Pathfinder Economic Flash

CPC and CEB: Without Reforms We Will All Tumble Down

The Case for Going beyond Monopoly and Duopoly

The Pathfinder Foundation (PF) welcomes the recent adjustment in fuel prices and the anticipated further reforms in the power and energy sector. It has advocated institutional changes, competitive industry structures and PPPs as in the case of the telecom sector. The massive accumulated losses of the CPC and CEB, amounting to about Rs. 400 billion, have seriously undermined not only the health of the state banks but ultimately public finances as a whole.

The unsustainable losses incurred by CEB and CPC are primarily due to the non pass-through of the international prices of oil to consumers and the highly inefficient institutional structures of the respective organizations. The subsidy arising from this was kept off the government balance sheet by transferring these losses to the books of the two state banks. The risks associated with the financial fragility of any state bank must ultimately be borne by the government. This means that these contingent liabilities result in the government's balance sheet being significantly worse than indicated by the headline figures given for the budget deficit.

The measures being introduced to arrest the steady hemorrhaging of the financial position of the state banks, and ultimately the government, are therefore much needed. The authorities need to be commended for the price adjustment measures and other anticipated structural and institutional reforms of the sector. As evident from experience of Sri Lanka (such as the telecom sector) as well as other countries, benefits for the customers, as well as for the government, can be realized through opening up of these sectors to a larger number of participants from the private sector.

Continued adjustment of fuel and electricity prices to reflect the international price of oil will address a major part of the problem. However, there are also structural issues which continue to hamper the operational efficiency of these two State Owned Enterprises (SOEs). The cross subsidization that currently provides a safety net for low-income groups (i.e. kerosene subsidy) should continue or be replaced by direct transfers from the government budget.

The Pressure for Subsidies: The Political Challenges

It is important to understand the underlying causes of the political compulsions that make it difficult for Sri Lanka to absorb the international price of imported oil. One can identify three reasons for this: macroeconomic, structural and subsidy addiction. The **macroeconomic** explanatory factor relates to the unsustainable budget deficit that has existed since 1977. It has led to Sri Lanka being a high inflation economy in relation to most of its competitors and trading partners. This has meant that the financing costs in the economy have been uncompetitive as nominal interest rates have been high. In addition, the inflation differential between Sri Lanka

and its competitors and trading partners has placed constant pressure on the exchange rate. In a country where the basic consumption bundle has a high import component, the politically expedient option has been to maintain an overvalued exchange rate for long periods of time. The negative impact on competitiveness of the combined effects of high nominal interest rates and an overvalued exchange rate has, in turn, generated pressure for the subsidization of fuel and energy as a means of compensating for this.

In the past, Sri Lanka has been able to sustain this non-virtuous policy framework because of generous access to concessional loans and grants. As a lower-middle-income country, that option is no longer available and the headroom for commercial borrowing is also diminishing. Sri Lanka now has to bite the bullet and address the underlying problem i.e. the unsustainable budget deficit. However, if Sri Lanka opts for "business as usual" and higher fuel and energy prices are imposed on top of high interest rates and an overvalued exchange rate, large swathes of the productive capacity of the economy would come under pressure and growth would plummet well below the target of 8%; and jobs will be lost.

The **structural** aspects of the underlying political pressure for subsidized fuel and energy relate to low productivity. Sri Lanka's productivity is half that of Thailand. Such low productivity means that incomes have to be maintained at levels that make it very difficult for a significant proportion of the population to absorb the international price of oil. ***It is often inappropriately stated that Sri Lanka has a high cost of living problem. It is more pertinent to say that the country has a low productivity/low income problem***. ***Incomes can only be increased in a non-inflationary way through increased productivity.***

Since independence Sri Lankans have been made **subsidy junkies (addicts)** especially with regard to rice and other food items. Following the dramatic international oil price increases experienced from 1972/73 our politicians have developed the habit of subsidizing or cross-subsidizing either diesel or kerosene to achieve short-term political gains. This subsidy dependent mentality has been the justification for maintaining highly inefficient, wasteful and corrupt structures in the power and energy sector.

Is there a way forward?

The authorities are to be commended for taking action to reverse the massive losses incurred by the CPC and CEB which have severely undermined the liquidity position of the state banks and ultimately the health of the government balance sheet. While welcoming this, it is important that the authorities now move beyond ad hoc piecemeal measures to more comprehensive reforms that incorporate: 1) broad basing the power sector through opening it up for new players and creating an environment to ensure a competitive pricing mechanism; 2) unbundling of CEB to help identify specific operational and management aspects for efficiency and productivity improvement; 3) further liberalizing Petroleum imports, storage, distribution and retailing so that the Ceypetco & IOC duopoly is ended (an internationally renowned Sri Lankan regulatory expert pronounced that the only thing worse than a monopoly is duopoly); 4) further fiscal consolidation, in the medium-term, to transform Sri Lanka into a low-inflation/low-interest rate/stable exchange rate country and therefore, an internationally competitive economy; and 5) structural reforms that generate productivity-induced increases in income levels to enable the population to absorb more easily the international prices of oil and other goods. There are both efficiency (growth/employment) and equity (welfare) considerations for supporting the price increases in fuel and energy with a more ambitious reform package. The adjustment of fuel and energy prices is a necessary but not sufficient condition for placing the Sri Lankan economy on a long-term accelerated growth path that also generates higher value employment.

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