

33612

THE ECONOMIC RATIONALE FOR THE 1986 BUDGET PROPOSALS

Gamini Abeysekera

*Additional Director
Economic Affairs Division,
Ministry of Finance and Planning*

It is a rare feature in any country that the same Minister of Finance could present budget proposals for nine consecutive years. The economic significance of this lies in the consistency and continuance of a set of development strategies which result from such an uninterrupted tenure of a policy maker. Re-vitalising of the economy with certain explicit objectives, such as economic growth and employment creation, being essentially a medium and long term effort, requires the reinforcement of a well integrated and a logically constructed policy framework. As the Minister of Finance and Planning stated at the outset of his ninth Budget Speech, the budgets over the past eight years have set the guidelines for development of this country and also "embodied the most important policy initiatives of the Government". Accordingly, it was essential to ensure that these policies would be carried to their logical conclusion in order to reap the intended benefits. The 1986 budget proposals must be viewed in the context of a continuing effort to give "a new orientation and dynamism to an economy which was at the verge of collapse" before the economic reforms of 1977 were introduced.

The most far reaching policy decision introduced with the first Budget of the present Finance Minister, in November 1977, was the liberalization of the economy. During the past eight years, there has not been any reversal of this approach. The liberalization policy included not merely removal of import and exchange controls but also removal of barriers to trade and investment. In

other words, both externally and internally opportunities for economic transactions and investment activities were opened up with a view to obtaining private sector participation and foreign collaboration in Sri Lanka's development effort. Every Budget presented during the 1977-1985 period has reiterated the policy reforms introduced in 1977 and re-affirmed the liberal economic philosophy underlying the present development strategy pursued by Sri Lanka.

It is clear from the Budget Speeches presented in the post-1977 period that a conscious attempt has been made to orient the macro economic policies towards growth and development. Thus, the achievements of the 1978-1985 period bear witness to the efficacy of the policy mix employed by the fiscal and monetary authorities of the country. The remarkable harmony between monetary and fiscal policy during this period helped sound economic management as well as implementation of the necessary structural reforms. Accordingly, it was possible to double the economic growth rate, halve the unemployment rate, and minimise the inflation rate in the country during the post 1977 period. However, there have been several areas causing concern to the policy makers despite such impressive achievements. For example, the bulk of the investment activity had to be financed with foreign assistance as the domestic savings rose only modestly. Although economic growth rate was maintained at a relatively high level, it was confined to mainly the domestic agricultural and services sector as the industrial sector did not grow rapidly. Furthermore, balance of payments performance was not very encouraging as the export earnings did not grow appreciably to finance the import expenditure. Similarly, adverse trends in the terms of trade prevented im-

provements in the balance of payments. Despite concerted efforts to reduce the budget deficit, it was difficult to generate greater resources due to the inelasticity of the revenue structure. The budgetary problem was aggravated by both escalating defence expenditure and the excessive financial burden caused by inefficient public sector ventures. Therefore, such problem areas had to be treated with special care when formulating the budget proposals for 1986.

The expenditure and revenue proposals of the 1986 Budget Speech primarily aimed at accelerating private investment, with the public sector concentrating on development of infra-structure facilities. Hence both tax-subsidy policies and expenditure allocations were oriented to promote exports and industries. In other words, the underlying assumption of the current budget proposals has been that the economy will respond to various incentives and favourable conditions for investment and growth. Nevertheless, the Budget Speech 1986 has emphasised that "sound economic management requires a strong planning process" which should be more "realistic and pragmatic than the ambitious efforts of the past which sought to plan for the entire economy without adequate provision for implementation". In other words, the need for a conscious effort by the Government to evolve a planning process consistent with an open economic policy and private sector participation has been recognized. In this context, the Public Investment Programme (PIP) prepared on the basis of a "rolling plan" appears as a supplementary document to the Budget. The annually reviewed PIP identifies the areas of investment by the Government while making provision and indicating the scope for private sector investment in the economy.

REVENUE PROPOSALS

It is appropriate to consider the revenue proposals in the Budget as the more controversial and thought

provoking aspect. One of the main features of the 1986 Budget proposals was the simplification of the income tax structure while effecting a further reduction in the tax rates. The experiences of both developed and developing countries in the recent years suggest that the collection of revenue improves with reduction of tax rates and simplification of the taxation system. Such improvement may be attributable to both higher tax compliance and better tax collection resulting from appropriate changes in the tax structure and rates. It is noteworthy that current budget proposals include several revisions to income and wealth taxation aimed at granting relief to tax payers. For example, the exemption limit for income tax purposes has been raised from Rs. 24,000 to Rs.27,000 per year leaving a larger disposable income in the hands of the income receivers. Further concessions have been granted to income tax payers by reducing the maximum rate of personal income tax from 55 to 50 percent. Also, the tax schedule has been simplified to bring down the number of tax bands from the earlier 11 bands to only 5 with the tax rates ranging from 10 percent to 50 percent for these 5 bands. Although the direct effect of these revisions would be to reduce the collection of income taxes by Rs. 150 million, there might be considerable scope for improving the revenue collection due to better compliance in response to lower tax rates. If lower tax rates result in a greater disposable income in the household sector, it should facilitate higher domestic savings and more private investment which is quite consistent with the overall growth and development strategy of the Government.

In addition to the concessions granted to the income tax payers in the Budget Speech 1986, the tax payers liability to both income tax and wealth tax was also reduced from 80 percent to 60 percent of the total income. In this case too, the estima-

ted loss of revenue of Rs. 5 million is expected to be offset by greater tax compliance due to a lower rate of liability. If lower tax rates result in a greater disposable income in the household sector, it should facilitate higher domestic savings and more private investment which is quite consistent with the overall growth and development strategy of the Government. The liberal approach to personal income taxation adopted in 1986 Budget was also reflected in the proposal to abolish Estate duty and Gift Tax. In view of the fact that the annual yield from these taxes had been rather small, being in the region of about 1 percent of the total government revenue, it was felt that it hardly compensates for the cost and effort of collection. Furthermore, the abolition of such levies is expected to contribute to an atmosphere more conducive to mobilize resources in the private sector for economic activities. Although the Estate duty and Gift Tax were abolished it was decided to retain the wealth tax for at least two reasons. First, it was considered necessary for an annual declaration of capital assets which would help the Inland Revenue Department to cross check the declaration of annual income by tax payers in high income brackets. Second, a levy on wealth was viewed as an inducement for tax payers to shift their assets from non-productive to more productive investment, which in turn could generate better yields to pay such tax.

While granting several concessions in regard to income and other capital taxes, the Minister of Finance and Planning stated that he has consciously restricted certain exemptions and reliefs which have been responsible for eroding tax revenue significantly. He referred to the curtailment of certain exemptions and concessions such as the lump-sum depreciation and 100 percent investment relief which had already been effected and proposed two more such measures. The first, was to limit the total deductions

that a tax payer is entitled to under the so called "qualifying payments" to Rs. 150,000 compared with Rs 500,000 per year. The next was to levy a with-holding tax of 20 percent on interest income of all income tax payers. These two measures are expected to generate Rs 50 million and Rs 250 million respectively, as additional revenue in 1986. Such measures have been adopted by several developed countries to protect the tax base as well as to circumvent tax evasion. Thus, it appears that the 1986 Budget proposals have been designed with a view to increasing collection of revenue through both prevention of tax evasion and improvement of tax compliance.

An important feature of Sri Lanka's taxation system appears to be the relatively high dependence on indirect taxes. As a proportion of the total government revenue in recent years, all indirect taxes accounted for about 70 percent. While this is a common feature in many developing countries, it is important to recognise the effectiveness of indirect taxes in expanding the tax base in a country by bringing into the tax net the otherwise "hard to tax groups". For example, in a country where a large number of small farmers, small industrialists and other small entrepreneurs are actively engaged in economic activities, but have not formed any formal business or commercial organisations, the scope for subjecting them to income taxation appears to be limited. Under such circumstances indirect taxes such as turnover taxes, sales taxes, excise duties and Customs duties become useful tax handles for a government. Given the economic structure of Sri Lanka with relatively large agricultural and services sectors, it becomes necessary to use such tax handles until the tax administration system generates the capacity to cover informal and unorganized economic activities. Nonetheless, considering the possible

regressive effects of indirect taxation on certain income groups, it is necessary to design the different forms of such taxes rather carefully. In other words, in levying indirect taxes it is important to take into account both their incidence as well as their effects on production and consumption.

Within the broad category of indirect taxes in Sri Lanka, at least five different sub-groups can be identified as the most important taxes from both budgetary and development points of view. These are the export duties, import duties, excise duties, turnover taxes and sales taxes. In the Budget Speech 1986, several proposals relating to such taxes have been made for a variety of reasons other than revenue. For example, export duties, in Sri Lanka's context, have been often considered as a flexible tax handle which could be adjusted in relation to fluctuations in export prices. Similarly, import duties are recognized as an effective mechanism to promote the objectives of balance of payments as well as industrial production.

Accordingly, the 1986 Budget proposals have taken into account the decline in tea prices in 1985 which averaged around Rs 32 per kilogram compared with Rs 63 per kilogram in 1984, and revised the export duty on tea to ensure the viability of the industry. The threshold below which no ad valorem tax will be levied has been increased from Rs 32 to Rs 40 per kilogram so that only teas fetching above the revised price will have to pay 50 percent of the excess as an ad valorem tax. Furthermore, the tax rates applicable to export of bulk tea, green tea, instant tea and packeted tea have been reduced by Rs 2 per kilo while the duty on tea bags has been reduced by Rs 1 per kilo. Similarly, in regard to coconut exports, duty on desiccated coconuts and edible copra has been reduced by Rs 2,500 per metric ton, in order to help the coconut industry which has faced a crisis situation. Prior to the 1986 Budget also, concessions were granted to the coconut industry (mainly because it is in the

hands of a large number of small holders) by abolishing the export duty on coconut oil when the price fell below Rs 20,000 per metric ton. Thus, the flexibility of export duties as an indirect tax handle has been made use of mainly in view of the price fluctuations in the international market that adversely affect the country's agricultural exports.

Another export item which was considered for export duty concession in the 1986 Budget was Graphite. It was granted a reduced duty rate of 15 percent compared with a previous 25 percent. The reason for this concession to graphite exports was the need to revitalize this industry and make it more competitive in the international markets considering the tremendous scope for its production, expansion and export. The production and export of graphite had fallen in recent years from 11,400 tons in 1978 to 7,800 tons in 1984 partly due to outdated machinery and equipment being used, despite the fact that the country possesses substantial resources of graphite. Therefore, the export duty concessions should enable and encourage investment in this industry and enhance its production and export capacity.

An important proposal in the 1986 Budget which aimed at a more fundamental policy objective than mere revenue generation was the liberalization of import of textiles. However, this liberalization was subjected to a duty of 100 percent or Rs 25 per square meter in the case of cotton textiles and Rs 40 per square meter in the case of synthetic textiles, (which ever the duty rate that is higher). The main intention of this proposal appeared to be to legalize the import of textiles which had been hitherto smuggled into the country. Following the general policy of import liberalization and the recommendations of the Presidential Tariff Commission, the Minister of Finance made the proposal to allow textile imports subject to a relatively high duty, because

it was felt that the strict import control has had virtually no effect in terms of protecting the local textile industry. Thus, the logic was to protect the local industry through a system of tariffs rather than through import controls, so that there will be some revenue from import duties as well accruing to the government. The economic principle in this context has been to allow free and competitive trade to take place instead of using quantitative or administrative controls so that the effective rate of protection granted to the local industry can be maintained at a desirable level at the same time.

It has been a common feature in many budget speeches during the past decade to increase the Excise Duty on tobacco and liquor. These items are often considered as having an inelastic demand so that a modest increase in price would not result in any substantial reduction in demand. When a tax is imposed on such an item the revenue collection can be expected to go up. Furthermore, both liquor and tobacco, unlike food or beverages, are not considered as basic or essential items that should be available at low prices. Instead, it can be argued that both these items can be hazardous to health. Thus, it is difficult to find an argument against an increase in the excise duty.

In Sri Lanka during the past decade, the revenue from excise duties has risen from Rs 642 mn. in 1976 to Rs 3,080 mn. in 1985 while the projected figure for 1986 is Rs 4,501 mn. The tax proposals for 1986 anticipates an additional revenue of Rs 260 million from duties on tobacco and liquor. Of this amount Rs 80 mn. will come from excise duty on tobacco which has been increased from Rs 371 per kilo to Rs 603.50 per kilo. However, the turnover tax on tobacco has been reduced from 40 percent to 20 percent according to the 1986 Budget proposals. Therefore the net effect of the increase in excise duty on tobacco will be limited to Rs 47.50 per kilo in turn, resulting in a price

increase of 5 cents per cigarette. Accordingly, about 58 cents per cigarette will be the excise duty component included in the price of a cigarette. Similarly as a result of increased excise duties on coconut arrack and molasses arrack the prices of locally produced liquor will go up by Rs 5 per bottle. Also, there will be corresponding charges in the import duty on imported liquor while excise duty on locally produced foreign type spirits has also been raised from Rs 73 per litre to Rs 80 per litre. An additional revenue of Rs 180 million is expected from these revisions in excise duties in 1986. The relative importance of revenue from such duties will be almost 15 percent of the total tax revenue of the government.

Turning to the changes in Turnover Taxes, it is possible to observe an attempt to streamline the tax structure while also effecting lower tax rates for a range of items. The number of rate bands has been reduced from 10 to 6 so that the tax rates applicable to them will vary from a minimum of 1 percent to a maximum of 20 percent. This reduction of tax bands was proposed in regard to simplifying and rationalizing the turnover tax system. As such, it would have the effect of lowering the tax rates applicable to a large number of items with the new classification of items into six groups instead of ten. For example, turnover tax on rice, rice flour, pharmaceuticals, ayurvedic preparations, animal and poultry food, charcoal and soya milk powder will come down to 3 percent from 4 percent. Similarly more than 30 items, including food items, raw material and production inputs, such as milk and milk foods, dried fish, eggs, malted milk, buns and rusks, safety matches and pencils, agricultural tools and implements, barbed wire, clay bricks and tiles, fishing boats and nets, pesticides, weedicides etc., will be subjected to 5 percent turnover tax compared

with the previous 6 percent. Therefore, the final impact of the revisions proposed in regard to the turnover taxes should be reduce costs to both consumers and producers. Thus, the general assumption that indirect taxes should be to reduce costs to necessarily be so, when tax bands are carefully selected and rates are accordingly determined.

In addition to the main tax proposals in the 1986 Budget there were several non-tax revenue measures such as the increases in postal and telegraphic charges, stamp duty on receipts, telephone charges, embarkation tax and railway fares. These measures were introduced primarily on the basis of the inelastic demand for such services so that the improvements in revenue will enable the relevant departments and agencies providing these services to at least, partially cover their recurrent and capital expenditure. For example, the Postal Department has been operating with a deficit of Rs 75 million per year while

the revenue of the Telecommunication Department was not sufficient to finance its heavy capital costs. Similarly the estimated loss of the Railway Department excluding depreciation would be Rs 565 million in 1986. Hence, the increases in the charges and fares of these infrastructure facilities had to be introduced both in order to improve the efficiency of their services and reduce the burden on the Government Budget due to their losses. It is important to recognize that public enterprises that depend on the budgetary transfers can entail the implication of deficit financing through inflationary sources.

Consequent to the revenue proposals introduced in the 1986 Budget the net increase in government revenue has been estimated at Rs 1833 million. This will result from additions to revenue amounting to Rs 2373 million and reductions of revenue to the extent of Rs 540 million. These increases and decreases in revenue are given in a summary table below:

REVENUE IMPACT OF 1986 BUDGET PROPOSALS

	Rs. Million	
(a) Increases in Revenue		
Limitation of Qualifying payments relief	50	
Withholding Tax on Interest Income	250	
Dividend Tax on Corporations	250	
Special Levy on Ceylon Petroleum Corporation	358	
Excise Duty on Cigarettes	290	
Customs Duty on Beedi wrapper leaf	80	
Net increase in Turnover Tax	255	
Customs Duty on Liberalised Import of Textiles	200	
Railway Charges	100	
Postal & Telegraph Charges	115	
Stamp Duty on Receipts	25	
Telephone Charges	200	
Airport Tax	<u>20</u>	<u>+2373</u>
(b) Decreases in Revenue		
Changes in personal Income Tax	150	
Abolition of Capital Taxes	15	
Limit on Income Tax & Wealth Tax	5	
Net change in Taxation on Tea less contribution from Stabilisation Fund	360	
Export Duty on Graphite	<u>10</u>	<u>- 540</u>
		<u>+1833</u>

As the pre-budget revenue estimates stood at Rs 37,256 million, with the net increase in revenue of Rs 1835 million consequent to the budget proposals, the anticipated revenue in 1986 will be Rs 39,089 million. This total will, mainly consist of the following major sources of revenue:

Source	Rs. Million
a) Taxes from Personal and Corporate Income	5,405
b) General Sales & Turnover Taxes	10,360
c) Excise duties & other sales taxes	4,740
d) Import duties	8,080
e) Export duties	1,803
f) Other non-tax revenue	6,290

Compared with the revised revenue figure for 1985 which amounted to Rs 36,325 million, the estimated revenue for 1986 reflects an increase of about 7.5 percent. It appears that revenue mobilization has not taken place at any faster rate than growth in the Gross Domestic Product. This is mainly due to the export prices which reduce the capacity to collect export duties. Furthermore, it is also indicative of the need to improve income and turnover tax receipts through more efficient tax administration. On the other hand, in view of the need to give tax incentives to promote savings, investment and production oriented activities, as well as to keep tax rates down to cushion the cost of living increases, there are built-in constraints to enhancing taxation in a developing economy.

When discussing the budget, the general tendency is to merely focus on the revenue proposals which are often referred to as the "budget secrets". Hence, the allocation of government expenditure and its impact on the economy is rarely given due attention. In this context, it is important to recognize that since the introduction of the new economic policies in late 1977, there has been a conscious attempt to expand the capital budget and restrict current expenditure.

This was necessary for several reasons. First, in view of the relatively low level of savings and inadequate capital formation in the previous years it was felt that a well worked out public investment programme should be launched to enhance the production capacity of the country. Second, in order to maintain economic growth at a rate higher than that of the population growth, so that per capita income can be raised rapidly, the government decided to take the lead in investment activity. Third, there was a felt need to rehabilitate the existing infrastructure including irrigation, power and telecommunications to attract both private and foreign investments. Fourth, in view of the massive unemployment level which had reached crisis proportions by the mid 1970's, there was an urgent need to increase investment in sectors which could create employment opportunities. Finally, to mobilize foreign assistance to bridge the gap between desired level of investment and available level of savings the Government had to formulate a medium term investment programme including a series of public sector projects. Accordingly, the successive budgets kept expanding on capital expenditure while arresting a rapid growth of recurrent expenditure. This approach, also helped to curtail the budget deficit

and remove a major source of inflation.

Although the recurrent expenditures were restricted for better budgetary management and greater capital investment, it is important to note that the government did not deviate from its overall social welfare programmes consisting of free education, free health and food subsidy; although in regard to the food subsidy a decision was taken to limit the benefit to the most needy groups. Accordingly the Food Stamp Scheme which was introduced late 1979 aimed at providing an income supplement to purchase essential food items to households that fell below a particular income level. Even under the Food Stamp Scheme almost half of the total population continued to receive the benefits. As the number of beneficiaries and the monetary value of food stamps remained constant it was possible to maintain the cost of such food subsidy program at a fixed level. In regard to the other welfare programmes there were no major changes so that the budgetary allocations for such expenditure in relative terms have been fairly stable.

The provisions made in the 1986 Budget, classified under selected major categories of expenditure, can be seen from the Table given below:

Budgetary Provisions - 1986		Rs. Million
Item		
1) Defence		5,791
2) Social Welfare		10,364
	of which, a) Education	5,318
	b) Health	2,897
	c) Food Stamps, Kerosene Stamps & other social services	2,149
3) Agriculture & Irrigation		6,743
	of which, Mahaweli	3,706
4) Plantations		1,246
5) Infrastructure		5,683
	of which: Electricity	1,256
	Railways	1,858
6) Housing, Water Supply & Drainage		1,288
7) Producer Subsidies (e.g. Fertilizer)		1,028
8) District Budgets		872

Considering the fact that total government expenditure including both recurrent and capital outlays in 1986 have been projected at approximately Rs. 66 billion, the relative emphasis placed on key sectors can be gauged from the above Table. It can be observed that defence expenditure will absorb almost 10 percent of the 1986 Budget expenditure compared with less than 4 percent a few years ago. Nevertheless, it is noteworthy that education, health, food stamps, kerosene stamps and other social welfare services have received a share of almost 16 percent of the total provisions; while social infrastructure consisting of housing, water supply and drainage will account for another 2 percent. Agriculture and irrigation sectors including Mahaweli, has been allocated more than 10 percent. Similarly the infrastructure activities such as electricity, railways, airports and telecommunications together will receive 9 percent. The percentage share of expenditure on producer subsidies mainly consisting of fertilizer reflects 1.6 percent while allocations for District Development Councils and Decentralized Budgets represent 1.3 percent of the budgeted expenditure for 1986.

The final estimates of expenditure and revenue after the 1986 Budget proposals appear as follows:

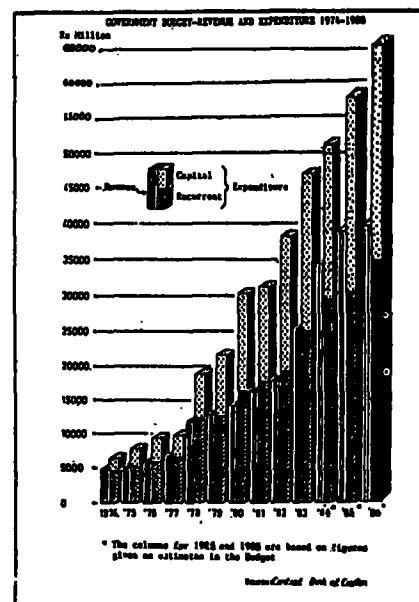
Item	Rs. Million
Recurrent Expenditure (less savings)	35,150
Capital Expenditure	30,125
Net Lending on Advance Account	800
	66,075
Total Revenue	39,089
Overall Budget Deficit	26,986

The above deficit will be financed from the following sources:

Source	Rs. Million
Foreign Grants	3,360
Project and Commodity Loans	10,840
Domestic Rupee Loans	10,800
	<u>25,000</u>

Thus, it can be observed that 92.6 percent of the budget deficit will be financed from non-inflationary sources. This means that the balance 7.4 percent amounting to Rs 1986 million will have to be financed by other sources such as borrowing from the banking system. However, since this unfinanced gap represents only about 1 percent of the Gross Domestic Product of the country, the recourse to an inflationary source of financing to bridge that gap should not disturb the financial balance in the economy.

In addition to the specific revenue and expenditure proposals included in the Budget Speech 1986, the Minister of Finance and Planning has touched on several other areas of socio-economic policy which are important for either generating necessary growth impulses or protecting certain socio economic groups. As an incentive for domestic agriculture production and also to improve the economic position of farmers, the guaranteed price of paddy was raised from Rs 62.50 to Rs 70 per bushel. Similarly the support prices of several other subsidiary food crops including cowpea, greengram, blackgram, maize, soya and gingelly were also raised. For this price support scheme a special fund with a capital of Rs 50 million will also be established. In regard to the promotion of private sector investments, the Minister of Finance emphasised the importance of establishing a proper Stock Exchange and Securities Market as well as the need to strengthen the operations of the Capital Development and Investment Company under the Ministry of Finance and Planning. Similarly, the need to fully implement the recommendations of the Presidential Tariff Commission was emphasised in the Budget Speech 1986. As another area that requires urgent action to improve management of the economy, the Minister cited a Reform of the Administrative System to meet the challenges of a dynamic economy. A pension Scheme for farmers to provide



at least Rs 150 per month as well as a death gratuity payment scheme were also proposed. The Farmer's Pension Fund would get Rs 750 million as a capital grant over a period of 10 years. Thus the government's conscious attempt to strike a balance between economic growth and social welfare was evident from the 1986 Budget Speech.

In conclusion, the Minister of Finance and Planning stressed that two factors are most vital for sustained economic development of Sri Lanka; i.e., peace and commitment. He added that if violence and terrorism continue unabated, the economic consequences will be very serious so that peace must be restored to concentrate fully on development. Furthermore, stating that "during these difficult days, the only silver lining has been the state of the economy" the Minister of Finance and Planning emphasized the need to have the political will and determination to carry through to their logical conclusion, the reforms initiated in 1977.