

Deficit Financing and Its Implications*

W.D. Lakshman

Professor of Economics, University of Colombo

A budget presented annually can be viewed from a number of different viewpoints. Depending on whose viewpoint one takes it may be pronounced good or bad. Focussing specifically on the budget for 1988, public sector employees might feel very happy about it at least for the salary increase promised. Similarly, for its various benefits to business, the business community might also be very happy with it. There might be others, who, for various sectarian interests would pronounce the budget unacceptable. Can one really rise above these sectarian interests and examine it objectively. It is clearly a difficult task; yet one ought to try to do it. Let me try, given the time constraint, to focus, as objectively as I could, on just one aspect of the budget, namely deficit financing and its implications.

sible economic and financial management, this Rs.12 billion which I hope to obtain from the International Monetary Fund can go up to about Rs.42 billion from the International Monetary Fund alone. This will help us to ensure a very viable balance of payments in the ensuing period.

"I am also negotiating with the World Bank and the Asian Development Bank for loans for industrial development, amounting to about Rs.6 billion. This will develop small and medium scale industry and create widespread employment in our land. Most of this money will be for private sector industrial development and will create employment for our youth in a very big way. I also hope to obtain some assistance to improve the public sector industries which can be made viable.

* Extracts from a Statement in Parliament on the results of the special Aid Group meeting convened in early December to consider assistance for Sri Lanka's post peace accord reconstruction.

The Minister Finance and the Government have been talking quite extensively about privatization, free market efficiency and advantages of these. Yet we have seen, under the management of Sri Lankan government finances, after 1977 an increasing involvement of the government in the economy.

I have absolutely no objection to it. In fact some of the "achievements" the government boasts about have come about through "big government". If one looks at the behaviour of the government budget over the last ten years or so, one cannot but be impressed by its remarkable expansion; achieved in the context of a lot of "privatization rhetoric". Those who are familiar with economic history of various countries in the world would agree with me that within market-dominated structures, early development was generally combined with increasing inequality in society. We in Sri Lanka under the "open economy", ourselves experienced this situation but because of continuing "big government" and the continued maintenance of services like free education, free health, food stamps, and similar schemes the conditions of the poor did not, perhaps, become intolerably bad. These conditions perhaps deteriorated, but not very sharply so. This is one major reason why I do not object to "big government".

"Yet there are certain aspects of expanding government activity in Sri Lanka over the recent past which arouses economists' concern. A main aspect of concern here is the consequent sharp growth of budget deficits. We have had a gradually increasing budget deficit since 1979. In this year the government started with an estimated deficit of Rs.10 billion which turned out to be an actual of Rs.12

billion. The actual budget deficit had gone up to Rs.22 billion in 1983 and Rs.28 billion in 1986. After 1986 it has been increasing and this year the forecast for 1988 is a deficit of Rs.37 billion.

The maintenance of a large government expenditure, without an increase, *pari passu*, of government revenue, is bound to raise enormous financing problems. What happened over the recent past was that the growth of government revenue fell short of the growth of expenditure. Economists might tend to argue that running large budget deficits is not all that objectionable provided they are financed through non-inflationary sources. The present government seems to have tried its very best to finance its increasing deficits through such sources - particularly foreign assistance. This attempt has not succeeded all the time and money supply increased sharply over the period.

The inflation aspect of deficit financing is an important matter to be discussed but I wish to focus on the debt implications of deficit financing in this brief presentation. Even if the entire budget deficit is financed through foreign sources, i.e. even if the "inflationary" financing is considered totally absent, yet the debt problem would remain as a real problem. The total public debt over the recent past has grown from 78 per cent of GNP in 1978 to 84 per cent in 1980 and 98 per cent in 1986. More menacing has been the foreign public debt in relation to an aggregate like export earnings: 103 per cent of exports in 1978, 122 per cent in 1980 and 253 per cent in 1986. As per cent of total foreign earnings (exports plus service earnings plus private transfer receipts), external public debt rose from 88 per cent in 1978 to 159 per cent in 1986.

These are clearly grave problems, which emerged from the extensive deficit financing of the last ten years - problems all of us, nationally minded people, should be concerned about. If the government takes increasing volumes of loans to finance deficits,

it has to try to channel substantial proportions of those loan funds to productive activities in order to make the nation able to pay the loans it takes. If this happens we need not be too much concerned for our future generations who will eventually be bearing the burden of repaying today's debt. The increasing debt to GNP proportions and increasing external debt to exports proportions seem to indicate that this has not happened in the recent past to an adequate extent. This is why we ought to be concerned about this increasing resort to deficit financing and its debt implications. Particularly noteworthy is the sluggish growth of exports and other exchange earnings. The increase in the debt service ratio from 19 per cent of exports of goods and services in 1982 to 26 percent in 1986 is particularly disturbing in this context. Indications are that this ratio might go up further.

Let me conclude by referring to a certain continuing problem, a contradiction, which has affected government budgetary policy over the recent past. What I am referring to here is the contradiction between the revenue requirements and needs for maintaining a large public sector and the need for keeping private incentives high in a market - dominated strategy. Because of the latter requirement the, private sector would not be taxed heavily. On the other hand, a large public sector is required to prevent the erosion of the living standards of the general mass of people, in turn giving rise to the need to maintain government expenditure at a high level. These conflicting forces have been in operation on public finances of Sri Lanka over the recent past. Growing deficits, with their adverse debt and inflationary implications, have been perhaps the result of the unsatisfactory resolution of the above conflict between the two contradictory policy aims. Let us hope that there will be a satisfactory solution of this contradiction in policy at least in the years to come.

** Prepared from a talk delivered at the Organisation of Professional Associations.*