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Island

The economics of war

by Analyst

The escalating expenditure on the war is brought out in the table below:

Unit	Defense Expenditure Rs. bn	GDP ratio %	Revenue/Revenue %
1995	42.5	6.4	32.2
1996	44.9	5.8	30.7
1997	45.0	5.1	27.3
1998	51.0	5.0	29.1
1999	63.4	5.7	33

Source: Trends in Public Finance 1998 by the General Treasury

In 2000 the estimated expenditure according to the Central Bank Annual Report is Rs. 70 billion, and this was before the crisis conditions that arose in the last month. There are two ways of finding the funds- by taxation or by borrowing. Both methods have adverse effects on economic growth and living standards.

Borrowing vs. Taxation

A temporary tax surcharge was introduced earlier to finance the war but it was abolished in 1996. Taxation has the advantage that it will eliminate the need to pay interest. Interest costs already are too high and consume a large part of the budget vide

Unit	1995	1996	1997	1998
Interest on Domestic Debt Rs.Bn	35.0	42.2	48.6	47.6
Percentage of Domestic debt %	12.2	11.8	12.7	10.7
Interest on Foreign debt Rs. Bn	6.2	6.7	6.7	7.3
Percentage of Foreign debt%	1.8	1.9	1.8	1.6
Interest/Total Govt: Revenue%	30.2	32.8	33.5	31.4

Source: Trends in Public Finance, General Treasury 1998.

table below

Borrowing also burdens the next generation with the repayment of our foolishness and burdens lower income persons with interest costs. The income tax on the other hand puts the burden where it belongs, namely the present generation. Excessive borrowing is not reasonable. But taxation also has adverse consequences.

Will the tax not have negative effects? A tax is a transfer from taxpayers to soldiers and the war effort while borrowing to finance the war is a transfer from depositors to soldiers and the war effort. Even a temporary tax surcharge will be a disincentive to investment and could lead to postponing investments even if profitable.

If your house burns down, should you not take out a mortgage to buy a new house to live in than to make do in a cardboard box until you have saved enough to buy a new house outright? Here is a basic principle. Strive within reasonable limits to smooth your consumption. If you spend say Rs 20,000 on a vacation, do not feel the need to reduce your expenses by 20,000 to finance it; instead reduce your expenses slightly in each of many months.

Do the same if you lose your wallet with your whole salary. You cannot starve until you receive your next month's salary. You will withdraw your savings or if you don't have any savings you will borrow at interest even from a moneylender. You can't cut down on essential expenditure. So is it with the government. It must maintain essential services. It must maintain capital assets and carry on capital expenditure as before, although it may not expand such capital expenditure without adverse repercussions on the economy as will be shown below.

Bad fortune is tolerable in small doses. So there is a case for borrowing to finance the war without reducing our living standards too much. But unnecessary expenditure must be cut down. This is what is involved in austerity required for the war effort. The public must put up with what such austerity involves. Collecting funds for the Defense Fund is only a gimmick. Such gestures will not finance the war effort. but higher taxation or higher prices, which will be inevitable as a result of the war expenditure, must be borne with resignation for the sake of the war effort.

Economics too has its conservation laws like physics. You can move resources from one place to another, but not even the government can create resources out of nothing. Just as the laws of physic preclude a perpetual motion machine, so the laws of economics preclude a free lunch. So those who argue for expanding the role of the government and urge on the government to increase its expenditure to do so are asking the government to divert resources from alternative use.

There could be a multitude of scenarios. Maybe the government taxes and spends (in which case the public will buy less goods & services) and spend it on the universities, on health, samurdhi etc., but this will mean less spending by the public in other sectors. Maybe the taxpayers will withdraw their savings and then there is less to be lent to business. Consumption will go down or investment goes down affecting the demand for goods consumed or used in investment.

Any rupee the govt. gets by taxation will reduce expenditure somewhere else in the economy. Unfortunately widespread economic illiteracy prevails. It is true that government spending on investment can stimulate aggregate output & employment in the developed countries. The simplest Keynesian models that economists would subscribe to go like this: The govt. spends on capital projects creating jobs but the funds have to come either from taxation or from borrowing.

If the funds are from taxation then people will try to keep up their consumption expenditure by drawing on their savings, thus reducing savings available to the private sector. This also bids up interest rates, which makes it less desirable to hold money (money is a non-interest bearing asset), so people attempt to divest themselves of money and purchase durable goods and assets - financial assets like shares and real assets like property.

This in turn drives up prices, but unlike in developed countries where there is unutilized capacity in production plants, there is no such spare capacity in developing countries and hence the higher investment will lead to higher prices only. As for the war expenditure, a good part of it (45%) is absorbed as personal emoluments of soldiers. No doubt the soldiers will spend on goods & services, making up for the cut in consumption by those who are taxed or perhaps even more than making up for it since their propensity to consume is likely to be higher.

But a good part of such war expenditure will leak out as foreign exchange in payment for arms and armaments. So the war expenditure financed through taxation is a transfer of resources from the tax paying general public to the soldiers and to foreigners in payment for arms.

When a tax is imposed on a commodity by way of a customs tariff or turnover tax or the General Sales Tax or GST, the supplier of the goods will invariably shifts the tax to the consumer by jacking up the price. You have only to look to your bank statement to see how the banks do it. The bank not only recovers the loan installment and interest but also the defense levy or any other tax which they will have to pay.

They are in effect acting as tax collectors for the government as though the liability is not on them. But when the price of a commodity is raised people will buy less of it and when there is a GST of 12.5%, on a wide variety of goods, there will be a reduction in aggregate demand for goods & services. This is why many firms in their Annual Reports now being released, report significant reductions in turnover.

Even where they have maintained the turnover they have not been able to maintain the same rate of gross profit or operating profit. The workers in the organized sector, who are represented by powerful trade unions, will demand higher wages & salaries to recoup the loss in their real incomes and they may well succeed because the government depends on their support. But every income earner in the economy will not be able to do so and those who fail will reduce their purchases of goods and services.

So taxes on commodities reduce aggregate domestic demand for goods & services. Taxation therefore leads to a transfer of resources from the public to the government to be used in government expenditure. When the government spends the money on the war effort, a good part of it will accrue to the foreign suppliers of arms and armaments and the balance to the local suppliers to the armed forces and to the soldiers.

Military Conscription not economic

There has been some suggestion to have military conscription. Is it cheaper and more advantageous? Although there is a strong case for military conscription on grounds of social equity, it is not the most efficient solution from the economic standpoint. Why? Because the loss to the economy will be more since those that could contribute to the economy as farmers, fishermen, mechanics etc, all of who make a greater contribution to the GDP than unemployed youth, will be forced into military service. So the use of a professional army is a cheaper alternative for the economy.

The best solution

The best way to handle this problem is to minimise the burden and spread the pain over time. Spreading the pain over time can be done by taking a smaller cut in living standards over a longer period of time. Just as people don't like having their bad fortune concentrated into a single dose, the government also should not depend entirely on taxation to finance the war.

There are many other economies that can be made in the government budget as pointed out in last week's article. Open and hidden subsidies in the supply of goods & services by the public sector should be removed and costs recovered. It would be ideal if such costs can be reduced, but this cannot be done in the short run. But it is essential to do so over the long run to save the public from extortionate prices.

Presently the governments reform of the public sector is confined to privatization of the commercial enterprises .The current transfers from the budget to public enterprises which are engaged in commercial activities should be phased out quickly. This is no doubt a priority.

The government announced this week an increase in the price of diesel and furnace fuel. It is no doubt necessary because the world market price of crude oil has doubled in the last year is now around $25. We are told that the cost of diesel is about Rs. 23 and that there is therefore still a subsidy to the consumer. We are also told that the Petroleum Corporation is running a loss of Rs. 10 billion. But is this loss due only to the rise in the price of crude oil?

What about the corruption and wastage, the large number of staff recruited to the corporation since the present government took office - staff who are being paid a dole for not working. They may appear to be working for according to Parkinson's law, work expands to keep people busy; but how productive are they?

Economists say the marginal worker (the last worker recruited) should add to the revenue product an amount equal to his wage. Thousands have been recruited under the ``spoils system" to provide jobs to the boys of the ruling party. Is it fair to recover their ``dole" from the public by way of price increases?

The government must follow up the price increase by downsizing the Petroleum Corporation by retrenching the excess staff and by effecting economies in its operations. This is a duty the government owes to the public. It is this wastage and corruption and the lack of efficiency that the opposition must expose to the public. But they must also show that if they were in power, there would be a difference that they would not resort to such pork barrel politics, something they have done in the past.

What is the current practice in this regard in bodies like the Colombo Municipality and other institutions they control? This writer does not think there is any great difference.

So their criticism lacks good faith and they cannot expect the public to be fooled by such criticism since the public is not so naive as in the past.

Costly politicians

The government departments should also be reformed. The whole issue of financing the Provincial Councils should be gone into. The public can't bear the burden of a large number of politicians at the provincial level who are overly compensated by lavish salaries and perks. We could perhaps do with a single chief minister who will, like the president at the center, be the chief executive for the province. The other members of the Provincial Council could be ordinary members, not part of the executive but only of the legislature paid only for attending the meetings of the council.

Parliamentarians sometimes put forward the spurious argument that it is necessary to compensate politicians for two reasons; firstly to discourage them from resorting to corruption and secondly to attract a better quality of politicians from among professionals. As for the first, it must be said that politicians become corrupt through greed for money not because they are not compensated adequately as the present situation confirms.

The second argument is also faulty. From the social economic standpoint, if politicians were to come from the ranks of professionals, society will be poorer by the loss of good lawyers, doctors, engineers etc. In spite of the high tax-free salaries and numerous perks like duty free vehicles, professionals have not taken to politics in any significant way. So, before the people are burdened with higher taxation, the remuneration and perks of the politicians must be cut since the war economy cannot afford them.

Boated public service

The efficiency of government departments should also come under scrutiny. Auditing has to be strengthened and officials who do not look after public resources should be dealt with. Please see the table below showing the average salary per person in the public service and the number of employees employed by the state.

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Unit	1995	1996	1997	1998
Average Salary/month	Rs. 2731	3153	3510	4135
No. of Employees	253,394,	284,084	279,789	266,202
No of Pensioners	310854	332,824	342,343	358,228

Source: Trends in Public Finance 1998 General Treasury

In spite of the statements by the government in budget speeches and elsewhere and commitments to the World Bank to reduce the excessive numbers in the public service, there has been no meaningful reduction. In fact the burden of the public service has increased.

It is not as if there has been more activity in the public service. In fact the service provided by public servants has deteriorated according to the views of the general public. It was thought that the introduction of the national languages in the administration would provide the ordinary man with a better service and greater accessibility to public servants. This hope has not been realized.

The Sinhala educated public servants have not been trained sufficiently in the principles of administration and not socialized into the ethos of the public service. Many public servants do not understand the reasons behind the administrative procedures and are blind adherents to them, causing much hardship to the people.

Your analyst had to visit the Registrar General's department to inquire about an application for birth registration returned to the head office by the Divisional Secretary, Panadura. The returned letter was sent by registered post and personally addressed to an officer. The letter was allowed to lie unopened on the table of the officer who was on long leave. Each time he visited the office, he was told the letter couldn't be opened because it was addressed by name. This is while the Establishment Code says letters should be addressed only by designation and not by name to particular officers.There is very little hope of a better service for the public.

Rising interest rates inevitable

Just as the people smooth out their consumption by borrowing in order to get through a temporary period of misfortune, the government too should borrow to maintain the normal services including the maintenance of capital assets. The government should borrow only for the productive capital expenditure projects in infrastructure.

The government borrowing will put upward pressure on interest rates. It means that the private sector will have to borrow at higher interest rates too. Now, the problem is complicated because we do not have sufficiently free markets for determining interest rates. The government controls the savings of the employees paid into the Employees Provident Fund, the Employees Trust Fund, and the National Savings Bank. There is pressure exerted even on the two state banks to invest in government treasury bills and bonds. So the interest rate is practically controlled by the government.

But there is a close relationship between the domestic interest rates and the exchange rate, between the money market and the foreign exchange market. If the domestic interest rates are held too low the exporters and banks will prefer to finance their operations by local borrowing, holding their export proceeds abroad. So the domestic interest rates cannot be controlled fully unless the Central Bank is willing to allow foreign reserves to be run down.

Even a temporary tax increase would put upward pressure on interest rates, though not to the same extent as higher borrowing. Of course an increase in interest rates will discourage investment by the private sector. Some projects will no longer be profitable or will have a longer pay back period making them less attractive. Also, the private sector will find it more difficult to raise the funds for investment as savings flow to the government. Raising interest rates also makes it difficult for people to borrow to even out the effect of their loss of real income due to higher taxes.

War is Costly

Modern war unlike the wars carried out by our forefathers as recorded in the Mahawamsa (someone counted 125 such wars) is very costly. Our war expenditure is high and in relation to the GDP only slightly lower than Pakistan. It is foreign aid that made it possible for us to carry on this war for so long. Now that foreign aid has practically dried up we will have to depend more and more on our own resources.

Fortunately we have the foreign exchange resources, thanks to our women laboring in the Middle East as housemaids. But the government has to raise the domestic funds through taxation or borrowing and this will cast more and more burdens on the people. But there is a limit to the arms race. Every time we buy more sophisticated weapons the LTTE has somehow got them too.

Those who champion war might point out that East Asia's Tigers - Taiwan, South Korea and Singapore, have combined rapid economic growth with military spending higher than the world average. But a would-be imitatator should note that they grew despite, rather than because of their heavy military spending. They also financed their spending out of government revenue, rather than by running up large budget deficits that would have destabilized their economies.

Their governments also viewed military service as a useful way to inculcate discipline in future workers. The government must avoid short-term fiscal policies, which put long-term growth at risk.