The Pathfinder Economic Alert

Excessive Salary Increases: Will the people and the country win or lose?

> *has been a deficit in the current account of the budget (public dissavings) in every year Can Sri Lanka afford to live beyond its means in this manner any longer? As a lower e country, it now has much less access to foreign aid and is more reliant on comm ving. Capital markets are brutal in the way they deal with macroeconomic imbalances a higher premium on maintaining macroeconomic stability than ever before. Fiscal consoli be at the top of the economic policy agenda. It is essential not only for reducing gover ings in order to help attain the investment necessary to place the economy on a higher g ory but also for the demand management necessary to contain inflation and achieve low i as well as a stable and competitive exchange rate. This is essential for creating the en nment for rapid economic progress*

Fiscal performance is an important determinant not only of macroeconomic fundamentals but also the overall trajectory of the economy. Increased government involvement in the economy, over several decades, has led to a sharp rise in government expenditure. At the same time, revenue collection has been weak. As a result, for much of the post-Independence period, Sri Lanka has experienced a structural budget deficit.

Overall budget deficits have been a permanent feature since 1956. Major explanatory factors on both the expenditure and revenue sides have been: an early commitment to high welfare expenditure (influenced by the Parliamentary strength of the left parties at the time of Independence and the creation of the welfare state in the post- 2nd World War Britain); the increase in the size of the public service; a decline in revenue from trade taxes; losses of SOEs; and escalating defense expenditure, particularly after 1983.

These deficits have been financed by high levels of borrowing from both domestic and external sources. The constant recourse to deficit financing has meant that debt and debt servicing have remained high.

Large domestic borrowing has also increased inflationary pressure in economy and exerted upward pressure on interest rates. External borrowing, much of it concessional, has generally been maintained at prudent levels though recourse to commercial borrowing has, from time to time, exerted pressure on the external position of the country.

It is not undesirable for a developing country to incur a budget deficit to provide the basic services and physical infrastructure necessary to accelerate growth and development. However, the deficit should be of a magnitude that does not fuel excess demand leading to inflationary and balance of payments problems. Nor should it result in a level of borrowing that crowds out the private sector by driving up interest rates. A build up of domestic and foreign debt servicing also preempts resources that would otherwise be available for provision of basic services or development activity capital expenditure). At present, total debt servicing (amortization and interest payments) exceeds total government revenue.

Borrowing for development activity, which generates a sufficiently high rate of return to service the debt, is sustainable. Attention must, therefore, be paid not only to the quantity but also the quality of development activity. Public investment that generates low returns serves to exacerbate the debt problem.

Borrowing to finance current expenditure is inherently unsustainable. External borrowing, particularly short-term commercial debt, for this purpose is especially dangerous. Several countries have gone down this route and have experienced severe financial crises, which have had extremely painful consequences for their people. The devastating crisis in Argentina is a recent example of this in a developing country.

It is noteworthy that the government had a surplus in the current account of the budget (revenue minus current expenditure) for the first 20 years after Independence. At the time of Independence, there was a current account surplus (public savings) of 3.5% of GDP. The average public savings rate for the subsequent two decades was 3.1% of GDP. The surpluses were available for development activity and public debt was contained at relatively low levels. The current account of the budget first recorded a deficit in 1968. Such deficits have been continuous since 1988. In 2009, public dis-savings amounted to 3.7% of GDP. This is clearly unsustainable, particularly as debt and debt servicing have reached worrisome thresholds.

Sri Lanka has clearly been living beyond its means for many years. As mentioned in an earlier Pathfinder Foundation Economic Alert, this has been possible through recourse to generous levels of conceessional external assistance. However, the rules of the game have changed significantly now that Sri Lanka has attained lower-middle-income country status. This now means greatly reduced access to foreign aid. As a result, the country is much more reliant on capital markets for its external borrowings. The terms and conditions attached to such borrowings are far more stringent. In addition, market confidence is extremely volatile and risk appetites can change very quickly.

Capital markets tend to lend countries more than they should when the going is good. They also punish them more harshly than warranted, if and when confidence is lost. A taste of what can happen was experienced in 4Q 2009, when about $ 480 million flowed out of the country and the Central Bank used $ 1.2 bn of reserves to protect the value of the rupee. The new context places a much higher premium on maintaining macro- economic stability than ever before. As the budget is the main source

of instability in the system, the stable environment needed to accelerate growth and development cannot be achieved without fiscal consolidation.

This is the context within which the case for salary increases should be considered. As mentioned above, fiscal consolidation has to be at the top of the policy reform agenda. It is essential for both: reducing government dis-saving to help attain the investment necessary to place the economy on a higher growth trajectory; and for managing aggregate demand to contain inflation and achieve low interest rates, as well as a stable and competitive exchange rate.

Fiscal consolidation should ideally entail a combination of increasing revenue, reducing current expenditure and containing capital expenditure at its current level of 6-7% of GDP. Revenue can be increased by a combination of introducing marginal tax rates that encourage compliance; broadening the tax base; rationalizing tax concessions and exemptions; simplifying the import duty structure; and strengthening tax administration through streamlining the tax structure and introducing new technology. The Tax Reform Commission seems to have addressed all these issues. The forthcoming Budget is expected to implement its recommendations.

Reducing recurrent expenditure has always proved difficult. However, ways have to be found to address the unsustainable expenditure on public service salaries and pensions, debt servicing (interest payments), losses of SOEs, subsidies and transfers, defence expenditure, conspicuous state consumption and waste.

Real wages have declined in recent years as salary adjustments have not kept up with inflation. However, a large salary increase at this point is likely to be counter- productive. It would undermine the fiscal consolidation necessary to improve the competitiveness of the economy- an essential prerequisite to boost its growth prospects and its capacity to generate productive employment that provides higher incomes on a sustained non- inflationary basis.

A large salary increase would fuel inflation. When salary increases are not linked to improvements in productivity, aggregate demand is boosted without a matching increase in the supply of goods and services. The resulting rise in prices, therefore, erodes the value of the salary increase in real terms. This serves to negate the point of the whole exercise. Inflation is also a highly regressive implicit tax on the poor. The appreciation in the value of assets owned by the wealthy provides them with a hedge against inflation. The poor have no such means of mitigating the adverse impact of inflation on their incomes.

Sri Lanka is at a historical conjuncture of immense promise on the development front. Its potential cannot be realized without addressing the structural budget deficits, which have been a major drag on the economic prospects of the country for over thirty years. A populist salary increase would only increase the magnitude of an already difficult challenge. There is an unprecedented opportunity to accelerate development. The question that remains to be answered is whether the political will exists to take the difficult decisions necessary to grasp it. The forthcoming budget offers the opportunity for

assessing whether the government has the commitment and political courage to use its decisive majority to create the enabling environment for rapid economic progress in the country.

As the Pathfinder Foundation has noted recently, there are demands for very high salary increases from various political parties and professional groups. Can a Government which seeks to narrow the current unsustainable budget deficit accommodate such demands without compromising development of the country and the living standards of the poor? In this Economic Alert, we have sought to set out the limitations and self- defeating nature of excessive salary increases.

This is the thrid in the series of Economic Alerts issued by the Pathfinder Foundation. Readers' comments via email to pm@pathfinderfoundation.org are welcome.