FIFTH GAMANI COREA MEMORIAL LECTURE

Sri Lanka's Policy Dilemma on Debt and Growth: The Challenges for an Upper Middle-Income Economy

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It is a great privilege to deliver the Fifth Gamani Corea Memorial Lecture. At the Institute of Policy Studies of Sri Lanka (IPS), we had the honour of interacting with Dr. Corea during his distinguished tenure as its founder Chairman from 1990 to 2006. I thank the Chairman, Vice Chairman and Directors of the Gamani Corea Foundation for the kind invitation to deliver this Memorial Lecture.

For Sri Lanka today, the biggest challenge on the economic front is an extended period of low economic growth amidst a rising public debt burden. The numbers are well known. GDP growth has been coming in at below 3.5 per cent for more than 11 consecutive quarters. This is not normal output growth for any persistent period of time for an emerging economy; the rest of South Asia is growing at above 6 per cent per annum on average. With the fallout of the April 2019 terrorist attacks factored in, Sri Lanka is expected to end 2019 with an expected growth rate of around 2.8 per cent.

While GDP growth has been low and on a persistent downward trend, Sri Lanka's public debt profile has been moving in the opposite direction. This is not unusual – excessive government debt acts as a drag on economic growth and low growth makes the debt numbers look worse.

Today, Sri Lanka's public debt stands at approximately 85 per cent of GDP, with the share of foreign debt rising steadily in recent years so that domestic and public debt ratios are now 50:50. Foreign debt carries higher risks from exposure to exchange rate volatility where a sharp depreciation can aggravate debt ratios as we experienced in 2018. For Sri Lanka, the risks of foreign currency debt are heightened given our growing reliance on foreign non-concessionary borrowing which makes up 55 per cent of total foreign debt outstanding in 2018.

The policy dilemma is clear. Fiscal consolidation of the kind that Sri Lanka has tried to implement over the last 3 years under an Extended Fund Facility program with the IMF is required for putting in place the necessary policy measures for debt sustainability. However, in reality, such austerity measures, have an immediate impact on growth outcomes, such that debt ratios can worsen, at least in the short to medium term.

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On the other hand, reviving growth and sustaining that growth momentum may require some form of a fiscal stimulus. But, how do we do this without putting debt sustainability at further risk? Should a fiscal stimulus be provided through taxes or spending? If taxes, what kind of taxes? The questions are endless and there are no easy answers. For Sri Lanka, the challenges are even more daunting in view of its rapid demographic transition at a relatively low level of per capita income and the gradual climb from being a low middle-income economy to an upper middle-income economy.

Moving from a low middle-income to an upper middle-income is the easy part

At USD 4,000 per capita income, Sri Lanka recently graduated to an upper middle-income economy in 2019. The real challenge is to move a notch further up to a high-income economy (USD 12,000 and above).

Indeed, international experience suggests that graduation to a middle-income status is the easier bit. Many countries in Latin America and the Middle East reached middle income status in the 1960s and 1970s. However, after the initial rapid ascent, the great majority have not made the transition to a high-income status. Only a handful of countries have done so successfully – of 101 middle income economies in 1960, only 13 countries (Equatorial Guinea, Greece, Hong Kong, Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, South Korea, Singapore, Spain, and Taiwan) have managed the successful transition to a high-income economy.[2]

In the circumstances, the transition to avoid a middle-income trap will be quite challenging. It requires faster growth that can be sustained only if there is growing demand for Sri Lanka's goods and services by foreigners. Relying on a small market of 20 million consumers is not adequate for this purpose.

Sri Lanka's export competitiveness has declined over the years – not only has the export share of GDP fallen, but so has our share of the global export market. Over the last 3-4 years, efforts to free up trade as a means of improving competitiveness, have come up against lobby groups. This is not unique to Sri Lanka – the almost universal push for freer trade and globalization is clearly under attack across many parts of the world. It is argued that proponents of globalization underestimated its disruptive impacts on domestic wages and labour market adjustments, leaving large swathes of disaffected voters, particularly in advance economies. The backlash is evident in electoral outcomes in the US and the Brexit referendum in the UK, supported by rising antipathy to issues of mass migration, etc.

The tendency to overhype the benefits of globalization and economic openness and create impossible expectations, while downplaying its potential disruptive effects have

[2] Agénor, P., and O. Canuto (2012), "Middle-Income Growth Traps", World Bank Policy Research Working Paper 6210, World Bank, Washington, D.C.

not helped. Indeed, the current backlash against globalization did not spring up overnight. It was a decade or more in the making and spilled over into national politics with issues of mass migration and other factors acting as catalysts. The Doha round of WTO negotiations collapsed, partly because global economic cooperation is perceived to be unbalanced – finance and capital can move much more quickly across borders than goods, services, and especially, labour. As a consequence, some countries benefit more than others, while some will face adjustment costs. Such economic adjustments can create long-term structural unemployment as has been the case in some advanced economies. At its simplest, the on-going US-China trade war is a manifestation of this, in the belief that it is better to keep jobs and capital at home, and the way to do that is by loosening the grip of global integration.

For Sri Lanka, raising competitiveness also means absorbing technological innovation. Our workforce is shrinking unlike in competitor countries like India or Bangladesh. For higher labour productivity, workers need to be equipped with the right mix of skills – learning in science, technology, English and mathematics are a fundamental part of this. Sri Lanka has to do much more to ready its workforce.

Sri Lanka has a low share of workers with tertiary level education. Of the 15+ aged population, only around 3.5 per cent hold a degree or above qualification. Of the annual university pass-outs (26,000 as undergraduates and 10,000 with post-graduate qualifications), only a limited per cent is following science (12.1 per cent), computer science (4.4 per cent), engineering (6.6 per cent) and other technology related subjects.[3]

The UNESCO Global Education Monitoring Report sets out some benchmark spending levels for countries at different levels of development. As a percentage of GDP, public education expenditure for an upper middle-income country is recommended to be around 4.6 per cent.

Public financing needs set to rise if middle-income trap is to be avoided

As the population ages, the dependency ratio rises, adding to existing fiscal burdens. A rising dependency ratio means there will be fewer earners and tax payers going forward. For the economy as a whole, these trends can lead to a drop in savings and investment. While economic theory suggests that people may save more to meet these demands, there is little evidence to indicate that this is happening in Sri Lanka, at least at present.

Many emerging economies that have seen rapid growth, also experience widening income inequalities. Indeed, integration into an increasingly globalized workforce can accentuate inequities in economic opportunities and income levels.

[3] Arunatilake, N. 2019, '4IR and the Future of Work in Sri Lanka' in Sri Lanka: State of the Economy 2019. Colombo: Institute of Policy Studies of Sri Lanka.

Sri Lanka's demographics, and structural transformation of the economy in the years to come, suggest that there is a high probability for such equity gaps to widen. With the graduation to an upper middle-income economy and rising wages, technology and innovation will be the driving forces for productivity growth. These tend to benefit the skilled and educated, whereby skill-biased technological change can have significant impacts on a country's wage dispersion.

Already, Sri Lanka has witnessed widening gaps. While income poverty is estimated to have reduced from 15.2 per cent in 2006/07 to 4.1 per cent by 2016, income inequality remains unchanged. The richest 20 per cent enjoy more than half the total household income of the country, while the poorest 20 per cent get only 5 per cent. Thus, spending on social safety nets and other forms of income support need to be factored in.

An ageing population will also require more state support for health, pensions, social security, etc. Sri Lanka spends a considerable amount on a non-contributory public service pension scheme. The fiscal burden on the Treasury is high and climbing; the rapid demographic transition means that these liabilities may lead to future fiscal stress in a significant way.

At the same time, there is relatively poor enrolment and coverage for most other citizens. Only about 55 per cent of the population is enrolled in some scheme or the other and this is sufficient to provide retirement income of some sort to only about 30 per cent of the elderly.[4] Extending coverage – i.e., that of a universal pension – will jump from 3 per cent of GDP in 2015 to an estimated 4.6 per cent of GDP by 2030.

Sri Lanka's public finance benchmarks fall well below comparator thresholds. For instance, against the average for emerging market middle income (EMMI) economies of Asia, Sri Lanka already does poorly on fiscal benchmarks. On expenditures, the average public spending ratio for Asian EMMIs is above 30 per cent whereas Sri Lanka is at around 20 per cent. On revenues, the gap is even bigger: the average for Asian EMMIs is about 26 per cent whereas Sri Lanka's revenue-to-GDP ratio is half of that, at around 13 per cent.

On public debt, Sri Lanka does very poorly. While Asian EMMIs have a public debt-to-GDP ratio averaging around 50 per cent, Sri Lanka is burdened with a ratio of around 85 per cent. The shift to commercial and non-concessionary foreign loans as Sri Lanka graduated into low middle-income will further curtail access to soft-window funds from multilateral development agencies, thus any future foreign borrowing will further raise the costs and risks of the country's debt profile.

[4] Samarakoon, S. & Arunatilake, N. 2015, Income Security for Older Persons in Sri Lanka, UNESCAP Working Paper.

In the circumstances, it would not be far off to argue that Sri Lanka is in an incipient debt trap. Overall, the future demands on public finances, alongside evolving debt dynamics suggest that Sri Lanka will have a tough road ahead in aiming for a sustained long term growth acceleration.

How can short-term growth objectives be balanced with long term solutions?

Growth is said to be the best solution for debt. For Sri Lanka's incoming new government, therefore, reviving growth will clearly be the preoccupation in 2020.

If the production structure of the Sri Lankan economy had been more reliant on tradables, the adjustment would have been easier – i.e., as domestic absorption of output falls, the excess could be exported. However, with heavy dependence on sectors like construction for growth, the domestic production structure has become skewed towards non-tradables over the past decade. As a result, the process of adjusting to a downturn, and measures for a recovery, become more complex.

Reviving export growth sustainably takes time and relies on a host of deeper structural reforms to bring about a shift in the pattern of production via a restructuring of the economy for a resource shift. In the interim, the Sri Lankan economy today exhibits all the signs of a significant production gap – low growth and low rates of inflation persisting for a period of time.

If there is slack in the economy, governments tend to rely on fiscal and monetary policies to drive growth, at least in the short term. Increasingly though, the traditional tools of fiscal and monetary policy are being questioned as never before in the post global financial crises (GFC) era, and conventional views are undergoing seismic changes.

The first policy tool to be tested in the GFC era is a new form of 'unconventional' monetary policy – i.e., quantitative easing – where central banks created piles of new money through various measures. While these measures had some successes, conventional monetary policy tools of slashing interest rates to spur consumption, investment, and employment have become less effective since the financial crises.

The problem for many advanced economies today, particularly Japan for instance, is that inflation and interest rates are stagnant at historically low levels, even as new money was pumped in. This has meant that the relationship between unemployment and inflation – the famous Phillips Curve – does not hold true in many of these countries. The theory tells us that if unemployment falls too low, inflation will rise; too high, and it will fall – leading to a U-shaped curve – but that curve is now flattening because these countries have low unemployment and low inflation.

These developments not only call into question the effectiveness of monetary policy tools, but they also suggest much more is at play in explaining these relationships in today's globalised economy. For instance, stickier upward wage adjustments owing to

higher foreign competition, changes in technological advancements etc. are considered as some explanatory factors. The point, however, is that our understanding of the role of monetary policy in stimulating economic activity is undergoing some major paradigm shifts.

Similarly, the approach to fiscal policy adjustments have also undergone changes. For developing countries like Sri Lanka, theories of optimum fiscal policy have been dictated through many stages. In the 1930s-40s, the preoccupation was with designing fiscal systems with a focus on social welfare. In the 1950s-70s, fiscal policy was seen as a means of promoting industrialization through import substitution. In the 1980s, the Washington Consensus gained ground to argue for non-distortionary tax and spending that allow markets to operate. Thereafter, in the 2000s, an added emphasis was on public finance management and administration – such as semi-autonomous revenue authorities – to support broader goals on institutional and governance issues.

There are no hard and fast rules on fiscal policy per se. Some governments opt to maintain balanced budgets while others may consider a more relaxed fiscal policy stance – where spending exceeds revenue – as acceptable. In the case of the latter, the emphasis is that any borrowing should be for investment purposes and not for consumption purposes. There too, the golden rule is that it is appropriate for a government to borrow in order to 'invest in the future' – i.e., to the extent that an investment makes the economy more productive, increased tax revenues may be available to pay off the loan. It also assumes that public investment will act as a stimulant to private investment, instead of crowding out more productive private investment.

A second important feature that is subject to much debate is the scale of government spending, and the preference for 'big' versus 'small' government. Many European and Scandinavian economies maintain government spending ratios of 40 per cent of GDP – twice the level currently maintained in Sri Lanka. In fact, some interesting new evidence from OECD countries suggest that large governments can be compatible with high levels of economic performance.[5] There is, however, an important condition: these governments are argued to provide their services very efficiently. Where government delivery of public services is deemed to be less efficient, if not weak – such as in Sri Lanka – reducing their involvement is widely viewed as one means of raising productivity and economic growth.

Still, the overall stance of fiscal policy under any governments is seen as a signal of its broader policy ideology. For many, fiscal policy is not designed solely to support economic growth; there are other, and equally important, considerations such as equity. While it is acknowledged that balancing different economic objectives and fiscal systems is not easy, fiscal policies can be strong catalysts in the process of economic growth. This is

[5] Boone, Lawrence. 2018. How can public finance reforms boost economic growth and enhance income inequality?. Paris: OECD.

particularly so in a developing country context, where private sectors are less dynamic and where markets are either underdeveloped or are missing.

In the post GFC era, as advanced economies grappled with weak growth, there was greater tolerance to the idea that context matters and second or even 'third-best' fiscal policies might be appropriate gained some acceptance. IMF fiscal adjustment programmes also became much less 'conditional', as Sri Lanka also witnessed in the 2009-2012 programme that was implemented.

Can second or third-best fiscal policies work to revive the Sri Lankan economy?

The Sri Lankan economy is essentially seeing a moderation in consumption, as taxes were increased to deal with a growing debt burden.

The course correction was inevitable. The disincentivising impacts of high levels of government debt on interest rates and private investment are well known. As the volume of public debt increases, it dampens investor confidence – not only does it create uncertainty about an economy's overall health, but it also raises questions on a government's future course of policy. Inevitably, investments will be deterred when such course corrections involve tax increases.

Sri Lanka has had many such course corrections to deal with the economic consequences of what is called a twin-deficit problem – persistent deficits on both the fiscal and external current accounts. This is symptomatic of a country that essentially lives beyond its means; our national expenditure exceeds national income, and we rely on foreigners to finance the gap by way of capital inflows.

Thus, it has been a story of impending crises that have prompted Sri Lanka to approach the IMF with clock-like regularity for bailout programmes. To date, we are into our 15th IMF programme within a fairly limited span of 52 years, accounting for nearly 70 per cent of years covered over the last four decades. The reason why Sri Lanka has continued to engage in this cycle is partly because the country has managed to avert a full blown crisis with stop-gap measures. Arguably, the fact that a deep economic crisis that necessitates shock therapy was averted, might also explain why reforms have not stuck.

If Sri Lanka wishes to avoid a regular does of IMF-style course correction, then ideally, the moment to turn to austerity is when the economy can bear it. This is what is recommended as a prudent means of carving out space to practice counter-cyclical fiscal policy.

Measures to cut spending and/or raise taxes are easier to implement when growth is high under such conditions. With surpluses, fiscal policy can then be used as a counter cyclical tool to stimulate an economy by adopting an expansionary policy stance – i.e., cutting taxes and/or raising spending. If surpluses are generated in good times and borrowing

limited to only to finance public investment means a more effective counter-cyclical fiscal policy.

Unfortunately, Sri Lanka has not at any point carved out that policy space. Instead, it has been a case of austerity measures being imposed, in the face of a looming crisis.

In that kind of a context as Sri Lanka was in 2016 when the latest IMF programme got underway, fiscal austerity takes an inevitable toll on GDP growth. It was a revenue-based fiscal consolidation process in view of the significantly low and declining revenue generation over the years. But, there are costs as expected – higher taxes bite into household disposable incomes as well as corporate earnings, impacting consumption as well as investments. These can in turn lead further to a stagnant or shrinking economy, at least in the short term. If growth slows, so can tax collection. This is what we have witnessed in the most recent fiscal consolidation effort.

Three years on, Sri Lanka is therefore still struggling with weak fiscal outcomes. Fiscal deficits are still relatively high in the range of 5.5 per cent of GDP, and more worryingly, public debt has continued to growth to a high 85 per cent of GDP.

However, while the overall revenue and fiscal deficit targets have been missed, the trends have been more promising. The persistent decline in the tax-to-GDP ratio reversed, and the overall fiscal deficit has narrowed when compared to the start of the programme.

More importantly, Sri Lanka has begun to record a primary surplus. For debt sustainability efforts, this is important. Debt begins to stabilise when the government's interest payment is exactly off-set by a primary fiscal balance – the government fiscal balance excluding interest payments. As a country that has consistently run deficits on the primary balance, Sri Lanka was able to record a surplus in 2017 for the first time after 1992, and the second time since 1955. In 2018, Sri Lanka was able to record a primary surplus of 0.6 per cent of GDP – albeit well below the total interest payments incurred of nearly 6 per cent of GDP – and appears to be on track to repeat a surplus in 2019 as well.

Thus, some gains have been made. But, this is of little comfort to the general population. Not only do people see a fall in their disposal incomes as taxes rise, but slow economic growth can also mean modest wage gains and job creation. Inevitably, it can generate a backlash, particularly when implemented mid-way through an electoral cycle, as tangible benefits of such reforms – in the form of higher private investments that can lead to more productive jobs and wages – take time to materialize.

In the interim, lower growth also means that the debt outlook worsens, at least in the short run. Thus, not surprisingly, IMF prescriptions for course correction have their share of critics.

Not surprisingly, there are calls to use fiscal and monetary policies more actively to stimulate economic growth. In an environment of low growth, and a relatively low and stable rate of inflation at mid-single digits, efforts have been made to lower interest rates and provide credit support to revive economic activity. But, monetary policy measures have no impact on the real sectors of the economy, and that is where the leading role of fiscal policy becomes important.

The quickest results on the growth front will come about from spending, rather than the tax side. When there is a slack in the economy, a spending stimulus can be an effective tool, owing to a 'multiplier' effect. For instance, money spent on putting up a school, is passed on as wages to a worker; the worker in turn may use the additional income on food and other purchases, raising demand for goods and services overall.

By contrast, passing on the benefits of tax cuts to put more money in people's hands to boost consumption or investments, may take longer. It can take time for tax cuts to be passed on to consumers, while corporates take other factors into consideration in their investment decisions besides lower taxes, such as policy and political factors.

Sri Lanka has opted for tax cuts as opposed to spending, as the primary means of providing a fiscal stimulus. The route of tax cuts, at least for now, makes sense for two reasons. The higher tax burdens imposed over the last few years have been highly unpopular, and second, for the more practical reason that expenditures cannot be raised given the ceiling imposed by a Vote on Account without a full budget being presented.

The question is how far a fiscal stimulus can go before the country comes up against debt sustainability concerns.

Tax cuts for a growth-friendly fiscal stimulus

The announced tax cuts raised immediate concerns on their revenue implications. They are estimated to amount to a revenue loss in the region of LKR 550 billion or around one-fourth of the 2019 estimated revenue collection.

In this context it is worth examining whether the tax revisions are supportive of efforts to stimulate and sustain growth. The decisions on shaping tax policies are not based on economic considerations alone; politics and voter preferences play a significant role in shaping what is palatable and what is not.

On the whole, the overall health of Sri Lanka's tax system is weak. It has obviously failed to achieve its most critical objective – i.e., Sri Lanka is a country that does not tax sufficiently to cover its spending. Indeed, it is the case today that total government revenues are insufficient to even cover total government current expenses, let alone capital spending.

Tax revenues have fallen steadily in relation to rising per capita income levels. The reasons put forward to explain this anomaly are many. A failure to broaden the tax base, weak tax administration and enforcement, exemptions offered under various Acts including for Board of Investment (BOI) enterprises, and the structure of the economy itself. In the case of the latter, the growing informalization of the Sri Lankan economy – with more than 60 per cent of the workforce employed in the informal sector at present – makes tax collection more difficult unless tax administrative structures are efficient and effective.

The tax system is also argued to be highly regressive. Indirect taxes continue to account for more than 80 per cent of total tax revenues despite stated intentions to reverse this to a 60:40 ratio. But Sri Lanka's tax system is perhaps even more regressive than what these numbers imply because of an often over-looked factor – i.e., the spending side. The better off pay rather limited taxes but benefit enormously from free health, education, and many forms of subsidies such as subsidized fuel, electricity, water, etc.

Despite the various tax exemptions and incentives granted to attract FDI, FDI inflows have also failed to substantially increase over the years. To add to the difficulties, ad hoc tax changes over time did not help. For instance, frequent changes to the value added tax (VAT) rate, personal income tax thresholds and rates, etc. have been a regular feature of Sri Lanka's tax policy regime.

At the same time, Sri Lanka's tax structure hurts export competitiveness. Taxes on imports are easy to collect, but it has a downside in terms of the impact on export competitiveness and efforts to link up to global value chains. These networks depend heavily on having a low and uniform tariff structure to allow raw materials, parts and components to be exchanged across multiple national boundaries before being incorporated into finished goods.

The recent tax revisions have brought relief to corporate and income tax payees. Rates have been lowered and/or thresholds have been raised. While taxes can distort economic activities, it is argued that some types of taxes harm growth prospects more so than others. For instance, if you believe that market forces provide the most compelling signal of economic choices, corporate/capital income taxes are likely to be categorized as the most damaging for growth, followed by personal income taxes, and then consumption taxes such as VAT. Property taxes and excise taxes will be thought of as the least harmful for growth. Thus, the revisions, in principle are seen as supporting growth objectives.

High rates of taxes on corporate income, given the high mobility of capital, can also prove counter-productive. Companies are inclined to move in search of more favourable tax treatment. Especially in today's digital global economy, high corporate taxes can drive out businesses and/or lead to exploitation of tax loopholes. Multiple CIT rates should also be avoided as they can distort the sectoral allocation of resources.

Are the tax revisions supportive of equity and social justice objectives? The traditional view that income tax is a major instrument to reduce inequality is changing. The fact is that employment income is often a small share of national income in developing countries and makes it difficult for personal income tax (PIT) to be a significant revenue source. The existence of a large informal sector and information paucity partly contribute to this. Thus, the effectiveness of PIT in reducing inequality itself is doubtful. High marginal income tax rates are argued to have distortionary impacts, especially when labour is relatively inelastic – a trend that Sri Lanka is facing at what we might call almost 'near full employment' reflected in a low unemployment rate of 4 per cent.

On income taxes, therefore, low rates – with some degree of moderate progressiveness – plus a broad base, favour economic growth. A flat rate is proposed by some. While it may hold some merit as being close to optimal when it is difficult to obtain information, etc. the rate structure for income taxes is a very visible policy instrument for governments to underscore their commitments to issues of equity and social justice.

The top marginal PIT rate should not exceed the CIT rate by a significant margin. Many taxpayers can choose to shift the way they report their income to take advantage of lower corporate-tax rates. Thus, it is difficult to push up the tax rate on individual incomes while simultaneously lowering the corporate rate.

Consumption taxes such as VAT are considered to be regressive. However, it is also possible to design non-regressive consumption taxes by exempting essentials such as unprocessed food items, etc. It is also not recommended to have differentiated rates, but to levy a broad based and simple VAT at a single rate. Multiple rates can be administratively costly. Despite their regressive nature, consumption taxes are seen as having a much less damaging impact on growth. As such, many countries are introducing a VAT scheme of one form or another (and lowering income tax rates at the same time).

In the long run, to put in place a simple and transparent system that broadens the base, reduces the rates and minimizes rate differences, issues of equity might be better addressed through the spending side – to increase incomes of the poor – rather than the revenue side of fiscal policy formulation.

In developed countries, more of their tax revenues are generated from income tax than consumption taxes. They also raise more from CIT than from PIT. Differences in wage income, more sophisticated tax administrations, and political power of the richer segments of the population are considered to be the main reasons for this. These trends do suggest that as countries climb up the income ladder, we can expect a relative shift from consumption to income taxes.

Another important issue that arises is whether Sri Lanka should provide tax holidays and exemptions to attract FDI. These are deployed in one form or another to increase investments in targeted sectors, achieve balanced regional development, augment

infrastructure, enhance exports and encourage the growth of small and medium enterprises (SMEs).

There are many forms of FDI: natural resource seeking, market seeking, strategic asset seeking, and efficiency seeking are some of the more common. Offering tax incentives indiscriminately to all is not helpful. Tax incentives are mostly target to the last category – efficiency-seeking FDI. This type of FDI – that brings technology and knowledge know-how – is particularly important for countries looking to integrate into the global economy and move up the value chain.
In recent years, Sri Lanka has been largely successful in attracting FDI into real estate, mixed development and construction. This is not the productivity-enhancing type of FDI that the country needs to raise its competitiveness and link up to global or regional value chains, in manufacturing or services.

Under the new Inland Revenue Act, the Board of Investment (BOI) provides incentives by way of reduced tax rates for specific sectors, and enhanced capital allowances based on capital investments made. This seems to be in line with the general understanding that tax holidays are best avoided, and that accelerated depreciation has the least shortcomings.

Despite the acknowledged problems of tax avoidance/evasion and uneven treatment to local businesses, many developing countries continue to offer them. Across sectors, 50-70 percent of all developing countries offer tax holidays, preferential or very low general tax rates, or tax allowances.[6] Tax incentives are most common for construction, information technology (IT) and electronics, machinery and equipment, and other manufacturing sectors.

Clearly, the pros and cons of this is open to debate. In many instances, tax incentives are abused by existing investors who re-enter the as new enterprises through some form of nominal reorganization. The arguments made against granting concessions is that efficiency-seeking investors are not necessarily looking for tax breaks, but rather for other advantages such as skills, location, supportive policy environment, etc. To support this, there is growing evidence on the effectiveness of tax incentives and FDI in developing countries that suggest that incentives do not compensate for shortcomings in the overall investment climate of a country.

Investors do want certainty about taxes and the broader economic circumstances. If Sri Lanka cannot assure investors of these, then we will have to rely to some extent on offering tax incentives to attract FDI into productive sectors. For instance, tax incentives can be justified if they are targeted at promoting high-tech industries that will extend

[6] Andersen, M. et. al. 2018. 'Corporate Tax Incentives and FDI in Developing Countries' in the Global Investment Competitiveness Report.

benefits to the rest of the economy as well. The other compelling case maybe when incentives are used to target specific regional development needs.

Thus, the direction of the latest tax revisions is sound, but its revenue implications need to be managed carefully. The expectation partly is that tax cuts will revive growth, and in turn lead to higher revenue collections. However, that depends on many other factors, including the sectoral drivers of growth. Sri Lanka has had past experience where a growth boom driven narrowly by public spending on infrastructure did not translate into higher revenues. Growth that is more broad-based across sectors of the economy will be more revenue-elastic.

Fiscal targets and debt sustainability

For now, Sri Lanka is very vulnerable to any signs of macroeconomic distress. Any fiscal policy measures that signals a widening of budgetary imbalances without credible policy measures on how these will be bridged can trigger a fresh macroeconomic risk assessment on Sri Lanka's sovereign ratings.

Immediately after the presidential elections Fitch Ratings issued a statement on 21 November 2019 titled 'Sri Lanka Election Result Increases Policy Uncertainty'. Following on from this, on December 19th, the outlook on Sri Lanka's sovereign credit was downgraded to 'negative' from 'stable'. S&P Global Ratings followed suit and revised its outlook too, from stable to negative on 14th January 2020.

Sri Lanka simply cannot afford continual risks of rating downgrades in view of the need to rollover significant volumes of maturing foreign debt. The debt build-up means that over the period 2019-2022, Sri Lanka must repay around USD 4,000 million on average per annum. The challenge of high debt exposure does not end there. Another bunching up of settlements from 2025 is clearly evident.

The outlook on the external front is also of concern. Sri Lanka's trade deficit has been narrowing but that is largely on account of persistent contraction in imports. Once the economy starts to recover, imports can be expected to pick up, not to mention the risks of higher international oil prices as a result of rising global tensions in the Middle East.

By contrast, export earnings are stagnant, earnings from remittances are on the decline while tourism earnings are still in a recovery phase. FDI inflows, which had failed to impress over the years, has also declined sharply in 2019.

Sri Lanka has very thin buffer stocks of reserves. The total is well below recommended thresholds – i.e., reserves should be able to cover at least 100 per cent of short term debt. As the cost of the outstanding foreign debt stock has risen, so too has the country's debt service ratio in the absence of strong growth in earnings from exports of goods and services.

Thus, reserves are not sufficient to cover near term foreign debt settlements. Sri Lanka needs to go to international capital markets this year, but what is the best time to do so, and what will be a convincing set of policy measures on the fiscal front to reassure investors of medium term macroeconomic stability.

Given the very limited policy levers available, the most prudent options are 1) set modest public investment targets when setting a budget in mid-2020; and 2) rely on private investment and FDI to fill the gap.

From amongst an array of different tools of fiscal stimulus, public investment is argued to have the largest impact on GDP.[7] But for a successful outcome, such investments have to be productive, especially so when they are financed with borrowing so that the returns on investments can help pay back the loans.

If, on the other hand, investment choices are compromised by poor analysis and incentive problems, low returns weaken growth prospects in the medium to longer term. Under such circumstances, major public investment drives in infrastructure are more likely to be followed by slumps rather than booms.[8] A good example is Sri Lanka's post-war boom where growth picked up to average nearly 8 per cent during 2010-12, but which proved to be short lived; GDP growth dropped to an average of 4-5 per cent thereafter, and has since slumped even further. Thus, to ensure that any quick fixes do not carry longer term costs, such spending should be evaluated for their economic and financial returns, particularly if such investments are being funded with foreign borrowing.

Additionally, if investment is tilted too heavily in favour of infrastructure, the resource shift towards tradables comes at the cost of a growing tradable sector. Sri Lanka cannot afford this as we aim to shift from borrowing to repayment which calls for a shift in the pattern of production.

Secondly, unlike in the immediate post-war period, when public investment was seen as the means of drawing in private investment, the government need not rush in to finance large scale infrastructure projects, and instead should rely on FDI and other forms of private investment. The Colombo Port City, for instance, is ready for investors to come in for a variety of mixed development projects. If such FDI was to come in, it will not only give a boost to growth, but it will also help the government to smoothen its debt financing requirements.

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[7] International Monetary Fund, 2016, Macroeconomic Management When Policy Space Is Constrained: A Comprehensive, Consistent, and Coordinated Approach to Economic Policy." Staff Discussion Note (SDN/16/09). International Monetary Fund, Washington, DC.

[8] Warner, Andrew M. "Public Investment as an Engine of Growth." IMF Working Paper WP/14/148. Washington DC: International Monetary Fund, 2014.

Once an economic recovery gets underway, attention can then focus on key micro reforms to ensure that the growth momentum accelerates in a sustainable fashion. Some of the micro reforms are related to: 1) policies aimed to improve efficiency of resources used by the public sector (public investment, state-owned-enterprises); 2) policies aimed to improve economic incentives (trade reforms, price systems in agriculture, state utilities such as electricity); and 3) policies aimed to improve institutional efficiency (customs, tax administration).

Such reforms are essential to broaden Sri Lanka's growth base and lay the foundation for a sustained export-led growth process. Given the country's heavy medium to long term foreign debt settlement obligations, generating hard foreign currency earnings is the only means of lowering Sri Lanka's current high risk exposure to external shocks.

In sum, reversing Sri Lanka's current low growth trajectory amidst a rising public debt burden requires a prudent mix of a macro stimulus and pro-growth micro reforms. What should be avoided is to set over ambitious targets for growth that can undermine macro stability, hinder debt sustainability efforts, and ultimately prove to be a short lived economic boom.

Thank you.