Budget 2023: Heal the Wound or Worsen it?

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The 2023 Budget proposals will further aggravate the problem of high inflation and rising unemployment, with no mechanism to address capital outflows which triggered the ongoing foreign exchange crisis. The key objective of the Budget is to raise government revenue up to about 11% of the Gross Domestic Product (GDP), from around 9%. The expectation is to collect as much tax revenue as possible and reduce the fiscal deficit. The conventional neoliberal idea is that Balance of Payments (BOP) crises in any economy are created by large fiscal deficits. Following that view, this budget is trying to reduce the fiscal deficit and prevent it from transforming into a BOP deficit. How is this related to the foreign exchange crisis the country is facing? I characterise the problem as a liquidity trap in the foreign exchange market in a context of economic backwardness, also escalated by the monopolistic structure of Sri Lanka's external sector. I want to begin by briefly explaining the foreign exchange crisis and how the Budget proposes to address it.

Fiscal Deficit and the Balance of Payment Problem

A leakage can be defined as a net outflow of foreign exchange from the economy, which can happen through the private or public sector. The neoclassical or neoliberal view asserts that the fiscal deficit is the primary cause for foreign exchange leakage from an economy. But contrary to that view, a chronic BOP crisis may be triggered while fiscal deficits remain quite low or are in surplus. For instance, Mexico and Argentina—currently facing similar chronic BOP crises – are experiencing very low fiscal deficits. Argentina defaulted on its foreign debt when its fiscal deficit was around five; and Mexico was having budget surpluses while they were facing extreme foreign exchange shortages.

These examples suggest that the leakage is not happening so much through the public sector. I am not however implying that there is no leakage through fiscal operations, but merely that the experience of the above economies shows how capital is predominantly flowing out through the private sector. Furthermore, we can also say Sri Lanka experienced budget deficits of well over 10% consecutively after 1977. But it was not a sufficient condition to trigger a crash of this magnitude. So, the proposition that the budget deficit is the root cause behind the BOP crisis can be contested in the context of Sri Lanka's recent history.

There is a significant outflow of capital through the private sector and that is much larger than our foreign debt currently in default. Global Financial Integrity, the Washington based think tank that specialises in studying and estimating illicit capital flows from developing countries, in December 2021, indicated that around 40 billion USD has been flowing out of the Sri Lankan economy from 2009 to 2018. This is a gross underestimation in my opinion. The report itself clearly highlights that trade mis-invoicing and transfer mispricing takes place through three different channels, and that they only looked into one particular method which is trade mis-invoicing through the open accounts system in merchandise trade. The other two methods are merchandise trade through letters of credit system (transfer mispricing is used under this method), and the services trade that does not come under the standard

HS Code System. So, within that limited framework they are indicating that roughly 40 billion USD has flown out of the country during this period.

Hyperinflation and Foreign Exchange Liquidity Trap

The other point about capital flight is that Sri Lanka has been experiencing trade surpluses during the last three to four months, and aggregate export income in 2022 was the highest in history. While we experience trade surpluses and record high export incomes, the banking system is experiencing serious foreign exchange shortages. Hand in hand with the foreign exchange shortage we also see tremendous shortages of essentials like medicine, food, paper, fertiliser, etc. This has led to hyperinflation because there is great disparity in income distribution in Sri Lanka: the upper middle classes yielding higher purchasing power will literally buy at any price available in the market. As a result, prices of essentials have shot up to levels two to three times greater than the rate of currency depreciation. We know that the rate of deprecation has hovered around 80% since April 2022, but the price increases of essentials have been far greater.

The 2023 Budget tries to address hyperinflation by reducing the fiscal deficit and increasing government revenue. The problem with this approach is that it does not address the leakage of foreign exchange through the private sector. What we are experiencing right now is a complete market failure in the external sector characterised by a liquidity trap in foreign exchange markets. That is to say, capital flows are not responding to the interest rate and exchange rate mechanism in the economy. As a result, monetary policy becomes powerless to influence capital flows, as demand for foreign exchange becomes highly elastic with respect to the interest rate and the exchange rate.

For instance, we have a currency that depreciated by 80%, which is far greater than the 17% depreciation the International Monetary Fund (IMF) recommended in its Article IV consultation in March 2022. Despite the unprecedented depreciation of the Rupee, the inflow of foreign exchange is inadequate at least to sustain the inflow of essential imports. When the exchange rate depreciates, domestic assets become cheaper, so it is more advantageous for whoever is holding foreign exchange to move their capital into the country. And when you raise the interest rate, that is also an incentive for people with foreign exchange or capital outside the country to bring that capital into the country given that returns of doing so are now higher. Interest rates have shot up about three times to around 30%, while the exchange rate also crashed by about 80%.

However, neither mechanism was able to attract the foreign exchange that is flowing out. For instance, recently the Governor of the Central Bank said that the exporters are not converting or repatriating their foreign exchange income. There has been an outflow of about 6.8 billion USD during 2022. The Budget has no answer for all these issues. So, despite the crash in the exchange rate, despite the increase in the interest rates about two to three times, the incomes that are already generated in the economy by workers are not accessible to the government or the public in general. It is captured by a business elite in the import-export sector who are more inclined to keep the capital outside the country.

Character of Savings

For an economy to grow and expand it needs to increase domestic savings and transform such savings into productive capital, which would result in greater employment and output. Sri Lanka has one of the lowest savings rates in the world. However, it does not mean that the private sector business elites do not have savings. Their savings are in the form of luxury apartments, vehicles, villas, and so on. What is the character of these assets? Are they productive? Can we employ these assets productively in the economy? What we can say is that they are foreign exchange consuming. On the other hand, you have a saving, an investment, and consumption, taking place at the same time. For instance, the owner can basically use a luxury apartment for his personal consumption, he can use it as a store of value, and also as an investment that generates capital gains and rent.

So, this particular asset class simultaneously engages in consumption, investment, and savings. We cannot restrict it to a particular category. Is the accumulation of these assets by the private sector addressing the key issues in the economy or making them worse? Obviously, we have a shortage in capital goods, essential requirements like food, stationery, fertiliser, machinery for the agricultural sector, and so on – the essential output which any economy would need to prosper. But the assets in the private sector that remain within the country also are not invested in these sectors and are used unproductively. But the Budget is trying to portray or frame workers as unproductive.

We need a working plan to transform these unproductive assets into tradeable savings where we can retransfer it to foreign exchange and into productive capital. This is not the place to go into how we can do that now; however, the Budget is trying to portray the workers as unproductive, not the business elites in the private sector.

Privatisation

The Budget proposes privatisation of State assets as the only means of boosting foreign exchange availability in the economy. It justifies privatisation by showing inefficiency of the public sector and the fiscal deficit hand in hand with lethargy of the workers as the root causes of the crisis. So now the solution is to bridge the budget deficit by starting a wave of privatisation of even profit-making State institutions, and relaxing labour laws. Contrary to this mainstream view, it is the business elite that is employing resources in a way that is unproductive from the perspective of the society. It must be productive for them individually to park assets the way they do, but if we take the collective requirement of the economy and society, it is highly unproductive. By trying to portray the government sector as unproductive, the Budget is implying that the private sector is productive. We have to reframe how people understand the crisis, and campaign against privatisation of State assets.

Taxation and Inflation

The other most pressing issue is unbearable food inflation. What's the 2023 Budget's response to addressing hyperinflation in the economy? The answer seems to be increasing direct taxation. A few months before the 2023 Budget, the government proposed to increase direct taxation. They introduced a wave of income taxes on higher income earners of the working class, the professionals, the managerial class, and also on corporate profits, trying to portray the Budget as progressive given that direct taxation is not inflationary.

This was the initial proposal. We must however consider corporate taxes specifically targeting exporters. Board of Investment (BOI) registered exporters were enjoying lengthy tax holidays and they are exempted from taxation on import of all inputs. Exemption of BOI firms from taxation are also a main contributor to the drop in government revenue as a share of the GDP. It has fallen from around 22% in the early 1990s to 8% in 2022. BOI firms account for over 70% of the merchandise export income. Here is a sector in the economy that is significantly important and significantly large compared to the rest of the economy that is not being taxed at all. This means that the GDP expands, while the demand for government services is also rising, without necessarily increasing tax revenue. This also contributed to the yawning fiscal deficit. So initially just before the Budget the government was suggesting to repeal all tax holidays, and tax the export sector evenly 30% on its profits. But the 2023 Budget has dropped that proposal.

The Budget estimates a 60% growth in direct tax revenue and surprisingly the indirect tax income is projected to increase by an even greater rate of 80%. So, while the government frames the Budget as progressive and non-inflationary, direct to indirect tax ratio is projected to fall down to around 29% from 30% in 2022. Although it seems like a small decline, it has a massive inflationary impact. Therefore, despite the significant increase in the direct tax component of the budget, it is still predominantly directed at the general public in an inflationary way.

A 'Stagflationary' Budget

With higher inflation, interest rates would rise further or remain elevated, aggravating the unemployment problem. This leads to stagflation, that is, the prevalence of high inflation hand in hand with high unemployment. So, the 2023 Budget is in fact aggravating stagflation we already witness in the economy. The Budget is re-imposing the traditional way of looking at the economy through IMF lenses, which is only focusing on the external sector equilibrium of the economy, or in other words the balance in inflows and outflows of foreign exchange.

Balancing the external sector alone does not ensure the economy is in equilibrium. There are labour markets, the balance of payments (reflected through the balance in investments and savings), as well as the goods and services markets (which is reflected through inflation) which need to be balanced at the same time for the economy as a whole to reach equilibrium. The government is focused on balancing the investments and savings problem or the BOP problem in the external sector. When the focus is only on balancing the external sector through interest rate and exchange rate mechanisms and through slashing the budget deficit, we end up pushing other sectors of the economy into chronic disequilibrium. This is the meaning of stagflation: the prevalence of multiple disequilibria in all primary markets of the economy.

I would also highlight the continuation of wasteful spending in the 2023 Budget. Unsurprisingly, the Budget allocated over 530 billion Rupees to maintain the armed forces this year. Also 1.2 trillion Rupees is allocated for public investments. The government is projecting a 2.4 trillion Rupee fiscal deficit in 2023. Out of that, they expect to secure around 600 billion Rupees through foreign borrowings which is almost equal to the defence ministry allocation. The projected increase in foreign indebtedness for the upcoming year is equal to the military budget. Secondly, public investments are mostly wasteful expenditure on roads and highways. So, we see a 20% increase in wasteful spending, amounting to 1.2 trillion Rupees in 2023 while the economy is collapsing.

Conclusion

The 2023 Budget contains the most regressive proposals since liberalisation after 1977. It does not address the inherent mechanisms in the private sector that inevitably lead the economy into recurring foreign debt crises and balance of payments crises as history has repeatedly shown us. The proposals are hence aimed at framing the problem as one of public sector inefficiency and low labour productivity of the working classes, shifting responsibility on to them as the main instigators of the ongoing crisis. By doing so the Budget justifies the sale of State assets and relaxation of labour laws, and at the same time exonerates the private sector from taking responsibility for the crisis. This will further expand the sphere of exploitation of domestic and foreign capital.

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In 2023, the Social Scientists' Association (SSA) will conduct a regular (monthly when possible), seminar-discussion on contemporary agrarian political economy, through mapping an agenda for critical agrarian studies in Sri Lanka in the 21st century.

The seminars seek to be critical of the dominant paradigm in agrarian studies – to be found in international financial institutions, development and donor agencies, university faculties and agricultural research institutions, ministries of agriculture, think-tanks – of "the need to subsume everything to the market, to transform labour, natural resources, the means of production, goods and services into commodities, based on taken for granted principles of private property rights, money and competition—in short: capitalism" [Akram-Lodhi et. al. 2022: 2].

Fundamental to critical agrarian studies is how "social structures, agrarian institutions and political agency of social classes and groups are constructed, reproduced and transformed across space and over time. It privileges inquiries into how the exploited and the oppressed social classes and groups understand their conditions and try to subvert and change them ..." [Borras 2023: 3]. Its objective therefore, is not only to understand the world, but also to transform it.

The SSA seminars intend to investigate connections between agriculture (subsistence and cash crop cultivation, waged work, commercial/agribusiness and plantation crops, fisheries, animal husbandry, pastoralism); rurality; rural-urban linkages; markets; state; relations of class, gender, caste, ethnicity, religion, region; politics, law and governance; conflict; environment; climate; food systems; energy; water; health; techniques of production; livelihoods; rights, among others [Edelman 2016: 1].

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