

## DEVELOPMENT FEATURES OF THE 1985 BUDGETARY PROPOSALS

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### Introduction

The Minister of Finance and Planning presented the government's eight budget on November 16, 1984, outlining the income and expenditure proposals of a Rs. 59,498 million budget for the fiscal year 1985. In current values the 1985 budget estimate indicates an increase of 16 percent compared with the 1984 budget estimate of Rs. 51,377 million. The Minister calls his 1985 budget a 'surplus budget' as he expects the total budgetary resources available to the government to exceed the total budgetary expenditures by Rs. 1 billion. However, in economic terminology, the 1985 budget does not meet the conditions of a 'surplus budget' as the income side of the budget consists of borrowings to meet the resource shortfall to fully support the planned budgetary expenditure program. Conceptually, a surplus budget is defined in terms of excess receipts from domestic revenue sources, excluding borrowings either domestically or externally, over the proposed expenditure programs. According to the revenue proposals, only Rs. 38 billion comes from revenue sources, thus the budget deficit of Rs. 21.5 billion is financed from foreign grants and loans and domestic borrowings. As a ratio to GDP in current prices, the 1985 total expenditure works out to an estimated 40 percent, slightly above the estimated ratio of 38 percent in 1984, but still an improvement compared with the 1983 ratio of 44 percent. Despite this estimated marginal increase, as a ratio to GDP in 1985, the government appears to be paying greater attention to

spending control in order to improve the viability of the economy on a sustainable basis.

### Expenditure Proposals

Expenditure related to a recurrent nature accounts for Rs. 30,371 million, or approximately 50 percent of the total budget, which represents a 5 percent increase in current terms compared with the 1984 recurrent expenditure estimate of Rs. 28,217 million. Based on past experience, it has been estimated that the actual recurrent expenditure will be around Rs. 29,764 million, and as such, the budget provides only this amount for recurrent expenditure, leaving the balance of Rs. 607 million as an under-expenditure item in the recurrent budget. Of the recurrent budget estimates, expenditure on salaries of the government sector will account for Rs. 6.8 billion or 23 percent; interest on public debt, both domestic and external, for Rs. 8.2 billion or 27 percent; subsidies and grants for Rs. 6.2 billion or 21 percent. Expenditures related to general administration, office requisites, vehicles and building maintenance, travelling etc. together account for Rs. 8.7 billion or approximately 29 percent of the total recurrent budget.

During the fiscal year 1985, expenditures related to a capital nature will require an estimated Rs. 29.7 billion. It includes Rs. 7.1 billion for capital repayment on public debt, reflecting a three fold growth compared with the 1984 estimate of Rs. 2.4 billion and an increase from 10 percent to 24 percent as a share of the total capital expenditure budget. In terms of sectoral disaggregation, agriculture and related activities

account for Rs. 8.3 billion (28%); followed by economic overheads Rs. 3.8 billion (13%); housing Rs. 1.8 billion (6%); and social overheads Rs. 1.6 billion (5%). Capital spending on defense related expenditures is estimated to increase from Rs. 913 million in 1984 to Rs. 1.5 billion in 1985 accounting for 5 percent of the capital budget compared with 4 percent in 1984.

Based on the rates of growth of sectoral capital allocation transport, power, education, health and defence appear to be the priority areas in 1985 as reflected from respective increases of 195%, 70%, 76%, 87% and 67% when compared with their allocations in 1984. The agricultural sector capital budget has declined by 6 percent, industry by 2 percent and housing also by 2 percent. The agricultural sector's drop in capital spending is largely explained by the declining capital allocation on the Accelerated Mahaweli Program (AMP) from Rs. 6 billion in 1984 to Rs. 5.5 billion in 1985.

### Revenue Proposals

The revenue proposals for 1985 aim at collection of Rs. 38,041 million from indirect taxes, direct taxes and other non-tax revenue sources. According to the latest revision, these sources have resulted in Rs. 34,583 million in 1984, an increase of 30 percent from the original estimate of Rs. 26,618 million in 1984. Compared with the revised estimate for 1984, the revenue estimate for 1985 indicates a 10 percent increase. As the 1985 revenue proposals contained no major changes to the tax structure to raise the revenue base as in the past, it is not clear as to how the revenue from sales, exercise, and income is expected to increase by 28 percent, 13 percent and 38 percent, respectively; compared with 1984. In the absence of a clear strategy regarding higher revenue in 1985, the inflat-

ionary effect on prices appears to be the most reasonable explanation to result in the higher revenue estimate.

As a share of the total expenditure of Rs.59.5 billion, the 1985 revenue estimate accounts for 64 percent leaving a deficit of 36 percent or Rs.21,457 million in absolute terms, to be financed from non-revenue sources. About 65 percent of this deficit, or Rs. 14,071 million, is expected to be financed from external grants (Rs.3,607 million) and loans (Rs.10,464 million). The balance Rs.7,386 million will constitute borrowings from the non-banking domestic sector such as the provident and trust funds.

### Measuring Growth Effects through Spending Policies

The budget is the principal mechanism of guiding economic development and resource allocation on priority sectors in the economy and as such it plays an important and pervasive role in the functioning of the economy. This economic significance of the budget and its role in the economic development process, is directly related to revenue and expenditure proposals. These proposals not only signal the direction of economic policies of the government but are also aimed at achieving certain targets on major macro-economic variables such as output, employment, prices, exports and imports.

A comparison of public expenditure and revenue trends in terms of current and real prices, is attempted here in order to examine the real effects of the budgetary proposals on growth and development. These trends are depicted in the figure (on page 10) for the 1980-1985 period. As is apparent, both expenditure and revenue trends in current terms show a steady growth during the period considered. The annual expenditure target of Rs. 59.5 billion in 1985 indicates a nearly two fold growth compared with the actual expenditure of Rs.30.3 billion in 1980, while the 1985 revenue estimate of Rs.38.0 billion from both direct and indirect taxes, reflects closer to a three fold growth in comparison with the 1980 revenue collection of Rs.14.1 billion.

The computation in constant terms (1979 prices) shows that it was only in 1983 that the total budgetary expenditure remained higher than 1979; in all other years upto 1985 the annual budgetary expenditure remained less than 1979 in constant terms. However, if the rate of inflation in 1985 declines below the projected rate of 15 percent, the 1985 planned expenditure could result in a marginal increase and a declining trend between 1980 and 1982, a sharp and steady increase in 1983 and 1984 and a marginal drop in the expected revenue for 1985. The revenue trends in constant terms show a mixed performance.

The difference in the trends between current and constant terms which is apparently quite significant underlines the inflationary consequences prevailing in the economy. This is very clearly featured in the annual public expenditure allocations. Although the annual public expenditure allocation is progressively increasing in current prices, the real effects of a given level of expenditure remains either stagnant

Table 1

#### Summary of Budgetary Operations

	1982	1983(b)	1984(c)	1985(c)
Recurrent Expenditure (a)	20,113	24,737	28,217	29,764
Capital Expenditure (a)	17,984	20,915	23,160	29,734
<b>Total Expenditure</b>	<b>38,097</b>	<b>45,652</b>	<b>51,377</b>	<b>59,498</b>
Revenue	17,809	24,094	34,588	38,041
<b>Budget Deficit</b>	<b>20,288</b>	<b>21,558</b>	<b>16,789</b>	<b>21,457</b>
<b>Financing from:</b>				
Foreign Aid	10,594	12,342	13,068	14,071
(Grants)	-	-	(4,218)	(3,807)
(Loans)	-	-	(8,850)	(10,464)
<b>Domestic non-balance</b>				
borrowings	4,006	8,625	3,721	7,386
Banking System	6,000	608	0	0
(a) Excluding under-expenditure estimates				
(b) Provisional				
(c) Estimate				

Source : Budget Estimates and Statistics

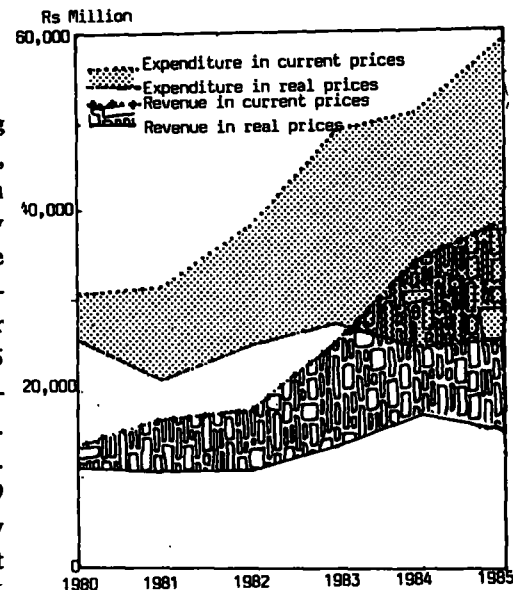
or declining with perhaps the only exception in 1983. The implication of this is that, to obtain a given volume of goods and services at any given time requires an increasing allocation of financial resources than what would have been required in the past. This higher cost during the latter period, compared to the former period, reflects the effects of inflation on prices. For example, the Rs.30.3 billion expenditure allocation in 1980 was equivalent to only Rs.25.7 billion, if the 1980 expenditure outlay is measured in terms of the 1979 prices. In other words, by spending Rs.1.18 in 1980, a rupee worth of goods and services in 1979 prices would have been purchased in 1980. By the same comparison it can be shown that Rs.2.40 in 1985 in current prices, is equivalent to Rs.1.00 in 1979 constant prices, implying the sharp deterioration of the real value of the rupee due to continuing high inflationary tendencies.

In an inflationary situation, an increasing allocation of public expenditure may not necessarily lead to an increasing level of public spending in real terms. As such, a higher expenditure allocation on current terms also may not necessarily lead to higher outputs of goods and services in the economy. For example, despite increasing capital spending in current terms, the GDP growth appears to have reached a stabilizing point of around 5 percent per annum and the economy is expected to grow at this same level until about 1988 according to the projected annual GDP growth rate in the Public Investment Plan (PIP) for the 1984/88 period. If the real value of the rupee experiences further deterioration public expenditure in current terms will have to be increased in ensuing years to offset inflationary effects on prices. Such increases of public spending are again not ex-

pected to produce any significant impact on real expenditure, output or employment.

Examining the capital spending component of the 1985 Budget, it is evident that the increase in current terms has been primarily caused by the increase of the capital expenditure in non-productive sectors in the economy. For example, in current value, the 1985 expenditure program, both recurrent and capital, increased by Rs. 8.1 billion from the 1984 estimate. Of this increase Rs.1,547 or 19 percent has been accounted for by expenditures related to recurrent nature. The balance of Rs.6.6 billion or 81 percent of the total increase, has been accounted for the capital spending budget. However, as the debt repayment in 1985 has been tentatively estimated at Rs.7.1 billion, an increase of Rs. 4.7 billion compared to the debt repayment of Rs.2.4 billion in 1984, increased debt repayment has absorbed over 70 percent of the increase in the capital budget. In addition, capital expenditure allocation of the defence budget has gone up by Rs.600 million and this together with increased debt repayment commitment account for over 80 percent of the increase in capital expenditure in 1985. Unfortunately, expenditures related to debt repayment and defence will have no impact what so ever on economic growth or employment. Moreover, as the total spending in 1985 is declining in constant terms, the increase in current terms in debt repayment and defence necessarily implies that there is a greater reduction of capital spending in constant terms in some economically important sectors such as agriculture. The picture that emerges from the capital spending allocation is certainly not a very promising one for growth and development.

EXPENDITURE AND REVENUE  
IN CURRENT AND REAL TERMS



#### Budget's Impact on the Private Sector

The budgetary proposals during the last few years reflected an increasing concern about the need for greater fiscal discipline with a view to achieve a reduction in the budget deficit, which in the early 1980's emerged as a principal contributory factor for sustained inflationary experience in the economy. This concern led to the introduction of a number of reforms including public spending controls and the mobilization of higher revenue from domestic sources. The 'no new development projects' policy adopted since 1981 still remains effective and only a few development projects have been approved subsequently on a very selective basis. While this policy helped to check on the public spending growth, tax reforms resulted in a considerable improvement in the revenue side of the budget.

While these measures are considered important in the present context, they are likely to have an

adverse effect on the economy particularly when there is a disproportionate increase in revenue compared with the increase in public spending. This over-riding importance in tax reforms often results in a situation known as a 'fiscal drag' which is characterized by slow economic growth due to reduced economic activities and consumer purchasing power. To a greater extent this situation could be avoided by making use of investment expenditure on short gestation projects with greater economic returns or by providing incentives and facilities to attract private sector investments into the production process. In the case of the former, the flexibility appears to be highly limited due to the government's prior commitment on long gestation projects such as the Accelerated Mahaweli Program (AMP) which still continues to be a priority area of public investments. Until the AMP is fully completed the economy will have to be largely dependent upon the private sector for investments to promote economic growth and generate employment.

The government is fully aware of the need for a greater private sector role in the economy. It is in view of this recognition that the Minister has decided to grant a few more incentives to the private sector in the form of reduced import duties for certain categories of imports. Although these concessions would help some industrialists, the effectiveness of such incentives to mobilise private sector interest on a much larger scale appears to be highly limited. Reportedly the policies on interest rates, foreign exchange rates, tax rates and domestic credit facilities have been designed to achieve narrow objectives and as such the private sector do not view these policies favourably to undertake production oriented undertakings.

Over 70 percent of the formal private sector activities still continues to be in the wholesale and retail trade and services.

### Growth and Development

Sri Lanka's GDP growth rate has averaged around 5 percent during the last few years and according to current projections, the growth rate during the next five years will also remain around the same figure. This certainly is an achievement particularly in the context of growth trends during the 1970-77 period. However, this growth rate does not look very optimistic in addressing persisting development issues such as poverty, unemployment, and under-employment, malnutrition and inequality in income distribution. Despite historically high growth rates since the economic liberalization in 1977 some of these development problems have either exacerbated or remained unaffected in recent times.

#### (a) Growth Trends in GDP and GNP

Perhaps the most important indicator with regard to economic and social progress accompanied by historically high GDP growth rates since 1977 is the real GNP per capita growth rate. The highest GNP per capita growth rate, after 1977, has been achieved in

1978 which amounted to 6.8 percent. Thereafter it has progressively declined reaching 2.5 percent in 1983 (Table 2). As this measure is arrived at by subtracting the annual rate of population growth from the GDP growth rate, the rate of population growth has a considerable influence in the GNP per capita growth rate. The 1.5 percent population growth rate employed in the 1983 computation of real per capita income substantially differs from the Census and Statistics Department estimate of 2.1 percent natural population growth rate for 1983, indicating that an adjustment has been made on net out migration to arrive at a 1.5 percent growth rate. It is certainly logical to make such an adjustment in computing the annual growth in real per capita incomes but, as the employment opportunities in the Middle Eastern countries are likely to stabilize over the next few years, the difference between the natural population growth rate and the adjusted growth is likely to be marginal. Moreover, the estimate of out migration resulting from the difference between the two rates in 1983 appears to be overly optimistic, as it works out to approximately 84,000 million leaving the country in 1983.

The figures in table II also reflect a growing difference between the GDP growth rate and the GNP

Table II

	1978	1979	1980	1981	1982	1983
1. GDP growth at constant (1970) factor prices	8.2	6.3	5.8	5.8	5.1	5.0
2. GNP growth at constant (1970) factor prices	8.8	6.4	5.6	4.1	4.8	4.0
3. Population growth rate	1.8	2.0	1.8	1.7	1.7	1.5
4. GNP per capita growth rate at constant prices	6.8	4.3	3.6	2.7	3.1	2.5

Source : Central Bank of Ceylon

growth rate. In 1983, for example, while the GDP growth rate increased by 5.0 percent, the GNP growth rate reflected only an increase of 4.0 percent. This difference between the two measures is explained by the outflow of resources in the form of dividends, profits and interest on foreign capital employed in domestic production. A gradual rise in net resource outflow will have to be expected in the coming years with higher outflow of remittances from the Free Trade Zone (FTZ) and Foreign Investment Advisory Committees (FIAC) projects. This increase in resource outflow together with a possible reduction in the migration rate will inevitably lead to a drop in the real per capita incomes unless the GDP growth attains higher levels than what has been currently projected for the next five years.

#### (b) Income Distribution and Nutritional Standards

One of the most frequently employed indicators in assessing and evaluating the effectiveness of development policies is the data on

income distribution. They reflect over time changes in the shares of income going to different segments of the population. Generally speaking an improvement in the income shares of the low income groups is viewed as a positive outcome of a given set of economic policies. Unfortunately the income distribution data, computed by the Central Bank and shown in table 3, available at the present time indicates a disappointing performance with a decline in the relative income shares of the low income groups. The most logical explanation of these developments in income distribution is that there has been a disproportionate growth in income among different income groups with the highest income groups receiving a higher share of income at the expense of the low income groups.

A recent analysis carried out by the Food and Nutrition Policy Planning Division (FNPPD) of the Ministry of Plan Implementation provides indirect evidence to support the increasing inequality in income distribution. This study shows a declining trend of the

overall nutritional standard of the population between 1970/71 and 1980/81. Moreover, the population suffering from malnutrition and acute malnutrition appears to have significantly increased. During the budget speech, the Minister of Finance acknowledged the fact that there has been a decline in the nutritional status of particularly the bottom 30% of the population. He proposed the revision of the Food Stamp Scheme, by limiting food assistance to the most needy bottom 30 percent of the population and doubling the value of food stamps, as a means to improve the protein and calorie intake of the low income groups. The most important point hidden in this discovery of the deterioration of the nutritional standards is that despite higher investments by both public and private sectors and growth and expansion of the economy, the proportion of population living below poverty has not diminished. The available evidence points to increasing incidence of poverty and declining socio-economic status.

#### (c) Employment and Unemployment Trends

While delivering the budget speech, the Minister noted that the current rate of unemployment has declined to about 12 percent compared with the rate of over 25 percent at the time that the present government assumed office in 1977

The unemployment rate figure quoted by the Minister comes from the 1980/81 Socio-Economic Survey of the Central Bank. On the other hand, the Census and Statistics Department reported an unemployment rate of 14 percent for the same period while the Public Investment Plan reported an unemployment rate of 15 percent for 1983. These varying rates of unemployment make it difficult to arrive

Table III

#### Percentage of Income Received by Each Twenty Percent Ranked Income Receivers - All Island

Ranked Income Receivers	1973	1978/79	1981/82
Lowest 20%	4.97	3.76	3.70
Second 20%	10.08	8.36	8.08
Third 20%	15.85	13.22	12.50
Fourth 20%	23.21	20.35	19.21
Highest 20%	45.89	54.31	56.52
Medium Income per month (Rs.)	180	408	612

Source : Report on Consumer Finances and Socio-Economic Survey 1981/82,

Part I, Central Bank of Ceylon

## EMPLOYMENT GENERATION (1978 - 1983)

	1978	1979	1980	1981	1982	1983	Total
Government	24,436	24,103	6,193	5,389	4,337	4,670	69,130
Semi-Government	35,439	68,000	8,812	9,077	4,035	1,340	126,703
Formal Private sector		110,000	3,030	5,411	7,687	N.A.	125,128
Total			18,035	19,877	16,059	6,010	321,961

Source : *Central Bank of Ceylon*

Note : These figures add up to less than 371,000 reported in the 1982 *Review of the Economy* as new jobs during the 1978-82 period .

at a firm conclusion about the level of unemployment currently prevailing. The methodologies adopted in the computation of the unemployment rates seen to reflect some manipulation with a view to report a lower unemployment rate. For example, the 1980/81 Labour Force and Socio-Economic Survey of the Census and Statistics Department classifies 6.4 million as economically inactive of which nearly 3.0 million have passed grade 6 or above and 6,693 are graduates.

To bring down the unemployment rate from over 25 percent in 1977 to between 12 percent and 15 percent at present required new jobs amounting to over 1.4 million between 1978 and 1984. According to the Central Bank data on employment generation, about 371,000 jobs have been created in the organized sector (ie. government, semi government and formal private sector) including 143,000 jobs in the formal private sector during the 1978-82 period. However, employment generation capacity in the organised sector has taken a downward trend thereafter. The 1982 Central Bank Review states that "Since employment generation has declined from about 45,000 jobs in 1980 to about 20,000 jobs

in 1981 and to only 16,000 jobs in 1982, this amount of employment generation in the organized sector is quite inadequate to cope with the unemployment problems in the country since about 125,000 persons are estimated to join the work force each year".

Unless the informal private sector has been very active to absorb between 800,000 to 900,000 of the labour force since 1978, the improvement in the unemployment situation appears to be significantly less than what has been claimed by official sources. It is generally believed that upto about 1980, there has been a rapid growth in informal activities in the economy but with the decline in the GDP growth rate and the new employment opportunities in the organized sector after 1980, the employment generating capacity in the informal sector could have drastically declined. An estimate of around 600,000 jobs would be the most optimistic figure of employment in the informal sector between 1978 to 1983, even if a very high ratio of 1:8 between direct to indirect employment is considered. Moreover, the increasing inequality in income distribution and declining nutritional status become conflicting findings if the economy is not confronted with a serious

unemployment problem.

The 1985 budget offers no relief to the unemployed. While no new development projects have been planned during the 1985 fiscal year, economic policies have not changed significantly to activate the private sector on a much larger scale. In addition, construction, services and wholesale and retail trade sectors, which together accounted for a greater proportion of formal and informal private sector employment during the 1978-80 period, have reached saturation points with the stabilization of economic growth around 5.0% per annum. Therefore, the likelihood of a significant upturn in the unemployment situation in 1985 is rather remote and, accordingly, both open and hidden employment among various income, educational age and sex groups could remain largely unaffected.

### Conclusion

Viewed from a development perspective, the 1985 budgetary proposals are not likely to bring about a significant growth impact in the economy either through public investments or through mobilization of private sector investments into new economic ventures. As noted earlier, the 1985 public investments reflect only a marginal increase, and, in constant terms the 1985 proposed expenditure levels could be even less than the 1979 level of expenditure. The Mahaweli program accounts for almost 1/3 of the investments leaving the balance for projects in all other sectors. Highway development and improvement has been identified as a priority area in the 1985 budget and apart from this new priority sector, the latest budget differs only slightly from the previous budgets since 1980 in terms of investment allocations.

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The most serious shortcoming of the budget is that it does not address policies to directly deal with issues such as unemployment, income distribution and nutritional standards. While the importance of the GDP growth cannot be undermined, the effectiveness of a given set of economic policies is often measured in terms of the improvements in employment, income distribution, nutritional standards and the poverty situation. Although the decision to revise the food stamp scheme indicates the government's awareness and concern regarding the declining status of nutritional level, the most appropriate approach would have been the provision of financial means through employment rather than increasing food assistance. For this to occur, development strategies should require the consideration of the poor as the specific beneficiaries or a target group.

Despite a number of positive features of economic liberalization policies, a comprehensive approach to development seems to be missing. Frequently the development policies are based on adhoc decisions and as such they suffer from lack of direction which in turn lead to conflicting objectives or outcomes in different sections in the economy. The lack of comprehensiveness is also the main reason for accepting financially and economically non viable projects and rejecting economically viable labour intensive projects. In other words, the policy framework within which the development policies are pursued neglects the fact that the Sri Lankan economy operates within a scarce resource base. If these concerns are not taken into consideration, we may have to define socio-economic development in terms of the volume of investments and not by the outcomes of such investments.