Spotlight: Econ Op-eds in Summary

Week ended 11th December '19

In Summary

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

1. Tax cuts Control the damage before the unconventional stimulus backfires
By: W.A Wijewardena

- While the general public welcomed the tax cuts, business sector and international organisations have been more cautious due to the fiscal and debt sustainability concerns. The rationale for the tax cuts has been to provide additional income to the taxpayers and broaden the tax net while simplifying the tax system.

- While marginal tax rates have reduced and tax-free allowances have increased, income tax brackets have been narrowed in an attempt to recover the government's revenue shortfall of around Rs. 650-680 bn. Reduction of VAT rates and coverage will be a relief to consumers and proposed exemptions can boost the specified business sectors.

- In such a situation a policy paradox is created where, short term revenue losses should be compensated by borrowing from the market or the Central Bank leading to conflicts with other government objectives. Abolition of taxes such as PAYE and WHT where such income is now subject to income tax can increase total tax revenue. The success in raising this revenue will depend on the efficiency of the IRD.

The public at large welcomed tax cuts because they thought that they would have more cash to spend. The business sector, including the chambers, watched the developments cautiously without making a too quick judgment. At the same time, Moody's Rating Services branded the stimulus package as 'credit negative' implying that it would lead to a downgrading of the country's present rating of B1/Stable unless it is managed properly.

Fitch Rating warned that the stimulus package would derail the budget disciplining exercise started by the previous Government. A similar view was opined by IMF's Sri Lanka Country Head too. In a similar note, the outgoing Central Bank Governor Dr. Indrajit Coomaraswamy has indicated that the stimulus should not undermine the debt sustainability exercise being carried out by the Government.

The World Bank's Chief Economist for South Asia, Hans Timmer said that though there may be reason for fiscal stimulus, there is no space for it in Sri Lanka and the policy makers should strike a proper balance between fiscal stimulus and the need for preventing the overheating of the economy – a situation where the aggregate demand rising faster than the aggregate supply demand causing the prices to increase and the exchange rate to fall. Both these outcomes are what the Government wants to prevent from happening at any cost.

Meanwhile, Sri Lanka sovereign bonds maturing in 2027 and 2028 witnessed a fall in market prices raising market interest rates from 6.8% to 8%. Against these contrasting signals, Finance Ministry, has assured that the Government will stick to its budgetary targets by cutting down the unnecessary expenses. It had also reiterated that it would continue to negotiate with IMF to save the present Extended Fund Facility or EFF of which the final instalment is due to be released in mid-2020.

The irrelevant Laffer Curve for Sri Lanka

The rationale for the tax cuts has been to lower the rates and rope in more taxpayers so that the overall revenue of the Government would increase over the time.

This logic is indeed in line with what is known as the Laffer Curve. According to Laffer, there is an optimal income tax rate up to which the revenue will increase and if the rate shoots over that optimal rate, revenue will begin to fall. Hence, when a country is in the revenue falling region, the reduction of the income tax rate would certainly increase revenue instead of reducing it.

Empirical studies have shown that this optimal income tax rate stands at around 70% for most of the countries. Sri Lanka's marginal income tax rate is just 24% and therefore, it has not yet reached the level of taxation that prompts an increase in revenue if the rate is cut.

Hence, it is not the Laffer Curve which may have prompted Sri Lankan authorities to cut tax rates but some other consideration. That is to provide an additional income to the hands of the taxpayers, catch more liable people into the tax net and increase the tax revenue by getting more people to pay taxes. This last goal had been expressly mentioned in the election manifesto.

According to press reports, the tax cut is intended to address both the individual taxpayers and the corporate taxpayers.

Promised relief to individuals may backfire

In the case of individuals, the presently available tax-free allowance of Rs. 1.2 mn in two slots, namely, Rs. 700,000 for employment income and Rs. 500,000 for non-employment income, will be increased to Rs. 3 mn. The applicable marginal tax rate will be reduced from the current 24% to 18%.

At the same time, the advance tax collection mechanisms involving the Pay-As-You-Earn or PAYE out of employment income and the withholding taxes or WHTs on interest, dividend, and non-employment income at 5% at source will be abolished. All these are final taxes at present and therefore, once they are abolished, all individual taxpayers are required to pay income tax on those incomes.

The applicable tax rates are 6% on the first Rs. 250,000, 12% on the next Rs. 250,000 and 18% on the balance. The current timeline introduced by the Inland Revenue Department or IRD is to pay the due tax at the end of every quarter and make a final adjustment tax payment at the end of the year. Hence, individual taxpayers who receive both employment and non-employment income will have to make the due tax payment to IRD quarterly.

According to the current law, it is mandatory for every taxpayer to inform IRD in advance the estimated tax liability in every quarter and pay the taxes accordingly. Hence, the abolition of PAYE and WHTs will pass the burden of remitting the due taxes to IRD from employers, banks and other payment agencies to individual taxpayers. In the case of employers and so on, the payment software used by them have already been adjusted to deduct these taxes and remit to IRD. Hence, it is not a burden for them to make those payments. However, the individual taxpayers, especially those of the small retail type, will have to make an extra effort to meet the tax payment obligations in time.

Expansion of VAT coverage

With regard to businesses, the most explosive tax cut has been for the Value-Added Tax or VAT. Vat was introduced as an improvement to Business Turnover Tax or BTT. BTT was a multi stage tax which taxed businesses again and again when they moved from one stage of production to another. Value added tax is equivalent to a tax on the final product unlike BTT.

Because of this position, if the governments are to earn a higher tax revenue, they have to adopt a multitude of strategies: increasing the rate, expanding the number of VAT payers by lowering the turnover limit and bringing more economic activities under its base.

Will VAT changes help the Government?

It in fact did the trick and the revenue increased from Rs. 171 bn in 2009 to an estimated Rs. 600 bn in 2019. The yield also increased from 3.5% of GDP to 4% of GDP during this period. From the Government's point, VAT has, therefore, been an efficient tax. However, more tax revenue means more resentment by taxpayers. The present Government appears to have yielded to that resentment and introduced a sweeping change to VAT. Thus, the rate has been reduced from 15% to 8% with the exception of VAT on banking, insurance and financial services.

At the same time, the eligibility threshold of turnover has been increased from Rs. 12 mn per annum to Rs. 300 mn taking out a large number of small businesses from the tax net. It is not a relief to businesses but a relief to consumers since VAT, being an indirect tax, is supposed to be passed on to the latter.

In addition, condominium property has been exempted from VAT, while tourism sector businesses have been exempted for five years provided, they increase the use of local inputs to 60% of their revenue. The former will boost condominium sales which are not doing well due to general economic slowdown.

The latter will not help tourism sector businesses since VAT is, as a general rule, passed onto the tourists. It will therefore reduce the costs of tourists and encourage them to seek Sri Lanka as a tourist destination. Thus, it could have been implemented as an incentive for tourists without bringing the 60% input requirement into it. The revenue loss due to VAT reduction is estimated to be around Rs. 300 bn in 2020.

Relief to businesses

The other business-related tax cuts are the abolition of Economic Services Charge or ESC, Nation Building Tax or NBT and the Capital Gains Tax or CGT. The Telecommunication Levy which stands at 15% now has been cut by a fourth so that new Levy rate becomes 11.25%. It is not a revenue earning by the Government but by the Telecommunication Regulatory Authority or TRC.

Further, the Debt Repayment Levy which had been imposed on banking and financial institutions as a way to get their support to repay debt has been abolished. There have been production related tax cuts as well. Accordingly, income from agriculture, fishing and livestock, information Technology services has also been exempted from taxes. Professional income being received by Sri Lankans in foreign exchange and interest income on foreign currency deposits have also been exempted from income tax.

The estimated loss in revenue

Based on the estimated revenue of the Government in 2019 from the taxes which have been abolished or reduced, the immediate loss of revenue to the Government ranges between Rs. 650 bn and Rs. 680 bn. This loss amounts to a third of the Government revenue or about 4% of GDP. In the medium term, a part of this could be recovered by roping in more taxpayers into the tax net, but in the short term, the Government will have to raise these funds by borrowing from the market after increasing the Government's borrowing limits through Parliament.

But when such a large amount is put on the market, there will be pressure for interest rates to rise, defeating the Government's objective of keeping interest rates below 10%. The immediate jump in the interest rates could be avoided if the same is borrowed from the Central Bank but it would amount to increasing the money supply putting pressure for domestic prices to increase and exchange rate to depreciate. It thus will defeat the Government's objective of keeping inflation below 5% and strengthening the exchange rate. This is a policy paradox which brings in harmful outcomes whatever the course of action the policy makers would be taking.

The plight of individual taxpayers

The abolition of the PAYE tax and the WHT on interest and non-employment income will have a dubious effect on individual taxpayers. At present, the PAYE tax and WHT collected at source are considered as final tax payments. Hence, after they are abolished, the individual taxpayers are required to indicate them in the annual tax returns and pay taxes at the normal tax rates.

There is a relief by way of a reduction in the marginal tax rates. However, this relief is being subsumed by two factors. One is the addition of two income sources which had been declared as final tax payments earlier to income which is now subject to income tax. The other is the reduction of the tax slabs from Rs. 600,000 earlier to Rs. 250,000 now. As a result, even at lower rates, a taxpayer will have to pay more now compared to the previous system. It would in fact increase the total tax income as expected by the Government.

Conditions for success

The success of the present tax reduction in raising revenue in the medium term will therefore depend on the efficiency of the IRD in roping in more taxpayers and collecting taxes from them.

With the new Revenue Administration Management Information System and the arrangement to pay taxes through LankaPay operated by LankaClear, it is not a serious issue for IRD to upgrade its systems and handle more tax files with the available human resource base. But it takes time and unless it is handled carefully, the stimulus package will backfire causing a large gap in the budgetary financing.

For the full article – Refer Daily FT

2. Laying the foundation for economic development
By Nimal Sanderatne

- Firm economic policies can only be expected once the new government is formed after the parliamentary elections next year. With electoral politics making the implementation of such policies difficult in the interim period, Furthermore, it is more likely that we will witness a slippage in the macroeconomic fundamentals of the economy – due to fiscal loosening. However, what can be achieved in the interim is the setting up of a foundation/institutional framework with which longer term economic policies can be achieved.

- There are several conditions that must be fulfilled in order to achieve the goal of more than 5% growth annually. These include peace between communities, reducing corruption, improving administrative efficiency, pursuing pragmatic economic policies, strengthening macroeconomic fundamentals and improving investor confidence.

- The government's commitment to developing a disciplined, peaceful society, eliminating corruption, and creating a culture of meritocracy – especially in the public sector, could be challenging given the organizational culture which has prevailed in most of the organizations.

Firm economic policies that can change the pace of economic development can only be expected after a new government is formed after the parliamentary elections next year. Meanwhile there could be a deterioration in the macroeconomic fundamentals, especially a fiscal slippage, as the people's expectations are for economic policies that would benefit them immediately irrespective of their consequences on the economy. Such is the nature of electoral politics, especially in Sri Lanka, where the complexity of economic issues is hardly understood and the popular demand is for tax concessions, lower prices, subsidies and hand-outs.

Interim

Furthermore, the parliamentary election early next year compounds the political pressures for populist economic policies. Therefore, too much cannot be expected from the change of Presidency and the takeover of the government by the opposition. This interim period could be one where the macroeconomic fundamentals of the economy could be undermined. This is especially so with respect of a lack of fiscal discipline. A further fiscal slippage could make the economic recovery and growth all the more difficult to achieve.

Post elections

In this context the economic reconstruction that was discussed in the November 22nd column is possible only after a stable government is established and a new framework of policies implemented. The interim period from now on till a government is formed after the parliamentary elections would be mostly one of laying the foundation for the new economic policies and the institutional framework for the economy to achieve the country's potential economic growth.

Economic growth

Achieving a higher trajectory of economic growth of more that 5 percent annually in the next five years would be a formidable and challenging task for President Gotabaya Rajapaksa. A number of economic and non-economic conditions have to be fulfilled for a robust economic performance. These include peaceful conditions among the plural ethnic and religious communities, reduction of corruption, enhancing administrative efficiency, pursuing pragmatic economic policies, strengthening macroeconomic fundamentals and boosting investor confidence. These have been enunciated as priorities by President Gotabaya Rajapaksa himself.

Resolve

President Gotabaya Rajapaksa has indicated his resolve to achieve these preconditions. Several of his actions have indicated a break from the past and a new resolve to build a united Sri Lanka.

Three noteworthy features of his policies that have been clearly enunciated are his commitment to establish a multicultural nation like Canada and Singapore, developing a disciplined society, eliminating corruption and ensuring an efficient administration by appointing professionals on the basis of merit.

These are three vital conditions for economic development. Their attainment would lay a solid foundation for economic growth and development. However achieving these are formidable and challenging tasks. Only a strong political will and resolve could achieve these.

Social cohesion

Foremost among the preconditions for economic development are ethnic and religious harmony leading on to social cohesion. The achievement of such cohesion would be a formidable task as his support base is a Sinhala Buddhist one. President Gotabaya Rajapaksa's task can be considered similar to the dilemma that Prime Minister SWRD Bandaranaike faced after his resounding victory in 1956.

However formidable and difficult the task of achieving a united country is, it is imperative. The economic history of the country is replete with serious setbacks to the economy due to ethnic violence. The most recent such setback was the Easter Sunday bomb blasts and the subsequent communal violence and tensions.

Eruption of ethnic and religious violence would setback the economy further. Social cohesion and peaceful conditions are fundamental imperatives for the country's economic development. The economy can progress only if there is no ethnic and religious tensions.

Corruption

The elimination of corruption is a foremost prerequisite for economic development. However reducing corruption to a minimum level is a gigantic task as corruption has permeated every aspect of public life.

The drastic reduction of corruption is a key element for economic success. It would enable an efficient allocation of scarce economic resources.

Meritocracy

President Rajapaksa has indicated very clearly that he intends to make a break from the past by appointing persons to key positions on the basis of their professional competence and capacity. This is a vital change as state enterprises are run inefficiently owing to inefficient management of them by political appointees. In 2018 over 400 state enterprises made an aggregate loss of Rs 27 billion. This is nearly one-third of the country's GDP.

Given the history of state enterprises, achieving efficient administration of state enterprises would be a Herculean task. Yet the reform of State owned enterprises is crucial for economic development.

Macroeconomic Fundamentals

The stabilisation of the economy's macroeconomic fundamentals is essential for economic growth. These include the reduction of the fiscal deficit by a two pronged strategy of reducing expenditure and enhancing revenue. This has been made extremely difficult due to expenditure overruns and revenue shortfalls of the government. However fiscal consolidation is essential for macroeconomic stability and economic development.

Reducing the nation’s external vulnerability by reducing the foreign debt is another foremost condition that must be achieved for economic stability and growth.

Summary and conclusion

Although the economy cannot be expected to revive till the installation of a new government after the parliamentary election, the commitment to forge a united nation without ethnic and religious tensions, ridding the country of corruption and ensuring that appointments to key positions based on professionalism, capacity and merit would be a sound foundation for economic growth and development. The weakening of the macroeconomic fundamentals owing to political compulsions would require redoubling efforts to ensure an improvement in the macroeconomic fundamentals, especially fiscal consolidation.

For the full article – Refer the Sunday Times