Spotlight: Econ Op-eds in Summary

Week ended 04th December '19

In Summary

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

1. What the private sector needs more than tax cuts
By: Waruna Singapulli CFA

- The new government has the challenge of working around foreign relations to make sure the country receives economic benefits. The non-aligned policy that the new President has proclaimed is a good step to this end. Receiving economic help from different countries can help Sri Lanka access technology and leapfrog its development significantly.

- While the tax cuts offered by the new regime are positive for consumption and will help revive the slowing economy in the short term, the medium-longer term impacts are more negative. If growth in demand happens without a similar growth in supply, the economy could overheat, seeing rising inflation and interest rates, that could even materialize near the next presidential election.

- Tax cuts will also be helpful for the IT and KPO sectors, but they alone will not be able to drive growth. The sector requires more skilled labour in order to grow and compete , and urgent action will be required here in order to see the benefits flow to the country. All this needs to be done before the economy possibly overheats in 2022/2023.

Foreign relations: The challenge is to get desired benefits

A key reason for concerns of the US (and India) in recent years on Sri Lanka arguably surrounded on the acquisition of the Hambantota Port by a State-owned Chinese company. Therefore, the announcement to renegotiate the Hambantota deal would help ease tensions with India and the US and bring the global foreign relations back to equilibrium.

However, the challenge would be to utilise foreign relations wisely to get ahead in the global economy. The new President has said that he'll pursue a non-aligned foreign policy. That's fine. However, we should be smart enough to realise that if a certain nation is willing to provide us with key factors to leapfrog in the global economy for a reasonable cost, there is no harm in aligning with that country. Or the other interested nations should also provide us with similar strategic benefits for us to maintain a non-aligned policy. These key factors to leapfrog in the global economy are the transfer of Technology and access to such technology-oriented markets (which means if a country is willing to buy such technological products and services from us).

India has been quick to offer a credit line of $400mn. However as mentioned above, it's not the money that we need to bargain for.

The tax cuts: A double-edged sword

It is certainly a bold move of the new Government to slash taxes which would certainly revive the economy in the near term. Especially with the Parliamentary Elections due in a few months, these concessions may not be surprising from a political angle as well.

While these concessions could make sense to revive the economy in the near term, at least some parts would need to be revised in a year or so. Most reductions such as VAT, PAYE and WHT would help boost consumption in the economy. As witnessed during 2012-2013, a boost in consumption sans a corresponding growth in supply/capacity would result in inflation and higher interest rates which would naturally bring down economic growth.

Therefore, if the same mistake takes place, the economy would be slowing down by 2022-2023, and with the next Presidential Election due in 2024 (unless the Constitution is changed), it could be to the disadvantage of the Government to see the economy slowing with the election round the corner.

In any case, Sri Lanka's challenge is to reduce the economy's dependence on consumption. The contribution of consumption of newly developed nations was around 60% while in Sri Lanka's case it's about 80%. To reduce exposure to consumption, Sri Lanka should aggressively develop foreign earnings segments. In that light, the tax concessions in the medium term should be more selective. For instance, the concessions on VAT etc. should be directed to foreign earnings segments. The tax policy should not only be to generate revenue for the Government but should also be a means of directing economic activities to desired segments – so that more entities are incentivised to shift towards the desired sectors.

What's more important than tax concessions?

However as someone involved in the KPO sector, I could say that what we need most are not such sweeping tax concessions. For us to make reasonable profits, first we should be able to grow the business in the form of revenues. The biggest obstacle in terms of growing the revenues is the unavailability of a skilled workforce. On one hand the labour market has become a competitive red ocean resulting in companies incurring exorbitant costs to acquire right staff and on the other hand the lack of skills in the labour force also makes the businesses uncompetitive in the global markets.

Therefore the priority of the Government would be to build capacity in the form of setting of universities and training institutes in order to develop the workforce. That would provide a key critical success factor available to these desired segments and enable growth and therefore would be a much more encouraging measure than the tax concessions. Therefore, the Government focus should turn to increasing expenditure in terms of providing specific infrastructure as mentioned above to unleash long term sustainable growth. This could be coupled with selective tax concessions. The other key success factor is the availability of technology and access to developed markets. It is paramount that the Government astutely use the foreign policy to make inroads.

Not a day to lose

However, if these measures are not pursued, the tax cuts could only result in a consumption bubble while inflation and a hike in interest rates could follow. Coupled with an ever-increasing debt burden, 2024 would come with a slowing economy and little tangible progress made in the economic front.

For the full article – Refer Daily FT

2. Gotabaya's tax cuts: Case of VAT
By: Sirimewan Dharmaratne

- The public should understand how the recent tax cuts affect the wider economy. In the case of VAT and NBT cuts, these represents over a 50% reduction in tax revenue., Normally tax cuts of this magnitude are phased over several years allowing the economy to adjust without short term shocks.

- These tax cuts are expected to be recovered through a widened tax base from expanded production. For this to happen fully, production should increase by at least 108%. This would impact significant pressures on labour and capital markets. This could include wage increases and impacts on prices as well.

- It is important to do a full 'scorecard type' analysis of each policy which covers 'side-effects' of the tax cut such as environmental impacts, impacts of income distribution and social costs. This analysis should be objective and free of political influence. The analysis should be of highest quality and open for public scrutiny.

VAT cuts

The cutting of combine VAT and NBT from 17% to 8% represents over a 50% reduction. Typically, tax cuts of this magnitude are phased in over several years, with marginal increases in each year. This will allow the economy to adjust to the new tax regime without major short-term shocks.

Presumably, the thinking behind these cuts is to expand production and widen the base on which the tax is imposed. Lower input prices would decrease the marginal cost of production and result in lower output prices. Consumers would respond though increased demand. It is rational to expect tax on this expanded demand would generate the same or more tax VAT.

According to media reports, loss of VAT revenue could amount to about Rs. 300 bn. Based on this estimate, to collect the same amount under the new VAT regime, the production of goods and services should increase by about 108%, or a tax cut elasticity is over two. This would require a massive response from producers.

Pros and cons

Increasing production by over 100% would impart significant pressure on input and labour markets. Therefore, the swiftness of the response would depend on whether the production process is labour or capital intensive. Labour intensive industries would be able to respond faster. However, if labour lacks directly transferrable skills and require training, then there will be a time lag to achieve the full production potential. If the production process is more capital-intensive, then then there will be a longer lag in response.

The question is whether Sri Lanka's input market is flexible and responsive enough to benefit from these bold initiatives. Either way, it is not difficult to anticipate a wage inflation due to increased demand. This will have a second-round effect on the general price levels. However, all tax cuts in combination will leave people with more disposable income. Therefore, both consumer and producer welfare should increase.

Scorecard

There is a justifiable concern of a Government revenue shortfall due to the tax cuts. Generally, governments implement policy changes in a revenue-neutral manner. This requires compensation of lost revenue through VAT in some other manner. They could be cuts in Government expenditure and/or through non-tax revenue. To this extent, there are reports that the Government has the leeway to increase rents of real estate that it owns.

Regardless of how the Government is planning to balance its finances, it is important to do a full analysis of each policy for the Government's own benefit as well as for public information. This is the purpose of a scorecard. This scorecard sets out what would be the effect of the policy over a period, typically a five-year period.

This scorecard needs to cover 'side-effects' of the tax cut as well. In the UK this scorecard comprises environmental impacts and impacts of income distribution as well as social costs, all monetised as much as possible. With the increased demand on inputs, for example for building material, there could be some environmental impacts. In addition, there could be social issues arising from labour transition as well as regional impacts. There should be a commentary on the plans attenuate these 'side-effects'.

A skilled team of Government analysts should analyse each policy objectively using available data and forecasts without any political influence or partiality. Their job would be work on behalf of the populace and not the Government of the day. Their work should be of highest quality and open for public scrutiny.

Prognosis

It is more than likely the President solicited sound fiscal advice for this policy. Yet, it is unlikely that the economy would see the full benefits of VAT rate cuts in the immediate future. This should not cause and undue alarm. Full benefits will only show when the economy has had time to adjust and make necessary structural changes to increase production.

For the full article – Refer DailyFT

3. Are our sick SOEs beyond redemption
By: Lionel Wijesiri

- State Owned Enterprises (SOEs) around the world are playing an increasingly important economic role, both globally and locally. In such a context, Sri Lanka's SOEs have been struggling for years, with privatization being seen as the only way of redeeming the ailing SOEs of the country.
- However, global success stories show that privatization is not necessarily the way to go. Instead, it is only sensible to first explore why these businesses have been encountering loss, and to make policies, learning from the private sector. In such a way, proper and sustainable measures will be more possible.
- Thus a few steps including, establishing clear roles and responsibilities, appointing qualified persons to SOE boards, making a cultural shift towards efficiency, having formal government agreements and establishing a commission to overlook these SOEs, should be taken to redeem the struggling SOEs.

Staggering loss

The subject of SOEs is an oft-spoken issue in Sri Lanka for the many past decades. To start with, no one seems to know precisely how many business enterprises the Government owns. According to the Mid-Year Fiscal Position Report 2019 issued by the Minister of Finance there are 422 SOEs. Nevertheless, according to a credible research done by a body of experts, there might be around 525 to 530 SOEs in Sri Lanka.

What is already published and known is that in 2018 the top 55 SOEs made a staggering loss of Rs.27.40 bn. What happened to the rest of the SOEs is anybody's guess.

Privatization is not the best way to fix struggling SOEs. Any sensible government would have first explored why these businesses have been encountering loss. For example, three years ago, the Myanmar Union Parliament appointed a commission to investigate state-run enterprises which are running at a loss and ones which were under-performing. A thorough understanding of the shortcomings and the recommendations of the Commission helped the government to evaluate the type of reforms needed to improve their financial standing.

Necessary tool

Globally, the importance of SOEs has steadily increased over the past few decades and are now found in a wide spectrum of industries, such as the natural resources, aerospace, defense, automobile manufacturing, chemicals, transportation, construction and banking. For instance, national oil companies own and control most of the world's energy supply and 73% of the world's oil reserves, and 61% of production is State-owned.

SOEs are also important in the domestic economies of many countries, given that they are often some of the largest employers. For example, Sweden's 2017 Report on State-Owned Enterprises indicated that Sweden has 48 SOEs, which employ 137,000 people. The situation is similar in China, Sweden, Norway, South Africa,France, Brazil, Mexico, India, South Korea, and Russia.

Swedish experience

The policies adopted by Sweden, China, Spain, Finland, and Norway may be examined as examples of good practice.

If we take Sweden as an example, it's State Ownership Policy has business sustainability at its core and it expressly states that - SOEs should take a long-term approach, be sustainable, efficient and profitable while being given the capacity to develop further. To promote long-term value growth, the sustainable business of all SEOs is integrated into corporate governance. They should thus serve as role models in the area of sustainable business and, therefore, perform in a manner that generates public confidence.

SOEs in Sweden work towards achieving a healthy work environment, respect for human rights, decent working conditions, environmental sustainability, and high standards of business ethics (particularly through the prevention of corruption), as well as responsible conduct with respect to the payment of taxes. The Policy forms an inherent part of the legal framework for the regulation of SOEs and it is mandatory for all companies that are fully, or majority owned by the State to comply with it.

In Sweden, the ultimate responsibility for the integration of sustainable business practices falls onto the boards of directors of SOEs. They are accountable and answerable. With regard to implementation, all SOEs have mandatory reporting obligations and the board of directors must ensure that sustainability reporting is done in a comprehensive and transparent manner. Disclosure must be made on the company website and the reports must include, among others, materiality analyses, appropriate sustainability disclosures, and clear information about stakeholder engagement. These are lessons Sri Lanka needs to learn.

Success stories

Some SOEs in emerging markets are closing the gap with their private-sector competitors. Let us take Petronas, an SOE in Malaysia, for example. It all began in 1974 as a medium-sized domestic-based national oil company. Today it is transformed into a fully integrated oil and gas multinational corporation with a value of US$ 90 bn.

The SOE drew from well-known best practices in the private sector; they also concentrated on three areas of specific importance:

1. clarifying objectives and securing an explicit mandate,
2. focusing scarce resources on areas with the highest financial impact, and
3. redefining the talent proposition.

What needs to be done

The recent COPE Committee reported a number of serious concerns of SOEs, which require immediate action. The concerns include

1. lack of transparency and accountability,
2. lack of professional management of public enterprises,
3. financial indiscipline, irregularities, manipulations and malpractices,
4. ineffective progress review and performance monitoring,
5. ineffective internal controls, risk management practices and audit and inadequate disclosures in financial reporting.

The report said that these losses continue to have high negative impact on our fiscal costs. Over the years, most of these establishments have reported significant persistent operating losses.

In this writer's opinion, if we are to revive the flagging SOEs, we need to confront four key challenges.

1. Clear clarification of the roles and responsibilities of the Government regarding the SOEs. This goal requires a balance, between the Government's active ownership responsibilities (like appointing boards and providing control and oversight), and the need to maintain a "level-playing field" for market competition. It is not going to be an easy task unless two important conditions are met:
    a. clear legal and regulatory framework, including corporate rules and codes, and
    b. a strong and independent coordinating body for oversight and control.

2. Appointment of a team of qualified and experienced persons to SOE boards. All board appointments should be based on merit and not any other criteria. This directs to the need for a unified minimum standard for SOE boards. It is advisable to take it off from the purview of the Minister concerned and make it an open affair where any professional could apply. Board members must be allowed to take independent decisions within the parameters of Government policies. Their performance must be judged on the service quality and profit earned.

3. An organizational culture of efficiency, integrity, competitiveness and innovation must be instilled in all SOEs. To do this, higher management should apply stringent internal controls and risk management systems.

4. In order for SOEs to implement best practices specified in (1), (2) and (3), formal Government agreement should be available.

5. It's time to establish a State Enterprises Commission. Their assignment is to
    a. regularly study in depth the operations of statutory bodies and SOEs, review their objectives, initiate thorough management audit and determine the suitability of enterprise management of all the SOEs.
    b. promote efficient and profitable operation of the SOEs, utilizing the tools of corporate planning, performance contracting, monitoring and evaluation.

As a final note, let me add that our SOEs critically sick but not beyond redemption. What is needed is an extraordinary political commitment from the highest echelon because SOEs are a crucial clue of the puzzle in achieving economic recovery and promoting sustained economic development.

For the full article - Daily Mirror

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