# "A half-truth is a whole lie"
## An Economic diagnosis

*by*
**Ibrahim Ameer**
***Assistant Manger, Monetary policy and Research Division, Maldives Monetary Authority***
***Lecturer, Economic principles and their applications to business, Clique College***

**10th May 2011**

---

*This paper empirically investigates the present economic condition of the Maldives and presents the reader with an alternative perspective on the causes of the current national economic crisis. While the continuous government budget deficit for the last few years (from 2005 to present) is what sparked the economic crisis, I disagree with the view that our country's economic problems stems primarily from it. I see it as a case of our country's wealth being controlled by a few and the government sectors inability to raise funds through proper and sound tax regimes.*

### Introduction

This article presents the reader with a diagnosis about the current macroeconomic disequilibrium facing the Maldivian economy. Today there is extensive debate in the country as to how we arrived at this economic abyss, who is responsible for the present condition and what are the policy measures that need to be adopted to correct the current economic debacle. In Maldives we have a very small and open economy. The Maldivian economy comprises of a narrow export base with a very high dependence on imports for most of our economic activities. Expansionary fiscal policies in Maldives after the 2004 tsunami led to severe fiscal and external imbalances, leaving the economy vulnerable. The situation deteriorated markedly in 2008–09, as the decline in tourism which followed the global economic crisis hit the Maldivian economy hard, aggravated the imbalances and pushed the country into recession. Hence, the foreign exchange market was and is badly hit and a parallel market for foreign exchange (primarily US dollars) ensued as the market was unable to provide US dollars at the official exchange rate.

It is not hiding the truth when it is stated that the present economic conditions arose due to the continued government budget deficit. The problem is even more exacerbated as a majority of the budget is spent on recurrent expenditure (71% of the 2011 budget is stipulated for recurrent expenditure). The current (2011) budget of Maldives is approximately RF13 billion with a deficit of approximately RF5 billion. Now the question is, after taking into account the changes that have taken place in our country, both politically and economically, whether we can decrease our budget to around RF7 billion and or achieve a deficit at 3 percent of GDP[1](Gross Domestic Product) .

## 1. Maldives Gross Domestic Product or Aggregate National Income

Gross Domestic Product (GDP) is total market value of all final goods and services produced in a country in a given period of time, usually one year. There are different methods to calculate GDP.

a. ***Income method****:* The income approach equates the total output of a nation to the total factor income received by residents of the nation in the production process.

b. ***The output approach****:* The output approach focuses on finding the total output of a nation by directly finding the total value of all goods and services a nation produces.

c. ***The expenditure approach****:* It focuses on finding the total output of a nation by finding the total amount of money spent. This is acceptable, because like income, the total value of all goods is equal to the total amount of money spent on goods.

In Maldives we follow the output approach to calculating GDP. In this method the economy is divided into classes of different industries. E.g. Agriculture, fisheries, manufacturing, construction wholesale and retail trade, tourism, transport and financial services, etc. In this method the value added approach is adopted.

[1]Budget deficit at 3 percent of GDP is considered an ideal situation by many economists. If it is higher than that it would lead to more imbalances in other markets.

The following is the Maldives GDP figures published by the authorities**.**

**Table: 1**.

| Year | 2005 | 2006 | 2007 | 2008 | 2009 (est.) | 2010 (est.) |
|---|---|---|---|---|---|---|
| Nominal GDP (RF million) | 9596.1 | 11717.4 | 13496.1 | 16130.9 | 16879.0 | 18941.2 |
| Nominal GDP (US$ million) | 749.7 | 915.4 | 1054.4 | 1260.2 | 1318.7 | 1479.8 |

The GDP figures show clearly that it is grossly undervalued. This is clear by the TGST (Tourism- Goods and Services Tax) of 3.5 percent paid by the tourism sector to the Maldives Inland Revenue Authority (MIRA). From the 871 registered taxpayers for T-GST almost 800 filed their tax return and MIRA received over US$7.2million as Tourism Goods and Services Tax in January of 2011. This means the whole tourism industry's revenue (market value) would amount to approximately US$210.0 million for the month of January and approximately US$2.5 billion for the whole year. If from only tourism related industries the country is able to raise market value of more than US$2 billion, then the total market value of all goods and services produced in the country (GDP) cannot be US$1.5 billion as published by government agencies (shown in the above table).

**The Expenditure Method of calculating GDP (aggregate demand)**

This is the sum of spending on Maldives produced goods and services measured at current market prices. The full equation for GDP using this approach is GDP = C + I + G + (X-M) where:

***C: Household spending***. (Consumption) is normally the largest GDP component in the economy, consisting of private (household final consumption) expenditure in the economy. These personal expenditures fall under one of the following categories: durable goods, non-durable goods, and services. Examples include food, rent, jewelry, gasoline, and medical expenses but do not include the purchase of new housing.

***I: Capital Investment spending***. Includes business investment in equipment for example and does not include exchanges of existing assets. Examples include construction of a new mine, purchase of software, or purchase of machinery and equipment for a factory. Spending by households (not government) on new houses is also included in Investment.

***G: Government spending.*** It is the sum of government expenditures on final goods and services. It includes salaries of public servants, purchase of weapons for the military, and any investment expenditure by a government. It does not include any transfer payments, such as social security or unemployment benefits.

***X: Exports of Goods and Services.*** Represents export of goods and services such as exports made by MIFCO or the re-export of oil by STO.

***M: Imports of Goods and Services.*** It represents gross imports. Imports are subtracted since imported goods will be included in the terms G, I, or C, and must be deducted to avoid counting foreign supply as domestic.

Now let's make an estimate of Maldives GDP by using the expenditure method as explained above and analyse the implications.

| | **2010 (in millions)** | |
|---|---|---|
| **Table: 2** | **Rufiyaa** | **US dollar** |
| **Consumption** | 19,275.00 | 1500 (est.) |
| **Investment** | 6,425.00 | 500 (est.) |
| **Government expenditure** | 10,999.60 | 856 |
| **Exports** | 28,270.00 | 2,200 |
| **Imports** | (14,072.04) | (1,095.1) |
| **Gross domestic product (GDP)** | **50,897.57** | **3,960.90** |

Government budget shows the planned expenditure of an economy in a year. In 2010 Maldives budget amounted to Rf12 billion[2]. After deducting transfer payments such as social security benefits, government expenditure would be approximately Rf10.9 billion. Exports include exports of goods and services. In 2010 the merchandise exports (domestic exports and re-exports) amounted to US$199.9. Hence total exports of goods and services amount to US$2.2 billion (i.e. merchandise exports plus the tourism receipts as reported by MIRA. There would also be other types of service exports, which may not be very significant). For the year 2010,

[2] http://minivannews.org/news_detail.php?id=7795

total Maldives imports c.i.f amounted to US$1,095.1 million.

For other variable like ***Consumptio*n** and ***Investment*** data is not available. Hence I have used probable figures looking at the level of government expenditure, imports and exports. As consumption is considered to be the largest GDP component in most economies and given that imports is more than US$1 billion for the year 2010, I have assumed aggregate household consumption to exceed US$1 billion. A consumer expenditure survey or taxation data would show aggregate consumer expenditure more accurately. Private Domestic Investment (PDI) includes business investment such as in equipment, and does not include exchanges of existing assets and investment in new housing. In order to find the correct PDI we need to conduct investments surveys. The investment of US$500 million is just a crude estimate (If we do an investment survey the actual figure will be much higher looking at the investments that is taking place in the country in different sectors such as tourism and fisheries, and on new housing).

**Table: 3**

| **2010** | **USD** | **Rufiyaa** |
|---:|---:|---:|
| **GDP** | **3,960,900,000** | **50,897,565,000.00** |
| **Budget deficit** | **362,946,504** | **4,663,862,576** |
| **Budget deficit as a % of GDP** | **9** | **9** |
| **GDP per capita**[3] | **10,064** | **129,320** |

As seen from the above table 3, our NGDP would be close to MRF 50.9 billion as opposed to the much underestimated figure of MRF 18.9 billion. Furthermore, budget deficit is 9 percent of GDP as per my estimates above (it would be much less with 100 percent accurate numbers), as opposed to 17 percent of GDP in 2010 as per government authorities. I suspect this underestimated figures are used by the authorities to prolong the preferential treatment Maldives has and in some cases continues to receive as a Least Developed Country (LDC).

With respect to the above, I am compelled to put forward the argument that our country's problems are primarily a case of the state's inability to collect revenue through taxation rather than a budget deficit.

[3] Population is 393,578. Source: Department of National planning

## 2. **Way Forward: A Proper Tax Mechanism**

After the global economic crisis of 2008 which is considered by many commentators and economists to be the worst financial crisis since the Great Depression of the 1930s, many developed and developing countries were and continue to face with unsustainable fiscal problems. This is because of the failure of key businesses and industries, declines in consumer wealth and significant decline in economic activity leading to a severe economic recession. The fiscal problems that low-income countries like us face are very different from those of developed countries. For many low-income countries like Maldives, government tax revenues are far from enough to meet the needs of the people. There is also an underlying crisis of inadequately resourced governments. It is not only the level of revenue that matters: tax design and implementation are also critical to the efficiency of economic activity, to fairness and to the legitimacy of the state.

***Why do we have taxes?***

The simple answer is that, until someone comes up with a better idea, taxation is the only practical means of raising the revenue to finance government spending on the goods and services that most of us demand. The other alternative is to monetize (printing money) for such purposes. Deficit financing through monetization for long periods will create money supply which is not backed by real output growth. Setting up an efficient and fair tax system is however far from simple, particularly for developing countries that want to become integrated in the international economy. The ideal tax system should raise essential revenue without excessive government borrowing, and should do so without discouraging economic activity and without deviating too much from tax systems in other countries.

Before I proceed further, let's look at tax levels and types of taxes in different countries.

**Table: 4**

| Country | Corporate | Individual income tax | VAT/GST |
|---|---|---|---|
| Afghanistan | 20% | | 2% to 5% |
| Argentina | 35% | 9% to 35% | 21% |
| Australia | 30% | 0–45%, 1.5% (Medicare levy) | 10% GST (0% on essential items) |
| Bangladesh | 0–45% | 0–25% | 15% |
| Barbados | 25% | 25%–35% | 15% (hotel accommodation 7.5%) |
| Belarus | 24% | 12% | 20% or 10% |
| Belgium | 33.99% | 25–55% | 21% (6% for essential and selected goods) |
| Bhutan | | 0–25% | |
| Brazil | 34% | 0–27.5% | 17% to 25% |
| Burkina Faso | 10–45% | 2–30% | 18% |
| Canada | 11–16.5% (federal) | 0–29% (federal) | 5% (Federal GST) |
| China | 0.25 | 5–45% | 17% with many exceptions |
| Czech Republic | 20% | 15% | 20% or 10% (certain goods) |
| Denmark | 25% | 36.57–60% | 25% |
| Egypt | 20% | 10–20% | 10% (standard), 25% (luxury goods), 0% (exports) |
| France | 33.33% | 0–40% (income tax) | 19.6% or 5.5% or 2.1% |
| Greece | 22/25% | 0–45% | 23% or 11% |
| Hong Kong | 16.50% | 0–15% | |
| India | 25% | 0–30% | 2%–12.5% |
| Italy | 31.40% | 23–43% | 20% or 10% or 4% (food, books) |
| Japan | 40.69% | 5–50% | 5% (consumption) |
| Malaysia | 25% | 0–26% | |
| Netherlands | 20/25.5% | 0–52% | 19% (6% for essential and selected goods) |
| Pakistan | 35% | 7.5–35% | 17% (GST) |
| Portugal | 25% | 10.5–40% | 21% |

| | | | |
|---|---|---|---|
| Russia | 13–20% | 13% | 0-18% |
| Singapore | 17% | 3.5%–20% | 7% (GST) |
| Spain | 25–30% | 0–47% | 18% or 8% or 4% |
| United Kingdom | 21–28% | 0–50% | 20% Standard Rate |
| United States | 0–35% (federal) | 0–35% (federal) | 0-10.25% (states and local) |

*Source: Wikipedia.org*

As seen from the above table, most countries have 3 types of taxes.

i. ***Corporate tax:*** Taxation imposed on the level of income or capital of business
ii. ***Individual income tax:*** An income tax is a tax levied on the income of individuals
iii. ***VAT/GST:*** Value-added Tax and General Sales Tax. A value added tax (VAT) is a form of consumption tax. The "value added" to a product by a business is the sale price charged to its customer, minus the cost of materials and other taxable inputs. A VAT is like a sales tax in that ultimately only the end consumer is taxed. It differs from the sales tax in that, with the latter, the tax is collected and remitted to the government only once, at the point of purchase by the end consumer. With the VAT, collections and remittances to the government, and credits for taxes already paid occur each time a business in the supply chain purchases products.

In Maldives, there is no proper taxation mechanism established so far. The parliament has this year passed laws pertaining to Tourism General Sales Tax (TGST) and Business Profit Tax (BPT). Hence, so far in Maldives government revenue mainly comes from customs duties (an indirect tax on the importation c.i.f value), bed night tax from tourism sector, land rent, bank profit tax, dividends from state owned enterprises, fees and other sundry charges.

When we talk about tax, it is necessary to understand what level of public spending is desirable for a developing country? What level of taxation is required to fund these public spending? It should not be the objective to achieve a budget surplus by higher taxes. In order to assess the appropriate levels of tax, one useful method is to compare tax levels in a country (such as Maldives) to the average tax burden of a representative group of both developing and industrial nations. In Maldives, we don't have individual income tax, corporate taxes (BPT or corporate tax is due to come in to effect from 1st July, 2011) and GST (TGST is been collected from January 2011). Hence it should be agreed that as the country marches towards full democratization, with new independent statutory institutions, local and atoll councils and increased civil service salaries, the country needs to rethink it tax policy. The most recent data show that the tax level in major industrialized countries (members of the Organization for Economic Cooperation and Development or OECD) is about double the tax level in a representative sample of developing countries (38 percent of GDP compared with 18 percent). Economic development will often generate additional needs for tax revenue to finance a rise in public spending, but at the same time it increases the countries' ability to raise revenue to meet these needs. More important than the level of taxation per se is how revenue is used.

Furthermore, a tax should be both efficient (whether the tax enhances or diminishes the overall welfare of those who are taxed) and equitable (whether the tax is fair to everybody). The issues involve the taxation of income relative to that of consumption and under consumption, the taxation of imports versus the taxation of domestic consumption. In this regard, I believe customs duties are not equitable. It is inherently more regressive (that is it is in effect harder on the poor than the rich). With regard to taxes on imports, lowering these taxes will lead to more competition from foreign enterprises. While reducing protection of domestic industries from this foreign competition is an inevitable consequence, or even the objective, of a trade liberalization program, reduced budgetary revenue would be an unwelcome by-product of the program. Feasible compensatory revenue measures under the circumstances almost always involve increasing domestic consumption taxes. Hence while taxing income entails a higher welfare cost than taxing consumption as it reduces the tax payer's ability to save and taxing consumption is thought to be regressive, it is essential the government strikes a clear cut balance between the income-consumption tax mix. Data from industrial and developing countries show that the ratio of income to consumption taxes in industrial countries has consistently remained more than double the ratio in developing countries. (That is, compared with developing countries, industrial countries derive proportionately twice as much revenue from income taxes than from consumption taxes.) The data also reveal a notable difference in the ratio of corporate income tax to personal income tax. Industrial countries raise about four times as much from personal income tax than from corporate income tax.

**Conclusions:**

1. Looking at the level of the Maldives' national income or GDP (as estimated above), I do not believe all our economic problems stem from the fact that we have a government budget deficit. I strongly believe that our budget cannot be decreased so much. We have a budget of MRF 12 billion. We only get MRF 7 billion as revenue. It will be impossible to decrease government budget to MRF7 billion to equal government revenue. We could save some expenditure through cutting waste, prioritizing projects and eliminating corruption. On the other hand, we must all agree that in certain areas wage and salaries given are very low compared to many countries. Hence, it is difficult to retain skilled and highly educated people in the country. This is why we see so many bright Maldivians leaving the country to work abroad. In the education sector, where the future of the country is molded and where the bright and the best are needed to teach future generations, the remuneration is pathetically low. The average wage for leading teachers with Master's degree is MRF8, 835[4]. One of the most important feature and tradition of civilized and developed countries is the importance

[4] JS-A/2011/20 job announcement by Jamaaludin School, (IUL) IM-AD/2011/10 announcement by Imaadhudhin School, MNU-HR/2011/163 announcement by Maldives National University

and the respect they give to academia and research. The academic and education sector should be highly competitive and more rewarding if we are to build a better future and save ourselves from the sort of "brain-drain" that we cannot afford. The situation is more or less the same with the healthcare sector of this country, with many of the brightest doctors and nurses opting for work abroad in countries as diverse as New Zealand and Canada.

2. Therefore, the long term solution should be to introduce an efficient and equitable taxation mechanism rather than drastically cutting down the government expenditure. In many cases for developing countries, a rigorous and sustainable government expenditure program is the key to development. Moreover, totally abandoning customs duties will be detrimental to the economy.
    i. As import duties act as a barrier to import, abolishing it all together would harm the growth of potential industries at home.
    ii. Customs duties comprise more than 20 percent of the total government revenue (largest contributor). Hence, shifting to a progressive and more equitable system of taxation should be carefully planned and systematic. *Customs duties should be used as a tool to discourage imports and encourage domestic production*.
    iii. For luxury goods, automobiles, cigarettes etc. higher import duties could be used to limit import and discourage the use of such items.

3. Housing problems are a major barrier towards real development in the country. This is mainly due to the over-concentration of economic activities in Male'. For many people in Male', more than 70%-80% of the income is used to pay rent. Male' is one the most highly dense and expensive capital cities in the world. As a result, disposable income is lower than it should be to encourage a more competitive market place and economy. Moreover, because only Male' is equipped with all the necessary facilities, like education and health care, more than one third of the population is living here. This creates irreparable social and economic damage. I do not see the need for additional housing in Male' or even within the Greater Male' Area to attract new immigration when already the place is more than over crowded. There should be a concerted effort to create cities like Male', especially in regions such as

the South where there is a high population density as compared to the rest of the nation, so that we would be able to have a much higher National income (GDP) than now and a situation where a higher productivity could be achieved.

4. For a small and open economy like Maldives, with extreme scarcity of resources, it is vital that the wealth that is generated by using these limited resources stays in the country. Research shows that from every US$100 that is generated from our tourism industry, less than US$13 remains in the country (Yahya, F.; Parameswaran, A.; Ahmed, I.; Sebastian, R., 2005). This is not acceptable. If we are to develop a nation with a sustainable and developed economy, this must be addressed through foreign exchange laws and incentives so that we are able to retain the wealth that is inherently ours. This is part of the reason why when the country is able to raise large amounts of foreign currency (such as US dollars); there is a chronic shortage of domestic supply of foreign currency.

5. There needs to be policies to reduce expatriate labor force and encourage Maldivians' participation in economic activities. The government also needs to reduce illegal workers through existing laws and/or through enacting new laws. There are more than 80,000 expatriate laborers in Maldives. In these many jobs, Maldivians are over looked because expatriate laborers are cheap and easy to manage. The economy is taking a huge toll due to this. Consider each expatriate worker will on average remit $100 per month to their countries. That is $8 million per month and US$96 million a year. This is an amount that can and should be mitigated.

6. The Maldives' legal tender is the Maldivian Rufiyaa. This means all the prices quoted in the territory of Maldives should be in Rufiyaa. Or else, we are inadvertently creating demand for foreign currencies rather than our own. This puts more pressure on the foreign exchange market. Today, all the prices in the tourism sector is quoted in US dollars, many airlines forces customers to buy tickets in US dollars, many job contracts in Maldives are in US dollar terms and a few restaurants even have their menus in US dollar prices.

   In order to create demand for Maldivian Rufiyaa and to get rid of a highly dollar-oriented economy, the central bank (Maldives Monetary Authority) needs to enforce the current monetary regulations to the full extent. This way the banking system will be able to create reserves in US dollars and the likelihood of any parallel market seems improbable. I would urge the TGST to be paid in Maldivian Rufiyaa, so that the banks are able to add to their reserves than the central bank.

7. The development we see in Maldives (Male') is not sustainable development. The "super-market/coffee shop" bubble is a smokescreen and is bound to burst dragging the economy into depression. To achieve sustainable development we need to see past supermarkets, boutiques and coffee shops in every corner. We need to learn from other developed nations where emphasis is on trade with other countries. As such we need to develop more export oriented businesses rather than opening up new super markets and coffee shops at every available corner. The wealthy need to realize that it is more lucrative to have businesses that decline our over dependence on imports. The present business model increases imports and puts more pressure on the foreign exchange. It only widens the disparity between the rich and the poor when there is a negative impact on the economy.

References:

1. http://www.gazette.gov.mv/new/home.php
2. Yahya, F.; Parameswaran, A.; Ahmed, I.; Sebastian, R., 2005, "The economic cost of tourism in Maldives" Vol. 53, No. 1/ 2005/ 33-44 • UDC: 338.486(548.82)