

TARGETS AND IMPLICATIONS OF RECENT BUDGETS

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The annual budget is essentially an accounting exercise trying to match the annual government expenditure with the financial resources available, or what can be mobilized during a given fiscal year. The financial resources available for financing public expenditure in a given year include: (a) government revenue, (b) domestic borrowings and (c) international borrowings and grants. International borrowings and grants are determined exogenously, depending on the country's ability to meet repayment commitments, and the Government's overall economic policy with particular emphasis on fiscal and monetary sectors. In general, borrowings from the domestic sector, which include market as well as bank borrowings, become the residual, that is, the difference between the total government expenditures and government receipts. Borrowing from the banking sector is kept as a residual in particular, because of its potential for generating inflation, and as such the government is trying to limit its dependency on bank borrowings to the minimum.

A balance between government expenditures and receipts is carried out through adjustments to expenditure and revenue flows. Although the figures that come out of this adjustment process are estimates, they must depend on sound economic judgement, particularly with respect to government receipts. Any changes from the budgetary estimates mean revisions either to the revenue or expenditure side and such revisions not only diminish the strength of the budgetary proposals but also introduce difficulties on household spending and uncertainties on business. What is important in the adjustment on expenditures and revenue is, however, the substance of proposals behind such adjustments; it is the substance that contains the policy action of the authorities to bring

about a discretionary change in the level of economic activity. Thus when the budget is considered as a policy instrument, the focus is on the substance to determine how the budget proposals influence economic targets such as output, employment, exports, imports, inflation and money supply. At the same time, the importance of the figures should not be undermined because the substance of the budget proposals is in fact reflected in the figures.

POLICY EMPHASIS OF RECENT BUDGETS

With the 1984 budget, the present government has presented eight budgets since 1977, the year that marked the change in public policy from controls and restrictions to economic liberalization. As opposed to most previous budgets, the policy package of the 1984 budget reflects the government's desire to reduce public spending while simultaneously making efforts to increase its revenue sources. The need for such measures were in fact recognized in 1981, partly as a result of external difficulties imposed on the economy with rising energy costs and world economic recession and partly due to the adverse developments accompanying the liberal economic policies and the pursuit of rapid economic expansion.

In the budgets that followed, there were efforts to accommodate these constraints. These included measures such as a reduction in the rate of growth of public spending, increased revenue from higher taxes and postponement of new development projects. Nonetheless, they were not strictly enforced, particularly with regard to public spending. This difficulty arose because of the political rigidity of bringing about a drastic change in the liberalized

economic policy. The government's emphasis is now shifting towards comprehensive measures on economic management to deal with the structural imbalances that emerged during the last few years.

In this brief presentation, the implication of this emerging shift will be examined. As a starting point, the budgetary proposals of 1984 will be compared with the revenue and expenditure proposal in the budgets of last few years to highlight the current policy emphasis. It is within this framework that the implications will be discussed in the subsequent sections.

(a) Revenue Proposals

As reflected in the budget proposals, the government expects Rs 30.8 billion as revenue in 1984, an increase of Rs 6.6 billion or 28% compared with the 1983 revised revenue estimate of Rs 24.1 billion. As in the past, indirect taxes constitute the main source of government revenue and account for 67% of the 1984 total revenue target. Non tax revenue, grouped in the 'other' category accounts for 18% of the 1984 total revenue estimate, followed by direct taxes accounting for 15%.

As shown in the figures of Table 1 nearly the 1984 revenue target, is nearly double the revenue collection of 1981. Moreover, the absolute increase in revenue in current prices in 1983 and 1984 together works out to over 90% of the total revenue collection in 1980. In absolute terms more than 60% of the revenue increases between 1980 and 1984 is accounted for by indirect taxes, indicating its relative importance as a source of financing the growing budgetary expenditures.

(b) Expenditure Proposals

During the fiscal year 1984, the government's planned expenditure has been estimated at Rs 47.3 billion consisting of current spending (Rs 28.1 billion) and Capital spending

Table 1

SUMMARY OF REVENUE ESTIMATES (Rs. Million)

	1981	1982	1983*	1984*
Indirect a/	12,105.0	12,432.7	16,594.0	20,698.4
Direct b/	2,029.0	2,922.8	3,300.0	4,500.0
Other c/	1,957.0	2,453.2	4,200.4	5,572.0
Total	16,091.0	17,808.7	24,094.6	30,770.4
Actual Charge (%)	11.3	16.7	35.3	27.7

Source: Budget Estimates

a/ Include (a) taxes on sales, (b) duties on excise, imports, exports and licences and (c) assets transfer.

b/ Include Income and corporate taxes.

c/ Include non tax revenue and capital receipts.

* Estimates

(Rs 19.2 billion). The recurrent expenditure estimate shows an increase of Rs 3.4 billion or 15%, while the capital expenditure drops by 1.7 billion or 8%, over respective estimates of 1983.

Table 2 presents recurrent and capital expenditure estimates by major categories for the 1981 to 1984 period. As shown in the annual

change, the rate of increase in overall expenditure is progressively coming down since 1982, after a modest increase between 1981 and 1982. As can be seen, reduced capital spending has been the main contributory factor for the overall expenditure levels to experience a declining trend. This has been largely due to the government's continuing policy on 'no new development projects', the

Table 2

SUMMARY OF BUDGETARY EXPENDITURES (Rs. Million)

	1981	1982	1983	1984
RECURRENT	16,005	20,113	24,737	28,077
Salaries	4,080	4,422	5,645	6,079
Interest on Debt	3,856	5,612	7,317	8,244
Subsidies & Grants	3,582	3,760	5,919	6,685
Other	3,589	6,319	5,854	7,067
CAPITAL	15,089	17,984	20,915	19,236
Loan	1,619	2,806	5,183	2,375
Capital Transfers	7,345	11,375	9,067	8,090
Other	6,125	3,803	6,664	8,769
TOTAL	31,094	38,097	45,652	47,313
ANNUAL CHANGE (%)	2.4	22.5	19.8	3.6

decision that was adopted in 1981 due to serious resource limitations. In addition, because of the nature of expenditure involved, the capital budget has been the main focus of public spending cuts imposed by the government since 1981. A similar exercise has been difficult in the case of recurrent expenditure due to its continuous nature.

(c) Financing of the Budget

Revenue is the main source of financing the budget. If the total expenditure exceeds the total revenue the budget is in a state of deficit and, conversely, a budget surplus is where the total revenue exceeds the total expenditure. In terms of this definition, Sri Lanka is yet to experience a budget surplus, according to records available for the last two decades. In general, the revenue collection during the last two decades has been sufficient to support only the annual current spending. There were also some years where the annual revenue was below the annual current spending.

Table 3 presents the sources of budget financing during the 1981-84 period. According to figures presented in the budget, the total revenue in 1984 allows Rs 2.5 billion surplus over current spending and accounts for 55% of the total expenditure. This is followed by foreign assistance accounting for 26% of the total expenditure and 74% of the budget deficit in 1984. Foreign assistance has become an important source of budgetary expenditure and has accounted for a minimum of 50% of the annual budget deficits since 1977. In some years its contribution to deficit financing has been over 70%.

The reduced reliance on bank borrowings, as a source of deficit financing in 1983 and 1984, is a clear indication of the government's decision to bring economic management to the forefront of government policy priorities. All other previous budgets of the present government very generously utilized this source to support expansionary budgets and

Table 3

FINANCING THE BUDGET (Rs. Million)

	1981	1982	1983	1984
REVENUE	16,228	18,200	24,095	30,770
EXPENDITURE	31,101	38,800	45,562	47,313
DEFICIT	14,873	20,600	21,557	16,543
Financing from:				
Foreign Loans & Grants	(8,183)	(10,594)	(12,342)	(12,312)
Domestic Non-Bank				
Borrowings	(432)	(4,006)	(8,625)	(3,550)
Bank borrowings	(6,296)	(6,000)	(608)	(681)

Source: Budget Estimates and Statistics

this has been a leading factor for sharp increases in money supply and inflation.

(d) A Comparative Assessment

The most convenient way to present the comparison of respective budgets is to express the main features

As can be seen from percentages, expressed in terms of GDP, all these macro targets are expected to improve significantly following the adjustments on revenue and expenditure brought about in the form of budgetary proposals in 1984. The expected improvement in the budget deficit and market borrowings are

Table 4

MACRO ECONOMIC INDICATORS EXPRESSED AS A PERCENTAGE OF GDP

	1980	1981	1982	1983*	1984*
Revenue	22.6	20.5	19.4	21.9	23.0
Expenditure	48.7	39.2	41.6	41.5	35.9
Deficit	26.1	18.7	22.1	19.6	12.5
Capital Spending	23.7	16.7	19.3	16.7	15.0
Non-Market Borrowing	—	.5	1.5	7.8	2.7
Market Borrowing	15.8	7.9	10.8	.6	.5
Foreign Aid	10.8	10.3	10.1	11.2	9.3

* Estimate

Source: Own Computation based on Budget Estimates

of the budgets in terms of Gross Domestic Product (GDP) in current prices as shown in Table 4. These percentages clearly bring out the government's current policy priority of higher revenue and lower expenditure. The main objective of this policy emphasis is to reduce the size of the budget deficit and the need for borrowings from both international and domestic sources for financing the deficits.

1. Because of the difference in the relationships between savings and investments and government revenue and taxation, the macro-economic aggregates stated in the above equation do not always add up to the Gross Domestic Product. For example, the national income that results when the 1982 values are substituted in the equation is different from the 1982 GDP in current market prices i.e.

$$Y = C + I + G + (X - M)$$

$$141.9 = 88.2 + 30.5 + 41.6 + (28.2 - 46.7)$$

(all in Rs. Million in current market prices)

This difference is accounted for by (a) higher investments (assumed to be equal to fixed capital formation) than domestic savings, and (b) higher government expenditure than revenue collection. The excess of investment over savings is accounted for by imports of capital and investment goods, while the difference between government expenditure and taxes is accounted for by borrowings and grants.

particularly important from an economic management perspective and a significant improvement in these two macro-targets has been the focus of policy recommendations to the international donor community during the last few years.

IMPLICATIONS OF BUDGET PROPOSALS ON THE ECONOMY

As an instrument of fiscal policy, the budget's role is to influence the economy through changes in the level, composition, and timing of government expenditures and revenues. The economy can be effectively influenced by the budgets through expenditure on goods and services, because Government spending constitutes a flow or injection into the economy. Private investments and export demands are also considered as having the same influence as public spending. All three sources generate incomes in the economy through spending on domestic product, goods and services. At the same time, there are also withdrawals from the national income; and such forms of withdrawals include taxes, savings and imports. Accordingly, the budget proposals can influence the economy through changes in the aggregate demand via changes in injection to and withdrawals from the economy. The changes in the aggregate demand in the economy indirectly influence the other two important public policies i.e. monetary and balance of payment policies.

The implications of the budget proposals on the economy can be examined by considering the national income aggregates, stated symbolically as follows:

$$Y = C + I + G + (X - M)$$

This simply means that national income or output (Y) is made up of consumption (C) Investment (I) government expenditure (G) and Export (X) minus imports (M). There are two other important Macro-economic aggregates i.e. savings (S) and taxes (T) which are only implicit in this equation. Savings is generally defined as equal to investment plus the difference between exports and imports (i.e. $S = I + X - M$ or $Y - C - G$). Taxation is that part of income collected by the government from people, both directly and indirectly, to support the government expenditure programs. (1) It should be noted, however, that the revenue collection from taxation is not always equal to government expenditure and when government expenditure exceeds revenue collection, the difference should be supported from borrowings either from domestic or international sources

An increase in income from one period to another is also used up by the same macro-economic aggregates which constitute the national income. The manner in which the income in one period is utilized by these macro-aggregates again determine the level of income during the next period. However, the budget, though its revenue and expenditure proposals can shift the pattern of such utilization and, therefore, the budget effectively alters the growth path in the economy. The discussion that follows briefly examines the role of budget proposals in affecting changes on these macro-aggregates and the implications of such changes on economic growth.

(a) Consumption

Of all the Macro-economic aggregates, consumption is the most important determinant of national income. This importance stems from the fact that consumption generates demands for goods and services in the economy and such demands, through feedback effects, lead to further additions to the national economy. The demand for consumption of goods and services mainly comes

from households, depending on their level of income and the availability of goods and services. The most important determinant of household income is the flow or injection of money into the economy through government expenditure, investment, and exports.

Since 1977, there has been a remarkable improvement in national

has been spent on consumption. In 1981, it recorded the highest share, but in 1982 both proportions have marginally declined. The decline in household consumption is more clearly shown in the values of MPC. Upto about 1980, an increasing share of the annual increase in income has been spent on consumption and this spending behaviour has been reversed

Table 5

PRIVATE CONSUMPTION MEASURED IN TERMS OF APC AND MPC EXPRESSED AS PERCENTAGE

	APC (Current Price)	MPC (Current Price)
1977	69.2	48.4
1978	68.9	60.8
1979	70.9	79.1
1980	75.3	96.1
1981	76.4	80.1
1982	76.2	75.6

NOTE: Both APC and MPC have been computed after making adjustments for indirect taxation excluding export duties.

Source: Own computation based on figures on private consumption GDP and indirect taxes reported in the Central Bank Reports.

income following the economic revitalization efforts brought about by the present government through its far sighted liberalized policies and development programs. The economic growth rate, for example, increased significantly from an average 3% between 1970-77 to about 6.2% between 1978 and 1982. As indicated by measures such as the Average Propensity to Consume (APC) and the Marginal Propensity to Consume (MPC) (2) this increase in income of households (resulting from higher economic growth) has, at the beginning gone mainly into consumption as evidenced from the values on APC and MPC shown in Table 5 for the period between 1977-1982.

The figures on APC show an increasing trend indicating that an increasing share of the additional income that has resulted during this period

in 1981.

The decline in consumption (as evidenced from both APC and MPC) is an important point for further consideration. The explanation for this in fact lies in (a) increasing indirect taxation and (b) reduced rate of economic growth. Due to the weak tax base, the government has been concentrating on indirect taxes as a means of increasing government revenue. For instance, the share of revenue from indirect taxes, out of the net annual increase in income, has risen sharply from 19.1% in 1980 to 24.7% in 1982 to an estimated 38.7% in 1983. It should be noted that these rates of increase in indirect taxes have been substantially greater than the annual GDP growth rates. In other words, the government is withdrawing an increasing share of the annual increase in income in the

2. While the APC is simply the proportion of income that goes into assumption the MPC is the Change in Consumption with respect to change in income.

form of indirect taxation and this increasing transfer to the government considerably affected the consumption pattern of the population. This point is very clear from the MPC figures from 1980 onwards. The figures indicate a sharp fall in marginal propensity to consume and this situation arises from higher indirect taxation leaving reduced incomes for consumption.

During the fiscal year 1984, the government has announced some relief in direct taxation. However, as a result of the rehabilitation tax and surcharge, the anticipated revenue from direct taxation is about 26% more than the 1983 revenue from the same source. In addition, the estimate on indirect taxation also shows a further increase of 24.7% over 1983 and this increase is accounted for by the increase in excise duties as well as taxes on general sales. Although some of these taxes are not directly applicable to the entire population, the overall situation is that the government is making efforts to collect more revenue from the households particularly through indirect taxation.

(b) Economic Growth and Development;

Recalling the relationship that exists between consumption and economic growth, the declining trend in consumption that emerges from the foregoing discussion is also in part due to reduced economic growth which in turn is accompanied by reduced consumer spending. It should be noted, however, a decline in current consumption does not necessarily lead to a drop in economic growth particularly if the society sacrifices current consumption and transfers real resources for the purpose of producing more goods and services. This allows the society to enjoy a high level of consumption in the future time periods which in fact is the sole end of economic activity, as economists such as Adam Smith and Keynes maintained.

This brings us to the need for consideration of the role of investments and public spending, the two important sources of income flow in determining the level of activity in the economy. The other income

flow results from exports; the demand for which is determined by the factors exogenous to the economy and only the supply is determined by domestic factors such as the level of production and technology. On the supply side, therefore, continued investment is necessary to increase or at least to maintain the level of production and production efficiency.

investment, is progressively declining in current as well as in real terms. The 1984 investment allocation, for example, is only about 76% of the 1980 allocation in current prices and only about 43% in real terms. The total capital expenditure allocation, however, shows an increasing trend from Rs 11,957 million in 1980 to Rs 19,236 million in 1984. This

Table 6
CURRENT PUBLIC SPENDING INVESTMENTS & CAPITAL FORMATION (Rs. Million)

Year	IN CURRENT PRICES			IN REAL PRICES		
	Current Public Spending	Public Investments	Capital Formation	Current Public Spending	Public Investments	Capital Formation
1979	11,588	7,729	13,246	10,077	6,721	11,518
1980	13,535	11,956	20,845	9,880	8,727	15,215
1981	16,005	11,261	23,279	9,700	6,825	14,108
1982	20,113	11,375	30,228	11,052	6,250	16,608
1983	24,737	9,102	—	11,836	5,663	—
1984	28,077	9,056	—	11,650	3,578	—

Source: *Central Bank Reports and Annual Budget Estimates*

Table 6 presents the trends in current public spending, public investments and capital formation in both current and real terms since 1979. It should be noted that the figures on capital formation include (a) public investment, (b) private investment and (c) capital expenditures related to replacement and purchase of real assets by both private and public sectors. However, due to the difficulty of proper disaggregation, public investment allocation is shown separately along with the capital formation figures.

Out of these three main indicators, the level of public investments is perhaps the most important from the economic growth point of view. This importance stems from the fact that over time the investment allocation allows growth in productive sectors as well as the expansion of economic and social services. Additionally, the public investment allocation is also important to enhance the private sector's role in production, distribution and marketing of goods and services.

The figures in the table show that the public expenditure allocation on

increase has been largely absorbed by non-investment expenditures such as capital repayment, acquisition of real assets and contributions to public corporations either in the form of share capital or loans for capital improvements. In contrast, the current spending allocation is progressively increasing in current terms. Even in real terms, the level of current spending has not been adversely affected. As noted earlier, the main reason why current spending is unaffected by public spending cuts is that it is continuous unlike the capital spending component. Therefore, the resource constraints of the government can only be effectively enforced on investment allocation.

Broadly speaking, therefore, the apparent emphasis of the budgetary proposals in this regard is not very encouraging for economic growth and development. On the revenue side, the government is making concentrated efforts to transfer resources to the government mainly through indirect taxation. This policy action on the part of the government reduces consumer spending of the general public. On the expenditure side, the

government is enforcing restraints on real investments in the economy. This combination of increasing resource transfer to the government and reduced investment in-flow implies that the society is compelled to reduce its present spending on consumption without the hope of increasing the level of consumption in the medium term.

BUDGET AS A MECHANISM OF STRUCTURAL ADJUSTMENTS

It is important to briefly examine why the government is bringing in such controls when it is certainly aware of the considerable drawback on economic expansion and particularly the slow down in employment potential in the economy, following cut backs in public spending. Moreover, such controls will weaken business confidence and hinder private investments on new ventures. As mentioned earlier, the issue that mostly warrants the need for tighter fiscal measures is, however, the large and continuing external trade deficit and the resultant pressure on balance of payments. This increasing pressure, as evidenced, from nearly a ten fold growth in the external trade deficit between 1978 and 1982, has been due to a combination of slow growth in import volume, relative to export volume, and a drastic deterioration in the terms of trade.

The main stimulus for rapid growth in import volume resulted from economic reforms introduced in 1977 and the expansionary fiscal and monetary measures that followed. As a result, the volume of imports grew rapidly. At the end of 1982, for example, the average index on import volume indicated a 48% increase over 1977 and this compares with the 12% increase in export volume during the same period. In the case of export volume, the poor production performance, due to (a) inefficient management (b) lack of real investments on agricultural plantations, production technology and research, since the government's take over in early 1970's and (c) the government's over commitment to the food self sufficiency goal, had been the major contributory factors for slow growth in export volume. In

addition, export prices also suffered heavily in the international markets due to depressed demand associated with the world economic recession of the early 1980's. Between 1978 and 1982, the average price of exports increased only by 19% compared with the increased of 209% of import prices, indicating an almost 1 to 11 ratio between the increases of export to import prices. This substantial price variation is well pronounced in the terms of trade which was only equivalent to 35% in 1982, when 1978 is taken as the base year.

Because of the large deficits in the external trade account, the current account of the balance of payments has also been in a state of deficit since 1978, despite increased remittances from Sri Lankans working abroad and positive balances in the service account. International borrowings have been a principal source of financing these deficits, and this source alone has been responsible for accounting for between 50% to 70% of the current account deficits since 1978. In economic terminology, international borrowing is considered a 'stock' variable because it constitutes accumulation and repayment characteristics, as opposed to 'flow' variables such as receipts from exports of goods and services and private remittances. Accordingly, international borrowing can only extend support for short run disequilibriums, in the balance of payments, and no government can over-utilize this source without serious side effects on the economy, which arise from debt accumulation and increased repayment commitments.

In comparison with the countries currently facing serious external debt problems, Sri Lanka's external debt situation is certainly not very critical. Nevertheless, it has been growing rapidly during the last few years to warrant being an issue of major economic significance. The likelihood of Sri Lanka reaching a critical external debt situation appears not too far, if the country continues to depend on external borrowings, both for budgetary, as well as balance of payments support, at the same pace as in the past few years. Sri Lanka's foreign debt has grown by Rs 25 billion since

1978 to reach the total outstanding external debt of Rs 49 billion by the end of 1983. This level of external debt is certainly high in terms of the country's ability to commit future resources for repayment requirements unless there is a substantial improvement in export earnings. In the Asian region, Sri Lanka occupies a prominent place among the countries having a relatively high ratio of outstanding external debt to Gross Domestic Product (GDP).

The magnitude of external debt is commonly measured in terms of the debt service ratio which expresses annual repayment commitments (Capital plus Interest) as a share of annual earnings from exports of goods and services. A higher ratio obviously indicates an increasing allocation of export receipts for such commitments. This is in fact the trend that Sri Lanka is beginning to experience, as shown by the increasing tendency of the ratio from 12.4% in 1980 to 15.2% in 1982 and to an estimated ratio of 19% in 1983. In computation of the debt service ratio, only the annual payments of long and medium term loans are taken into consideration, thus excluding the repayment commitments of short term and commercial credits. When the debt service ratio is computed on the basis of all forms of repayments, approximately 65% of Sri Lanka's total export earnings in 1982 has been accounted for by external repayments. In 1980 the ratio on the same basis stood at 30%. This wide range in the two ratios (i.e. with and without short term borrowings) is certainly not a healthy sign as it shows the increasing dependency on short term loans and credits from international financial markets at commercial interest rates. On the other hand, this situation compels the country to secure more borrowings due to shortfalls in foreign exchange requirements to meet the country's import needs.

It appears, therefore, that an improvement in the balance of payments is the principal target of the fiscal measures that have been contemplated in recent budgets. Despite a straight forward relationship between the fiscal policy and the deve-

lopments in the balance of payments, an improvement in the balance of payments can be indirectly brought about by reduced public spending through lower demands for goods and services in the economy. This drop in demand follows a slow down in import demand as well. Additionally, a reduction in public spending also helps to stabilize the rate of inflation which is also an important determinant in the demand for imports.

The objective of public spending controls are best achieved when supplemented by restrictive policies on money supply growth. Recently, the Central Bank announced measures in this direction with higher reserve requirements by commercial banks with the Central Bank and instructions to commercial banks to give credit priority to productive sectors in the economy and to curtail bank lending to consumer oriented needs, particularly bank credit which goes into support the imports of consumer goods. The large and growing external trade deficit has also prompted the government to use the exchange rate policy more frequently in 1983 to dampen the volume growth in imports. While the rupee has depreciated by 63% against the US dollar since the 'adjustable peg system' was adopted in 1977, the rupee marked the highest rate of depreciation in 1983, in any given year, of 17% as against the US dollar. The government is currently using fiscal, monetary and exchange rate policies, both singly and jointly, to correct the balance of payments disequilibrium which, apparently, is the main target of the economic management efforts. An improvement in the balance of payments is needed to strengthen the domestic economy and to continue with open economic policies; without reintroducing the quantitative controls and restrictions of the period before 1977.

POLICY CONSIDERATION;

The rationale behind these policy adjustments is certainly understandable in the context of current economic difficulties faced by the country. Nonetheless, these policies must not be adopted at the expense of the

country's growth prospects. Otherwise, the economy will be confronted with a situation known as the "low equilibrium trap"; which in specific terms implies economic stagnation, resulting from low investments, reduced economic growth and increasing unemployment, along with improvements in the balance of payments and the rate of inflation, the two specific targets of the current policy emphasis. Just as it is difficult to sustain the liberalized policies with continuing balance of payments disequilibriums the possibility of maintaining liberalized policies under continued economic stagnation is also highly doubtful.

While the society cannot readily conceive the implications of weak balance of payments on the domestic economy, it can, however, easily recognize the implications as well as the likely outcomes of economic stagnation, as evidenced from the role of economic factors in the 1977 election. The expectations of the society were set high at the beginning when the economy was freed from controls and restrictions and a free market system introduced in 1977. In addition, the society was compelled to undergo a number of sacrifices, including cuts in many forms of consumer subsidies which were hitherto enjoyed by the people at large. If the growth momentum is not maintained, there will be increased difficulties and disappointments on the domestic front with concomitant implications on economic liberalization and political stability.

Accordingly, the policy makers must attempt to strike for a compromise between the needs of economic management, on the one hand, and the necessity for continued economic growth and development, on the other. It is common knowledge that wastage and mismanagement are widespread in the public sector and these are the areas where policy focus is urgently needed, in order to improve economic management as well as economic efficiency. It is also important to frequently scrutinize the operational expenditure component of the government, which is growing at a rapid rate annually, to check on wastage and unnecessary expenditures. The aggregate current

expenditure shown in the budget is in fact prepared by respective ministers where the emphasis is on receiving a higher operational allocation every year rather than on financial management, planning and control. A large number of public corporations also fall into this category of poor financial management, especially those depending on continued government assistance for survival. Another area that can and should be economized is the government purchases of real assets, including equipment and vehicles. Strict controls need to be enforced to eliminate expenditures that do not contribute to the country's productive capacity.

At times of economic difficulties, government policy should be re-evaluated (1) to give priority to programs which contribute to the gross domestic product with relatively smaller annual investments and (2) to delay programs which add strains to the limited resources. Although the government has been giving investment priority to areas that will enhance medium and long term economic growth and development, such as the Accelerated Mahaweli Program, irrigation development and agriculture and infrastructural development such as energy, telecommunication and water supply, investment emphasis is also continuing on some programs which are economically not sound especially in the present context. A case in point is the government's costly housing development program. There are many reasons why the housing development program is a strain on the economy.

- (a) Housing is considered as a durable consumer good. A greater proportion of raw materials required for production of housing units are of a non-renewable nature, such as bricks, cement, sand, iron and steel and roofing materials; while others such as timber require a longer gestation period to reproduce. Although most housing materials can be produced locally, the existing capacity is not sufficient to meet rapidly increasing demands.
- (b) The government intervention in housing development can be conceived as worthwhile, only if it brings economic benefits to the

society, in general, and to the consumer, in particular. When public funds are used for development programs, the economic justification of investments is rather important. Apart from the aided self help program, all other housing programs are costly in per unit terms. The attraction that the owner's of government housing units are offered is the interest subsidy and a longer repayment period. Interest subsidy and longer repayment period, especially when the rate of inflation is higher than the rate of interest, are, on the other hand, direct economic costs to society.

Most countries in the world, both developed and developing, are not very actively engaged in housing development programs. Rather they have invested on production technology and production of housing materials. This approach not only helps the consumer with low costs on housing materials but also helps society with employment and increased productive capacity. Unfortunately, Sri Lanka is committed to produce an end product, that is housing. With rising costs of building materials, the demand for housing is slowing down and the dynamism of the housing and construction sector that prevailed in the economy in the early years after the liberalization is also gradually fading out.

Given the country's development needs arising from poverty, population pressure and high unemployment, a curtailment of investment on productive sectors is clearly not affordable. What should be done in the present context is to focus on small scale projects with high capital/labor ratio, and projects that utilize local resources, talents and manpower. In this regard the government should invite the participation of banks, cooperatives, development councils, voluntary organizations and other local institutions. To make such development efforts successful, the government could set up a separate fund, managed by the Ministry of Finance and Planning, to provide the investment needs on projects designed by these institutions.