ECONOMIC ALERT

A New Paradigm for Providing Economic Services.

Introduction

There was a significant policy shift, in 2005, when the government took the decision not to privatize any State Owned Enterprises (SOEs). Instead, priority was attached to improving their operations. In order to achieve this objective, all SOEs have been called upon to revisit their vision, strategies and business models in line with national objectives. The government invested Rs. 635 billion in SOE's during 2005 – 09. The return on investment to the government is generated through levies and dividends declared on SOE profits after tax. These rose from Rs. 5.9 billion in 2005 to Rs. 23.7 billion in 2009. The most significant contributors were the state-owned banks, the Telecommunications Regulatory Commission and the National Insurance Trust Fund. There has also been a turnaround in the performance of the non-functioning SOEs. This has enabled the government to reduce its subventions (recurrent and capital) to these enterprises from Rs. 2.8 billion in 2006 to Rs. 486 million in 2009.

Despite the improvement and performance of a number of SOEs, since the policy shift in 2005, their operations continue to impose a heavy burden on the national budget. The major loss-makers during this period include the Ceylon Electricity Board (CEB), Ceylon Petroleum Corporation (CPC), National Water Supply & Drainage Board (NWS&DB), Sri Lanka Ports Authority (SLPA), the Sri Lanka Transport Board (SLTB) and Sri Lanka Railways (SLR). However, the operational losses have been reduced in all of these entities.

Strengthening SOE Operations for Fiscal Consolidation

The government has recognized that it is essential to reduce the losses of SOEs to maintain its fiscal consolidation programme. It has announced that the operations of the CEB and CPC, taken together, will have a neutral impact on the budget in 2011. The authorities are aware that there needs to be sustained improvement of the operations of SOEs, if the risks associated with the twin challenges of unsustainable budget deficits and debt are to be mitigated effectively.

Reducing the losses incurred by SOEs can also make a significant contribution toward mobilising the funding required to meet the Mahinda Chintana (MC) infrastructure development and growth targets. The net losses incurred by the CEB, CPC, NWS&DB, SLTB and SLR amounted to Rs. 40.2 billion (0.77% of GDP) in 2010. The government's investment plan (2010-

2015) assumes investment of 5.7% of GDP per year in the infrastructure sectors. This means that the elimination of SOE losses can release almost 15% of the resources required to attain the annual infrastructure investment needed to meet MC targets.

Elimination of SOE losses requires concerted action on several fronts. In the energy and the water and sanitation sectors, tariffs need to be streamlined and made more responsive to costs. Price controls were re-introduced on electricity tariffs in 2004, which meant that they ceased to reflect fluctuations in international prices, resulting in losses for the CEB. However, recent electricity tariff re-structuring by the Public Utilities Commission (PUC) is intended to make them fully cost-reflective by 2015, while subsidizing low-income households. Tariffs have also been below cost in the water and sanitation sector. The subsidies in this sector have been poorly targeted with the bottom quintile receiving only 14%. The SLTB and SLR are confronted with the challenge of addressing extremely high cost structures, primarily because the state has been the employer of first resort. The economy was not able to generate sufficient productive employment during the conflict. Now that it has ended, priority needs to be attached to reallocating labour from less to more productive **activities; with employment shifting from over- staffed SOEs to new emerging market opportunities**. The initial challenge is to attain the quantity and quality of investment needed to generate productive employment.

Major Loss-Making SOEs

The **CEB's** electricity tariff has been below the cost of production. This has meant that it has had to resort to debt financing. The accumulated debt outstanding to the Treasury, CPC and state banks is enormous. The Treasury has provided a debt moratorium since 2006. This costs the government Rs. 7-10 billion per year. The state has also issued a large amount of guarantees in favour of the CEB.

The CEB has set out to improve its financial and economic performance. Measures are being introduced to improve the efficiency, reliability and management of the system. The energy mix is also being diversified to drive down unit costs.

The commissioning of the Norochcholai coal-fired power plant and the Kerawelapitiya power plant is expected to reduce the cost of production significantly, with less reliance on expensive thermal generation. The CEB was expected to break- even (excluding accumulated debt servicing and capital expenditure) following the electricity tariff adjustments announced in the Budget (Nov 2010). The prospects of the CEB breaking-even this year would have been affected by the temporary closure of the Norochcholai and Kerawelapitiya power plants, in July, and the low water levels in the reservoirs servicing hydro-based power generation. While operational losses are expected to be eliminated, the ambitious development plans for the power sector will continue to require considerable financing. This raises the question regarding the appropriate mix of budgetary and private funding for the power sector that is aligned with the overall public investment ceiling of 6% of GDP.

The **CPC** has also been incurring heavy losses (Rs **28.6** billion in 2010). This was entirely due to the CPC having to sell Heavy Fuel well below the actual price and the large unpaid dues from the CEB. Historically, governments have found it difficult to resist populist pressures for increased subsidies, when international oil prices rise, thereby undermining fiscal discipline. The government has, in recent times, sought to maintain its trajectory of fiscal consolidation by passing through the increased international oil price.

The Iranian credit line for fuel purchases has helped ease the CPC's liquidity constraints stemming from the losses incurred from the sale of subsidized Heavy Fuel. The CPC has also commenced preliminary work on expanding the Sappugaskanda oil refinery. This project is expected to double the processing capacity of the refinery, thereby increasing the commercial viability of CPC and enhancing energy security. However, there are technical and financing concerns regarding the project.

The **NWS&DB** operates connections that reach about 40% of the total population. The average water tariff neither covers the basic operating cost nor encourages water conservation. Water wastage and uncollected revenues are other issues that need to be addressed. This has resulted in liquidity constraints that have prevented the NWS&DB from repaying Treasury loans. The government's envisaged investment plan (2010-2015) for the sector would place pressure on the budget. This again raises the issue whether private financing would be useful to meet the targets in this sector.

The total revenue generated by the **SLTB** is insufficient to meet total operational expenditure, despite the receipt of an inefficient route subsidy, as well as a subsidy to meet salary commitments. High cost structures, particularly staffing costs, are a major issue for the SLTB. This can be addressed by developing profit centres in each depot as a means of improving commercial viability.

SLPA has experienced a decline in profitability. This may be attributed to the sharp increase in employment costs, since 2005. The SLPA has not made any contribution to the Consolidated Fund in the form of dividends or levies. However, the government is disbursing considerable resources to the SLPA for Port development.

SLR is faced with a high cost structure, coupled with poor quality service, declining traffic and inadequate resources for modernization. Allocations for capital expenditure have been utilized to reduce the backlog of deferred maintenance. This has had the knock-on effect of a decline in rolling stock. SLR's share of passenger (7%) and freight (2%) transport has been declining steadily over the years. It has incurred losses year after year.

The hope has been expressed that the railways would account for a substantial proportion of freight movements. However, this would require major reforms that increase both the efficiency and level of service. International comparisons indicate that for distances less than 400km, it is difficult to provide rail freight services that are competitive vis a vis road

transport because of the high capital costs. However, it is likely that passenger services for the commuter belt around Colombo and links between major cities could be run on a viable basis. The Colombo-Kankesanthurai link, in particular, was commercially viable before the conflict. The railways can also be an important component of multimodal transport systems supporting airports and ferry services.

A possible way ahead is to carve out the profitable segments of the railway system. This can be operated as an integrated train and track system; or the operations of the trains can be separated from the building and maintenance of the track. The latter model has been tainted by the unsatisfactory UK experience. However, there are valuable lessons that can be distilled from the UK experience to develop a more robust model. One option for meeting the large investment required is to consider whether private participation can deliver value for money, while reducing the call on the over-stretched public purse.

The railways also own valuable land in cities and rights of way linking all the major population centres. There is considerable potential for turning this into a lucrative means of mobilizing resources.

New Paradigm

The government has recognized that it is essential to reduce the losses of SOEs to maintain its trajectory of fiscal adjustment. Sri Lanka cannot be a low inflation, low interest rate, high investment and high growth economy without fiscal consolidation. Reducing the losses of SOEs has to be an important element of fiscal adjustment. Significant progress has already been made. It must be consolidated and built upon.

The need for maintaining fiscal discipline has been heightened by the risks associated with the public debt and Sri Lanka attaining middle income country status with reduced access to concessional financing (foreign aid).

The attainment of lower - middle income country status has also raised questions regarding the viability of the model of subsidized economic services that has been seen in this county. It has not delivered efficiency or equity (as the subsidies are poorly targeted). When Sri Lanka was a low-income country, there was a stronger case for providing subsidized electricity, petrol, public transport and water. The resulting losses of the state-owned providers were borne by the balance sheets of the government and/or the state banks. The country was effectively living beyond its means. This was made possible by the access available to generous amounts of foreign aid. Whenever there was the threat of a fiscal crisis, Sri Lanka, which was a “donor darling”, was able to mobilize sufficient concessional funding to restructure the balance sheets of both the government and state banks without too much pain. The reduced access to concessional money, as well as increased exposure to commercial markets that accompanies lower-middle-income

country status, challenges the **sustainability of the current subsidy-driven model for public provision of economic services**. There is now an even greater need for SOEs to be commercially viable as the room for fiscal maneuver available to the government has been reduced. It has become much more difficult to fund unsustainable budget deficits without the risk of a financial crisis that would have a devastating impact on output, incomes and employment (similar to the middle-income country debt crises experienced in Latin America)**. Attainment of lower-middle income country status has necessitated a shift to a new paradigm based on a combination of cost-reflective pricing and a well-targeted social safety-net. The current subsidy-driven model is not viable without access to generous amounts of concessional financing.**

Conclusion

Cost reflective pricing and efficiency measures can **reduce/eliminate SOE losses** and make a major contribution to mobilizing the resources needed to meet the country's infrastructure targets on a sustainable basis. At present, subsidies are also poorly targeted. As per capita incomes increase, it becomes even more important to rationalize them. These elements would need to be an important part of reforms to strengthen the operational efficiency of state-owned enterprises.

With regard to improving further the efficiency of SOEs, they should be restructured, where, necessary, including through the unbundling of highly integrated entities, such as the CEB and SLR. Such unbundling will enable the authorities to identify the units that require corrective intervention. Consideration can also be given to increasing competition in the import of and distribution of petroleum through moving beyond the current duopoly, on the basis of a level playing field.

The way ahead in lower-middle income Sri Lanka seems to imply more realistic pricing of economic services, combined with a well designed social safety net involving income transfers to needy households (this requires the reform of the Samurdhi programme as well). Such a package of reforms seems necessary to attain much-needed fiscal stability and deliver the necessary quantity and quality of infrastructure, while responding to need-based equity through effective social transfers. Failure to eliminate SOE losses will place a burden on the people through different channels: higher taxes; foregone infrastructure development/delivery of basic services (e.g. education and health); and increased interest payments on higher levels of debt. **It is also unrealistic to assume that resources will be available to implement the government's infrastructure development programme without significantly reducing SOE losses. The fiscal space does not exist for this.**

The current subsidy-based model of delivering economic services is no longer affordable without risking a major financial crisis such as in Latin America in previous decades and Greece today. A paradigm-shift is required to a new model based on cost-reflective pricing

and a well-targeted social safety-net. A safety-net based on income transfers is preferable as subsidies distort resource allocation and discourage conservation.