Spotlight: Econ Op-eds in Summary

Week ended 29th January '20

In Summary

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

1. A child's guide to price determination in the market: Tax cuts won't always reduce prices
By: W.A. Wijewardena

- The government had introduced a number of new tax reforms with the objective of pushing the market prices of most consumer goods down and provide relief to consumers. To the dismay of everyone, this effect was not seen in the market, leaving the policy makers worried.

- The worry is mainly due to a misunderstanding of how prices are determined in the market. What we had failed to account for is the fact that market prices are not only dependent on supply but also on how the consumers respond to price changes. The market demand in this case is expected to change in the near future due to a number of reasons.

- Among the reasons are the increase in money printed and the increase in disposable income resulting from the recent tax reforms. The proposed tax reforms will help us in the long run. But in the immediate future, despite a rise in consumer spending due to these reforms, managing the economy without causing a major damage to it is challenging.

Tax reduced, but no relief to the consumer

The Government has cut the Value Added Tax or VAT rate from 15% to 8% and removed a large number of businesses from VAT by increasing the minimum sales level from Rs. 3 mn a quarter to Rs. 75 mn a quarter. To reinforce this measure, two other taxes have also been abolished, namely, the Nation Building Tax or NBT and Economic Services Charge or ESC. The objective has been to push the market prices of most consumer goods down and provide relief to consumers. But it hasn't happened in the market and both the Presidential Secretariat and the Inland Revenue Department have been worried.

The worry is mainly due to a misunderstanding of how prices are determined in the market. Prices are determined by the interaction of both the demand and the supply forces. Either one alone cannot determine the prices. The VAT cut may reduce the supply prices of goods if and only if traders had already passed the VAT to consumers. But whether the market prices have also declined after the VAT cut will depend on what has actually happened to the demand.

Ignoring the demand

A common mistake people does is ignoring the demand factor that influences the market prices. When the tax on a good is reduced, the supplier is able to supply the same at a lower price minus of the tax. It is only supplier's price tag. But what happens to the market price of rice is determined what has actually happened to the demand.

- If the demand has increased when the tax is removed by an equal amount, then, the market price remains same.

- If the demand does not change but remain at the same level, then, the market price should fall. But whether it falls exactly by Rs. 10 will depend on the elasticity of the demand.

What is elasticity and how does it affect the market price?

Elasticity is the relative response of the buyer to a relative change in the price.

- When the prices fall by one percent, the consumer increases his buying by more than one percent then the demand is elastic.

- If the consumer increases his demand exactly by one percent when the prices have fallen by one percent, the elasticity is said to be one.

- If prices fall by one percent and if the consumer increases his demand by less than one percent, then it is inelastic demand.

- If the consumer doesn't change his buying at all, then it is a situation where the demand is totally inelastic. No matter what happens to the price, the consumer buys the same.

How does this affect the market prices?

- If the consumer buys everything in the market irrespective of the price, his demand is perfectly elastic. In this case, no matter by what amount the supply price is reduced, the market price remains the same. Since the supplier increases the quantity available at that market price, the consumer buys the entire amount at the prevailing market price. Hence, the tax cut has no impact on the prices there.

- If the consumer's demand is perfectly inelastic, the prices would fall by the full amount of the tax cut since the consumer buys the same amount at a lower price now. What the Government had expected from the reduction of VAT had been this situation. But for it to happen, the consumer demand should be totally inflexible or unresponsive to price changes. But there are only a few commodities that possess this characteristic. A good example is salt. People buy more or less the same quantity of salt irrespective of what has happened to the price.

- All other demand conditions are in-between these two extremes. The demand is either more elastic or less elastic. If it is more elastic, the price reduction is relatively small. If on the other hand the demand is less elastic, the price reduction is relatively large.

Hence, one should look at the elasticity of the demand for a good before blaming the producers for not reducing the prices. Producers may have reduced the prices. But the market price is determined not only by the supply, but by both the demand and the supply forces. Here again, the amount of market price reduction depends on the size of the elasticity of demand for a particular product.

But when taxes are imposed on goods, market prices go up.

Whether a tax would result in an increase in market prices depends on the elasticity of supply. That is, by what percentage a supplier would change the supply relative to a percentage change in the price.

- If he doesn't increase supply at all, then, his supply is perfectly inelastic. Since he supplies only a given quantity no matter what the price is, any tax imposed on that good has no impact on the price.

- If he is ready to supply an unlimited quantity at a given price, his supply is perfectly elastic. In this case, his supply curve moves upward by the amount of the tax imposed, because he is ready to supply an unlimited quantity at the new higher price now.

All other price increases are in-between these two extremes. But what actually happens to market prices will depend on how the consumers respond to price changes.

Tax cuts are not a very good move to reduce market prices

Tax cuts are not a very good move to reduce market prices, that is because markets are very complex organisations and they can change at every moment. When we cut the taxes and expect market prices to fall, we expect markets to remain unchanged. That does not happen in reality. When we have the newly changed situation, the rules of the game also change and can't expect to have the previously anticipated results in the market. What it means is that we must look for what is to be foreseen.

Other factors that can cause changes in the market

The demand depends on the money income which the consumers are having. That income can change in the immediate future due to two reasons.

- One is new money printed by the Central Bank and made available to people through Government expenditure programs. For instance, suppose the Government has a cash problem to pay salaries. It then has to borrow from the market by issuing, most probably Treasury bills. If people do not buy those Treasury bills, the Government does not have an option, but to get the Central Bank to buy those Treasury bills and make available the required cash to the Government. The Central Bank does so by printing new money. When the Government uses that money to pay salaries, people will get new money into their hands and start spending on goods and services. That increases the demand.

- Other is a sudden increase in the take-home pay of people which economists call the disposable income. That is the income minus taxes paid. If there is a reduction in the tax rates, the take-home pay of people will go up allowing them to buy more goods and services. That too increases the demand and upset the plans of the Government to reduce market price through VAT cuts.

We cannot look at the VAT cut in isolation

Both these factors in the coming months will cause an increase in the demand. The VAT cut and other tax reforms which the Government has introduced will reduce the revenue of the Government drastically immediately.

- The VAT cut alone, according to Inland Revenue people will reduce Government revenue by about Rs. 148 bn.

- The income tax reduction on companies engaged in the production of alcohol and tobacco from 40% to 28% as from 1 April will cause the Government to lose a tax revenue of about Rs. 8 bn.

- The increase in the tax eligibility limit from the current Rs. 1.2 mn to Rs. 3 mn and abolition of the withholding taxes on income from employment and interest earnings will deny a regular monthly cash flow to the Treasury.

It will take time for Inland Revenue people to catch all the people who are not paying taxes now and get them to pay taxes. Hence, in the next few months, the Government will have to use Central Bank's money printing power generously.

Similarly, the abolition of withholding taxes on employment income and interest earnings will leave more cash in the hands of people increasing their take-home pay. That too will increase the demand. What this means is that the goal of reducing market prices through VAT cut will be negated by increases in the demand for goods. This year is a critical year for the Government as well as for the Central Bank. Already, inflation has moved a little above 6%, the upper limit of the inflation targeting corridor of the Central Bank. With the increase in the new demand, it is extremely difficult for the Bank to keep inflation within its targeted limits.

The proposed tax reforms will help us in the long run. But in the immediate future, managing the economy without causing a major damage to it is challenging.

For the full article – Refer Daily FT

2. Sri Lanka at tipping point?
By: Rohantha N.A. Athukorala

- Sri Lanka has faced numerous economic challenges recently. While short term economic injections such as the 1-year debt moratorium on SMEs can boost market sentiment, they also carry potential negatives. Straining public finances, downgrade in sovereign rating and fiscal indiscipline are among these.

- While the direct benefits of such measures are yet to be fully realised, the private sector has displayed confidence in an economic turnaround, despite shrinking household consumption. This is supported by the 4% increase in advertising spending of Rs. 125 bn during 2019, despite adverse economic developments and 4% contraction in the FMCG segment.

- Maintaining private sector confidence by ensuring sound macroeconomic fundamentals is necessary. In turn, the private sector must drive the market with innovation in response to economic growth, and look to penetrating export markets to ensure sustainability.

Sri Lanka's economic woes include low growth at +2.6%, the 5th consecutive month of declining exports at +1% growth, tourism declining by -20% and S&P credit rating at B with Negative Outlook.

Short-term injections to the economy can have collateral damage on the economy on public finances and overall credit rating of Sri Lanka, but have these policies placed the economy at a tipping point?

Economic injection

While the announcement of a one-year relief on SME debt improved market sentiment, it has significant implications for the financial sustainability of the banking sector, considering skewed SME loan portfolios. This measure also affects financial discipline within the customer base, while only time can reveal whether the moratorium will boost the economy.

The Rs. 1,000 wage tier to the estate workers put pressure on the tea industry. Planned strategic investments in replanting and fertiliser application by Regional Plantation Companies were delayed. The stipulation for good agricultural practices compounded the situation. Nevertheless, the industry generated $ 1.5 bn.

While instilling private sector mentality within the public sector will help move towards a 7% plus economy, fundamentals must also be kept in check to maintain private sector confidence.

Consumer reality

During Q1-2018, consumer household consumption registered a marginal 2.7% growth in volume. By Q2-2018, the economy showed signs of shrinking with household consumption slowing down to +1.3%. By Q3-2018, FMCG consumption declined in volume by -1.3% and -4.9% respectively indicating people were cutting back on consumption due to financial pressure.

Private sector reality

A similar decline was also seen in the corporate sector, with the BCI dropping from 128 in January, 2018 to 81 by June, 2019.

Despite the FMCG sector recording a -4% volume down turn in 2019, the private sector invested at rack rates on advertising despite tough macroeconomic conditions, displaying their optimism in an economic turnaround.

Tipping point – Rs. 125 bn

This investment in advertising increased 4% from Rs. 120.5 bn to Rs. 125.4 bn in 2019. Even though this spend is below the 12% and 19% growth seen in the previous two years, given the Easter attack shock, a slower recovery was anticipated. Hence, the 4% growth seen is commendable. This would serve as the tipping point for the Sri Lankan economy.

(The share of advertising due to the Presidential Elections would also have driven this number.) The Rs. 125 bn is advertising on TV, radio and press but if below-the-line activities by companies are considered, the spend could exceed Rs. 200 bn.

The top 10 categories

The breakdown of the Rs. 125 bn spend reveals Telecom and Banking Services dominate, spending of Rs. 18 bn (though down from Rs. 21 bn in 2018.)

Telecom has kept its brand building initiative but banking services have cut its investment post the April attack. The Financing and Leasing sector dropped from Rs. 3.4 bn to Rs. 2.8 bn in 2019 due to industry correlation with the tourism sector.

Overall consumption of toilet soaps declined by -9% and -6% in the urban and rural market respectively in 2019. Companies have continued to build the market by investing Rs. 4.6 bn, up from Rs. 2.9 bn in 2018. A similar pattern is seen in the toothpaste industry where overall consumption slipped by -2% but investment rose to Rs. 4.8 bn indicating a positive outlook on the economy despite financial pressure on households.

The creams and lotion segment also increased spending from Rs. 3.1 bn to Rs. 3.7 bn. Milk powder manufacturers cut spending from Rs. 3.2 bn to Rs. 2.8 bn, and saw households moving out of the segment for the first time due to financial pressure.

Next steps

It is very important to monitor brand penetration given that economic stimulus injection can get households to start using your brand again. If the category expands due to the overall pick-up in the economy, then brand marketers must capitalise by driving the market with innovation.

To ensure sustainability, key brands may drive export marketing, starting with the Sri Lankan diaspora, using this strategy to mitigate the 'risk spread' to the company. While it is uncertain whether the conflict between the US and Iran will result in a global downturn, it us worth being proactive on the global stage as competition is entrenched.

For the full article – Refer the Daily FT

3. The economic benefits of the digital economy
By: Dinesh Weerakkody

- The concept of the digital has revolutionized how government and businesses operate. Today many governments promote a cashless economy. Most recently, India withdrew notes from circulation in an effort to digitize the economy where the real objective was to withdraw the black money in the economy.

- Most black money is either converted into assets such as gold and real estate. With demonetisation the money flowing into gold for such purposes reduces. As India was the largest gold consumer, this demonetisation enabled the digital currencies to overtake the gold price in international markets which also led the real economy to lose.

- Digital transformation can lead to social issues such as increased poverty and identity theft. Banks and companies therefore will need to work together in promoting digital payments. This can help SMEs to migrate to digital payments and other technologies enabling SMEs easy access to capital and increased knowhow.

The digital economy that results from billions of everyday online connections among people, businesses and devices has greatly changed our economic environment in relation to how the government and businesses operate and provide goods and services.

Prosperity in the new economy involves more than capitalising on knowledge assets. Prosperity involves increasing employment in those industries that are growing. Digital payments, digital data, digital customer service, payments through new platforms, along with real-time analytics are becoming entrenched in the world economy.

Digital transformations facing large companies are beyond typical planning cycles and most CEO tenures. This makes good timing absolutely critical when it comes to allocating resources effectively. These elements will forever change consumption, because of the effort of many of the governments to push fast towards a cashless economy to keep transaction cost down.

Some time back, India in an effort to move to a digital economy and combat corruption, tax evasion and counterfeiting, all 500 and 1,000 rupee banknotes were withdrawn from circulation. Many international bankers argue that India failed miserably in their demonetisation effort. The Modi Government publicly declared their demonetisation objectives saying that the Government wanted to transform the economy into a digital economy.

Black money

In the Indian demonetisation effort, the real objective was to attack the "black money," stored by the political and business elite. Around 90% of the demonetised notes were returned to the banks, far more than the Government expected. This means, as the

Guardian explained, that "either the Indians concealed less wealth from taxation than was thought, or that money has been preserved in the form of goods or gold rather than cash".

In fact, according to economists, very probably less than 3% of "black money" is held in currency. In an Indian context it is still big money. Almost all of it is either converted into gold (it is said India has by far the largest private gold reserves in the world), or put into purchases of jewellery, real estate, or land, when it isn't put into financial investments. And then when all that money goes into their bank accounts or other establishments that money too comes to the so-called 'white system'.

Opportunity for SMEs

A full digital economy can drive away lots of people and perhaps increase poverty if digital transformation is done by creating limitations and wealth limits. Many people faced identity theft as a result of the transformation.

India being the world's largest democracy has the most business savvy politicians, but even they are people who transform wealth to various other business, religious and social establishments. Several top economists have said globally that what India did was a failure, and it only hugely troubled poor families and especially older people's savings.

India is the largest gold consumer and India's activity in impacting global gold prices took a different turn because of demonetisation. It enabled the digital currencies such as Bitcoin to overtake the gold price in international markets. If you take Bitcoin, people trade in those digital currencies and their capital gains are transformed to other asset classes resulting in the real economy losing. Banks and companies therefore will need to work with each other to promote digital payments. They can help many small SMEs to migrate to digital payments and to use stock-keeping data over the cloud. This can enable SMEs to raise more working capital loans from banks.

Every businessman has a smartphone and therefore we only need smart leaders who understand the payoffs to proliferate this idea and help SMEs to access easy capital and knowhow.

For the full article – Refer Daily FT