

MACRO-ECONOMIC IMPLICA-**P.B. Jayasundera***Ministry of Finance and Planning*

The Government Budget is a financial plan showing an estimate of Revenue and Expenditure and the manner in which surplus is disposed of or a deficit is financed in a given time period. The Revenue - Expenditure-financing process of the Budget strongly influences the economic activities of the country. Mobilization of resources through tax and non-tax sources as well as through borrowings and allocation of these resources through expenditure programs influences overall economic activity by altering the resource allocation and redistribution of income and wealth among different income groups of the society. In this process the budget also influences prices, interest, exchange rate, employment and income.

Hence, the budgetary policy alone or with the help of other policy measures can be used to achieve social and economic objectives in a variety of ways. For instance, it can introduce measures to increase the rate of savings and channel them into productive areas. Similarly, measures can be introduced to eliminate distortions in relative prices and designed to maintain stability in prices by minimising fiscal imbalances. Since these objectives are not mutually consistent and difficult to achieve simultaneously, policies have to be designed more often, with a view to achieving most important objectives. For instance, though rapid economic growth is a primary objective of a developing country like Sri Lanka, it cannot be pursued without giving due consideration to other development objectives such as welfare and income redistribution. However, the latter objective cannot be achieved without channelling sufficient resour-

TIONS OF THE BUDGET

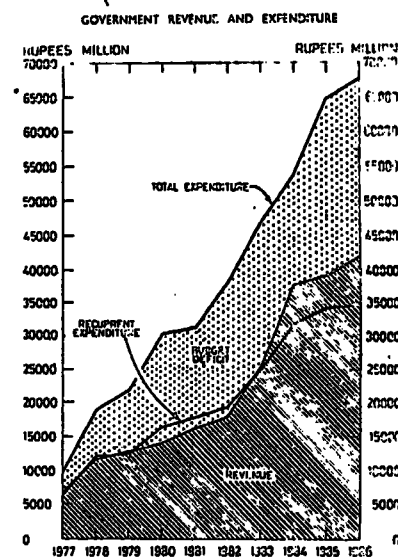
ces to achieve an adequate rate of economic growth and employment. Both these objectives on the other hand could also be self-defeating ones unless adequate consideration is given to the importance of stability in prices, interest rates, exchange rates and balance of payments.

Sri Lanka witnessed sizeable budget deficits in recent years. For instance the average budget deficit for the period 1985-1987 was 12 per cent of GDP. The basic cause for a higher budget deficit is due to the tendency for government expenditure growth to outstrip growth in government revenue. Although, Government revenue was increased over 20 per cent of GDP, keeping government expenditure in check was a problem largely due to the escalation of defence related expenditure during the last few years. Although, a large part of the deficit has been financed by foreign and domestic non-bank sources as shown in table 1, borrowings from the banking system also has been a regular feature in recent years.

The higher budget deficit has a decisive impact on the economy. Firstly,

the deficit financed from banking sources tends to increase the money supply in the economy exerting pressure both on prices and balance of payments, leading to a frequent loss in external reserves. In this context, maintenance of a stable exchange rate becomes a difficult task. In order to minimise the adverse consequences of liquidity effect of the budget, monetary policy is required to adopt a restrictive stance. However, this leads to higher interest rates which in turn affect private sector investments. Secondly, a higher deficit financed by foreign borrowings leads to an accumulation of foreign liabilities which in turn creates a debt service burden on the economy. Thirdly, a higher deficit also tends to pre-empt available resources to the private sector, and raise interest rates which in turn affect investment adversely.

Therefore, it is necessary to reduce the budget deficit to manageable proportions in order to achieve social and economic development objectives. For this purpose, mere increases in tax rates, or reduction in expenditure are not adequate. Instead, far reaching policy measures are necessary to expand the tax base and to rationalize government expenditure programs. Simplification of taxes, reduction in



the tax burden and improvement in tax administration can be useful to expand the tax base and at the same time minimise tax avoidance and tax evasion. Government expenditure can also be checked by selecting priority areas of social and economic development and through an effective fiscal monitoring system. Through these efforts borrowing requirements of the government can be reduced so as to contain debt service payments and provide more resources to private sector economic activities. It would also be of substantial assistance to ensure the stability in macro economic variables.

Budget for 1988

The Budget for 1988 carries as one of its main objectives the importance in the fiscal management and is designed primarily to enable the government to reduce its budget deficit on a gradual basis, in order to achieve a sustainable level of economic growth and maintain financial stability and at the same time achieve a viable balance of payments position. For this purpose the budget is intergrated into a medium term policy framework to be carried out in the period 1988-1990. In essence the budget for 1988 laid a foundation for the medium term policy framework by setting initial targets for macro economic variables.

The main features of the proposals in the 1988 budget were the measures to simplify income taxes and import

TABLE 1

BUDGETARY COMPONENTS

(FIGURES ARE GIVEN AS PERCENTAGE OF GDP)

	1985-87 (Average)	1988
1. Government Revenue	21.3	20.4
2. Recurrent Expenditure	19.6	17.9
3. Government Savings (1-2)	1.7	2.5
4. Capital Expenditure	13.6	14.1
5. Overall Deficit (4-3)	11.9	11.6
6. Foreign Grants	2.2	2.2
7. Deficit after grants (5-6)	4.7	5.5
7.1 Foreign loans	4.4	5.5
7.2 Domestic borrowing O/W Bank financing	5.3 2.2	3.9 1.1

Source: Central Bank of Sri Lanka.

duties and to provide additional incentives to the exporters who have adversely been affected by the declines in export prices. Meanwhile, revenue mobilization efforts are strengthened through sales taxes, fees and charges on selected government services. The emphasis on government expenditure is placed on priority areas, on-going development projects and welfare programs for the low income groups. Capital expenditure of the government is planned to reduce gradually. Hence, in 1988, the government Revenue/GDP ratio is expected to be around 20 per cent, while the Expenditure/

GDP ratio is to be around 32 per cent.

As shown in table 1, the projected budget deficit for 1988 is 11.6 per cent, which is slightly lower than the average deficit for the period 1985-1987. Although the overall deficit/GDP ratio is 11.6 per cent, the borrowing requirements of the budget is 9.4 per cent of GDP, as foreign grants amount to 2.2 per cent of GDP in 1988. In financing the deficit, foreign loans are expected to contribute 5.5 per cent of GDP. Hence, resource requirements from domestic sources will decline to 3.9 per cent of GDP in 1988 from 5.3 per cent of GDP in the 1985-

1987 period. Because of the reduction in the use of domestic resources for financing purposes, Bank borrowings in 1988 will be about 1 per cent of GDP as against 2 per cent in the 1985-87 period. Hence, the inflation potential of the budget, resulting from liquidity creation, is reduced in the 1988 budget. Adjustments towards lowering budget deficits and at the same time towards reducing the recourse to Bank borrowings will contribute to ensure macro economic stability and thereby to bolstering confidence in Sri Lanka's effort to accelerate its economic and social development.

BUDGET 1978-

15 Nov. 1977

The first Budget presented by Minister of Finance and Planning, Mr. Ronnie de Mel introduced far reaching measures to liberalise the economy, including abolition of import and exchange controls, allocations and licensing procedures, and unification of the exchange rate. Total expenditure in the Estimates was Rs.18.9 billion and total revenue was Rs.12.3 billion, leaving a budget deficit of Rs.6.6 billion to be financed by foreign resources Rs.3.8 billion (58%); and Rs.2.8 billion (42%) domestic resources.

15 Nov. 1978

Carrying forward the objectives and policies laid down in his first Budget the Minister announced more reforms and concessions in taxation, duties, social welfare and wage structures in his Budget for 1979. Public servants and pensioners were granted a 10% increase in consolidated salary subjected to a minimum increase of Rs.50 per month. A new Inland Revenue Act to simplify and rationalise taxation was proposed while tax incentives were introduced for Housing, Savings and Investments, and the five year tax holiday for small and medium scale industries further extended. Total expenditure in the Draft Estimates was Rs.21.5 billion and total revenue was Rs.14.1 billion leaving a budget deficit of Rs.7.4 billion to be financed by foreign resources Rs.2.9 billion (39%); and Rs.4.5 billion (61%) domestic resources.

14 Nov. 1979

The third Budget afforded relief to the plantation sector with price supports for Tea, and increases in the rubber replanting subsidy and also for coconut new plantings and replantings. Export duties for certain minor export crops were also abolished. The rate of taxation on resident companies was revised and new broad based companies offered tax exemptions. The maximum marginal rate of income tax was reduced from 70% to 55% and value of immovable property frozen at the March 31 1977 value for wealth tax purposes. Total expenditure in the Draft Estimates was Rs.30.3 billion and total revenue was Rs.16.7 billion leaving a budget deficit of Rs.13.6 billion, to be financed by foreign resources Rs.4.1 billion (30%); and Rs.9.5 billion (70%) domestic resources.

5 Nov. 1980

The fourth Budget imposed a once and for all surcharge of 19% on income tax payable by all persons including companies for the year of assessment 1980-1981. It made provision to grant every employee in government services and government pensioners an allowance of Rs. 70 per month from January 1981, as a special Cost of Living Allowance. The guaranteed price for a bushel of paddy was increased from Rs.40 to Rs.50 a bushel. A withholding tax of 2% was brought in respect of contracts relating to building and construction, and changes were announced to rectify existing anomalies in the Inland Revenue Act regarding small quoted business companies, export oriented industries, and capital gains. Automatic penalties on tax in default were increased from 25 to 50 percent. Total expenditure in the Draft Estimates was Rs.31.1 billion and total revenue was Rs.19.0 billion, leaving a budget deficit of Rs.12.1 billion, to be financed by foreign resources Rs.5.5 billion (45%); and Rs.6.6 billion (55%) domestic resources.

12 Nov. 1981

The fifth Budget introduced a surcharge on income tax and wealth tax covering companies and individuals with taxable incomes, exceeding Rs.25,000 per year; a cessation of tax holidays on approved projects and withdrawal of tax exemption to foreign contractors. A withholding tax of 33.5% was introduced on income of foreign entertainers, and artists, a 15% tax on interest on Minor's Deposits schemes, and a 10% tax on interest of compensation payments by the Land Reform Commission. Turnover taxes were extended to business turnover on several categories of imported and local sales items and fees and charges of certain government institutions doubled. Total expenditure in the Estimates was Rs.37.9 billion and total revenue was Rs.21.2 billion leaving a budget deficit of Rs.16.7 billion to be financed by foreign resources Rs.5.4 billion (32%); and Rs.11.3 billion (68%) domestic resources.

8 March 1983

The sixth Budget was presented four months later than the usual budget. The authority for expenditure until the approval of this budget was granted by way of a Vote on Account passed in November 1982. The minister announced extension of tax relief from 5 years to 15 years for individuals constructing a house using their own capital while no approval to be granted for 100% invest-

The Budget and Foreign Aid*

Ronnie de Mel

Minister of Finance and Planning

The total estimated expenditure in this year's Budget amounts to Rs 83 billion. The total estimated revenue before foreign aid amounts to Rs 46 billion. The Budget deficit for 1988 therefore is Rs 37 billion. This shows that we spend over twice as much as we earn and that we are living beyond our means. I hope to bridge this Budget deficit in a number of ways. I hope to get Rs 5 billion as outright foreign grants and Rs 17 billion as foreign concessional loans with

interest ranging from 0.5 to 3 percent, repayable over periods of 20, 30, 40 or 50 years. I hope to get Rs 11 billion from non-inflationary sources within the country such as loans from the National Savings Bank and the Employees' Provident Fund. I am still left with a deficit of Rs 4 billion: Rs 2 billion of which I hope to get from my revenue proposals and the remaining Rs 2 billion from inflationary sources, that is, by printing currency notes which I am reluctantly compelled to do.

I have got Rs 22 billion as foreign aid whereas Mrs Bandaranaike in her time got only Rs 500 million as foreign aid inspite of her being the leader of the non-aligned world. We have been able to do all this during the last ten years for the development of the country, to create employment for our youth and to continue to maintain welfare services like free health, free education and to give food stamps to the neediest sections of the people because we have been able to get increasing foreign assistance from all countries which Mrs Bandaranaike could not do.

DIARY

1988

ment relief and continuation of tax holidays allowed only for exports other than Tea, Rubber, and Coconut. A 5% duty was introduced on all items hitherto free of duty and turn over taxes on sales increased from 2% to 4%. Planting subsidies were increased. The guaranteed price of paddy was increased by Rs. 5, to Rs.55 per bushel. Total expenditure in the Draft Estimates was Rs.46.8 billion and total revenue was Rs.27.7 billion leaving a budget deficit of Rs.19.1 billion to be financed by foreign resources Rs.7.5 billion (39%); and Rs.11.6 billion (61%) domestic resources.

16 Nov.1983

The seventh Budget increased the exemption limit for income tax from Rs.12000 per annum to Rs.18000 per annum and a change of the income tax slabs. It further reintroduced the withholding tax on dividends at 20 percent; and introduced a rehabilitation surcharge of 10% on income tax, and a rehabilitation levy of 1% on the gross remuneration of all employees in both public and private sectors. The private sector tea planting subsidy was increased from Rs.29000 to Rs.38000 per hectare for low grown tea and from Rs.35800 to Rs.43000 per hectare for high grown and medium grown teas. Total expenditure in the Draft Estimates was Rs.53.6 billion and total revenue was Rs.41 billion leaving a budget deficit of Rs.12.6 billion to be financed by foreign resources Rs.8.0 billion (63%), and Rs.4.6 billion (37%) domestic resources.

14 Nov.1984

The eight Budget further increased the personal income tax exemption limit from Rs.18000 to Rs.24000 and exemptions were introduced for dividend income up to Rs.12000, and terminal benefits from Rs.50000 to Rs.100000; while tax slabs were widened from Rs.25000 to Rs.50000; and interest on NRFC accounts exempt on tax up to 10 years. It reduced rates on on-resident companies from 55% to 50%. Turn over tax on petrol (gasoline) was increased from 4% to 20%. The threshold price for duty on coconut oil was increased from Rs.13100 to Rs.20000 per metric ton, while export duty on Tea and Rubber were reduced. Total expenditure in the Draft Estimates was Rs.64.7 billion and total revenue was Rs.42.3 billion, leaving a budget deficit of Rs.22.4 billion to be financed by foreign resources Rs.8.9 billion (40%); and Rs.13.5 billion (60%) domestic resources.

13 Nov.1985

The ninth Budget raised the personal income tax from Rs.24000 to Rs.27000 while the maximum rate of tax was reduced from 55% to 50%. Tax bands were reduced from 11 to 5 percent. Railway charges were increased from 8% to 30% and the airport embarkation tax rate increased from Rs.100 to 200. The guaranteed price for paddy was raised from Rs.62.50 to Rs.70 per bushel. The total expenditure in the Draft Estimates was Rs.69.7 billion and total revenue was Rs.45.4 billion leaving a budget deficit of Rs.24.3 billion to be financed by foreign resources Rs.12.1 billion (50%); and Rs.12.2 billion (50%) domestic resources.

12 Nov.1986

The tenth Budget announced that capital gains arising from the business of purchasing and selling property were to be taxed, and a 20% tax on interest income of provident, pension and saving funds, and 10% tax on interest income (in excess of Rs.27000) of thrift and savings societies. Abolition of the 10 year tax exemption time limit for NRFC accounts and tax exemption on capital gains on the transfer of ownership of shares in public quoted companies. Stamp duty on letters of credit, trust receipts and letters of trust were increased from Rs.1.00 for every Rs.1000 or part thereof to Rs.20.00 for every Rs.1000 or part thereof. Duty on tobacco was increased from Rs.603.50 per kg, to Rs.865.50 per kg, and a special levy of Rs.500 million made on the Petroleum Corporation. Total expenditure in the Draft Estimates was Rs.70.1 billion and total revenue was Rs.48.2 billion leaving a budget deficit of Rs.21.9 billion to be financed by foreign resources Rs.11. billion (51%); and Rs.10.8 billion (49%) domestic resources.

17 Nov.1987

The eleventh Budget announced a pay increase for public servants; annual licence fees on bookies and casino operators; and increased prices on arrack and cigarettes; a reduction on the maximum rate of personal income tax from 50% to 40%, and also a reduction in turnover taxes; and the imputation system in taxation of profits of companies and their shareholders. The total expenditure in the Draft Estimates was Rs.83 billion and total revenue was Rs.46 billion, leaving a budget deficit of Rs.37 billion to be financed by foreign resources Rs.22 billion (57%); and Rs.15 billion (40.5%) domestic resources.

We have been able to get all the Foreign Aid needed for the forward march of this country during the last ten years; and in the years to come foreign Aid amounting to Rs 80 billion or Rs 100 billion is needed to keep the country going. No other party can hope to get so much foreign aid as we have been able to get.

The Budget for 1988 is a Budget for 'Economic Recovery' and 'Economic Revival'. This is a new beginning and not the beginning of the end or the end of the beginning. Peace and Law and Order are absolutely necessary if we are to succeed. Since 1983 we have been a nation that has lost it's way. Now the time has come for us to steadfastly work towards repairing the damage caused since 1983, by increasing investment, growth and employment opportunities for our youth.

Some of the major aspects of areas proposed for consideration in my Budget Proposals for 1988 are (1) the medium term Economic Policy Framework for three years. (2) The medium term investment program for five years. (3) Reconstruction and Rehabilitation of the areas devastated by the ethnic violence since 1983 (4) Employment Generation - creating at least 500,000 jobs for the youth. (5) Administrative Reform, which includes a salary increase about ten times as large in nominal terms as any previous increase (6) Creating a share-holding democracy through a well thought out program of privatisation.

The two main points that our critics have advanced are that we depend too much on foreign aid and that the salary increase is inadequate. No country in the world has developed without foreign aid. It was the Marshall plan that helped all the countries that were devastated by the Second World War to develop so fast. If I did not get the sum of Rs 22 billion which I got as foreign aid I would have had to cut salaries and not increase them.

* From a speech at a seminar on the Budget 1988. Organised in Colombo by the Organisation of Professional Associations.

AID PLEDGES FOR RS. 15 BILLION MORE*

Ronnie de Mel, *Minister of Finance & Planning.*

"As a first step, my Ministry made an assessment of the damage that had occurred as a result of the ethnic conflict with the assistance of a team of experts from the World Bank and our own officials both in my Ministry and the Ministry of Rehabilitation. This report was prepared in August when there was comparative peace in the land before the out-break of fresh hostilities in October and November. This report tentatively estimated the damage at Rupees 60 billion including losses in domestic production, tourist earnings foreign investment and additional outlays on defence.

"The physical damage to the infrastructure alone was estimated at around Rs.12 billion. Since these estimates were made, further damage has occurred in the country after the end of September. This additional damage may be tentatively estimated at about Rs. 3 billion, the actual damage may be more.

"The programme of reconstruction was clearly beyond our own financial resources. If we had tried to undertake this work without foreign assistance, we may well have taken decades to repair the damage. I therefore sought the assistance of the international community for this gigantic task.

"It must be appreciated that this reconstruction programme is of critical importance to Sri Lanka in not only strengthening and holding the peace but also strengthening and reviving the economy in the long run.

"So from all points of view; this Special Aid Group Meeting in Paris which has just been concluded was of supreme importance to the entire future of Sri Lanka.

"This meeting was a resounding success for Sri Lanka. We were able to obtain pledges of aid totalling Rs.15 billion. Nearly half this aid is in the form of out-right grants which we do not have to repay at all, not one cent either in the form of capital of interest. In actual terms Rs.7.3 billion are out-right grants. The balance is in the form of highly concessional loans, some with no interest whatsoever, others with interest of 1/2%, 1% or 2%.

"We are allowed to repay in 30 years, 40 years or 50 years with a ten years grace period. No country could have ever obtained better terms for reconstruction and rehabilitation after four years of ruinous civil war. The aid which we obtained surpassed all our expectations. When I spoke during the second reading debate on the Budget in this House a few weeks ago, I stated that we hope to get about Rs.9 billion at this meeting. We have actually obtained Rs.15 billion - i.e. 6 billion more than I expected. These pledges of aid are additional to the Rs.18 billion which we have already obtained in June this year for the normal development programme of Sri Lanka.

Therefore in the two meetings held this year, we have obtained a total of Rs.33 billion in aid pledges for Sri Lanka which is a record for this country in any single year. We have every reason to be happy that the international community still has confidence in Sri Lanka, despite everything that has happened in the last four years".

"I also thank the World Bank and the donor countries and organisations for taking the trouble to meet twice in one year to help our country which I think is rather unique for any aid receiving country. This must also be the highest volume of aid ever pledged for any country in a single year relative to its population, its national income or its GDP.

"When we compare this amount with the total revenue of the Government this year which is only Rs.41 billion and the total capital expenditure of Government this year which is only Rs.22 billion by any yardstick this is really substantial and unprecedented international support".

"The international community is prepared to assist us even more in the next six months if we are able to put our own house in order and restore peace in our land. I am negotiating with the International Monetary Fund for a Structural Adjustment Facility of Rs.12 billion which I hope to obtain in the next three months if possible. If this Government continues in power after the next election and if we also continue with the same sen-