

# Some Perspectives on Macroeconomic Implications of the Budget - 2009

## Introduction

Sri Lanka has faced with multiple challenges, where policy making has become extremely difficult. With enhanced focus on fighting the Liberation Tigers of Tamil Ealam (LTTE) and reorienting the government's social welfare programmes, government has been compelled to generate additional funds.

The budget for 2009 is examined in light of the policy thrust of the government. Sri Lanka has followed various brands of mixed economy models since its independence, viz., market-intensive mixed economy, where most of the economic activities that the market can provide efficiently are managed by firms or individuals, and the government-intensive mixed economy, where most of the economic activities that the market can efficiently provide are done and managed by government. The current regime appears to be characterised by the following (Government of Sri Lanka 2006):

- i. There is a tendency for moving away from a more market-intensive mixed economy towards a more government-intensive mix economy.
- ii. Attempts are also made to move away from a more export-oriented economic strategy to a more import substitution economic strategy.
- iii. There are signs of re-emergence of protectionism in light of the experienced and perceived balance of payments difficulties.

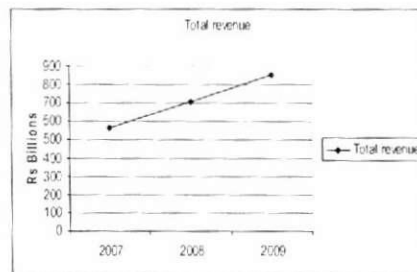
This paper focuses on briefly analysing the macroeconomic implications of government budget for 2009. The paper examines whether the budget for 2009 contributes to improvements in the fiscal situation of the government; the

trends in revenue, expenditure and budget deficit; and the macroeconomic implications of the budget deficit and budget proposals. The data used for this paper were obtained from the Budget Report 2009 (President of Sri Lanka 2008; Central Bank of Sri Lanka, 2007, 2008, 2009).

## 2. Trends in Government Revenue and Expenditure

One of the prominent features of the fiscal situation in the country for the past three years is a notable improvement of the government revenue. Starting from around Rs 550 billion in 2007, the total government revenue increased to about Rs 700 billion in 2008, which is expected to increase to Rs 850 billion in 2009. (Figure 1).

Figure 1  
Trends in Government Revenue



Source: President of Sri Lanka, 2008

This enhanced revenue will provide a better opportunity for the government to effectively provide public goods and services necessitated as a duty of the government even in a market economy.

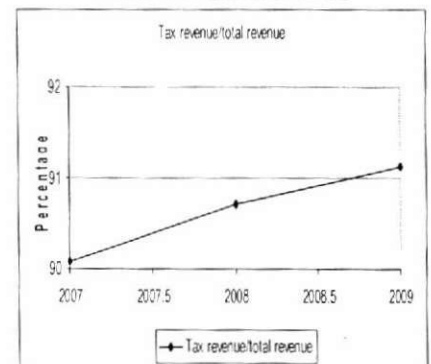
It is also important to look at the sources of this increased revenue. It is noticeable that the tax revenue has increased from 90% of total revenue in 2007 to about 91% of total revenue in 2008, which is expected to further increase to about 91.2% in 2009. This increase in government revenue is a salient feature of fiscal trends in recent years. However, enhanced government revenue during the past two years has been from external trade taxes. The

Dr. O.G. Dayaratna Banda

Department of Economics and  
Statistics,  
University of Peradeniya.

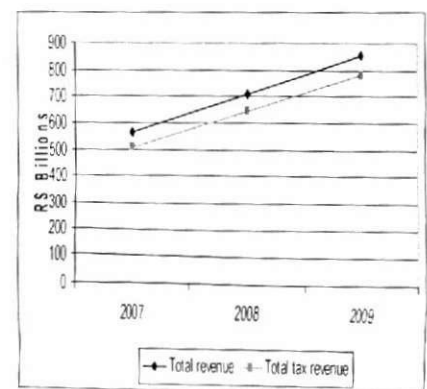
expected revenue in the next years will also basically be from the taxes on foreign trade. Though total tax revenue has increased, the revenue from income taxes has not increased considerably. In the coming year, this will not increase notably. While revenue from income taxes will remain more or less constant, revenue from external trade taxes will increase notably. Government has increasingly chosen to rely on external trade taxes to enhance revenue through a protectionist policy thrust in order to generate revenue (Figure 2 to 4).

Figure 2  
Trends in Tax Revenue



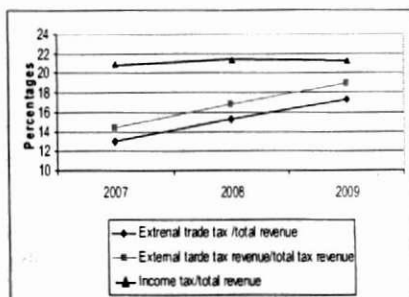
Source: President of Sri Lanka, 2008

Figure 3  
Total Revenue versus Tax Revenue



Source: President of Sri Lanka, 2008

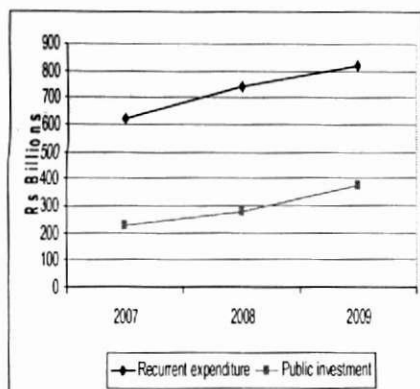
**Figure 4**  
Relative Importance of External Trade Taxes



Source: President of Sri Lanka, 2008

Total government expenditure has also increased from about Rs 800 billion in 2007 to around 1000 billion in 2008. This will further increase to about Rs 1200 billion in 2009. This increase in government expenditure has mainly been driven by the military expenditure, social welfare expenditure, expenditure on various subsidies, and investment in infrastructure. One has to understand these trends within the context of fighting LTTE militarily, refocusing more on various subsidies and social welfare programmes, and developing physical infrastructure to honour the majority's preference even with enhanced budget deficits (Figure 5 and 6 for trends in public investment and budget deficits).

**Figure 5**  
Public Investment

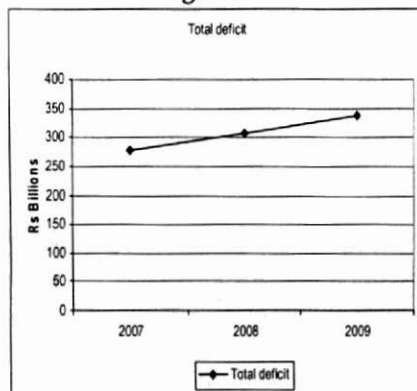


Source: President of Sri Lanka, 2008

Both government consumption expenditure and investment expenditure have increased from their levels in 2007. The total government consumption expenditure has increased from about Rs 590 billion in 2007 to about Rs 720 billion in 2008. This is expected to increase to Rs 800 billion

in 2009. The investment expenditure has also increased from about Rs 220 billion in 2007 to about Rs 290 billion in 2008. This is expected to increase to Rs 400 Billion in 2009. While there is heightened focus on confronting LTTE militarily, it is imperative that government spends money on building infrastructure to sustain the support of the electorate.

**Figure 6**  
Budget Deficit

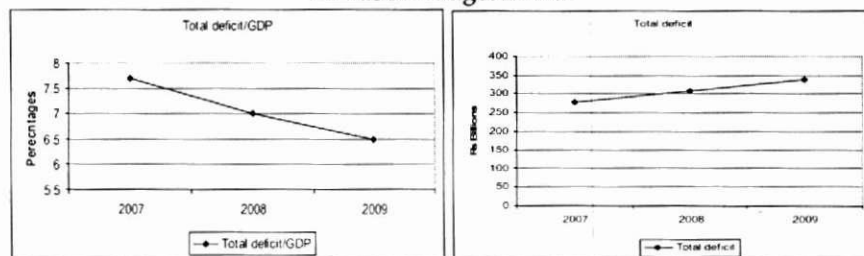


Source: President of Sri Lanka, 2008

### 3. Budget Deficit and its Financing

Two aspects have to be looked into regarding the budget deficit. While the budget deficit as a percentage of gross domestic product (GDP) has declined from about 7.5% in 2007 to about 6.5% in 2009, mainly because the increase of GDP exceeded the corresponding increase in budget deficit; the total budget deficit has increased from about Rs 270 billion in 2007 to about 300 billion in 2008, which is expected to increase to about Rs 340 billion in 2009 (Figure 7).

**Figure 7**  
Trends in Budget Deficit

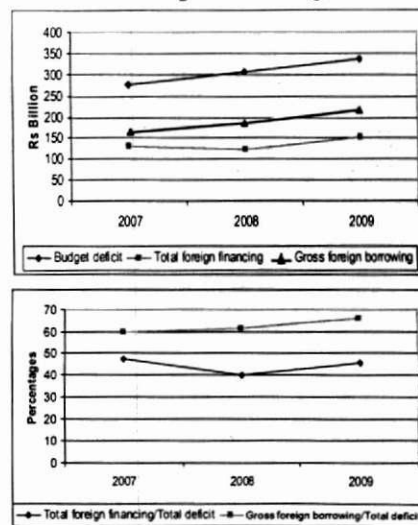


Source: President of Sri Lanka, 2008

Though the rhetoric has been otherwise, the government has relied and will continue to basically rely on foreign sources for financing budget deficit, through non-concessionary

borrowing (Figure 8). While the initial attempts during 2005-2006 was to focus more on domestic sources, government appears to have been concerned about the inflationary effects of budget deficits.

**Figure 8**  
Foreign Financing



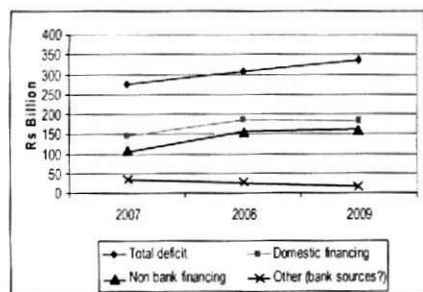
Source: President of Sri Lanka, 2008

To avoid conditions attached to foreign financing, government has been borrowing and will borrow at market rates from foreign markets (Figure 8). Issue of dollar denominated bonds is an example. However, borrowing from foreign sources at market rates will be difficult for the year 2009 as a result of current global financial crisis. However, there are few issues here. First, borrowing from foreign countries to develop economic activities in the non-tradable sector is not feasible, as repayment will be

difficult in the future. If foreign money is not able to develop the export capacity of the economy, it will be difficult for the government to find foreign exchange for servicing debt in the future. Second, borrowing from

market sources at market rates will be extremely difficult due to the current global financial crisis. It should be noted here that Sri Lanka's sovereign credit ratings have been downgraded by rating agencies recently as a result of increased budget deficit and worsened fiscal situation.

**Figure 9**  
**Domestic Financing**



Source: President of Sri Lanka, 2008

Borrowing from domestic sources has also increased. Government has been heavily borrowing from domestic non-bank sources, as they do not have inflationary effects. However, government has chosen not to depend on domestic banking sources as it creates inflationary pressures. This policy may change in the years 2009 as earmarked foreign borrowing will become difficult due to global financial crisis. Government will be compelled to draw resources from domestic banking sector for financing deficits.

#### 4. Some Perspectives on Macroeconomic Implications

Whether a budget can stimulate or retard economic growth depend on to what activities that the government is expected to channel funds. Government consumption expenditure has increased because of the war-related expenditure, enhanced social welfare subsidies, recruitment of personnel for public service. However, government has to rethink about the enlarging government size in the form of increased public consumption, as this expansion might occur at the expense of the private economic activity.

Government's thrust towards developing the physical infrastructure

will be favourable for economic growth. The budget is likely to positively contribute to economic development as a result of the increased government investment spending, development of sea ports to promote Sri Lanka as an international logistic hub, enhanced focus on the small- and medium-scale industrial sector, and measures taken for promoting the paddy-dominated agricultural export-oriented sector.

The increases in government investment spending will generate activities that will complement private economic activity, thereby, fostering economic growth. Efforts to develop the physical infrastructure by devoting resources for the roads and sea ports can be appreciated. It would be best if the government can focus more on the activities which the market fails to provide such as public goods and services and social safety nets rather than trying to be a substitute for providing activities which can be provided effectively by the private agents in the economy. It appears that policy makers have failed to recognise and give prominence to the activities which the market system fails to provide efficiently.

However, this budget also contains elements that are likely to retard economic development. Economic development will be negatively affected as a result of increased government consumption spending, lack of focus on measures to exploit the benefits of the global outsourcing industry, weakening private economic activity due to credit crunch created by increased interest rates, and lack of policies for promoting productivity growth.

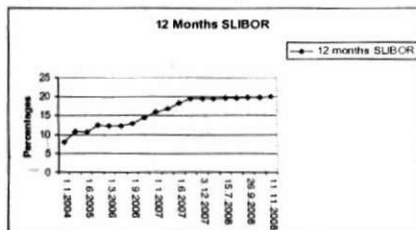
The budget has not clearly envisaged the role of the private sector in absorbing the unemployed population. What has been done basically is the absorption of these persons into the government sector for various jobs. The domestic agricultural sector is facing a huge labour shortage, though the number unemployed is notable. Lack

of modernisation of the agricultural sector has prevented even low-educated and low-skilled individuals choosing to employ in the agricultural sector. There is also an expected decline of garment exports to the North America and Europe due to global financial crisis and emerging global recession. This will worsen the unemployment problem. The declines in commodity trade, especially rubber, due to global financial crisis and emerging recession will also worsen unemployment problem. However, measures taken to reduce the level of unemployment through productive market-based approach are not present in this budget.

The government has taken a concerted effort in the budget to avoid inflationary effects of deficit financing by choosing to finance the deficit from foreign sources and domestic non-inflationary sources. While non reliance of the government to finance the deficit through inflationary sources is appreciated, government will likely to be compelled to tilt towards financing the proposed deficits through domestic inflationary sources as external borrowing will be limited due to global financial crisis.

During 2006-2008, inflation rate increased to about 25%. In order to contain inflation, the Central Bank had to raise official interest rates. As the figure shows, the Sri Lanka inter bank offer rate (SLIBOR), the rate offered by the banks to customers, has been increasing very rapidly. The SLIBOR has increased from around 7.5% in 2004 to about 20% in November 2008 (Central Bank of Sri Lanka, 2008). This increase has raised the cost of borrowing. The borrowing potentials of small- and medium-scale borrowers have declined. The fiscal and monetary policies have, therefore, created a situation of credit crunch, leading to crowding out of private economic activity. The source of this crowding out of private economic activity has been due to the increased public spending. This pressure on private economic activity is likely to weaken the local economy.

**Figure : 10**  
**Trends in Interest Rates and Possible Crowding out of private economic activity**



Source: Central Bank of Sri Lanka, 2008

### Concluding Remarks

Though there are measures in the budget that would enhance fiscal situation, the measures taken do not suffice to improve fiscal situation. Though foreign commercial borrowing has been identified as a mean through which the budget will be financed, borrowing non-concessionary loans under London Inter Bank Offer Rates (LIBOR) (Figure 10) will be unfeasible

and extremely difficult with the current global financial crisis. As borrowing from commercial sources will be difficult, government will either have to seek funding from various international development institutions under various conditions, or will have to focus on borrowing from domestic inflationary sources creating inflationary effects of budget deficit in the year 2009. Increased interest rates have discouraged private borrowing and hence retarded private economic activity. There is no effective policy switch to abandon the populist non-productive subsidies. There is a lack of focus in the budget on reforming education and health sectors with a view to develop a knowledge economy. The present regime appears to operate on the premise that government should be a substitute for individual economic activity, rather than working to support individual economic activity. Rather than focusing on providing

essential public goods and services, government is increasingly entering into areas which can be effectively provided by private economic agents. The budget does not include a clear policy or programme to enhance total factor productivity growth through a proper national innovation system. The proposed budget will generate both positive and negative macroeconomic implications, the net effect remains to be seen at the end of year 2009.

### References

- Central Bank of Sri Lanka. (2007). *Annual Report, Colombo.*
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Hence, any decline in foreign inflows due to these reasons would affect the planned public investments of the government, which will lead to the prioritisation of the development projects particularly to continue with mega infrastructure development projects unabated. In addition, the disbursement of concessional financing could also be slowed down in 2009 if there are difficulties in providing necessary counterpart funds by the government.

The difficulties in obtaining foreign commercial financing point to the necessity of introducing alternative financing methods to face the challenges during a historically difficult period of time. Accordingly, the government and the Central Bank of Sri Lanka have introduced alternative financing mechanisms to better face this emerging challenge. The opening up of the government securities market for Sri Lankan Diaspora and the working community overseas is one such activity that has been introduced with a view of obtaining new sources for invest in government securities.

### The Way Forward

Sri Lanka, being a small open economy, seems to be impacting from the ongoing global financial crisis slowly. In the meantime, the humanitarian operations are nearing completion requiring a huge amount of funds to resettle people and, rehabilitate and reconstruct the infrastructure in the conflict-affected areas. At this critical juncture, the country needs to handle the emerging issues cautiously with a better understanding about the potential risks. Hence, a concerted effort by all stakeholders is necessary to face the challenges particularly emanating from the global financial crisis, in which the success of the implementation of Budget 2009 would mainly depend.

### References

- Ministry of Finance and Planning (2008), *Budget Speech - 2009, Sri Lanka.*
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- International Monetary Fund (2008). *Global Financial Stability Report (October 2008).*
- International Monetary Fund (2009). *World Economic Outlook Update (28 January 2009).*

### Footnotes

- <sup>1</sup> The views expressed in this article are those of the author and are not those of the Central Bank of Sri Lanka.
- <sup>2</sup> IMF, October 2008
- <sup>3</sup> IMF, October 2008.
- <sup>4</sup> The use of 'fiscal stimulus' as a counter cyclical or stabilisation measure has gained momentum in order to offset declines in economic activity of the private sector in the midst of adverse economic developments.
- <sup>5</sup> The IMF has also indicated that "a sustained economic recovery will not be possible until the financial sector's functionality is restored and credit markets are unclogged. For this purpose, new policy initiatives are needed to produce credible loan loss recognition; sort financial companies according to their medium-run viability; and provide public support to viable institutions by injecting capital and carving out bad assets. Monetary and fiscal policies need to become even more supportive of aggregate demand and sustain this stance over the foreseeable future, while developing strategies to ensure long-term fiscal sustainability".
- " This amount includes the provision of a concession of Rs. 20 per litre for the petrol for three wheeler owners with a view of giving the ultimate benefit of this measure to the passengers who use three wheelers as their mode of transport.
- <sup>7</sup> IMF, 28 January 2009.