Rs. 447 billion or 2.8% of GDP.

An undisciplined fiscal scenario

From the low base of 9.8% of GDP in 2020, government revenue will begin to increase slowly. In 2021, it is estimated to rise to 11.8% of GDP, still below the level of 12.8% achieved in 2019. In 2022, it would rise to 13.5% of GDP, well below the planned target of 17% of GDP made in 2018. In 2023 and 2024, the revenue targets are very modest at 14.3% and 14.5%, respectively.

With these low revenue bases, all other fiscal numbers would be unwieldy. The Current or Revenue Account balance would rise to a historical peak of 5.1% in 2020 and are expected to be in the negative range in the medium-term, albeit at a decreasing rate, from then. The budget deficit, according to the Bank, would rise to 7.9% of GDP in 2020 and remain at around 5% thereafter. Thus, the fiscal discipline which had been planned to be attained under the old tax regime is to be sacrificed under the new tax regime.

The loss of a regular cash inflow

The new tax reforms, while increasing the tax-free threshold to Rs. 3 million from previous Rs. 1.2 million, had abolished two advance tax collection systems that had been working perfectly up to date. One was the advance income tax collection made through employers from the salaries of employees known as Pay-As-You-Earn or PAYE. This was a compulsory payment done automatically enabling the Inland Revenue Department to collect about Rs. 50 billion every year at the rate of Rs. 4 billion per month.

The other was the withholding tax on interest income and other miscellaneous incomes collected at source from income recipients. That tax too generated an automatic cash inflow of Rs. 50 billion per annum or Rs. 4 billion per month. By abolishing these advance tax collecting systems, the Inland Revenue Department has lost a monthly combined cash inflow of Rs. 8 billion.

APIT is more confusing

After realising its mistake, the government has tried to make amends by slightly revising the advance tax collection system. It has issued instructions to employers to get the consent of their respective employees to deduct an advance payment of income tax, code-named APIT to distinguish it from the old PAYE, and remit to Inland Revenue Department monthly. Since APIT is a voluntary payment, it cannot expect to generate the same tax yield as the yield generated under PAYE or old Withholding Tax system.

Tax reforms should be tried out under normal situations

These types of tax reforms should be tried under normal situations. The present COVID-19 environment is not the ideal situation to do so. It has handicapped the government by restricting its freedom to respond to the rising demands made of it by affected individuals and businesses. If the revenue does not flow into the Consolidated Fund, there is no way for the Minister of Finance to withdraw funds from it by issuing a warrant under the Constitution.

Even after the expected approval of a formal budget by a new Parliament, the government will continue to suffer from this handicap due to its low revenue base. It will not be able to meet its financial obligations unless it borrows heavily from the local and foreign markets. Both would worsen the country's debt situation pushing it further down to an inescapable debt trap.

Given these circumstances, it will be prudent for the government to postpone its generous tax reforms until the country returns to normalcy.

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