

THE ECONOMIC OBJECTIVES OF THE BUDGET 1985

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The Budget for the financial year 1985 was presented by the Hon. Minister of Finance and Planning to the Parliament on 14th November, 1984. This was his eight consecutive Budget Speech which represented the continued and concerted attempt of revitalizing the country's economy. The preparation of a Budget involves the difficult but essential tasks of balancing a set of multiple objectives; more precisely, economic growth, price stability, employment generation, income distribution and social justice. In this context, it is important to recall that a conscious decision to shift the budgetary policy from a mere consumption and welfare oriented focus towards a more broad based production and employment oriented strategy was first embodied in the Budget Speech of 1978. The introduction of the new economic policy package relating to the liberalization of the economy has had a far reaching impact on the Sri Lankan economy. The Budget Speeches of the 1978-85 period, therefore, can be considered a logical sequence of a consistent process. Thus the recently presented Budget Speech is not an isolated event or an ad hoc approach to tinker with the economy but an attempt to reiterate and reinforce the production and employment oriented strategies for development of the economy of Sri Lanka.

The task of simultaneously achieving a range of objectives has been extremely difficult not only due to the high aspirations and challenging demands of different segments of the society but also in view of a variety of economic

pressures and constraints. As the Minister of Finance and Planning listed at the outset of his Budget Speech of 1985, the main economic difficulties were, lack of resources, low revenue, large deficits in the budgets and balance of payments, high oil prices, deteriorating terms of trade, growing protectionism, increasing interest rates and the very unfavourable international economic environment. Added to these domestic and foreign constraints in the economic sphere, there were several other natural, social and political hostilities such as severe drought, floods, cyclones, political violence and ethnic disturbances. Hence, the Minister of Finance exclaimed, it was "a wonder that we survived at all, far from growing and developing" during such a period. He added that the fact that we did so was due to the appropriateness of the economic policies which were adopted since late 1977, and he assured that there would be no deviation from the chosen path.

However, the Minister emphasized that there was no room for complacency as it was essential to try and adopt the correct mix of policies in a changing context and according to the needs of a given time in the best interests of the country and the people. In this context he emphasized the crucial importance of maintaining more and more financial discipline and outlined several essential measures to realize this objective. These measures, which appeared to have been the guidelines on which the Budget for 1985 was formulated are summarized below:

- i) recurrent expenditure must be kept under strict control;
- (ii) tax revenue must be raised by improving tax payers compliance and tax enforcement;

- (iii) new sources of revenue must be found;
- (iv) public organisations must be efficiently operated;
- (v) a surplus in the current account of the budget must be generated for self-financing of capital expenditure; and
- (vi) quality and composition of the capital budget must be improved through judicious selection and careful preparation of projects.

Furthermore, the need to blend the fiscal measures with appropriate monetary policies was recognized as essential to achieving the twin objectives of domestic and external financial stability without undermining the growth and employment momentum in the economy. Hence, the budget proposals were also aimed at containing the inflationary and balance of payments pressures. For this purpose, while resorting to non-expansionary sources of financing the budget, effective strategies have also been proposed to divert credit and foreign exchange resources towards production and export oriented activities.

Finally, specific revenue and expenditure proposals have been designed with due concern for the social objectives of maintaining the physical quality of life of the people while pushing ahead with the massive development programme undertaken by the government. The importance of safeguarding the welfare of the poorest segments of the society in a period of rapid economic transition has been explicitly recognised by the Minister of Finance and Planning in his presentation of the Budget - 1985. Accordingly, while placing greater emphasis on maintenance of existing assets and improved management efficiency in the social sector, efforts will be directly

towards streamlining the welfare services to needy groups. In summary, the main endeavour of the Budget proposals for 1985 should be viewed as the pursuance of an appropriate set of policies to attain a balance among the broad socio-economic objectives of the country rather than merely facilitating the task of an accounting balance in terms of revenue and expenditure items of the government.

Massive increase in debt repayment

Before revealing the specific budget proposals for the year 1985, the Minister summarized the budgetary out-turn in respect of the financial year 1984 and the outlook for 1985. On the basis of the draft estimates the gross expenditure for 1985 has been placed at Rs.59,900 million compared to the revised gross expenditure for 1984 projected at Rs.53,733 million. The estimated gross expenditure of 1985 will be composed of Rs. 30,366 million representing recurrent expenditures, and Rs.29,534 million reflecting capital expenditures. The main reason for the growth in recurrent expenditure which indicated an estimated increase of 5 percent over the revised level of projection for 1984 has been the escalation of interest payment which accounts for more than one quarter of the recurrent budget. Similarly, the increase of 18 percent in the estimated capital expenditures for 1985 compared with the previous year's level appears to have arisen mainly in view of higher repayments of debts which are expected to mature in the year to come. The massive increase in debt repayment amounting to Rs.5,132 million in 1985 compared with Rs.709 million in 1984, reflects the maturity of debts that were incurred in the financial year 1980 when recourse was made to heavy domestic borrowing to finance the unprecedented budget deficit of that year.

Hence, when allowance is made for public debt redemption, the net capital expenditure of 1985 at Rs. 22,519 in fact, would reflect a slight decrease compared with the previous year. This indicates an attempt to prevent any over-heating of the economy consequent to heavy government expenditure on long gestation projects.

The revenue estimates for 1985 envisage an increase of 10 percent over the previous year rising to Rs.38,041 million consequent to the Budget proposals. This increase has been projected mainly on the basis of the favourable tea prices which in turn, should contribute to a higher government revenue. If not for this reason, the estimated revenue of 1985 would not have been any better than in the previous year. Hence, the inherent nature of the inelastic revenue structure appears as a basic problem in budgetary management in Sri Lanka. In other words, despite accelerated growth in a range of economic activities in the recent years, the mobilization of revenue has not shown much progress. Therefore, the need to effectively employ the tax handles of the system and progressively enhance the revenue sources of the government has emerged as a vital consideration in designing Sri Lanka's budgetary policy.

The estimated levels of revenue and recurrent expenditure for 1985 are likely to generate a current account surplus in the budget indicating a modest improvement compared with the revised budgetary out-turn for 1984. Accordingly, it should be possible to provide funds to meet approximately one fifth of the capital budget out of the current account surplus in 1985 as in the case of the current financial year. Nonetheless, the overall deficit in the budget in 1985 would still be quite high at an estimated

Rs.23,066 million. The trend in the past several years, however, has been towards reducing the magnitude of the overall deficit in the budget and this trend has been sustained adequately in the present Budget as well. As further reductions in capital expenditure did not appear feasible or desirable due to the need to continue the development projects already started, the alternative strategy was to ensure that the overall deficit would be financed causing minimum harm to the economy.

Consequent to the budget proposals for 1985, there will be a modest reduction in the estimated overall budget deficit to Rs.21,457 million. This deficit will be financed entirely by foreign assistance and non-bank sources thereby causing no inflationary impact. Furthermore, after several years, the budgetary prospects for 1985 appear to generate a surplus cash balance. In financing the estimated budget deficit, foreign grants and loans amounting to Rs.3,607 million and Rs.10,646 million respectively, would contribute approximately 60 percent of the resource needs. The domestic non-bank sources such as the Employees Provident Fund and the National Development Fund are expected to provide a total of Rs 9,100 million towards bridging the remaining budget deficit. Accordingly the total resources available for financing would exceed the extent of the deficit by Rs.1,714 million thereby leaving a cash surplus. Hence the objective of not resorting to expansionary sources of financing required for monetary stability might be realised through the Budget - 1985. Furthermore, it should be possible to utilize the

envisaged cash surplus towards setting up of another stabilization mechanism - namely a Stabilization Fund proposed for the plantation sector.

Three specific concerns behind budget proposals

There were at least three specific concerns in formulating the specific budget proposals for the year 1985. These may be summarized as (i) promoting savings, investment and economic growth (ii) accelerating growth of exports over the medium term and (iii) safeguarding the incomes and welfare of the mass of the population. Therefore, it is possible to relate almost all the different revenue and expenditure proposals to one or more of these three major objectives.

For example, the raising of the exemption level of income for taxation purposes from Rs.18,000 to Rs.24,000 and widening of the slabs of the income tax rate schedule should help the lower middle-class and middle class fixed salary earners and may also facilitate a higher rate of private savings. The changes effected in regard to taxation of dividends income by exemption of such income up to Rs. 12,000 per year, as well as the reduction of tax rate of non-resident companies are expected to contribute to greater investments by the private sector. It was also considered that the proposed revisions regarding wealth tax, gift tax and estate duty should result in lessening their heavy incidence and thereby help to reduce their adverse impact on savings and investment. In general, the proposals in respect of taxation of personal income, capital and companies have been designed on the basis of the argument that the tax system should leave a sufficient surplus in the hands of the private sector to facilitate savings and productive investment. As the Government is committed to a policy of encouraging private sector participation in the country's development effort aimed at increasing productive employment, income and living standards,

the proposals regarding taxation had to be conducive to promoting private savings and investment. However, the Minister of Finance has emphasized the importance of improving the efficiency of tax administration with a view to minimizing tax evasion and enhancing tax collection.

It became clearly evident from the Budget Speech 1985 that the Government considers development of the export sector a priority objective. Hence in granting of tax relief the export sector has been favourably treated. Hitherto the export sector enjoyed a five-year tax holiday. This will be extended for a further period of ten years as a "half-tax holiday" for selected export industries. It is noteworthy that the extended tax relief will accrue only to such cases where the net foreign exchange earnings of the industry from exports would be 75 percent or more of the f.o.b. price. Accordingly, the proposal will benefit those industries based primarily on local raw material and whose value added by domestic labour is quite high. This should encourage not only efficiency in export industries but also adoption of labour intensive technology. In the case of export plantations also there were several significant revisions to the structure and rates of taxation.

For example, the fixed rates in respect of export duty on all varieties of tea were reduced by approximately 15 percent to 30 percent. Also, the tax free threshold of Rs.28 per kilogram in regard to Ad-Valorem Tax on tea exports was raised to Rs.32 per kilogram and a uniform tax rate of 50 percent above this floor was proposed. The development cess for the tea industry will be increased six-fold to Rs.1.50 per kilogram to service the subsidy programme as well as research and development expenditure related to the tea industry. The final aim of these

revisions is to enhance producer margins and encourage tea exports. In regard to rubber exports, despite relatively low current international prices, the sliding scale of duties were revised in order to facilitate a greater profit margin for producers. These revisions should result in a reduction of export duty, at current prices by about Rs. 2.25 per kilogram. It should be noted that this relief will be in addition to the duty reduction of Rs. 2 per kilogram which came into effect in July 1984, a few months before the Budget Speech. In the case of coconut also, the budget proposals were based on the belief that enhanced producer margins will lead to higher output and exports. Accordingly, instead of levying an export duty on coconut oil at the cut off f.o.b. price level of Rs.13,100 per metric ton the duty will be applied only when international prices of coconut oil move to Rs.20,000 per metric ton while the tax rate will be a uniform 50 percent. In regard to desiccated coconut, copra and fresh nuts the minimum export levies have been determined with a view to ensuring that the producer margins will be enhanced from the current level of Rs.1,400 for 1,000 nuts equivalent to at least Rs.2,000 per 1,000 nuts. Out of the tax revenue collected from coconut exports 10 percent will be contributed towards the proposed Stabilisation Fund for the plantation crops.

Further assistance to the export sector has been proposed in the Budget Speech 1985 by way of relaxing import duties applicable to items used in export oriented industry. For instance, no import duty or turnover tax at the point of import will be levied on machinery imported by an industry where at least 50 percent of the output is for export. Similarly, another incentive to the export sector will be the exemption from

customs duty and turnover tax at the point of import of raw material and other intermediate inputs identified and certified as imported for use in manufacture of articles for export. Thus, one of the principal objectives of the new import tariff structure would be to remove the bias against production for export.

'Growth without equity is no growth at all'

In addition, to the import duty revisions related to granting incentives to the export sector, the 1985 Budget Speech announced the implementation of the detailed tariff structure evolved by the Presidential Tariff Commission based on the concept of providing an effective rate of protection to the local industries. These protective duties range from 60 percent to 100 percent for the majority of locally produced agricultural and industrial commodities. However, to stimulate new investment the import duty on machinery will be reduced from 7 1/2 percent to 5 percent. Furthermore, a number of essential inputs for agriculture and industry such as fertilizer, seeds, fruits and spore plants, a variety of chemicals and metals, certain drugs and medicinal plants used in preparation of indigenous medicine and raw cotton and synthetic fibres were exempted from import duty to promote local industrial and agricultural activities.

It is noteworthy that the revised import duty structure has been worked out in relation to the turnover tax system of the country. The principle behind the scheme has been to separate the revenue element in customs duties from the protective element and impose the former in the form of a turnover tax on imports. Accordingly; certain changes were necessitated in

the turnover tax consequent to the revisions in import duties. In regard to selected items where customs duties were reduced turnover taxes had to be correspondingly raised. However, these adjustments in turnover taxes were intended to merely compensate for the loss in revenue resulting from lower import duty rates so that they should not warrant any upward revision in prices.

A basic endeavour of the Budget Speech 1985 appears to be the protection of living standards of the poorer segments of the economy. This has been attempted broadly through an investment and production oriented approach emphasising employment creation while providing several specific measures to benefit vulnerable groups. For example, special investment relief will be granted to labour intensive industries located in regions with relatively high rates of unemployment. The fixed income earners in the public sector whose real income is more susceptible to erosion in times of inflation will be assisted with an increase of Rs.100 per month in the cost of living allowance. The charitable allowance to the indigent and handicapped is to be enhanced and the food stamps scheme which supplements the purchasing power of food items of the poor revised in due course, to grant further relief to such groups. Similarly, specific mention was made in the Budget Speech about the Governments concern for improving nutrition and a special grant was also announced for this purpose. In this context, the Minister of Finance stated in the course of his Budget Speech that "growth without equity is no growth at all" and added that the government has given "highest priority to maintaining the considerable gains that Sri Lanka has made as far as the physical quality of life of the people is concerned."