

ECONOMIC ROOTS OF A POLITICAL CRISIS

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ABSTRACT

Populist politicians have been successful in coming to power in several countries by building their appeal partly on claims that they will base their policies on the needs and interests of the people. However, once in power, their decisions often create grave problems for the very voters they purport to champion. For proof, look no further than what has befallen the people of Sri Lanka. Sri Lanka is facing a clear 'Arab Spring' moment triggered to overthrow the autocratic rule, highlighting the rampant corruption, increasing debt and rising poverty. The purpose of this paper is to understand what led to the devastating economic, political and security crisis in Sri Lanka through an in-depth analysis of various political decisions and macroeconomic factors.

Keywords: Taxation, Ban, Sri Lanka, Autocratic, Externality, Debt.

Introduction

Sri Lanka is facing its worst economic crisis since its independence which has fueled a security and political crisis as well. Sri Lanka is a classic case of twin deficits. Starting as a debt crisis, it has devolved into a greater economic turmoil including shortages of basic commodities, rising poverty levels and a sky-rocketing increase in inflation. This paper is going to explore the reasons behind the deteriorating conditions in Sri Lanka.

1. Taxation

Tax cuts are a major problem in developing countries like Sri Lanka. Tax revenue is one of the state's main sources of revenue. The government faces difficulties in funding government projects and paying government expenditures when taxpayers pay lower taxes.

While Sri Lanka's GDP per capita increased between 1990 and 2020, the share of tax revenue in

total government revenue decreased from 19% to 11.5%. Sri Lanka's tax system is very regressive and relies heavily on indirect taxes, including border taxes, to finance government spending. Regressive tax structures increase income inequality by improperly taxing poor people, but more progressive income taxes account for only 25 percent of their tax revenues.(Bhomwick, 2022)

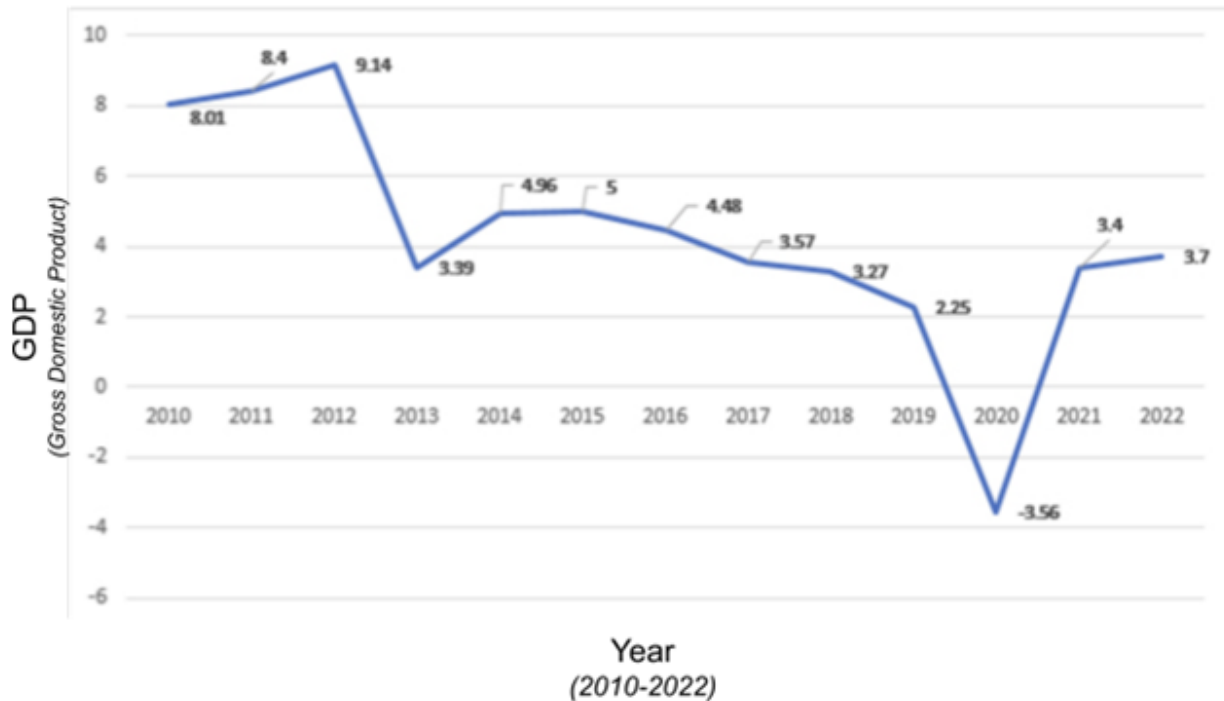
The Sri Lankan Government in 2019 introduced a tax cut in fulfillment of an election promise, prior to the general election in 2020, the year that saw the rise of coronavirus. This created a massive challenge for an economy that was already suffering from widespread tax evasion. This resulted in the worst budget deficit the country had ever seen, eroding an already low tax base by 33.5 percent. This approach to the tax system made it almost futile and was unable to meet the financial needs of a developing country like Sri Lanka since it requires a reformation to a more progressive tax structure.

Table 1: lists the direct and indirect taxes that were amended by the Sri Lankan government.

Tax Category	Amendment
Value Added Tax (VAT)	Reduced from 15 to 8 percent.
Nation Building Tax (NBT)	The earlier 2 percent of NBT was abolished. NBT was combined with the Ports and Airport Development Levy with a relevant ratio of 10 percent.
Economic Service Charge	Eliminated
Debit Tax on Banking and Financial Institutions	Eliminated
Capital Gains Tax on the Share Market	Eliminated
VAT on Sovereign Property	Eliminated
Pay As You Earn (PAYE) Tax	Eliminated
Withholding Tax on Interest Income, other types	Eliminated
Credit Service Tax	Eliminated
Tax on Telecommunication Tariffs	Reduced by 25 percent.

Source: Colombo Page

Figure 2: Sri Lanka’s Real GDP Growth Rate (2010-2020)



Source: World Bank, 2022 Projection by Central Bank of Sri Lanka

Prior to these tax cuts, Sri Lanka already had one of the lowest tax revenue-to-GDP ratios in South-Asia; these cuts created an additional burden on the treasury. The ratio dropped to a disastrous 7.7 percent (See Table 2) in 2021 after the unplanned tax cuts in 2019 and 2020. This led to the loss of approximately one million taxpayers between 2020 and 2022, a massive challenge for an economy that was already suffering from widespread tax evasion.

In the case of Sri Lanka, the government continued to spend money on infrastructure and other projects while remaining in debt, this caused the government expenditure to be greater than the government revenue. This led the country to reach a phase where they didn't have enough foreign reserves to import necessary commodities and were forced to turn to neighboring countries, India, and China as well as the IMF.

2. Infrastructure

The Rajapaska regime, under both Mahinda and Gotabaya Rajapaksa commissioned major infrastructure projects that were supposed to be beneficial for the rapid growth of the Srilankan

economy, however, they have instead turned out to be the harbingers of the economic crisis in the country. The debt-ridden government spent massive sums of money on projects such as the Lotus tower and the Hambantota port that have turned out to be a curse for the country.

Operational since 2011, the Hambantota port recorded losses till 2016. The Government looked towards this port to reprieve from its tremendous debt. The 80% of the port was leased to China Merchants Port Holdings for 99 years in exchange for USD1.12 Billion. However, this money that was supposed to be used for relieving the country of previous debt was instead used to honor its unrelated foreign debt obligations and add to foreign reserves as the country's currency depreciated.

Similar is the story of another port just 258 kilometers away from the Hambantota port, 43% of which was leased to a Chinese investor for USD 1.1 Billion. Since the deal is not a debt-for-equity swap, Sri Lanka will have to repay the money when the 99-year lease is over. (Gora, 2022).

Experts say that one of the major reasons both these projects are floundering is because desire for political growth overshadowed economic rationale and unfavorable viability reports were ignored. Experts, banking professionals, economists and international experts had warned the government but the advice was neglected.

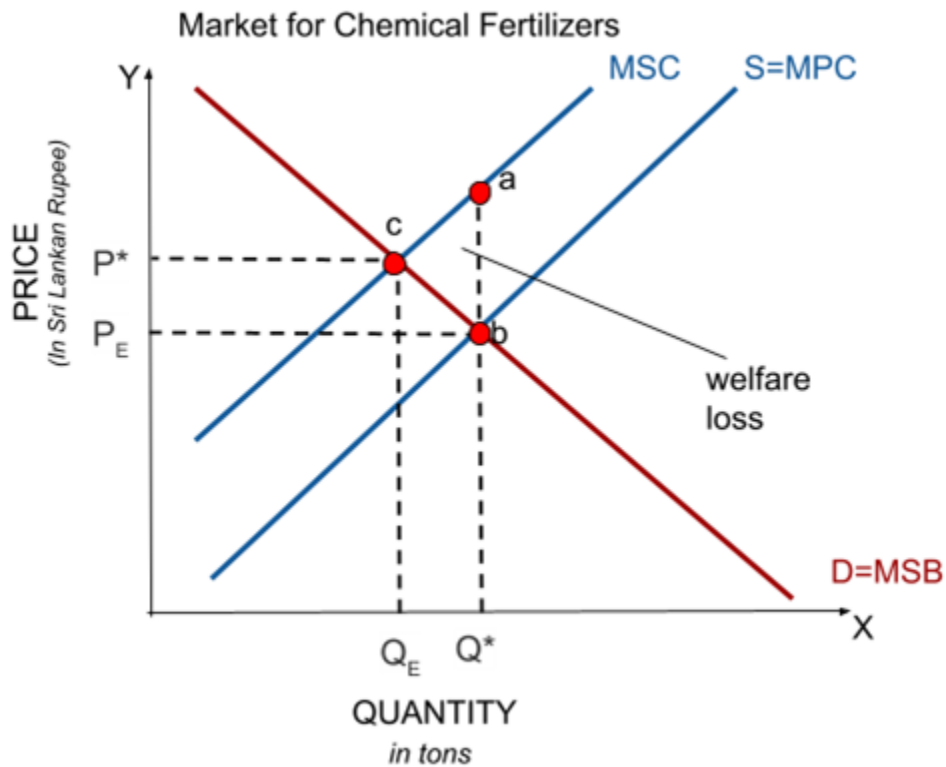
Neither port has delivered much revenue in the last few years because of weak commercial activity — first came the COVID-19 pandemic, which disrupted global supply chains and curtailed operations for the better part of 2 years and then came an economic crisis through which Sri Lanka has had no money to pay for imports and has suffered economic setbacks that have hurt exports.

Now, Sri Lanka is on the brink of bankruptcy and has defaulted several loans. It is negotiating for aid from agencies such as the International Monetary Fund (IMF), and has requested the two powerful countries in its neighborhood, India and China for loans. The vanity projects commissioned by the Rajapakas for supposed economic growth have instead proven to be a doom.

3. Ban on Chemical Fertilizers

For the farmers of Sri Lanka, their problems began when President Gotabaya Rajapaksa, who now stands accused of pushing the country into financial ruin, implemented a sudden ban on chemical fertilizers. The ban was put in place to turn to a green agricultural policy with organic fertilizer and minimize the negative externality of production caused by chemical fertilizers. The

government admitted that the use of chemical fertilizers has led to better harvests but has also contaminated lakes, canals and groundwater. Sri Lanka imported chemical fertilizers worth \$400 million a year. With the ban, according to the government, it would not only save dollars but also the island nation would become the world's first organic-only state.



At free market equilibrium of P_E , quantity Q_E is produced. At that quantity, the external costs to society are very high and are represented by areas enclosed between the triangle abc which represents the welfare loss. This implies that if the price of the chemical fertilizers was to cover all of the relevant costs, the price would be much higher. In fact, the entire MSC curve lies above the MPC curve, showing that the private costs of production are way less than the costs to all of society at every price.

Moreover, if the marginal social costs are the actual costs to society, the intersection of MSC with the MSB curve provides the socially optimal equilibrium point which is the best allocation of resources, where $MSC = MSB$. The socially efficient price and output would be P^* and Q^* . When all the costs are added into the process, it appears that the optimal amount of production is Q^* , significantly less than Q_E , indicating that chemical fertilizers are overused. It can also be

concluded that if the equilibrium price would be higher, at P^* , than the current free market price of PE . Furthermore, there is a misallocation of resources. The distance between MSC and MPC at QE represents the marginal negative externality at that point. If the optimal output and price are Q^*P^* , then the production beyond that amount produces the negative externality, shown by the area of the shaded triangle. Economists refer to this area as a welfare loss. This welfare loss is the reason why government intervention is required in the market.

While most governments have this intervention in the form of taxation, the Sri Lankan government chose an extreme step by banning the chemical fertilizers. This led to a severe food shortage pushing up the retail price of rice by around 30%. Sri Lanka, which usually grows rice and vegetables in abundance, ran out of food as harvests dropped and the government could no longer afford the food imports which it had become over dependent on in recent years. According to reports, Sri Lankan tea production is likely to suffer owing to the government's policy. The country produces about 300 million kg of tea which is an earning of \$1.25 billion from tea exports.

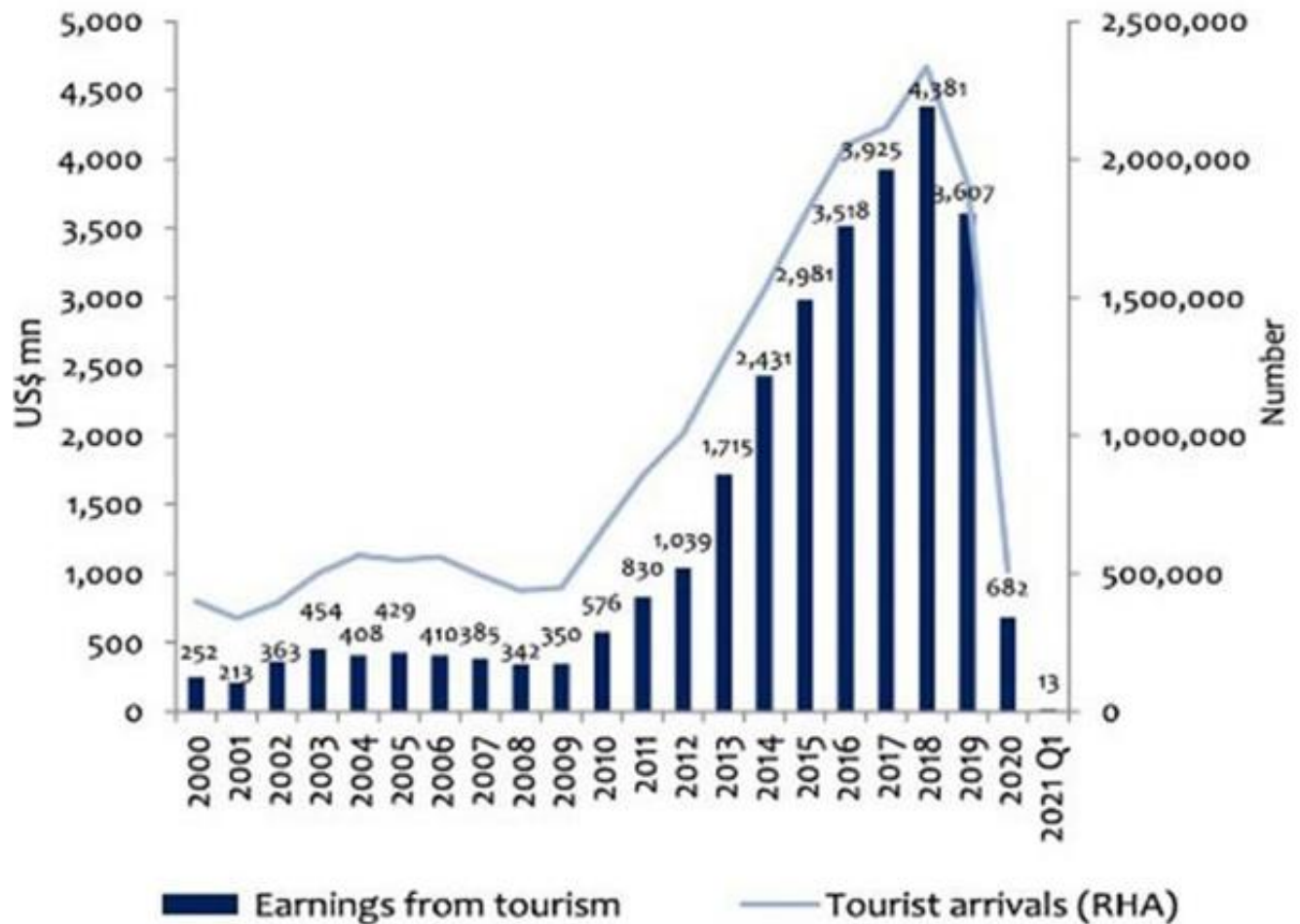
Farmers protested this move. Although the ban was rolled back after widespread protests, only a trickle of chemical fertilizers made it to farms. To ease the hit on consumers, Rajapaksa's administration is importing rice using credit lines from friendly neighbors and it raised the minimum government purchase price and announced a 40 billion Sri Lankan Rupee (\$200 million) compensation package. Sri Lanka's 1.5 million rice farmers are the key vote bank of the nationalist Rajapaksa family, who have helped them with fertilizer subsidies and higher crop prices. The farm sector contributes 7% to the country's GDP but employs about 27% of the workforce, mostly in rural areas. That could make it harder to achieve its 8.8% budget deficit target for 2022, and leading to a higher inflation rate. (Jayasinghe,2022; Ghoshal,2022).

As Sri Lanka's looming economic and political crisis continues, many believe that banning chemical fertilizers may have been the start of the raging protests which led the protesters to burn the private residence of the President.

4. Tourism

The tourism sector in the country became prominent when Sri Lanka took progressive steps to enhance the tourism sector. However, the civil unrest and the Global Financial Crisis had a detrimental impact on the tourism industry as well. It was only after 2010 that this sector saw a vertiginous growth (see figure 3), proving itself to be one of the most important industries in the economy of the country.

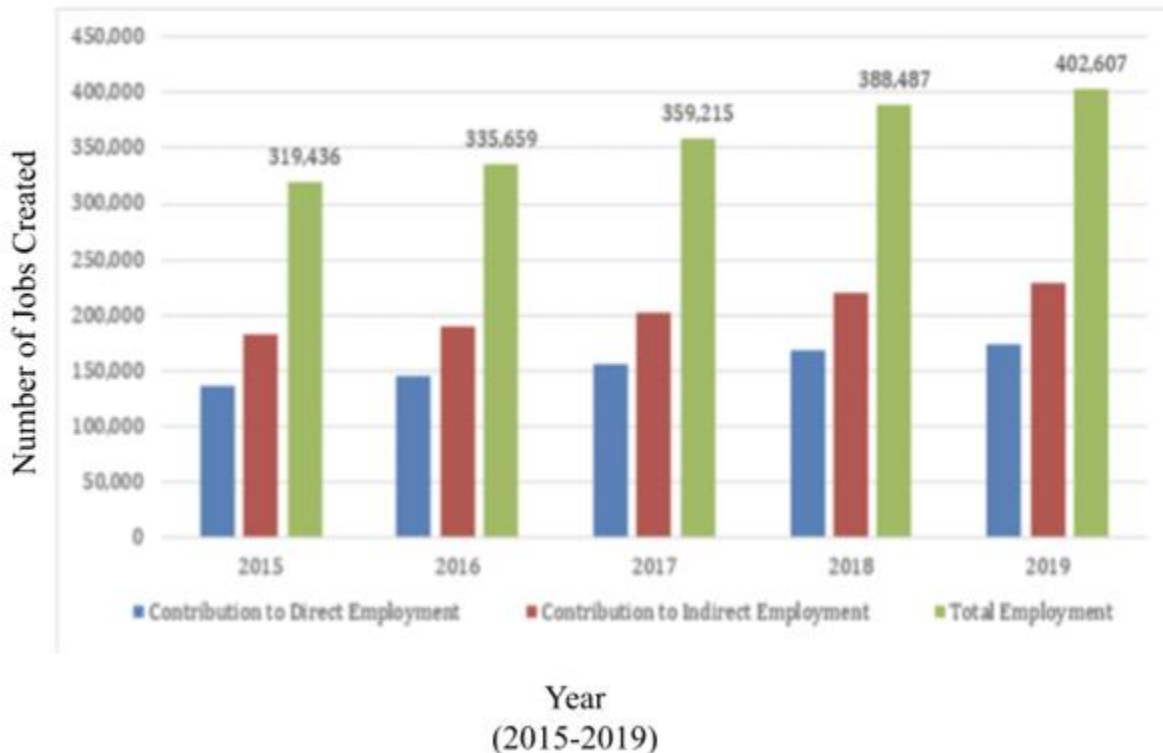
Figure 3: Tourist Arrivals and Earnings in Sri Lanka (2000-2021)



Source: Central Bank of Sri Lanka and SLTDA

Sri Lanka’s tourism sector contributed to direct and indirect employment of many Sri until the pandemic hit (see figure 4). The devastation piled upon the country’s tourism sector and associated channels due to the current economic crisis, as well as other macroeconomic factors, which has put an alarming impact on Sri Lanka’s unemployment situation.

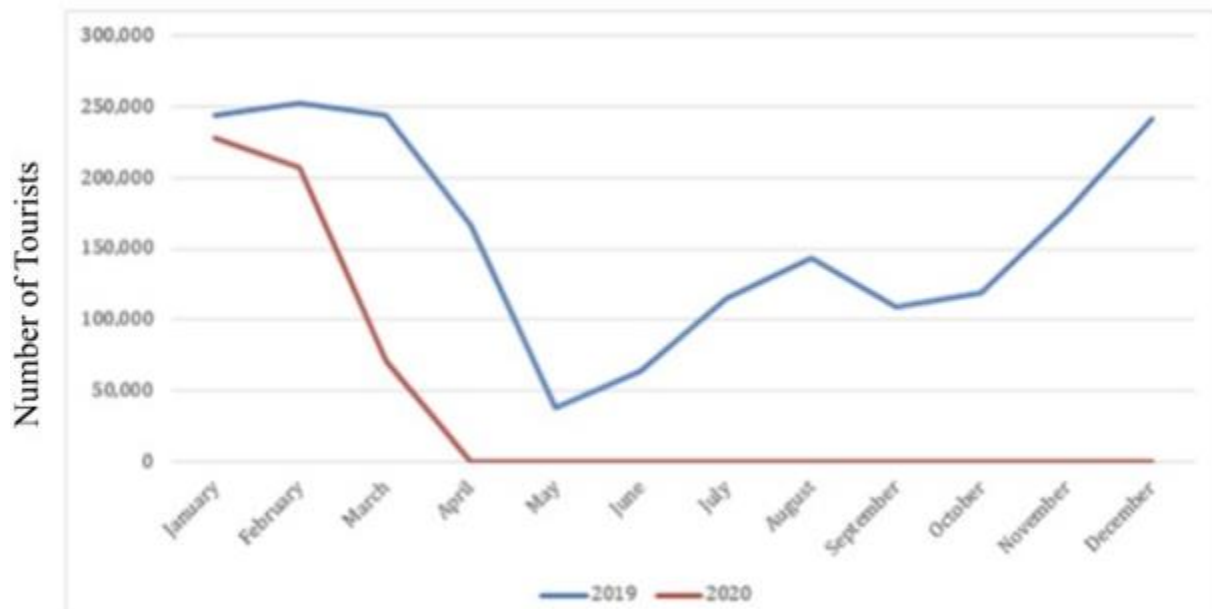
Figure 4: Employment generated by Sri Lanka’s Tourism Sector



Source: SOUMYA BHOWMICK from Thushanga and Piyada (2021)

In the aftermath of the Easter Sunday Bombings in the national capital of Colombo which results in deaths of 42 foreign tourists among others, many of the establishments across Sri Lanka were forced to shut down. Several countries put out travel advisories warning their citizens to not travel to Sri Lanka. Tourists left the nation in massive numbers, and there was a drastic fall in the number of national tourists as well.(see figure 5).

In 2018, tourism provided US\$ 4.4 billion in earnings to the Sri Lankan economy and contributed to 5.6 percent of the nation’s GDP, but this estimate came down to 0.8 percent in 2020, post the pandemic.(see figure 3 and 5). The onset of the pandemic also led to a 50 percent drop in revenue in 2020, and a consequent fall in the number of tourists. The loss of tourists from China and the European countries, came as a major blow to the deteriorating sector.(Bhomwick, 2022)

Figure 5: Sri Lanka's Tourist Numbers in 2019 and 2020

Source: SOUMYA BHOWMICK from Thushanga and Piyada (2021)

Making matters worse for the Sri Lankan economy is the ongoing Russia–Ukraine conflict which started in early 2022 and has crippled the tourism sector of Sri Lanka further. Russia and Ukraine were the top tourist markets for Sri Lanka and the conflict has curtailed this flow of visitors to Sri Lanka. According to official records, the country earned a whopping \$ 3.6 billion in tourism revenue in 2019, before the country's economic difficulties rapidly diminished it to less than one-fifth in just two years.

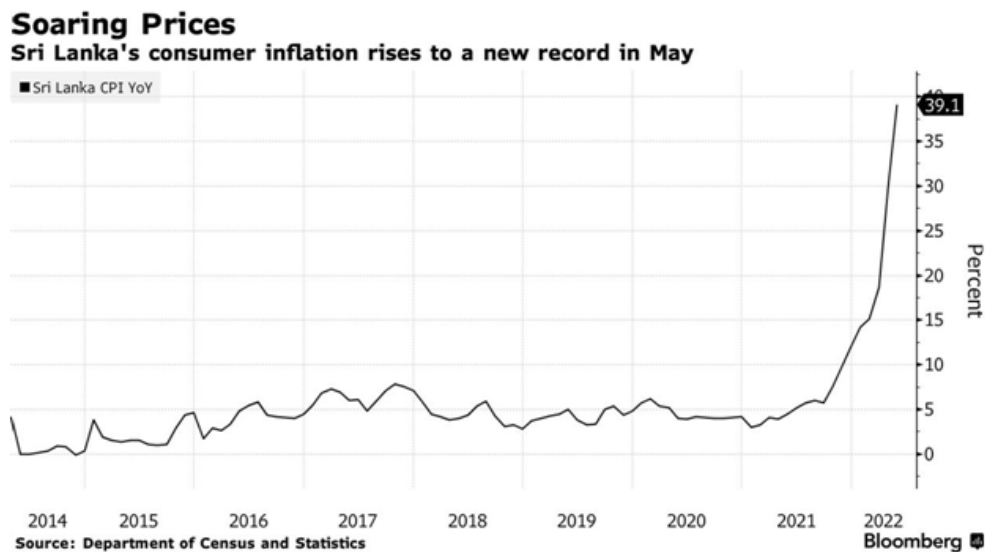
A steady influx of tourists would undoubtedly help its foreign exchange woes. However, the crisis' repercussions, along with other variables, are threatening an industry that has long proved to be a significant contributor to the country's progress.

5. Inflation

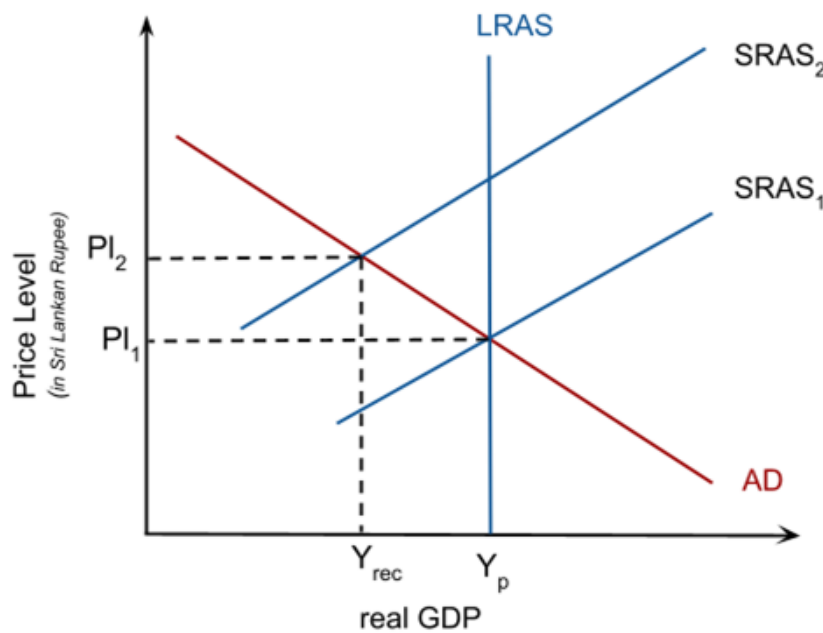
Inflation is defined as the sustained increase in the general level of prices. Sri Lanka is facing its worst inflation since its independence. As of April 2022, the inflation rate has soared to over 21.5% (Ondaatjie, 2022) which has caused severe food insecurity in the country. As the Sri Lankan Rupee depreciates, the cost of importing increases leading to cost-push inflation. Cost-push Inflation is caused by a fall in aggregate supply due to an increase in prices of other inputs,

shown by a leftward shift of the AS curve in an AD-AS model.

Graph 6: The graph above shows the increase in price level over the years.



Source: Bloomberg



In the AD-AS model represented above, it is assumed the economy is at a full employment level of output, Y_p and suppose there is an increase in the cost of production. The SRAS curve shifts from SRAS1 to SRAS2, leading an increase of the price levels from PI_1 to PI_2 and a fall in the equilibrium level of real GDP from Y_p to Y_{rec} . The increase in the level due to the fall in SRAS is known as cost-push inflation.

A sharp fall in the Sri Lankan rupee and heightened global uncertainty also stoked prices. Alongside the depreciating value of the rupee, the increase in price levels of the mineral oil due to the Russia-Ukraine conflict has left Sri Lanka in an unfortunate position. Food inflation rose to 57.4% in May, non-food climbed 30.6%. Inflation is likely to rise further as fuel price hikes of 35 percent for petrol and 65 percent for diesel feed into the wider economy.

6. The Political Crisis

In autocracies, the famous quote by Peru's General Óscar Benavides seems to be true: "For my friends, everything; for my enemies, the law". In Sri Lanka, where the political dynasty of the Rajapaksa family expanded its autocratic control, that phrase can be revised: "For my family, everything; for my enemies, the law." Most of the recent economic and political crisis has been blamed on Gotabaya Rajapaksa's presidency and his family members holding multiple government portfolios.

As the economic crisis heightened, a political crisis broke out with thousands taking to the streets to protest against the Rajapaksa family and demanding resignation. They also demanded political accountability, transparency in governance and an end to corruption.

In Sri Lanka's history of ethnic violence, this protest is exceptional for its diversity and peaceful demonstrations. With massive participation from the youth, the movement united people regardless of their religion, class, ethnicity, gender and profession.

With mounting pressure from the peaceful protest, a state of emergency was declared on May 6, soon after the previous state of emergency had been revoked. However, the peaceful protests did not remain peaceful for long as on May 9, supporters of the government attacked the peaceful protesters letting loose a new wave of violence. This led to the sudden resignation of Mahinda Rajapaksa and the imposition of a national curfew.

After Mahinda Rajapaksa's resignation, Sri Lanka had neither a prime minister or the cabinet for three days. The country's growing political, economic and security crisis was alarming. On May 12, veteran politician Ranil Wickremesinghe was appointed prime minister, after which some

allegedly involved in the crisis were appointed to the new cabinet, raising questions about the legitimacy of the new government.

Growing anti-government sentiment, the power struggle between Parliament and President, mixed with the economic situation has reached a boiling point and the peaceful protests have become violent. The Sri Lankan people have begun to realize that the power ultimately rests in their hands. As the looming Sri Lankan Crisis continues, it only leaves behind questions without any answers.

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