

# World Bank economist warns of worsening crisis in Sri Lanka

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Hans Timmer, the World Bank's chief economist for South Asia, has warned that promised tax cuts by the new minority government of President Gotabhaya Rajapakse could destabilise the economy and deepen the island's financial crisis. His comments were made at a December 3 public lecture hosted by the Central Bank of Sri Lanka in Colombo.

Timmer acknowledged that the government's plan to boost the economy in the lead up to the forthcoming general election but cautioned that its "stimulation package" was risky and insisted on the full implementation of the "structural reforms" demanded by International Monetary Fund (IMF).

"Sri Lanka may not have the needed fiscal space for an ambitious stimulus," he said. Fitch Ratings, the global ratings agency, had previously warned that new tax concessions would derail budget discipline. Imposition of "fiscal discipline" means slashing the country's budget deficit as demanded by the IMF. The IMF wants the Sri Lankan government to reduce the deficit, which has risen to 7 percent of gross domestic product (GDP) this year, to 3.5 percent.

The minority government's recent concessions include a reduction of individual income tax rates from 24 to 18 percent; abolition of the 5 percent withholding tax on dividends and interest; abolition of the Nation Building Tax; exempting agriculture, fishing, livestock and information technology services from income tax; and a reduction in the Value Added Tax (VAT) from 15 to 8 percent. The previous government, on IMF orders, had increased VAT.

The Sri Lanka Podujana Peramuna (SLPP) government and the media have insisted that the tax reductions will boost business and the ailing economy and increase consumption.

Moody's Investors Service, however, has predicted

that the tax cuts will reduce government income by between 1 and 1.5 percent of GDP. The government estimates a 500- to 550-billion rupee (\$US3 billion) annual decrease.

Timmer noted that South Asia, after five years of being the fastest growing region in the world, was experiencing a steep reduction in growth projections. India's GDP growth, previously considered one of the engines of the global economy, is expected to decline this year to less than 5 percent. Sri Lanka's growth has been projected to fall to 2.7 percent.

The World Bank economist said that "huge uncertainties in growth markets with trade wars, policy uncertainties [and] political tensions" would exacerbate economic difficulties in South Asia. "The big problem in South Asia is that there is no fiscal rule which impacts on the macroeconomic environment" and added that "crony capitalism" was a common problem across the region.

Timmer called for increased "formalisation" of the economy, noting that 80 percent of South Asian workforce was in the informal sector and there was an "underutilization" of women workers. The World Bank, he continued, was focused on bringing the informal sector into the formal sector so that tax income could be increased. In other words, to create the conditions to further reduce business and investment tax rates.

Timmer warned that unless Sri Lanka reduced protectionism the country's growth prospects were bleak. The structural changes required, he said, included broadening the tax base and reducing government spending—i.e., further cuts to health and education and rural subsidies.

The business environment would be developed, he continued, through a "private investment-tradeable

sector-led growth model” to “improve governance and performance of state-owned enterprises.” This implies cutting funds to the state-owned enterprises, forcing them to become profitable and privatising them.

Timmer called for the “underemployed” or “unutilised labour” to be fully utilised and said the aging population was a burden on the economy. He said arrangements were needed to boost skill levels, improve productivity and encourage “longer working lives.”

Timmer’s remarks were delivered as the Sri Lankan economy confronts a severe crisis with the foreign and domestic debt burden now at 85 percent of gross domestic product (GDP) and the country’s growth rate dropping to similar levels as Pakistan and war-torn Afghanistan.

Central Bank governor Indrajit Coomaraswamy recently warned that Sri Lanka would face the same situation as Greece if it failed to raise the required funds to service its debts. Colombo currently needs about \$US4 billion per year, until 2022, to pay its debt.

President Rajapakse hopes to consolidate his regime by obtaining two-thirds majority in parliament by holding a snap general election in April.

While Rajapakse is desperately attempting to generate some positive economic news and win electoral support, the government has announced initial expenditure cuts to all government ministries, departments and statutory boards and agencies.

On December 3, the finance ministry said that the estimated fiscal deficit for 2019 would be 7 percent of GDP and the government would “make a concerted effort to recalibrate its operations along a sustainable deficit reduction path towards 4 percent of GDP in the medium term.” The next day, the finance ministry issued a circular that said “all non-essential and non-priority expenditure” was to be curtailed at the request of the president.

Rajapakse’s government has also indicated that it will need the last instalment of the IMF bailout loan negotiated by the previous government. The IMF will no doubt insist that the new regime sharply reduce the fiscal deficit and implement its austerity program.

While Rajapakse is hoping to win a two-thirds majority in an early general election his government will soon confront a combative working class that will not tolerate further attacks on its living and social

conditions.



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