BUDGET 2003: AN ECONOMIC PERSPECTIVE

Chandana Aluthge

Since late 1977, economic management of Sri Lanka has been generally based on monetarist-type policies, though the emphasis given to monetarism has been slightly changing over the past years. The monetarist logic is centered on the rate of inflation. In the monetarist world, inflation becomes number one enemy and not unemployment. It is said that inflation is caused by an excessive increase in the supply of money. To reduce inflation to healthy levels, money supply has to be reduced. Only when the prices of domestically produced goods are competitive both at home and foreign markets will unemployment be checked from rising. To reduce the quantity of money, monetarists argue, first, that interest rates must be raised. At higher rates, it is believed that productive firms will use credit efficiently. Secondly, government spending must be cut down or in other words budget deficit should be reduced.

Banking on this ideology, since late 1977, subsequent governments have presented their annual budget proposals to achieve the dual economic objectives: low inflation and higher economic growth and employment. Fiscal discipline, government expenditure cuts, money supply growth targeting, market oriented interest rates and prices etc., have been the mantra of the last two decades and market mechanism, competition, privatisation, liberalisation of the balance of payment and other economic activities, etc., were assumed to do the trick in bringing economic prosperity to the country. The government s role in economic activities was gradually phasing out giving way to the private sector. However, the reality is that the economy has not been able to deliver even the basic necessities of life to a large portion of its population.

The objective of this discussion is to provide an alternative view to the Budget 2003, focusing on the political economy aspect of certain budgetary proposals of Budget 2003. When reading the Budget 2003 carefully, one would realise that it entails a few contradictions. On one hand the budget banks more on market mechanism, privatisation, competition or basically the monetarist prescription discussed above. On the other hand it has recognised the fact that the monetarist logic has failed in the past. By looking at the following statements the said inconsistency is easily understood.

> A start has already been made in reducing high interest rates, which tend to promote inflation. Strong economies have low interest rates as their base (Budget Speech, 2003).

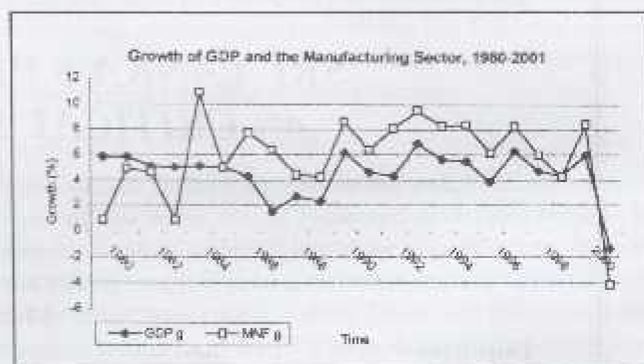
> All these measures depleted revenue, but were nevertheless implemented to reduce prices. We are unhappy to see that resulting benefits have not been passed down by the trading sector to the consumer (Budget Speech, 2003).

> Importation of petroleum products will be opened up to international suppliers on franchises. By doing this, competition will increase and prices will be reduced (Budget Speech, 2003).

According to the first quotation above, government has finally accepted the fact that it is the high rate of interest that has caused inflation and not the increase in supply of money as given in monetarist reasoning. While the second quotation highlights the failure of market mechanism and competition, the third indicates the government s commitment on market mechanism and competition as the optimum condition.

During the past, interest rate has been allowed to move upwards or towards its so-called market determined rates. The objectives of high interest rate policy were to 1) promote efficient use of financial resources by the productive sectors 2) efficient mobilisation of financial resources by financial intermediaries and 3) low inflation through money market equilibrium. Monetary authorities have constantly checked money supply growth. However, the result has been low economic growth with high inflation due to high financial cost. Therefore, shifting towards a low interest rate environment probably is the first truthful step on the correct direction mentioned in Budget 2003. However, that alone may not be sufficient.

Figure 1



Notes: GDP g-GDP growth; MNF g- Manufacturing Sector Growth

Source: CBSL Annual Reports

This argument can be well supported by looking at some real world information of the Sri Lankan economy. Figure one indicates the growth rates of GDP and the manufacturing sector over the past two decades. Both rates have moved in the same direction, indicating a strong correlation between them. That means, given the present economic scenario, to achieve a higher economic growth, a steady growth in the manufacturing sector is a must. When interest rate is market driven with constraints on money supply growth by the authorities, interest rates becoming excessively high would be the most likely economic consequence due to shortage of liquidity. High financial cost tends to erode profitability of productive enterprises or/and competitiveness of their products in the market, discouraging expansion and new investment in the sector. On the other hand firms generally tend to pass additional costs to consumers through higher prices fuelling inflation.

We can further elaborate on this by looking at Tables 1 and 2. Table1 indicates the direction of commercial banking loans. The striking feature in the table is the steady decline in relative significance of banking credit for industrial purposes in particular from 1980 compared to the other two major categories. It is discussed that industrial sector and GDP growth are closely correlated. But at the time when interest rate is high and market determined, banking loans going into the industrial sector have declined. Then the expansion in this sector becomes weak and as a result GDP growth too becomes low. This may have been the main cause for slow economic growth of the Sri Lankan economy in the past two decades.

Banking institutions are profit-seeking enterprises and channel financial resources basically to areas from which they can maximise their profits with the least amount of risk. From their point of view, whether a particular sector is growth promoting is totally irrelevant. Then will a low interest rate environment promote manufacturing sector growth and then economic growth? Certainly, the cost of finance for productive firms will be lower under a low interest rate policy. But there is no guarantee that the market channels financial resources to growth promoting sectors such as the manufacturing sector, in sufficient amounts irrespective of whether the rate of interest is high or low. Channeling of financial resources is purely based on the profit motive of individual financial institutions. The question is, then, what are we going to get as a whole from competition, liberalisation, market determined interest rates, etc., without an efficient system to oversee that the correct dose of financial resources are constantly released to the sectors to which the economic growth is closely linked.

Table 1
Banking Credit by Purpose
(as % of total credit supplied)

Period	Commercial Banks		
	Com	Ind	Con
1970	41.7	26.9	6.4
1975	47.1	22.4	4.2
1980	51.2	22.4	2.1
1985	49.6	23.7	1.7
1990	49.4	21.1	2.5
1995	41.7	13.3	7.3
1996	45.2	14.1	7.7
1997	45.1	12.3	8.8
1998	42.7	11.4	9.7
1999	39.9	12.1	10.5
2000	48.5	12.7	11.7

Notes: Com-Credit for Commercial Purposes, Ind-Credit for Industrial Purposes, Con-Credit for Consumption Purposes.
Source: Annual Reports, CBSL.

The manufacturing sector forms the production base of a country. Table 2 indicates the size of the manufacturing sector of Sri Lanka from 1970. Information shows that the manufacturing sector has failed to expand under pro-market conditions at least to its 1977 position. When the production base does not take off, goods and services have to be imported to bridge the gap between aggregate demand and domestic supply. Consequently the demand for credit to import sector increases. Consumers too need money in advance to buy imports because the economy does not generate sufficient income. And that is exactly what has happened over the past two decades in Sri Lanka. Banking credit to very short-term activities such as buying and selling and consumption has improved in a big way whereas credit to manufacturing upon which the economic growth is heavily dependant has declined. In such a situation, increased poverty and inequality in the society is unavoidable. Low GDP growth means less income to people and thus poverty prevails in society. On the other hand, only a small segment of people can afford consumption credit. They will buy the lion s share of the GNP, increasing inequality. Inequality promotes social unrest and violence-prone society will be the final consequence.

Table 2
Manufacturing Sector as % of GDP

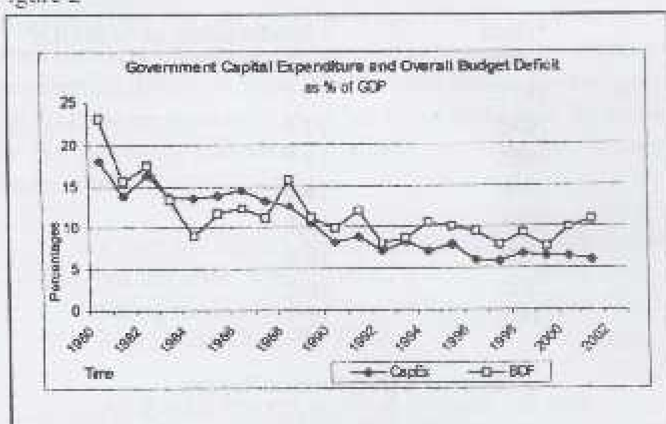
Period	Manufacturing as % of GDP
1970	16.7
1977	23.1
1980	17.7
1985	14.7
1990	14.9
1995	15.7
1998	16.8
1999	16.9
2000	17.3

Source: CBSL Annual Reports

Monetarism firmly believes that government expenditure is a chief source of inflation via money supply growth. It vehemently advocates government expenditure cuts popularly known as fiscal prudence or discipline in a big way to control inflation, assuming that everything will be fine with a low rate of inflation. However, monetarism does not specify what type of government expenditure should be reduced to reach the ultimate objective: a smaller fiscal deficit. To monetarists, it matters not how it is being done. This is where the economic trouble starts especially in the case of economies like Sri Lanka. For a developing nation like Sri Lanka, the government has to play a key role, in particular through its capital expenditure, to fast-forward the economy even though monetarists do not agree on this. Government capital expenditure can be considered as one of the best means of income redistribution through various types of mega projects such as power generation, rail roads, mass transportation, highways, irrigation, etc., rather than spending millions of rupees on vote-catching handouts to people. It is a fact that Sri Lanka possesses a highly politicised economy. As a result, governments are reluctant and/or find it difficult to cut down on government recurrent expenditures. Instead to narrow fiscal deficit governments cut capital expenditure. This is easily done because the ultimatum is a smaller fiscal deficit. It also goes hand-in-hand with monetarist ideology: a small government and a growing private sector in the economy. Government capital expenditure is slashed and on the other side, utterly dissatisfactory growth in the manufacturing sector largely due to high financial cost would have been a double blow to the economy. Consequences are crystal clear: slow economic growth, high inflation and unemployment, increased inequality, and finally social unrest.

This argument is supported by the exiting empirical information. Figure 2 provides the behavioural pattern of capital expenditure and overall budget deficit as a percentage of GDP over the past two decades. Based on the trend of both series given in Figure 2, it is evident that deficit cut has been possible at the cost of government capital expenditure. The fluctuations in budget deficit, even when capital expenditure was declining in general, indicates that there has not been a serious attempt to slash recurrent expenditures.

Figure 2



Note: Cap Ex-Government Capital Expenditure, BDF-Overall Budget Deficit. Source: CBSL Annual Reports

Budget 2003 more or less has taken the same capital expenditure stance — less and less capital expenditure. Howeve the difference is, it proposes to establish a number of funds with a view to finance specific types of capital expenditure. They are the Human Resource Endowment Fund, Road Fund, a Fund for Tourism Development, Infrastructure and Corporate Restructuring Fund, the Rural Economy Restructuring Fund, etc. It is proposed that money for these funds will be generated through indirect-type taxation, which will be imposed on top of the existing tax bases. Generally, indirect taxes are passed onto the society (in most cases the full extent of the tax) through increased prices of goods and services. For example, those who operate motor vehicles on roads are required to pay the proposed road tax. In Sri Lanka, a smaller number of individuals and other commercial establishments own the bulk of motor vehicles, which are run on roads. But given the nature of indirect taxes, it will be passed onto the general public who has neither private motor vehicles nor proper service of public transportation. That means, those who are stranded on a daily basis due to lack of public transport facilities and/or due to the fact that they do not own private vehicles, are ultimately forced to pay for the road maintenance fund. Those who own vehicles will be richer and hopefully will have a better road network for their vehicles to run on while those who do not have vehicles will be poorer because they shoulder the road tax. Finally, income disparity widens. In the same line of reasoning, generating money for the other funds will have roughly the same economic consequences.

The proposal of Youth Corps entails a question mark. It is proposed in the budget to establish 160 vocational training centers in eight regions in the country to provide market oriented vocational training for unemployed youth. The question is what is the use of existing technical colleges of which the prime objective more or less is the same. If so, why does the budget propose to allocate an enormous amount of money to establish these new centers to provide vocational training under the Youth Corp programme whereas the same aspirations may be achieved through the existing network of technical colleges. Perhaps new funds may be required for expansion work to these technical colleges in order to provide learning facilities for an increased number of unemployed youth. The problem associated with youth-corps-type programmes is, that it is highly unlikely that the programme will be carried forward in the event of a governmental change (e.g. Gam Udawa, Janasaviya, Samurdhi, etc., have disappeared with the governmental change). The money invested in these centers will then be utterly ineffective and frustration among youth will increase. In contrast, to provide financial resources to develop the existing technical colleges to provide unemployed youth with a market oriented vocational training will be more rewarding because it is almost certain that the technical colleges will continue to be in existence regardless of the governmental change unless some extraordinary policy shift may take place in the future to close down all technical colleges in the country.

Policy makers often articulate on sustainable growth. It is evident that without sustainable policies, growth simply may not be sustainable. Ideally, for countries like Sri Lanka, government budget should have been the prime mover that pushes the economy towards a sustainable growth path with equity and justice for the society. However, it seems that the budget has become a rescue-mission-type operation by the governments in power in post-independent Sri Lanka. The government in office may not have time or simply does not want to go beyond these rescue-mission-type policies. The problem with such policies is that they promote a lop-sided economy. Then slow economic growth, widening income disparity, frustration among youth, violence-prone society are the unavoidable consequences. ■

Chandana Aluthge is Senior Lecturer, Department of Economics, University of Colombo.

Social Science Research Council

South Asia Regional Fellowship Program

The Social Science Research Council (SSRC), New York, is pleased to announce the second round of their annual postdoctoral fellowship competition.

The theme for 2003-4 is Migration.

The primary intent of the fellowships is to enable successful applicants to take leave from teaching and other responsibilities to write up completed research. Applications proposing new research or seeking support for ongoing field research will not be rejected but have much lower priority. Funding is offered for short-term fellowships (3-4 months) on topics related to this theme from scholars in any discipline of the social sciences, humanities, and other related disciplines.

The South Asia Regional Fellowship Program seeks to strengthen the link between teaching and research, hence, the competition is open only to full time faculty members holding earned Ph.D s and presently teaching in an accredited college or university in Pakistan, India, Bangladesh, Nepal or Sri Lanka. Junior fellows will receive up to $2,200, senior fellows up to $3,000 as fellowship awards. As many as twenty fellowships may be awarded each year.

Deadline for receiving applications is 15th May 2003. This program is supported by a grant from the Ford Foundation.

Please email queries to sur@ssrc.org. Application forms may be downloaded from http://www.ssrc.org/fellowships/southasia/ and can be obtained from:

SSRC Fellowship Program
Attn: Suzie Beling
425/15, Thimbirigasyaya Road, Colombo 5
Tele: 501339/504623/ 0777-536153
Fax: 595563, E-mail: ssrc-ssa@eureka.lk