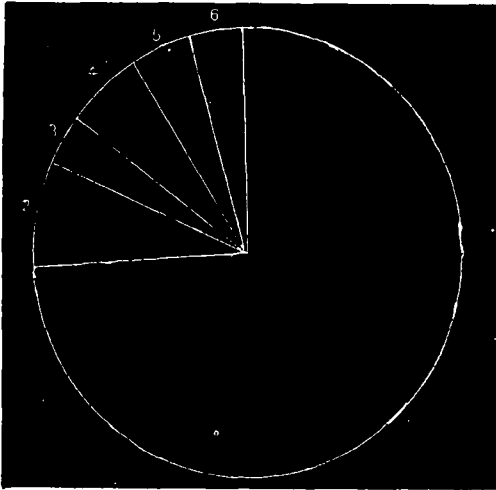


REVENUE

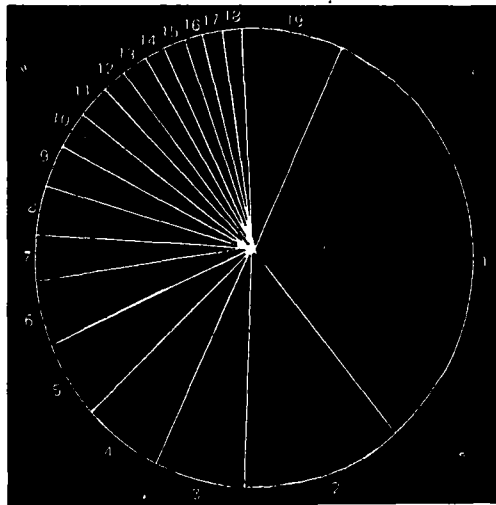


Revenue

1. Taxes on production
2. Taxes on corporate income
3. Taxes on non corporate income
4. Receipts of trading enterprises
5. Rates, interests, profits and dividends received
6. Others

EXPENDITURE

(Ministries with an expenditure of over Rs. 1 billion)



Expenditure

1. Finance & Planning
2. Defence
3. Mahaweli
4. Education
5. Power & Energy
6. Public Administration
7. Health
8. Local Govt. Housing & Construction
9. Social Security
10. Lands & Land Development
11. Transport
12. Posts & Telecommunications
13. Plan Implementation
14. Highways
15. Agricultural Devs. & Research
16. Women affairs & Teaching Hospitals
17. Higher Education
18. Justice
19. Others

THE BUDGET 1988

The Minister of Finance Mr Ronnie De Mel taking one more stride beyond his 1987 budget land mark of 10 consecutive government budgets called for a new beginning with his 1988 budget, particularly in the light of the peace accord that came after three disrupting years for the economy. In his determined drive for economic recovery and revival the Minister listed his priorities quite frankly and precisely. He maintained that there have been two major structural weaknesses in Sri Lanka's economy, one the excessive budget deficits and the other the vulnerable balance of payments. The Minister said he had intended reducing

his budget deficits and balance of payments deficits to more manageable levels by a series of reforms; but two problems had marred his intentions (i) the unprecedented drought, (ii) the escalation of defence expenditure in 1987.

This did not mean that the structural balances in our economy could not be tackled. Now that peace and stability was being gradually restored, he said, "the set backs in 1987 should increase our resolve to put our house in order as early as possible over the next three years. The medium term policy framework for 1988 to 1990 has therefore been revived in order

that we may get back on track without any delay".

The Minister warned of the dangers from budget deficits and excessive debt "I have repeatedly mentioned in my previous budget speeches that Sri Lanka's budget deficits are clearly excessive by any standards. With such budget deficits year after year, it is not possible to maintain domestic financial stability. It is indeed regrettable that we, as a nation, have come to expect annual budget deficits as an inevitable part of our way of life. This is a situation fraught with serious consequences for the economy and the country in the long run".

"We in Sri Lanka have a tradition of accepting even a headache if it is given free by a foreigner. Thus, government expenditure tends to grow, deficits widen. If the borrowing is made abroad, the resulting growth in borrowing saddles the country with a rising foreign debt burden. If the borrowing is made locally it pre-empt the domestic savings available to the private sector. It also raises interest rates if Government borrows too much within the country".

The Minister also explained that a most dangerous situation could arise when we were compelled to borrow from banks because non-bank savings are not available. This bank borrowing is highly inflationary, as it brings new money into circulation. Interest rates are pushed up further and private investment is discouraged. The people ultimately pay for budget deficits by higher prices in the market and less investment and employment in the country. That is why inflation is a tax, levied on all the people, rich and poor alike.

The evils of inflation, caused by excessive budget deficits, was another topic dealt with in detail. Among the four evils in inflation, the Minister listed were; firstly, inflationary price increases affect all people - rich and poor alike. Whereas the rich can look after themselves, because their profits and incomes generally tend to increase with inflation and they have the ability

ty to hedge it, the poor especially the fixed income earners, are most vulnerable. The latter are the vast majority, and they will find their incomes getting wiped out.

Secondly, inflation discourages people from saving, because it becomes no longer profitable or worthwhile to save. Thirdly, with low savings, there will be low investment, and therefore, lower economic growth and employment. Fourthly, inflation begins to pervade the economic psyche of the population. People would tend to go for a quick buck and away from durable investment. Fly-by-night investment could start, and life becomes a gamble from day-to-day.

A fifth aspect of inflation is that connected with balance of payments deficits. What happens is that when large budget deficits are tolerated they fuel inflation; and the additional money put into circulation is spent by the people more on imports than on locally produced goods. The situation results in an increase in the import bill and worsens the balance of payments with the rest of the world. On the other hand, inflation also raises the costs of locally produced goods and pushes up wages; the result is that immediately exports become more expensive and less competitive. Sri Lanka's foreign buyers will then go elsewhere, and our export incomes would fall. This would further increase the deficit in our balance of payments and then the country will be compelled to use its hard-earned reserves to meet this deficit or we will have to borrow.

The dangers of this situation are that the country could finally exhaust its revenue and foreigners would stop giving us credit. One solution would then be the imposition of import controls and exchange controls to limit imports and the outflow of scarce foreign resources. But the arbitrary and bureaucratic solution of controls to a fundamental imbalance in the external payments situation has proved detrimental to the country in the past. The stark conclusion is that no country can

run deficits in their balance of payments indefinitely. The Minister said "Whenever local inflation rates rise above those of our trading partners and competitors there is no alternate but to let the country's exchange rate depreciate to reflect the true relative economic conditions prevailing, if the external payments position is to be safeguarded. There is no alternative. A revaluation like that of 1976 borders on sheer lunacy. That is why, we have adopted a flexible exchange rate policy since we came to power".

Referring to the floating rate of exchange the Minister said "We are in a state of flux, and little Sri Lanka, like all other countries, has to keep floating, trying to keep its head above water. This gives us an opportunity to let economic fundamentals determine the value of our Rupee, rather than fight against the whole world to maintain an artificial value, which we once tried to do with the most disastrous consequences to our economy before 1977. If our economy grows in strength, our Rupee will appreciate, if our economy deteriorates, our Rupee must necessarily decline, because then and only then can we even hope to recover eventually, by promoting exports and discouraging imports. Otherwise, we are condemning ourselves to eternal damnation in order to maintain an artificial exchange rate.

The budget speech stressed that if economic policies were to succeed it was necessary to eliminate certain structural rigidities in Sri Lanka's economy by determined and courageous action. This situation required specific structural reforms and the Minister outlined eight such measures he hoped to implement in the next three years.

Firstly, to continue with our policy of maintaining a flexible exchange rate policy. In other words we should not let our rupee appreciate in value, there by making imports cheaper and exports dearer. This is fundamental to diversification and expansion of exports, and to avoid a re-introduction of controls.

Secondly, to reform the tax system. Taxation should be pitched at levels where people will pay, and which do not affect incentives to earn and produce and create employment. Also for greater convenience, we collect most of our taxes by indirect methods, but this is highly regressive. We must therefore, move gradually to a tax system that is more direct. It was also hoped to move towards a more buoyant tax system—by widening the tax base such a system will not be over-burdensome and should not affect incentives; and also to reduce the levels of personal and corporate taxation in keeping with the reduction in budgetary expenditure.

Thirdly, to make our economic activities especially our industries, internationally competitive so that we can export more.

We should now further reduce protection on a systematic basis, thereby inducing our local industries to improve their quality and efficiency, so that some day they will expand and move on to capture export markets.

Fourthly, a sweeping reforms of public enterprises was contemplated. We do not think that privatisation is a panacea for all ills. As pragmatic people, we will ask ourselves whether there is a current justification to keep certain enterprises under State ownership anymore. This is what the Presidential Privatisation Commission will do.

Fifthly, to implement a coherent national industrial policy. This policy is basically aimed at establishing a sturdy, self-reliant, export-oriented industrial sector in Sri Lanka. This is the only way to create more growth and employment in Sri Lanka.

Sixthly, to identify and eliminate the remaining unproductive controls and regulations that still hinder free economic activity.

Seventhly, better control and monitoring of government expenditure by various Ministries, Departments and Corporations.

Eightly, to have more competitive money and capital markets and a

monetary policy that is more market-oriented. Only then will we have efficient money markets where demand and supply of credit will be matched with efficient resource allocation. Where institutions are lacking or deficient, we need to develop them. We have not made enough progress in developing efficient financial markets because, for years, we have attempted to unnecessarily interfere in these markets, especially with a view to grabbing most of the available savings for the public sector. This situation should change now.

Other significant points made by the Minister on the economy and monetary policy were:

- Increase the role of market forces in determining interest rates; Continue to shift toward open market operations in the conduct of monetary policy; and Take steps to reduce the costs of financial intermediation in an effort to reduce the spread between deposit and lending rates. The latter is an important objective as it would help to bring down the cost of funds and thereby stimulate investment which in turn promotes growth and employment.
- Containment of inflation in the future depends on our maintaining strict financial discipline and successfully, implementing our programme of fiscal adjustment in the medium-term. Let us not for a moment delude ourselves that we have beaten inflation completely. There are growing demand pressures in our economy that would well lead to a resurgence of inflation, unless appropriate remedial measures are promptly taken. Eternal vigilance is the price of keeping inflation under control in any country. We hope to maintain the same vigilance in future.
- There must be a deficit to absorb foreign borrowing, and as long as this borrowing is on concessional terms, we will not face difficulties regarding our debt. By this type of borrowing, we are only supplementing our local savings with foreign savings. It is important, however, that we should use

Main Aspects of the Budget

In his summing up speech of the Budget Debate, the Minister of Finance re-emphasised that it was most important to correct the structural imbalance in the economy in order to inspire international confidence so that the international community would continue to assist us. He listed 15 corrective measures which are contained in the medium term economic policy programme, which he said "is the very core of my Budget, not the salary increase or other things that the people are taking about".

These 15 measures outlined by the Minister are as follows:

1. Revive and restore economic growth from the present 3 percent to at least 5 percent in two or three years. We can do so, if we follow that programme.
2. Reduce the Budget deficit from 12 percent of GDP which is far too high to 9 percent GDP by 1990.
3. Reduce the deficit in the current account and the balance of payments from 9 percent of GDP to 6 percent of GDP in the same three-year period. You cannot do these things in one year.
4. Reduce inflation from the present 8 percent to 4 percent in the same three-year period.
5. Implement a new industrial policy which has been drafted by my Ministry in co-operation with the Ministry, particularly with a view to increasing exports.
6. Implement the tax reforms which I have outlined in my Budget Speech to increase investment and employment.

these savings, foreign as well as local, on highly productive investments, and not on conspicuous but low-yielding projects.

There should be only modest local borrowing because we must leave a good part of domestic savings for the private sector, which is highly produc-

7. Implement the tariff reforms I have outlined in my Budget Speech. That is also to increase investment, employment and export in our land.

8. Reduce the losses of Public corporations. Many public corporations are doing so but there are still some which are white elephants. Reduce the losses of public corporations and their burden on the Budget.

9. Implement a series of reforms for the reorganisation of heavily indebted public enterprises like Air Lanka and the Shipping Corporation. Big reforms are necessary in these ventures. They are a great burden on the Budget and these reforms and re-organisations should be done.

10. Reduce import licensing to a minimum. It is a millstone round our neck.

11. Strengthen export promotion.

12. Facilitate investment procedures and cut out red tape and bureaucratic delays which investors, both local and foreign, still face from various departments - Not from the GCEC or the FIAC. You can get an investment approved even within two weeks by the GCEC or the FIAC.

13. Reduce cost of funds to investors. That should follow if the Budget deficit and inflation are reduced.

14. Improve accounting and expenditure controlling Ministries, departments and corporations. The Treasury is finding it extremely difficult to get proper accounts and accounts in time from certain government departments and corporations.

15. Implement a well thought out and planned programme of privatization.

ive and generates more employment than the public sector.

• We must nurture and foster our private sector by not diverting all the savings available in the economy to the public sector. If we continue with large Budget deficits year in and year out, this will happen and the private sector will be starved of resources.